Preparatory Process for the
Third International Conference on Financing for Development

Substantive informal session: “Debt crisis prevention and resolution”

9 December 2014, 4:30 to 6:00 p.m.
Trusteeship Council Chamber, United Nations, New York

The Monterrey Consensus called for innovative mechanisms to comprehensively address debt problems of developing countries, and welcomed consideration by all relevant stakeholders of an mechanisms to engage debtors and creditors to come together to restructure unsustainable debts in a timely and efficient manner. Since the Monterrey agreement, the Heavily Indebted Poor Countries (HIPC) and the Multilateral Debt Relief (MDRI) initiatives have helped resolve debt overhang in poor countries, and along with economic growth in many developing countries over the last 10 years, helped reduce debt ratios in developing countries to historically low levels. The introduction of Collective Action Clauses (CACs) in sovereign bond contracts to facilitate the so-called “voluntary” market-based restructuring process, along with laying out of voluntary principles for a code of conduct were marks of progress.

The financial and economic crisis has exerted new pressures on debt sustainability in developed and developing countries. Recent debt distress and litigation cases prominently highlighted the gaps in the architecture for debt crisis prevention and resolution and its attendant risks. The policy debate has thus in part been reignited by the following developments: the on-going debt problems in some countries in the Eurozone; the growing strength of holdout creditors in a debt restructuring, and in particular due to the ramifications of the court decisions in the NML v. Argentine litigation in U.S. courts; the delay in initiating the Greek restructuring and the full payment to hold out creditors in the restructuring; the litigation against many low income countries by creditors who did not take part in the HIPC debt relief undermining the success of the initiative; and the real possibility that many countries may not be in a position to return to growth and stability without a debt restructuring, which has significant implications for the role of the Fund and the scale of its financing, and the timing and extent of debt restructuring.

Debt defaults and debt restructuring have high costs for debtors and creditors and when problems occur in systemically important countries, it has negative implications for global financial stability as well. A review of debt restructuring processes and frameworks which capture the new realities and ensure sustainable growth of developing countries in the medium- and long-term has gained prominence in the international agenda and intergovernmental discussions. Despite progress in introducing collective action clauses in bond contracts, several gaps remain for a comprehensive treatment of all components of debt in a debt restructuring. In order to facilitate mutual understanding amongst stakeholders, today’s discussion is crucial to identify the gaps in the financial architecture and discuss possible policy options to improve the architecture.
This session will explore where the difficulties are and what options are available to strengthen work on debt crisis prevention and management. It will be useful to discuss how relevant international organizations can work together with all relevant stakeholders in order to facilitate a more comprehensive solution to debt problems, lessons learned from previous debt crises, and expedite the process to return countries quicker to a sustainable debt and growth trajectory.

**Programme**

*Co-Chairs*
- H.E. Mr. George Wilfred Talbot (Guyana)
- H.E. Mr. Geir O. Pedersen (Norway)

*Moderator*
- Ms. Benu Scheider, Senior Economic Affairs Officer, Financing for Development Office, UN DESA

*Panellists*
- Hugh Brendenkamp, Deputy Director, Strategy, Policy, and Review Department, IMF
- [Andrew Powell](#), Research Director, Inter-American Development Bank (tbc)
- Richard Kozul-Wright, Director, Division on Globalization and Development Strategies, UNCTAD

*Discussants*
- Prof. Anna Gelpern, Professor, Georgetown University, Washington, D.C. (tbc)
- Richard Gitlin, President, Richard Gitlin and Company, LLC, Connecticut (tbc)

*Guiding questions*

1. What are the lessons learned from the history of debt crises? Why did present approaches to debt resolution not work? What are the costs of debt defaults and debt restructuring?
2. What are the new challenges and emerging vulnerabilities?
3. What are the biggest deficiencies in the present approaches to debt crisis prevention and resolution?
4. Is the evolution in the voluntary approach sufficient to deal with debt crises? Can current proposals accord comprehensive solutions for all components of debt? Do we need a legal framework for sovereign debt restructuring?
5. Are current legal systems in financial centres adequate to deal with vulture funds? Where should debtors turn to for a redressal system when holdouts by some creditors and litigation undermine the very success of official sector and private sector initiatives to accord relief?
International cooperation on preventing debt crises has focused on developing statistical instruments to estimate debt sustainability and applying them in annual economic assessments made in cooperation with the International Monetary Fund (Article IV consultations) and the World Bank (debt sustainability assessments for low-income countries). The methodology for making the assessments is periodically reviewed and updated. International cooperation on resolution of debt crises is largely a decentralized process in which countries in crisis negotiate with different classes of creditors to restructure their obligations, including outright cancellation of some of them in some instances. Proposals to improve on the standard practices continue to be considered in international forums. The following reviews recent developments in debt crisis prevention and resolution.

Frameworks to evaluate debt sustainability

The Bretton Woods institutions have sought to lessen the frequency and depth of sovereign debt difficulties by heightening the salience of the prospective implications of national budget and borrowing strategies. To this end, they introduced “debt sustainability analyses” that projected the implications of current policies for various debt burden indicators into the future. Separate but related approaches were developed for low-income countries and for countries enjoying significant access to private market financing.

The Debt Sustainability Framework (DSF) for low-income countries (LICs) was introduced jointly by the International Monetary Fund (IMF) and the World Bank in April 2005 to help guide these countries and their donors in mobilizing more financing for development needs, while reducing the chances of an excessive build-up of debt. The 2012 review of the DSF produced some additions to the framework, including strengthening the analysis of total public debt and fiscal vulnerabilities. The approach embodies indicator triggers which if exceeded are meant to signal, not only that budgetary and tax policy should be adjusted, but also that more of its international assistance should be provided as grants instead of loans. Presently, a review of the policy on debt limits is underway at the IMF, with a view to ensuring that it continues to strike the right balance between safeguarding debt sustainability and ensuring adequate financing for development needs.

In addition, the IMF carries out a Debt Sustainability Analysis for Market Access Countries (MAC). In this framework, public debt can be regarded as sustainable based on projections of the primary fiscal balance (the budget balance excluding debt servicing). When that balance over time is estimated to stabilize or reduce the ratio of debt to gross domestic product, the debt situation is deemed sustainable, which is to say that the level of debt is consistent with an acceptably low rollover risk while preserving potential growth at a satisfactory level. In its recent paper to the IMF Board, IMF staff agrees that in hindsight, assessments of debt

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sustainability and market access may have been too sanguine. New guidance for the IMF Debt Sustainability Analysis for MACs includes: more systematic assessments and greater transparency in risk reporting; drawing on alternative stress-test scenarios; and paying greater attention to debt levels and risks to funding sources and market access.

In each of these analyses, projections are made for a “baseline” case (most likely), an “historical” case (assuming that historical policies and economic developments continue) and several “stress test” scenarios. Major economic shocks—such as devaluation, increased cost of capital and loss of growth and exports—are part of the stress tests performed in assessing debt sustainability, but structural economic characteristics that increase debt vulnerability have not been incorporated. A borrower country may have macroeconomic policies considered to be sound, but it may still be negatively affected by external events beyond its control that are not captured in the scenarios. Examples include environmental or natural shocks, which encompass natural disasters (earthquakes, volcanic eruptions) and the more frequent climatic shocks (typhoons, hurricanes, droughts, floods, etc). However, such factors may be analysed using customized scenarios within the DSF, to simulate, for example, new natural resources coming online or vulnerability to climate change. Besides the choice of analytical framework, problems in assessing debt sustainability occur because of the continued difficulties with timely reporting of external debt and contingent liabilities and the reconciliation of debtor and creditor records.

A more useful, albeit perhaps more challenging, approach would be to introduce an asset liability management framework. This balance sheet approach would monitor all the government’s assets and liabilities, including their maturity structure and currency composition, in order to assess debt sustainability. It would allow a better understanding of the linkages between internal and external debt and the value of debt management strategies, as well as more fully include contingent liabilities and the impact of private debt.

Enhancing approaches to debt restructuring

Currently, there is no institution that serves the function of an international bankruptcy court for sovereign debt restructuring to provide timely, predictable and impartial solutions to debt problems. This absence has increased the cost of sovereign debt restructuring for the debtor and the creditor, and in the case of systemically important countries, for global financial stability as well. Although sovereign debt restructurings do take place, these are often “too little too late”. In practice, solvency problems are frequently dealt with like liquidity problems, thereby often requiring multiple restructurings. Prior to the HIPC initiative, serial rescheduling was a common feature in LICs, as it was in middle-income countries, that resulted in delayed solutions to the

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5 Despite efforts in the 1980s to reconcile external debt statistics by the International Monetary Fund, the Organization for Economic Cooperation and Development, World Bank and Bank for International Settlements based on a “core” definition of external debt, these statistics are not strictly comparable and gaps remain in coverage and timeliness.

6 International Monetary Fund, “Sovereign debt restructuring”, op. cit.
problem of debt overhang. A more timely debt stock reduction would not have necessitated the scale of resources required for the much-delayed HIPC Initiative, and would have more quickly returned countries to a higher growth trajectory. Going forward, a timely solution in cases of debt distress will ultimately reduce costs for all stakeholders.

The Paris Club has been an important ad hoc mechanism for restructuring debt obligations to bilateral official creditors. However, looking forward, it is important to bear a few issues in mind. First, not all creditor Governments are members of the Paris Club. In recent years, financing flows emanating from South-South cooperation have increased. The Paris Club also excludes consideration of debts owed to multilateral institutions, commercial banks and other private creditors. Over time, multilateral creditors have informally been granted preferred creditor status. Paris Club agreements contained an agreement that the debtor will seek comparable treatment from other creditors. The implementation of the comparability of treatment principle faced many difficulties, as Paris Club agreements have no binding legal foundation. The debtor thus has no formal legal instrument through which it could seek comparable treatment from other creditors. Moral suasion has worked in some cases, but in others has led to litigation against the debtor. And now with the increase in private capital flows to developing countries, the importance and relevance of the Paris Club is reduced.

Bond debt and bank debt now have a significant share in the composition of overall developing-country debt and pose challenges for timely and adequate resolution of debt problems with issues in creditor coordination and the threat of litigation by hold-out creditors. Indeed, the number of lawsuits has dramatically increased in recent years (see figure). Despite changes in contractual terms to facilitate the so-called voluntary market-based restructuring process for sovereign bonds through the introduction of Collective Action Clauses, and although voluntary principles for a code of conduct have been identified, challenges still remain regarding how to return a country that is in debt distress to a sustainable fiscal track, how to resuscitate its growth, and how to balance the risks that debt restructuring poses to the banking system. Often, all creditors do not participate in a restructuring, leading to either costly settlements or expensive litigation against the sovereign debtor by hold-out creditors. In the light of lengthy litigation against Argentina in the federal courts of the United States, there is a growing view that further improvements in contractual terms are needed both to bind hold-out creditors and to strengthen clauses in bond contracts to aggregate voting on restructuring by owners of bonds of different series. Restructuring of bank debt, which is typically managed through informal advisory clubs of banks known as the London Clubs, has also often been fraught with delays and inadequate relief.

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7 For example, in 2014 a US district court judge ruled in favour of hedge funds vs. the Democratic Republic of Congo. The ruling was opposite to the objective of the HIPC initiative and, in effect, resulted in the official sector providing relief to the country, while the country repaid hedge funds. It also illustrates the legal gaps for dealing with vulture funds for commercial debt.

8 The litigation in the United States courts between Argentina and NML, a hedge fund, has implications for the future of sovereign debt restructuring. The Intergovernmental Group of 24 developing countries (G24) in its April 2014 communiqué stated that it is “closely following the litigation in United States courts between NML and Argentina and believe it has systemic relevance and potentially profound implications for all countries. Any resolution that incentivizes predatory hold-out behaviour would, in its view, undermine the basic architecture for sovereign lending and debt resolution. Given the limited progress towards a comprehensive sovereign debt workout mechanism, emerging market developing countries may have to take leadership in facilitating dialogue.” (para. 6, available from http://173.254.126.101/~gtwofouo/wp-content/uploads/2014/03/G-24-Communique-Final-ENG-2.pdf).
Outstanding creditor lawsuits against sovereigns in US and UK courts, 1976-2010

![Graph showing number of cases and volume (real US$) in court from 1976 to 2010.]


There are limits as to what can be achieved through fiscal consolidation programmes that cut expenditures and/or raise new revenues, which sometimes make it necessary to undertake debt restructuring, in particular where the system is dealing with insolvency. There is a real possibility that some countries may be in no position to return to growth and stability without a debt restructuring.

The euro-area crisis, like the Latin American crisis in the 1980s, has revealed the interrelationship between sovereign and banking sectors and the danger that official sector financing can, in effect, bail out the private sector, as was recently done in Greece. Moreover, Greece’s financing package with the IMF, the European Commission, and the European Central Bank (ECB) did not prove sufficient to address concerns regarding debt sustainability and did not avert a spreading of the crisis beyond Greece. In reflecting on its role, the IMF is currently reviewing its lending framework in high debt situations to prevent the use of its resources to bail out the private sector and finance an exit of private capital. The IMF is thus seeking to strike a carefully thought-out balance between financing and adjustment.³

The international community has called for an examination of enhanced approaches to sovereign debt restructuring in the Monterrey Consensus and the Doha Declaration, and reiterated the request in outcome documents of major United Nations conferences and annual General

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Assembly resolutions. Presently, discussions on improving the architecture for sovereign debt restructuring are being debated in various forums, including in the United Nations system. The Financing for Development Office of the United Nations Department of Economic and Social Affairs organized a series of expert group meetings involving official sector and private sector experts to develop an understanding of the key issues to be resolved in sovereign debt restructuring and rally around options going forward. An expert group at the United Nations Conference on Trade and Development (UNCTAD) released the Principles on Responsible Sovereign Lending and Borrowing in 2012 and, in 2013, began a project to identify and formulate a body of principles and rules on which a sovereign debt workout mechanism should be built. The IMF has undertaken a comprehensive review of some key instruments, and is taking further consideration of its lending policy in high debt situations. In the annex to this note, a more detailed listing of options is presented, some of which have been deemed too radical and some not radical enough, and perhaps the kernel of a reform that could be an acceptable intermediate step.

**Guiding questions**

1. Has the focus on debt sustainability analyses in country discussions with the Bretton Woods institutions made borrowing Governments more cautious? Too cautious? (e.g., foregoing growth inducing public investments) Not cautious enough? (e.g., raising the risk of insolvency)
2. What are the lessons learned from the history of debt crises? Did the approaches to debt crisis resolution work well enough? What are the biggest deficiencies?
3. Is the evolution of the market-based voluntary approach to crisis resolution that has occurred in response to the Greek and Argentine experiences sufficient? What additional reforms are required?
4. With the virtual completion of the comprehensive approach of the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI), is the international community adequately prepared to handle a new wave of debt difficulties in LICs should it be triggered by a global economic crisis? How adequate are present tools of debt crisis prevention? Do we need new tools of debt crisis prevention?
5. Is the international community adequately armed to deter disruptive litigation that harms both debtor countries and cooperating creditors of those countries?

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10 See reports of the expert group meetings on [www.un.org/ffd](http://www.un.org/ffd) and for identification of problems and options going forward.
Annex I: Options for debt crisis prevention

Option A: Improving information on debt stocks and flows:

There is an urgent need to improve information on debt stocks and flows. Reliable and consistent information on international liabilities is needed to facilitate debt sustainability assessments and timely debt restructurings. An international registry of debt data reported by creditors and reconciled with debtors maybe the way forward.

Option B: Responsible lending and borrowing

Adherence to some principles and guidelines for responsible sovereign borrowing and lending could be an important first step in debt crisis prevention and reducing the occurrence of debt problems. UNCTAD has taken the initiative to formulate the “Draft Principles on Responsible Sovereign Lending and Borrowing” which have already been endorsed by 13 countries. It is time that the international community adopt at least informal governance standards for sovereign borrowing and default.

Option C: Debt management

Implementing well designed debt management strategies and risk management becomes increasingly important as the range of creditors and instruments expands. An appropriate medium term debt management strategy is crucial in countries with regular use of analytical tools to assess alternative borrowing strategies and manage the assets and liabilities on their balance sheets. Technical assistance and capacity building have an important role to play. Bolstering technical cooperation to strengthen debt management capacity in developing and transition economies and making use of debt sustainability analyses is the way forward.

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Annex. II Five options for the orderly restructuring of sovereign debt

Option A: An improvement in the contractual technology

The increased diversity of creditors and the ensuing divergence in interests makes creditor coordination a difficult task. Efforts are underway to improve contracts so that they are able to mimic an essential principle of insolvency – binding holdouts by mechanisms of super majority of bondholders to new payment terms. It remains to be seen if standardization of bond contracts covering essential features of a bankruptcy regime is the way forward. The following are some of the proposed changes in contractual technology:

a) Aggregation in bond contracts

Most bond issues with CACs that are currently in use do not include an aggregation feature. The inclusion of an aggregation feature received a big push in the Treaty Establishing the European Stability Mechanism (ESM) requiring the inclusion of aggregation clauses in all new euro area government bonds with maturities above one year. The IMF in 2014 proposed changes in collective action clauses to allow for aggregation across different series of bond issues.\(^\text{14}\)

b) Standardising pari passu clause

There is currently no standard pari passu clause, with differing language even within the same sovereign’s bonds. The Argentine litigation in New York courts has brought attention to the interpretation of this clause and its implications for debt restructuring. While the general understanding was that the clause implied equal ranking, the Second Circuit Court in New York has given it a broader interpretation of “ratable payments”, thus increasing the leverage of holdout creditors in this case. This interpretation affects third parties\(^\text{15}\) and those bond holders that accepted the restructured bonds. It increases the incentive for creditors to holdout in a debt restructuring and utilizes the pari passu clause to receive full payment on the bonds held by them. It creates the environment for other creditors to be less willing to accept a restructuring. It allows holdout creditors to interrupt the flow of payments to creditors who participated in earlier debt restructuring, creating incentives for non-participation by creditors in a debt restructuring and has the potential to undermine and alter the doctrine of sovereign immunity. Thus the legal framework needs to strengthen pari passu in light of the Argentine litigation. The IMF (2014) proposes model language for pari passu clauses that clarifies the intent of the clause. Capital markets would function better with more uniform and more easily understood provisions.

\(^{15}\) To enforce the order against Argentina, the District Court would prohibit payment by the trustee and other parties involved in the payment chain to the holders of restructured bonds, unless the holdout creditors are at the same time paid the full amount due pre-restructuring.
c) **Standstills**

Standstills, or suspensions of payments, can provide a “breathing space” in which the borrower can identify and implement a sound policy framework that promotes sustainable adjustment, preserves asset values and supports growth to the mutual benefit of debtors and creditors. Such a process would provide a stay on all litigation by individual creditors, preventing a panicked rush to the exits that triggers a rollover crisis and a race to the courthouse. Standstills can be achieved through voluntary and statutory approaches via inclusion of standstill clauses in bond contracts, through sovereign “cocos” (contingent convertible bonds that would postpone payments under certain conditions) or through an amendment of IMF Article VIII 2 (b) to include capital transfers.

d) **Process questions in creditor coordination – consultative vs. creditor committees**

With the increasing importance of bond finance in emerging market debt, two processes are at work to facilitate market-based debt restructuring. The first is a consultative process in which the debtor engages a debt advisor to garner informal “soundings of creditors” to gauge their willingness to take part in a debt restructuring and tractability with regard to the restructuring. It is thus an informal process to gather views to work towards possible restructuring offers. A second approach to facilitate market-based bond exchanges is a formal creditor committee for effective creditor representation. An option for facilitating creditor coordination would be setting out ex-ante structures for creditor bodies with an oversight structure and a balanced governance body.

**Option B: Statutory solution to address holdouts by minimizing litigation risks in the Eurozone**

A recent proposal was made for the European context by a committee of experts and academics which suggests that the Treaty establishing the European Stability Mechanism (ESM) could be amended so that the assets of a sovereign located within the Eurozone would be immunized from attachment by those creditors not participating in the sovereign’s debt restructuring where that sovereign was benefitting from a financial assistance program from the ESM.\(^\text{16}\) This approach might be a model for a global policy.

**Option C: A regime incorporating both the voluntary contractual and statutory approach**

This proposal is a version of the dispute settlement mechanism of the WTO wherein an institution like the IMF has the convening power. It could create the shadow of the courthouse to facilitate voluntary debt restructuring. Like the WTO dispute settlement mechanism this could have three stages: the first stage would involve voluntary negotiation between the debtor and creditor; this is the status quo with an essential difference that it will be time bound. If no agreement is reached on a voluntary basis, then the second stage consists of a panel of experts (not IMF staff) acting as arbiter similar to the WTO process and again time bound. And finally,

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\(^\text{16}\) Brookings Institution (2013). Revisiting Sovereign Bankruptcy, Committee on Economic Policy and Reform, October
if this also does not result in a settlement between the debtor and its creditors then in the third stage a panel can settle the dispute which is binding on all.

If debt is bought in the secondary market it should not have any preference in debt restructuring.

A similar mechanism proposed is a “Re-solvency” Procedure. The first step of this mechanism consists of a re-solvency clause, a contractual clause which permits the sovereign to commence a re-solvency procedure if it reaches an insolvency state. The second step would then be a re-solvency court led by a permanent president and a limited pool of potential judges who would act if appointed for a particular case. The third step would consist of a set of rules governing the procedures. This system would then mix contractual innovations with a more statutory approach.

**Option D: A statutory regime**

**a) International Debt Restructuring Court**

This independent court would be part of a more permanent debt mediation and arbitration mechanism created under the auspices of the UN with technical support from the IMF and the World Bank and its legitimacy recognized by national courts. The establishment of this court would ensure that debt restructurings are conducted in a manner that is efficient, equitable, transparent and timely. The transparency on general borrowing would contribute to more efficient financing. The rules governing the court would clarify process and sequence questions and its functions based on internationally agreed principles to determine the priority of claims, the required debt reduction (by systematically involving all classes of creditors) and determining inter-creditor equity. Moreover, the court would evaluate the legitimacy of debt claims and enable private and official creditors to extend new loans despite a default.

**b) Europe Crisis Resolution Mechanism (ECRM)**

This proposal draws upon the IMF 2002 proposal for an SDRM in the European context but does not assign a role to the IMF. It could be initiated on a debtor’s request and like the SDRM impose a stay on litigation against the debtor country, a cram down process by a super-majority of creditors and an aggregated voting across all creditor claims.

Interim financing in this proposal is envisaged through a financial body such as the ESM, an assessment of debt sustainability and oversight of economic adjustment through an economic

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body and legal body to resolve disputes. Again, this proposal could be a model for a global policy.

c) **Sovereign Debt Adjustment Facility**

This would be a facility at the IMF which would combine IMF lending with debt restructuring. A set of pre-defined criteria would need to be developed to access this facility. The proposal envisages an amendment of the Articles of Agreement of the IMF to shield countries undergoing a restructuring from holdout creditors when decisions had been reached by a super-majority of creditors.

**Option E: An informal platform for creditor-debtor exchanges**

A proposal for a Sovereign Debt Forum, a standing body based on an informal consensus that could help address the information and analytical issues associated with the question of debt sustainability and debt restructuring. This process would provide a standard template that would remove the guesswork from initiating an open dialogue on a particular restructuring, but it would be non-statutory and flexibly applied on a case-by-case basis. This should result in the creation of a sovereign debt workout facilitation, which would equally represent the concerns of debtors, public creditors, private creditors and multilateral institutions. The forum would be structured to permit a free exchange of ideas with strict confidentiality. Its work would be supported by the compilation of a permanent debt registry that would reduce information gaps. The forum would also provide a platform for a frank exchange between creditors and debtors on the macro program and the extent of adjustment feasible and necessary to achieve sustainability and a resumption of growth in the debtor country.

**Available short-term actions**

Even while stakeholders are presently considering options to improve the architecture for sovereign debt restructuring so that it serves as the analogue to domestic bankruptcy courts, there are some incremental steps that could be taken by both private and public sector participants that would be a step in the right direction.

A first step could be to set up a registry of debt data, along with a mechanism to maintain an institutional memory of debt restructuring cases and provide a platform where debtors and creditors could engage with each other.

A second step is that Member States could endorse the Principles of Responsible Borrowing and Lending as a tool of crisis prevention.

Third, Member States could consider domestic legislation to prevent vulture funds from benefitting more that those who accepted the restructuring, similar to the legislation passed in UK for the HIPC debt.

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