

**Statement by IMF First Deputy Managing Director, Anne O. Krueger
on Sovereign Debt Restructuring Mechanisms
IMF Executive Board Seminar, Washington DC, March 6, 2002**

Directors now have two staff papers outlining the case for a new approach to the restructuring of sovereign debt and alternative ways to change the system. I thought it would be useful at the start of the discussions to explain how these papers reflect the evolution of our thinking on alternative ways of tackling the problem at hand.

During the past several years there has been extensive discussion inside and outside the Fund of the need for a new approach to sovereign debt restructuring. There is a growing consensus that the existing process of restructuring the debts of a country whose position is untenable is more prolonged, more damaging to the country and its creditors, and more unpredictable than would be desirable. The current restructuring process leaves no one satisfied: it imposes unnecessarily high costs on the debtor and creates uncertainty that reduces value for the vast majority of creditors. In this context, exploring ways to improve the sovereign debt restructuring process should constitute a key building block of the new architecture.

Before outlining the broad options for improving the sovereign debt restructuring system, it is worth reviewing the case for reform. The core problem is compelling. Developments in capital markets have created an increasingly numerous and diverse set of creditors with claims on the sovereign. This is not a bad thing: it expands sources of financing and diversifies risk. But it does pose problems when the sovereign's debt service exceeds its payments capacity, as the evolution of capital markets has not been matched by the development of a sufficiently robust framework for coordination among creditors during a restructuring with sufficient clarity about the relative roles of the Fund, the authorities, and its creditors. The absence of an orderly, predictable process for debt restructuring has a number of costs. It can lead the debtor to delay seeking a restructuring, draining its reserves, and leaving the debtor and the majority of its creditors worse off. Protecting inter-creditor equity during the restructuring is also complicated by the diversity of creditors and instruments. At a minimum, the risk that some creditors may be unfairly favored over others creates additional uncertainty about recovery value that is priced into sovereign debt contracts. At a maximum, concerns about equitable treatment, including the treatment of potential free riders, may inhibit creditors from agreeing to a needed restructuring.

All of the approaches that are currently under discussion are motivated by recognition of the need to improve the debt restructuring process. They all seek to provide ways to improve the current legal framework out of a recognition that a more coherent legal framework would make the process more prompt, orderly and predictable. Finally, they all build on the important role currently played by the Fund in shaping the debt restructuring process, including through its judgments on the availability of Fund resources before, during and after a debt restructuring and the design of the member's economic program.

The key differences between the approaches relate to the design of the framework.

Statutory Approach with Enhanced Fund Authority. One approach, which was outlined in the first paper, would involve granting the Fund additional legal authority that would enable it to make key decisions in the operation of the mechanism, including the approval of a stay and the endorsement of a restructuring agreement. Although the debtor would still need to request activation and a majority of creditors would also be required to support an agreement, the need for Fund endorsement of both these decisions would provide some assurance that the debtor and creditors would not abuse the process. The legal basis of this approach would be statutory and could be effectively implemented through an amendment of the Fund's Articles.

Statutory Approach Based on Majority Action. An alternative approach, which was discussed in the second paper, would place all key decision-making powers in the hands of the member and a super-majority of creditors. Although an amendment of the Articles would still be used to provide a statutory basis for this power, the Fund would not be empowered to make decisions that limit the enforcement of creditor rights. Such a decision making process would build on the process found in existing collective action clauses, but would provide for coordination among the holders of different bond issues and debt instruments in a way that collective action clauses do not. The vote of all creditors, not the vote of the holders of a given instrument, would be binding. A group that obtained a majority interest in a small bond issue, for example, would not be able to disrupt the overall process. This protects both the majority of creditors and the debtor from potentially disruptive action by a minority. The Fund's existing financial powers would still be relied upon to ensure that the parties did not abuse the mechanism.

Contractual Approach. A third approach would rely on strengthening incentives for the use of contractual provisions already found in certain bonds that allow a majority vote of holders of a single bond issue to bind other holders of that issue. One variation of this approach would be to build on existing efforts to promote the use of such clauses. A key drawback of this variation – that it only binds the holders of that bond issuance and, therefore, may not adequately address inter-creditor problems – could conceivably be addressed through a second variation that would rely on the development of a more ambitious set of contractual provisions that could create the legal basis for decision making by a vote of all creditors. Both variations of this contractual approach have the appeal of avoiding the need to amend the Fund's Articles to establish a universal statutory basis. But a contractual approach has important drawbacks. It is not clear how debtors and creditors can be persuaded to include such contractual provisions in all future bond issuances. The problem of market acceptability becomes more acute if consideration is given to the development of provisions that attempt to aggregate claims across all instruments (including bonds and syndicated loans). Even a successful effort to convince debtors to make use of improved contractual provisions in all new issues would not address the problem of the existing stock of debt with long maturities. Moreover, relying on contracts as a means of aggregating different instruments for voting purposes also raises other issues: the absence of uniformity of text, applicable law, interpretation and enforcement across jurisdictions; the difficulty of achieving the

establishment of a centralized and coherent process for the verification and voting of claims and, finally, the possibility of future circumvention through financial engineering.

I look forward to our joint exploration of the relative merits of these options as we explore ways to strengthen the debt restructuring process.