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February 5, 2003

To: Members of the Executive Board
From: The Secretary
Subject: **Note by Staff on Official Bilateral Creditor Claims and SDRM**

Attached for the information of the Executive Directors is a note by the staff on official bilateral creditor claims and SDRM. The note was requested by the Paris Club in the context of its further consideration of SDRM issues, and will be provided to the Paris Club Secretariat, for their meeting on February 12, 2003, concurrently with its circulation to Executive Directors.

The staff does not propose the publication of this paper.

Questions may be referred to Mr. Gilman, PDR (ext. 34823) and Mr. Hagan, LEG (ext. 37715).

Att: (1)

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Department Heads

Note by Staff on Official Bilateral Creditor Claims and SDRM

1. The treatment of official bilateral creditor claims is important to the design of the SDRM. In its January 2003 discussion, the Fund's Executive Board deferred reaching a definitive view on this issue. However, the Executive Board requested staff to continue discussions with the Paris Club Secretariat on the possible modalities of coordination between the restructurings of official bilateral debt and private debt, whether along side or inside the SDRM. This note continues the discussions that will provide input for the Fund Executive Board's further deliberations on the SDRM.

Importance to SDRM objectives

2. The objectives of the SDRM are to establish a framework that addresses collective action problems and thereby strengthens incentives for a sovereign debtor and its creditors to reach a rapid and collaborative agreement on a restructuring of unsustainable debt in a manner that preserves the economic value of assets and facilitates a return to medium-term viability. To this end, the SDRM would need to catalyze an early and effective dialogue among the sovereign debtor and various creditor groups. The SDRM provisions for aggregation, creditor classes, recognition of creditor committees and requirements of verification and transparency all enhance the required dialogue and supports its constructive outcome.

3. Irrespective of the relative volume of official bilateral and private creditor claims, coherence in the actions of official bilateral and private creditors is commonly an important factor in determining the speed, orderliness and predictability of a substantial sovereign debt restructuring. Accordingly, the appropriate framework for the treatment of official bilateral creditor claims—in relation to that of private creditor claims—is integral to the SDRM.

4. The Paris Club has been a valuable instrument in achieving collective debt “restructurings” among the official bilateral sector. Moreover, the constructive role played in providing financing assurances at an early stage in the elaboration of Fund-supported programs and the signaling provided by Paris Club agreements have been an integral element of the strategy for restoring confidence and macroeconomic stability. Throughout its history, the Paris Club has displayed its innovation in order to meet challenges that have emerged. The shift over the last 15 years from syndicated lending by banks to securitized instruments held by a diffuse group of creditors, however, has heightened the challenge of effective dialogue between the Paris Club and private creditors. Consequently, a comprehensive debt restructuring in which inter-creditor equity between official bilateral and private creditors is achieved (and perceived to be achieved) difficult to attain within the current framework.

5. The SDRM proposal thus recognizes that the mechanics for effective dialogue among creditors and the sovereign debtor have not kept up with the increased complexity of the international capital markets. The proposal is calibrated to enhance constructive features of the current system and, only where necessary, to displace impediments to effective collective

action. Accordingly, the SDRM seeks to the extent possible to preserve the positive elements of the current framework, including most critically the effectiveness of the Paris Club.

6. A key feature of this effectiveness is predicated on the cooperation between the Paris Club and the Fund. This relationship has become, over the years, such a normal component of Fund-supported programs where there are inherent debt-related issues that it has almost come to be taken for granted. In fact, the coordination and sequencing of decisions have played a timely and often decisive role in program design and implementation. Nothing proposed under the SDRM need affect the essential aspects of that relationship. Hence, it is likely that, in most cases, the SDRM would operate in the context of a Fund-supported program.

Distinctive features of official bilateral creditors

7. The significant progress made in the design of the SDRM with respect to private creditors has provided greater analytical focus to addressing official bilateral creditor claims. In this analysis, it is important to take into account the distinctive decision-making processes and motivations of official bilateral creditors. Perhaps most importantly, the governmental process presents formal constraints on the manner in which negotiations are conducted and how agreements are reached with official bilateral creditors. And countries vary in the formalities required to express assent to a measure and for bringing it into legal effect. With respect to motivation, official bilateral creditors have a shared interest as actors in the international official sector. This factor distinguishes their motivations from the essentially commercial considerations of the private sector. The international interest of official bilateral creditors in supporting a country's adjustment efforts sets the tone for dialogue among themselves, the sovereign debtor, and its other creditors.

8. In analyzing the issues with regard to official bilateral claims, the following additional points merit emphasis:

- Among official bilateral creditors, the Paris Club rescheduling process has been substantially successful in overcoming problems of collective action.
- In many emerging market economies, official bilateral claims constitute a relatively small share of the sovereign's external debt and, therefore, for these countries the primary problem remains resolving inter-creditor problems among private creditors.
- Any framework will need to take into consideration the fact that the restructuring of official and bilateral claims will often need to take place sequentially rather than simultaneously. In particular, Paris Club reschedulings (at least with respect to the Agreed Minute) will often need to take place before private creditors are ready to reach agreement, or even before private creditors have formed a representative group that could be a counterpart for coordination. Early rescheduling by the Paris Club has been an essential vehicle for signaling international support for a member's adjustment program, and laying the basis for export cover.

9. Accordingly, whether official bilateral claims are included in the SDRM or would be restructured along side the SDRM, the mechanism would need to retain sufficient flexibility so that agreements on the restructuring of official bilateral creditor claims could be coordinated with private creditors agreements, but not necessarily concluded at the same time, nor on the exact same terms. For instance, agreement on the rescheduling of official bilateral claims should be able to take place prior to the member's activation of the SDRM, with the member later activating the SDRM to achieve the paramount goal of binding dissenting private creditors to an agreement with a qualified majority of such private creditors.

Option 1—Official bilateral claims along side the SDRM

10. This option would build along side the current Paris Club rescheduling process. Coordination between the SDRM and the Paris Club process would be facilitated by features of the SDRM. The transparency and verification requirements would ensure that private creditors would have adequate knowledge of the sovereign debtor's treatment of official bilateral creditors when it makes a restructuring proposal. Also, in the event that a representative private creditors' committees is formed on a timely basis, it would provide a focal point for effective dialogue between private creditors and official bilaterals.

11. It should be recognized that although on this approach, the operation of the SDRM would not determine changes in organization of official bilateral creditors, it could have possible ramifications, including for the Paris Club process. For example, there is a question of whether invocation of the "comparable treatment" principle could be difficult to apply where the sovereign and a qualified majority of private creditors reach an agreement under a SDRM restructuring. (These ramifications might extend to the Paris Club process in cases where the SDRM has not been activated.) This potential difficulty underscores the importance of the two-way channel that the SDRM would need to establish between official bilateral and private creditors. Furthermore, it highlights the question whether inclusion of official bilateral creditor claims inside the SDRM would provide a stronger bridge for coordinating decisions of the official bilateral and private creditors. This potential difficulty underscores the importance of the two-way channel that the SDRM would need to establish between official bilateral and private creditors. Furthermore, it highlights the question whether inclusion of official bilateral creditor claims inside the SDRM would provide a stronger bridge for coordinating decisions of the official bilateral and private sectors.

Option 2—Official bilateral claims inside the SDRM

12. If official bilateral claims are inside the SDRM, the certified restructuring agreement could embrace terms of restructuring of both official bilateral and private creditor claims. Such a coordinated restructuring is particularly advantageous in situations where the claims held by official bilateral and private creditors are both numerically significant and thus the concerns of inter-creditor equity are significant. As envisioned, official bilateral creditors would form a class of their own distinct from the private creditor class(es). Because the affirmative vote of a qualified majority in each class would be required for a restructuring

agreement to be certified by the SDDRF, the class of official bilaterals would have a veto over the vote of the private creditors, and *vice versa*.

13. The incorporation of official bilateral creditor claims inside the SDRM could be tailored to the distinctive features of official bilaterals:

- It could continue to accommodate a two-stage process by the official bilateral sector towards a comprehensive SDRM restructuring agreement. In the first stage, official bilaterals through the Paris Club could signal early support for the debtor's adjustment program through a flow rescheduling with a relatively short consolidation period, with a commitment to provide for a more comprehensive treatment within, say, six months. The period could be tailored to establish a firm track record of implementation under a Fund-supported program. In the second stage, official bilateral creditors could provide a more comprehensive treatment in the context of coordination with private creditors under the SDRM.
- The requirement that official bilateral creditors form a separate class from private creditors would ensure that they could continue to receive different terms. Thus, while private creditors could agree to restructure the stock of debt using instruments that are attractive to private creditors,¹ official creditors could continue to provide for flow relief, with the restructured amounts scheduled to be amortized over an extended period. Moreover, even if official bilateral claims only represented a small portion of the overall amount of debt, approval by this class would be necessary in order for the overall SDRM restructuring to go forward.

14. Notwithstanding this flexibility, a number of important issues would need to be resolved.

15. ***Intra-class issues: binding official bilateral creditors***—Assuming the agreement is approved by a qualified majority of creditors in both classes, would that vote have a legally binding effect on all official bilateral creditors? Formally, the vote could become binding once the SDDRF has certified that both classes have approved the agreement. If such an approach were adopted, it would represent a significant change in the existing legal framework governing official bilateral claims. Certification of a restructuring agreement involving official bilateral claims could impose an international obligation on each country whose claims are on the restructuring list. Discharge of that international obligation would entail each country giving legal effect to the compromise of its respective claims, as determined in the restructuring agreement. Unless otherwise specified in the amendment to the Fund's Articles, failure by a country to implement the terms of the certified restructuring agreement would constitute a breach of obligation under the Fund's Articles.

¹ That is to say, bonds with bullet maturities bearing interest rates well above a risk-free rate, issued at a discount relative to the face value of the original claim.

16. Formally, with regard to official bilateral creditors, the binding effect of the certified restructuring agreement would be at the international law level. The terms of the official bilateral claims need not be legally affected until the country complied with its international obligation to give effect to the restructuring agreement.² It would be for the legal system of each country to determine the process through which the required legal result is achieved. For some countries, no steps other than acknowledgement of the SDDRF certification would be needed; for others, implementation would require, e.g., bilateral executive agreements or legislation. However, the SDRM would not interfere with any internal processes for implementing the agreed restructuring terms.

17. To ensure that these obligations would only be created in circumstances where the SDRM is used in the context of a Fund-supported program, one could also provide that an SDDRF certification could only be made if a Fund-supported program was in place. Such a condition could be justified on the basis of the common international policy motivations of official bilaterals to hold them to an SDRM restructuring where, through their representation in the Fund, they are not yet satisfied of the viability of the member's adjustment program.

18. *Inter-Class Issues*—As noted above, it is recognized that the above approach would constitute a significant departure from the existing legal framework and may not be acceptable to official creditors. Accordingly, could the SDRM be designed in a manner that, while the decision of official creditors would have no binding effect on the restructuring of official claims, it would still be of legal relevance from an inter-class perspective? Specifically, it would be a legal condition for the effectiveness of the restructuring terms that have been accepted by a qualified majority of private creditors; i.e., it would still give official creditors a legal veto over the restructuring of private claims.

19. Of course, the general design of the SDRM would assume that the veto would operate in both directions; i.e., support by a qualified majority of private creditors would also become a legal condition for a restructuring of official bilateral claims under the SDRM. While, on its face, such a two-way veto would be constraining on official bilateral creditors, it may not, in practice, be as problematic if the existence of a Fund-supported program becomes a condition for including official bilateral claims under the SDRM. Given the fact that the sovereign will always have the authority to take claims off the SDRM restructuring list at any time, official bilateral creditors could avoid the blocking veto of private creditors by restructuring their claims by agreement with the debtor outside the SDRM when they determine it necessary. The existence of a Fund-supported program would provide some assurance that official creditors will have adequate control over the listing and de-listing process. Of course, this flexibility will be regarded by the private sector as reducing the benefits of the SDRM. The question is whether it would represent, nevertheless, an improvement over the existing

² In contrast, upon certification, the restructuring agreement would directly supplant contrary terms of the original claims of private creditors.

framework and catalyze further coordination. On balance, staff considers that it would be a helpful development.

20. **The role of the Paris Club**—Whichever approach is chosen, the Paris Club need not—and should not—be displaced as an instrument of collective action among official bilateral creditors. For example, the Paris Club currently adopts decisions on the basis of a consensus. This decision-making process need not be abandoned under the SDRM. Paris Club rules could still provide for decision by consensus. Paris Club creditors could simply agree among themselves to vote as a “block” under the SDRM. Accordingly, if the first alternative discussed above is chosen (where the certification would have a binding effect on official creditors), and Paris Club claims represent more the qualified majority voting threshold (say 75 percent), a Paris Club decision would bind other non-Paris Club official creditors.

21. This raises a second issue: where Paris Club creditors represent less than 75 percent of official bilateral claims, is there a risk that non-Paris Club creditors would block a restructuring of Paris Club claims? In this regard, it is notable that claims of Paris Club creditors could be restructured outside the SDRM (through the debtor removing them from the SDRM restructuring list). Use of this avenue would thus preempt a blocking minority from stalling a rescheduling in which the Paris Club is willing to go forward.

22. Another issue arises where the Paris Club creditors represent less than a blocking 25 percent of the official bilateral creditor claims on the SDRM restructuring list. In such situations, Paris Club creditors could be bound to a restructuring agreement in which they dissent if one adopts the approach that these votes would be binding on official creditors. As noted above, this possibility is likely to become somewhat hypothetical if a Fund-supported program becomes a formal condition for a restructuring agreement to become effective.

Going forward

23. The design of the SDRM is a decision for the Fund membership, wherein official bilateral creditors are fully represented. However, as recognized by the Fund Executive Board, this decision should be informed by the analysis of issues of coordination between official bilateral and private creditors that would arise in any case. The Paris Club is well placed to contribute to this analysis.

24. In a number of respects, the coordination issues are starker in the option of inclusion within the SDRM and consequently this note identifies more points in relation to that approach. However, the coordination issues that may arise with regard to the option of official bilateral claims along side the SDRM are subtler and because they are less tangible, their *ex ante* resolution may prove more difficult. If official bilateral claims are included under the SDRM, it is recognized that it may be difficult to change the legal framework in manner that would require official bilateral creditors to be legally bound to a restructuring agreement that has been approved by a qualified majority of such creditors. The question

arises as to whether the inter-class veto could be feasible and, if so, whether this feature on its own would justify inclusion.

25. We welcome the Paris Club's views on resolution of the coordination issues presented by the SDRM, including the points outlined in the August and November Board papers and elaborated in this note.