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February 28, 2003

To: Members of the Executive Board

From: The Secretary

Subject: **Sovereign Debt Restructuring Mechanism—Summary of January Workshop**

Attached for the information of the Executive Directors is a Summary of the Workshop on the Design of the Sovereign Debt Restructuring Mechanism that was held in the Fund on January 21, 2003. The illustrative text of an SDRM-related amendment of the Articles will not be issued as a supplement, as was initially contemplated, as there are still a number of open issues on which further work by the staff would be required.

It is not intended to publish the Summary on the Fund's external website; the main paper (SM/03/67, 2/12/03) has been proposed for publication.

Questions may be referred to Mr. Fisher, PDR (ext. 38755) and Mr. Hagan, LEG (ext. 37715).

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Summary
Workshop on the Design of the Sovereign Debt Restructuring Mechanism
January 21, 2003

The one-day Workshop examined key issues that need to be addressed in the design of the Sovereign Debt Restructuring Mechanism (SDRM), using as a starting point the proposal contained in the most recent staff paper on the SDRM (EBS/02/201, 11/27/02). Set forth below is a summary, without attribution (except for management's presentation), of the key points made by panel members and audience participants (collectively referred to as participants) during the Workshop.

Introductory Remarks

Fund management's opening remarks emphasized that the purpose of the Workshop was not to examine whether the establishment of an SDRM was justified, but rather to discuss how an SDRM should be designed, assuming that a decision is made to establish it. Management noted that input from professionals during the Workshop was a particularly important means of anticipating and avoiding difficulties that could arise in designing the SDRM, thereby strengthening the proposal. Participants were therefore encouraged to scrutinize all relevant features of the SDRM proposal, and not only more controversial matters such as whether or not there should be an automatic stay on creditors after activation of the SDRM.

Coverage of SDRM

With respect to the scope of the current proposal, it was emphasized that exclusion of particular debt claims did not necessarily mean that these claims would not be restructured, but rather only that they would need to be restructured outside of the SDRM framework. Two broad themes emerged. First, any definition of the debt to be restructured under the SDRM should be flexible enough to accommodate specific circumstances of different countries, as well as future developments of the financial markets. Second, the ultimate consideration in assessing what claims should be restructured should be what is necessary to ensure a return to debt sustainability.

As regards coverage of *official bilateral creditors*, it was noted that the Paris Club provides a framework for dealing with claims of distressed sovereigns, which has generally worked well in practice. It was noted that the Paris Club had not yet formed an official position on whether official bilateral claims should be included or excluded, but that discussions were underway as to how the restructuring of such claims would be affected by the SDRM, whether within or alongside the SDRM. A number of key issues being addressed included: (i) the need to recognize the sovereignty of official bilateral creditors, (ii) the fact that a Fund-supported program is a key condition for the operation of the Paris Club process, and (iii) the need to preserve the ability of the Paris Club to move quickly. There was general agreement for improving dialogue and interaction between official and private creditors in

sovereign restructurings, and that any outcome resulting in a more coordinated, transparent and collaborative process should be viewed positively.

On the general issue of defining a list of *eligible claims*, some participants stated that no *ex ante* list should be specified. Rather—reflecting the current approach in restructurings—it should be left to the parties to decide in an informal and flexible manner what claims need to be restructured to ensure sustainability. In some cases, this would mean restructuring even *domestic debt claims* under the SDRM. Such flexibility would enable parties to address situations that could arise, for example, where claims of state-owned enterprises are in principle subject to a *domestic insolvency law* but are not capable of being effectively restructured under that law. It would also enable a more flexible approach to handling claims that, although different in form, are not different in substance (e.g., debt issued in foreign jurisdictions compared with domestic debt that is linked or hedged with a foreign exchange instrument). Other participants, however, noted that there was a case for exclusion of domestic debt, given the sovereign's ability to deal with such debt using existing instruments. They reiterated that this would not mean that the instruments would be immune from a restructuring – in most cases the restructuring would take place in parallel. For this reason, transparency requirements were essential.

It was noted that the exclusion of *claims of international financial institutions (IFIs)* from the SDRM is viewed by some private investors as an attempt to formalize the senior status of official sector claims. However, other participants saw merit in leaving IFI claims outside of the SDRM, given the unique role of IFIs. It was also noted that some private investors believe that any decision to include or exclude specific claims, by itself, changes creditors' rights. From their perspective, these private investor concerns—along with the general suspicions of the private sector towards the SDRM—are likely to be reflected in the pricing of sovereign debt instruments.

Stay on Enforcement

A number of participants emphasized that creditors view their right to pursue legal actions against sovereigns as very important, although litigation against sovereigns remains relatively rare. The value creditors attach to this right mainly reflects their belief that the threat of a lawsuit—and the general sovereign concern for disruptive litigation and damage to reputation—is a critical factor in bringing sovereign debtors to the negotiation table. Going further, one participant suggested that the volume of credit flows to sovereigns over the last 50 years is at least in part due to the fact that U.S. law has allowed suits against sovereigns since that time (compared with the previous law of absolute sovereign immunity). Some participants warned that any proposal to weaken creditors' rights would likely lead to increased caution in lending to sovereigns (e.g., higher interest rates, shorter maturities and less volume), thereby disadvantaging sovereigns.

The view was expressed that it is *unnecessary* to include an automatic stay feature in the SDRM, given the relatively small risk of disruptive creditor litigation compared with the significant implications of taking away creditors' rights in such a fundamental area. It was

emphasized that, as a tactical matter, creditors would be especially disinclined to file lawsuits in an SDRM context, given the high likelihood that such suits would be futile (due to the involuntary restructuring of claims allowed under the SDRM and the coverage of judgment claims), compared with the high legal costs of filing a lawsuit. Another participant noted, however, that the existence of the SDRM may encourage earlier litigation

One participant made the separate point that it would be *inappropriate* to have an automatic stay in an SDRM context, given that the mechanism contains no proposal for a general cessation of payments. It was argued that a general cessation of payments would be an important complement to an automatic stay, as cessation is a minimum device for maintaining inter-creditor equity during the period of the stay; i.e., it assures the creditor that is being deprived of its enforcement rights that the debtor's assets are not being depleted to pay other creditors. A number of participants agreed that the issue of an automatic stay is closely related to the question of whether there should be a general cessation of payments.

Priority Financing

Participants generally questioned whether *priority financing from private creditors* was likely to be forthcoming in the context of the SDRM. It was noted that, unlike the case in a Chapter 11 (i.e., the U.S. corporate insolvency) context, existing lenders do not benefit from the provision of priority financing to sovereigns. In addition, there was limited scope to provide protection to private priority financiers, inter alia, because sovereigns cannot be liquidated (which limits seniority to a contractual concept); and because of the potential that financing given priority under one SDRM restructuring could still be restructured in a subsequent SDRM proceeding. An additional concern was raised that BIS capital adequacy and provisioning rules are likely to limit the capacity of banks (the primary candidates for priority financing) to provide financing to a troubled sovereign. In light of these considerations, it was argued that any priority financing would be on short maturities and at high interest rates.

Some participants were skeptical about any approach that contemplated *contractual subordination*, inter alia, because the requirement for creditor approval would complicate SDRM negotiations, and creditors inclined to be supportive would generally prefer to provide cash flow relief on their own claims rather than creating a new "super class." A separate question was raised as to whether the speed necessary to facilitate private priority financing could be accommodated within the SDRM. Panelists underscored that rejection of the idea of private priority financing should have limited impact on trade credit, as such credit is typically provided to private parties rather than to sovereigns.

Many participants argued that the only desirable source of priority financing within the SDRM would be *Fund lending into arrears to private creditors*. Some participants further argued that private creditors should have the opportunity for greater dialogue with the Fund regarding the Fund's lending into arrears decisions, as a quid pro quo for private creditors' acceptance of their de facto subordination to Fund financing.

Verification and Voting Procedures

Participants noted the tension between *speedy verification procedures and fairness*, pointing out that a rapid verification process had benefits but also increased the chances for errors. It was also observed that, in the SDRM context, creditors may not be in a position to meaningfully challenge the validity of a claim or a creditor's right to vote on the proposed restructuring agreement, unless they know the identity of the end-investor (e.g., to determine whether the sovereign debtor is actually in control of the beneficial holder of a claim). At the same time, however, it was recognized that identifying end-investors during the verification process would not be feasible under current market practice, inter alia, given the complexity of financial products (e.g., derivatives and synthetic securities) and the widespread use of settlement companies and depositories to hold public securities issued in a global form. This problem is more acute in some European markets because of the existence of secrecy laws.

Participants suggested that, in order to avoid a protracted verification process, claims that have been registered should be considered verified unless they are challenged. Some participants argued that the *burden of proof* should be on the challenged party, as currently envisaged under the staff proposal, given that the challenging party (because of the lack of SDRM discovery procedures) would not have access to information on the relationship between the challenged party and the sovereign debtor. Other participants were concerned, however, that it may not be meaningful to ask the challenged party to prove that it is not under the control of the sovereign.

A further alternative to address the potential control issue would be *higher voting thresholds* for approval of the restructuring proposal. There was a recognition that the *aggregation of all foreign law instruments* for voting purposes would make it more difficult for the sovereign to distort the voting process. One participant noted, however, that voting thresholds based on the aggregated outstanding principal of all registered and verified claims may be problematic in cases where the outstanding principal of a debt instrument is not available.

Dispute Resolution

Participants generally agreed that the *selection process* for the Sovereign Debt Dispute Resolution Forum (DRF) outlined in the staff proposal would result in an independent DRF, particularly because of the consultative manner in which the selection panel is to be formed and the open nomination process for the DRF candidates. A number of speakers also noted that the independence of the DRF will be further enhanced by the provisions for self-governance proposed in the paper and by the consultative budget process.

The role and structure of the UN Commission on International Trade Law (UNCITRAL) were examined, with emphasis on the fact that UNCITRAL would be uniquely qualified to assist in choosing the DRF selection panel. One participant noted that, based on informal consultations, the UNCITRAL Commission would likely respond positively if the Fund were to ask UNCITRAL to assist in choosing the selection panel.

Regarding *decisions of the DRF in individual cases*, it was noted that one DRF panel's decisions would not bind subsequent panels, but that each panel should be cognizant of decisions reached in other panels in order to ensure a general degree of predictability. Further, there will be a need to establish standards for burdens of proof and the DRF must be able to judge its own competence and jurisdiction. Additionally, there must be transparency of decisions and the proceedings should be public.

As regards the *rules and regulations* of the DRF, there was general consensus in favor of an approach that would give the DRF more rule-making powers than envisaged in the paper. It was noted that this could be controversial, but emphasis was placed on the fact that such powers are important if the goal is to draft a flexible amendment of the Articles that would allow for adaptation over time. Participants also noted that, in adopting rules and regulations, the DRF should pay careful attention to establishing fast-track procedures that would enhance the objectives of orderly, predictable, and speedy dispute resolution, and should reflect consideration of the approach in other international fora with power to establish their own rules.

On other issues, some participants argued that *appeals* should be restricted to certain fundamental issues, since otherwise the dispute resolution process would simply be duplicated at the appellate level. Participants were not unduly concerned about possible *constitutional issues* raised by the establishment of the DRF or, more generally, the SDRM. Participants noted that, although it is a difficult issue, the DRF's *powers of sanction* could have been addressed more directly in the paper. It was also suggested that there may be a role for *national courts* on the sanctions issue (e.g., in cases of fraud or forgery by creditors).