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THE EVOLUTION OF BONDING TECHNOLOGY, CREDITOR COMMITTEES AND THE IMF

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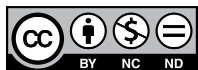

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EXECUTIVE SUMMARY

This paper reviews a range of issues associated with proposals for creditor engagement clauses (CECs) in sovereign bond contracts. CECs have moved onto the international policy agenda in the wake of the recent introduction of model "second-generation" collective action clauses (CACs) designed to address problems highlighted by the protracted litigation between Argentina and its holdout creditors.

Specifically, the new CACs should limit the ability of holdout creditors to impede restructurings acceptable to a supermajority of creditors and address the problematic interpretation of *pari passu* language that has plagued the Argentina debt restructuring. However, the introduction of these clauses, building on the foundation laid a decade ago by Mexico's innovation of first-generation CACs, has led some observers to express concerns that the sovereign debt restructuring playing field has become "tilted" to the benefit of sovereign borrowers. Recent contractual innovations should be balanced, these experts contend, with CECs requiring sovereign issuers to convene and negotiate with creditor committees.

This view is not necessarily shared by sovereign borrowers. Some recent restructurings have been achieved in a timely and orderly fashion through the use of unilateral exchange offerings, rather than formal negotiations with representatives of various creditor groups. Borrowers may be reluctant to voluntarily constrain their ability to conduct such exchanges.

From an economic perspective, the benefit of CEC clauses lies in their ability to reduce the transactions costs of re-contracting sovereign debt by transforming a heterogeneous collection of creditors with disparate interests into a coordinated bargaining partner. A reduction in these costs could benefit both parties if it results in more timely restructurings. But this coordination could also affect the terms on which borrowers access credit markets *ex ante*, and impinge on the borrower's ability to secure a favourable restructuring through a unilateral exchange offering *ex post*, reducing their attractiveness to sovereign borrowers.

The issue comes down to the exercise of good faith versus the role of self-interest. In domestic bankruptcy, disinterested judges oversee the restructuring process and penalize parties that fail the good faith test. A legal framework for international bankruptcy does not exist — and one is unlikely to be created in the foreseeable future.

That being said, the International Monetary Fund (IMF) has the capacity to influence restructuring behaviour through the provision of resources, including its lending into arrears (LIA) policy, under well-articulated programs and appropriate conditionality. In this respect, CECs and the modalities of creditor engagement more generally should figure into the Fund's ongoing efforts to improve the framework for the timely, orderly restructuring of sovereign debt.

Although the terms of the debate on CECs remain to be fully defined, the paper concludes that efforts to develop rules of the game for creditor engagement that are supported by both sovereign borrowers and the creditor community may generate benefits to both groups. Rules that limit discretion may restrict a sovereign's options in any particular situation, but could promote sovereign debt as an asset class and provide long-term benefits in terms of more stable access at lower cost. The Sovereign Debt Forum proposed by Richard Gitlin and Brett House (2014) could be the venue in which such rules are developed.

Ultimately, however, the "market test" will determine whether or not CECs are adopted and become sovereign bond boilerplate, similar to first-generation CACs. The case for policy intervention is unclear. But action may be warranted if these clauses reduce deadweight losses and uncertainty about the definition of "good faith" in the IMF's LIA policy blocks their introduction. In this case, providing greater clarity, which is useful in its own right, would serve a public policy purpose. Achieving this clarity should be a key priority for the IMF's continuing efforts to improve the framework for timely, orderly restructurings.

INTRODUCTION

Contractual terms for sovereign debt have evolved significantly in recent years. Slightly more than a decade ago, Mexico introduced first-generation CACs in its New York law bonds. These clauses, which are intended to facilitate the timely, orderly restructuring of bond issues, endow a supermajority of bondholders with the power to amend key payment terms. The new clauses were quickly adopted by other sovereign issuers, and today constitute sovereign bond boilerplate and accepted market practice. More recently, Mexico likewise led other sovereign issuers in introducing second-generation CACs intended to resolve serious issues not addressed by existing CACs.[1] Most important of these issues is the problem of aggregation — the fact that investors in a particular bond issue, representing a small share of the total stock of outstanding debt, can block a restructuring proposal acceptable to the preponderance of other creditors — and the troublesome language in *pari passu* clauses providing for ratable payments to creditors.[2]

Proposed changes to bonding "technology" are not limited to CACs. The nature of recent international financial

1 These issues are discussed in Gelpern, Heller and Setser (2015) and Haley (2016a).

2 See the discussion in Gelpern (2013).

crises originating in the capital account — reminiscent of panicked bank runs, in contrast to Bretton Woods-era balance-of-payments problems — have led to calls for adoption of comprehensive standstill clauses. The idea is that standstill clauses would act as "circuit breakers," giving distressed sovereigns breathing space in which to implement strengthened policy frameworks.[3]

Proposals have also been made for CECs. Such clauses would convene creditor coordination committees in the event of default or other prescribed events, and specify the ground rules under which sovereign borrowers negotiate with their creditors in the event of a payments disruption.[4] For example, once constituted, a committee is empowered to engage legal and financial advisers at the expense of the issuer and adopt the rules under which it is to operate. Engagement clauses also enjoin the issuer to engage in good faith with bondholder committees, although what that means in practice is not well defined. Conceptually, the advantages of CECs are readily apparent.[5] In particular, engagement clauses could facilitate the early coordination of bondholders and transform a potentially heterogeneous group of disparate creditors into a more coordinated negotiating body.[6] In this way, time lost to organizing restructuring negotiations could be reduced, economizing on the transactions costs of restructuring bonded debt.

THE ISSUES

To assess the potential impact of enhanced measures to promote effective creditor engagement, a range of issues must be considered, starting with the costs of restructuring bonded debt.

The Costs of Re-contracting

The transactions, or re-contracting, costs of restructuring debt can be considered a function of different classes of outstanding claims (bonded versus non-bonded), the number of separate bond issues and the numbers of atomistic creditors in each category. Under this assumption, the greater the complexity of the debt structure and the greater the number of outstanding bond issues, the higher the costs of restructuring. Complex debt structures with multiple issues in different jurisdictions denominated in different currencies create the potential for costly restructurings.

But why would governments pursue such debt structures in the first place? Cost minimization by the public debt manager seeking out jurisdictions and currency of issue that provide the most advantageous terms is surely part of the answer. However, governments may also use a proliferation of different bond issues of different maturities, issued in different jurisdictions and denominated in different currencies to signal their intent not to default.[7] A key point here is that debt structures are endogenous and can play a dual role — balancing refinancing risks against costs considerations as well as acting as a signalling device.[8] The problem is that the two roles may not align: highly complex structures designed to signal *ex ante* commitment to payments discipline (and which reduce borrowing costs in "normal" times) could lead to very large costs *ex post* in the event of an unusually severe shock that triggers a disruption to the payments schedule.

Problems can arise because restructuring bonded debt is fundamentally different from restructuring intermediated

3 Economic arguments supporting standstill clauses are provided in Haley (2014).

4 Under clauses proposed by the International Capital Markets Association for English law bonds, bondholder committees could be triggered by actual default, an event or circumstance that could become an Event of Default, a public announcement by the issuer that it is seeking a rescheduling or restructuring of the bonds, or with the agreement of the issuer.

5 See DeSieno (2016) for a discussion of the benefits and drawbacks of creditor committees.

6 In the past, standing creditor committees evolved to represent the interests of specific creditor groups, typically based on nationality. The Corporation of Foreign Bondholders (UK) and the Foreign Bondholders Protective Council (US) are examples. However, these bodies arose only after protracted disruptions to creditor payments; they were not convened as a result of specific clauses in particular bond contracts.

7 Default is costly to the sovereign to the extent that access to international capital markets is interrupted. In credit-rationing equilibrium models, such a threat is an effective disciplining mechanism and a deterrent to opportunistic default. See Eaton and Gersovitz (1981).

8 Bolton and Jeanne (2007) argue that creditors can increase the likelihood of repayment in the presence of weak contract enforcement by making their claims more difficult to restructure. While such contracts may reduce borrowing costs and increase the debt capacity of the sovereign borrower in good times, they result in higher deadweight losses in bad states of the world in which a re-contracting is required. Halonen-Akatwijuka and Hart (2013) contend that parties may deliberately write incomplete contracts (or contracts that are less complete than would be feasible) since the specification of remedies in the event of particular events may influence expectations with respect to events not subject to state-contingent clauses and lead to higher deadweight losses. See also the discussion in Guzman and Stiglitz (2016).

debt. Banks can reschedule loans at their discretion.[9] And while loan syndications typically involve many banks, the numbers involved are well below the number of atomistic investors in a single bond issue. This difference can have profound effects. In the protracted debt problems of the 1980s, for example, bonded debt was exempt from restructurings (in part, because of small amounts outstanding and the complications of securing the agreement of bondholders). As a result, market practice evolved; rather than issue debt on their own balance sheets, large international banks underwrote sovereign bond issues. However, whereas bond issues of the 1980s restructurings were truly *de minimus*, this was not true in subsequent debt restructurings. Bonded debt is thus now the focus of efforts to improve the framework for sovereign debt restructuring.

To the extent that creditor coordination problems represent a major impediment to timely, orderly restructurings, effective CECs could increase the degree to which bonded debt can be re-contracted, reducing the distinction between it and bank debt. And, to the extent that CECs would generate the timely resolution of debt problems, they could help reduce the deadweight losses associated with the status quo, which, in the words of the IMF (2013), too often results in debt restructurings that are "too little, too late."

Bargaining over Debt Relief

For such clauses to gain widespread acceptance, issuers must view them as beneficial relative to the status quo. In this respect, while there is broad agreement that sovereign insurers benefit from effective, timely creditor engagement, and negotiations today are typically preceded by a committee process, the question is whether a committee process is always, and everywhere, of such material benefit as to warrant a formal contractual commitment to convene a committee. There is less agreement on this score: whereas creditors may contend that CECs are a *necessary* — but not *sufficient* — condition for timely, orderly debt restructurings, debtors are more likely to argue that CECs are neither necessary nor sufficient.

Consider the basic issues at play. To begin with, both sides have a shared interest in returning the country to a growth path as quickly as possible. Growth is obviously beneficial to the sovereign borrower, as it relieves social and political pressures. At the same time, a growing economy enhances debt-servicing capacity and supports the value of creditors' assets.

Borrowers and creditors (as a group) may therefore share a common interest in completing restructurings quickly, and in ensuring that these restructurings are as comprehensive as is potentially feasible. But that is where the commonality of interests ends. Borrowers seek a quantum of debt relief (or debt "discharge") as large as possible, since a dollar less in servicing the debt held by foreign creditors means a dollar more available for domestic consumption or investment. Creditors, on the other hand, want to minimize the size of debt relief — subject to maximizing the expected return on the remaining claims. That is, creditors will trade off a lower face value on their claims in exchange for an increased value of expected repayment (agreeing to a restructuring that increases the total repayment capacity). Expressed somewhat differently, borrowers' returns are a strictly increasing function of the size of debt discharge, while creditors' returns are subject to diminishing returns: beyond some point, expected returns fall as the increased probability of repayment without further disruption fails to compensate for the decrease in the value of the claim.[10]

This difference in return functions drives a wedge between the two parties. While both sides can agree that timely restructurings are preferred to protracted disputes that erode asset values and impair growth prospects, from the perspective of the debtor, a "good" restructuring is one that produces sufficient debt relief to allow the country to restore its access to capital markets and fosters long-term growth. Needless to say, the quantum of debt relief needed to achieve this felicitous outcome is the sticking point in the restructuring process.

The problem is that the bargaining process is subject to uncertainty and information asymmetries. Debt restructurings are built on assessments of future economic growth, the capacity of the sovereign borrower to implement adjustment measures and a range of external factors — global interest rates, external demand, commodity prices and so on. There is considerable uncertainty

9 This characteristic imparts an element of state contingency to bank-intermediated debt not found in bonded debt. The terms of a bank loan, including the payments schedule, can be modified in response to new information on the underlying payments capacity of the debtor. Such adjustments are made at the discretion of the bank's management and board, all with the same objective of maximizing the net present value of the expected payments schedule to the bank. This is not possible in the case of a bond issue, which requires the agreement of a disparate group of heterogeneous investors with different holding periods, risk tolerances, and so on. The challenge is magnified by the presence of multiple bond issues with different payment terms and currency of denomination, issued in different legal jurisdictions. For a recent discussion of the malleability of bank-intermediated debt, see Tett (2015).

10 This "more (debt relief) is preferred to less" assumption on the part of borrowers is made for expositional simplicity. While it may hold in a single-shot bargaining game without the possibility of a counter-offer, it would not hold in the case where output declines the longer that a restructuring is delayed. In such circumstances, borrowers would have an incentive to agree to a restructuring short of full debt relief. Similarly, the timing of restructurings may depend critically on external factors beyond the control of either borrowers or creditors: in periods of strong global demand, for example, or periods of low interest rates, borrowers may have an incentive to agree quickly to a restructuring to benefit from external demand and gain access to international capital markets on favourable terms.

associated with each of these projections.[11] At the same time, a sovereign borrower seeking to maximize the size of debt relief may obfuscate the underlying situation in the economy and misrepresent the degree of adjustment that can be credibly undertaken. From the perspective of creditors, the problem is that the sovereign has more information about likely growth prospects and, what is perhaps more important, its willingness to adopt policies that "grow the pie." Such policies, which generate higher growth and debt-servicing capacity over the medium term, often entail considerable disruption and political costs in the short term. Governments accountable to electorates or powerful interests that would be negatively affected by these measures may, therefore, seek to maximize debt relief in order to minimize adjustment.

The inescapable conclusion is that debt restructurings entail a conflict between good faith negotiations and the pursuit of economic self-interest. The dilemma for the negotiating parties is that, because of uncertainty, negotiations conducted in good faith may result in a restructuring that is insufficient to assure debt sustainability or that subsequently leads to future payments disruptions and repeat restructurings. In contrast, negotiations conducted under more coercive terms (say, on a "take-it-or-leave-it" basis) may result in a restructuring that is sufficiently deep to ensure a robust debt sustainability analysis, which, however, clearly fails the good faith test.[12]

Good Faith versus Self-interest

The question is how to bridge the divide between good faith and self-interest. The starting point is the balance of bargaining power. A process that is widely perceived by one of the parties to be unduly advantageous to the other side is unlikely to generate timely restructurings. This is because notions of "fairness" often influence negotiating positions, notwithstanding the results of axiomatic bargaining theory.[13] Moreover, forward-looking sovereigns and creditors that are likely to be involved in future restructuring negotiations may wish to reject offers that are skewed to the other side, even if that is the best they can expect. Doing so is tantamount to investing in a reputation for tough bargaining that would assist them in future debt restructurings.

Some creditors have argued that the adoption of first-generation CACs has eliminated a significant source of leverage to the creditor community and made the restructuring process too borrower friendly.[14] According to this view, CECs would help level the playing field and rebalance the restructuring process; indeed, some warn that failure to effect such rebalancing could result in lasting damage to the asset class.

Juxtaposed to this quid pro quo perspective is the view that the introduction of CACs resolved a collective action problem that harmed both creditors and sovereign borrowers — supermajority provisions, it can be argued, reduce the leverage of individual creditors, but strengthen the position of bondholders as a group. The point here is that the actions of a few holdout investors ultimately impose costs on other creditors, as recent litigation involving Argentina highlights.[15] In this respect, some contend that the status quo ante, in which New York law bonds required unanimity for the modification of payment terms, was harmful to both sides. Proof of this proposition is found, arguably, in the speed with which CACs were adopted by issuers without a market reaction in terms of a premium on bonds with CACs.[16] Since these clauses were adopted voluntarily, the market evidently welcomed their introduction. Similarly, the true market test of CECs would be their adoption: since there are no restrictions to the voluntary inclusion of CECs, if both sides of the debt contract value such measures (creditors for the clarity they provide; borrowers for the better financial terms that might result), they will be adopted.

11 See the discussion on debt sustainability assessments in Guzman and Heymann (2015).

12 The tension between good faith and economic interest underscores the fact that debt restructuring is a non-cooperative bargaining game. Absent an international legal framework or treaty-based obligations, the process must be self-enforcing and subject to repeated renegotiation. A theoretical treatment is provided by Bulow and Rogoff (1989) in their model of sovereign debt.

13 A well-known result of bargaining theory is that simple games of dividing prizes with a limited number of iterations between offer and counter-offer lead to very unequal outcomes. In these games, individuals are assumed to maximize the monetary value of the division. Specifying a somewhat broader objective function, in which fairness and considerations of equity play a role, consistent with experimental evidence, results in far more equal distributions. Such outcomes align with the results of more complex bargaining games with an unlimited number of iterations between offer and counter-offer, including Rubinstein's celebrated perfect equilibrium result. See Rubinstein (1982).

14 See, for example, comments of Hume (2016).

15 The returns from holding out (and incentive to act opportunistically) increase as the size of the blocking coalition shrinks; in the limit, a single holdout with the power to block a restructuring wields the power to frustrate the wishes of all other creditors and is in a position to extract rents — typically, in such cases, the bonds of the holdout are excluded from the restructuring.

16 Bradley and Gulati (2013) present evidence that the presence of CACs leads to a lower cost of capital, especially for below-investment grade bonds, in contrast to previous empirical work that found the inclusion of CACs either has no effect on or raises the cost of capital. It should be noted, however, that this conclusion is contradicted by anecdotal accounts that investors have not yet priced in these clauses, and will likely not do so until a bond featuring them is restructured. More troubling is the observation of market experts that some investors holding Greek government bonds subjected to the retroactive application of CACs were unaware that their claims were issued under Greek law.

The issue of balance in bargaining power highlights an important distinction between sovereign debt restructurings and domestic bankruptcy proceedings. At the national level, bankruptcy judges oversee the process, enforcing procedural rules aimed at effecting timely restructurings that are in the interests of a supermajority of creditors.[17] No such disinterested judge plays a role in sovereign debt restructurings. And, absent a neutral referee in the renegotiation game, sovereign borrowers will likely be reluctant to give up an instrument they can employ to secure the debt discharge they are seeking — unilateral debt exchange offerings. In this regard, the possible prerequisite of CECs as a condition of good faith may be viewed by sovereign issuers as unduly tilting the balance of power toward creditors by removing a powerful weapon to use against recalcitrant creditors. Of especial concern would be the possible use of creditor committees as a prior condition of good faith bargaining to gain access to IMF resources under the Fund's LIA policy.[18]

This is a sensitive issue, quite apart from the fact that good faith is not well defined.[19] From the creditor perspective, the introduction of provisions for the initiation of effective creditor engagement distinguishes good faith actions from opportunistic behaviour. Debtors balk at that suggestion, however, given the imperfect nature of the signal. In the labour market, for example, it is possible for a worker seeking separation payments to induce a "fire" and a firm wishing to avoid redundancy payments to induce a "quit." In a bargaining game, one side could conceal activities that elicit "bad faith" bargaining from the other party. From the perspective of sovereign issuers, therefore, making good faith conditional on provisions to initiate creditor engagement may be too crude an indicator.[20]

Nor is the establishment of a creditor coordination committee a guarantee of efficient negotiations. If the rules of the committee require unanimity, for example, it is possible that the process will be stymied by a single representative. The provision could, in effect, undermine the objective of CACs. In such circumstances, striking a creditors' committee consistent with good faith negotiations could be harmful to the borrower and creditors as a group. From the borrower's perspective, a far more efficient process is to retain an adviser to take "soundings" from a broad cross-section of creditors to inform the drafting of a debt exchange proposal. A well-designed offer, with a sufficiently high required take-up rate, could result in a much speedier resolution of the debt problem.

Enter the IMF

While an international analogue to domestic bankruptcy courts does not exist, the IMF has long served as a surrogate.[21] For the past 60 years, the framework for sovereign debt restructuring has been based on rules of the game established by the Paris Club and the IMF. The process is initiated when sovereigns suffering from severe payments difficulties seek a rescheduling of claims in the Paris Club of official sector creditors. With a Paris Club agreement in place, a presumption of "comparability of treatment" is then applied to private sector claims.

The key question, though, is how comparability is enforced. This is where the IMF comes into the picture. In most cases, the ability of a distressed sovereign to service the claims of private creditors is highly dependent on access to IMF resources. But before the IMF can agree to a program, the member must first seek a Paris Club rescheduling. Moreover, under its Articles of Agreement,

17 In addition, the doctrine of "unconscionability" or, in English courts of equity, "inequality of bargaining power," addresses situations in which contracts reflect the use of duress or unequal bargaining power. In such cases, courts may substitute standard contractual clauses in place of excessively onerous or one-sided terms; in extreme cases, courts may refuse to enforce contractual terms.

18 The IMF's LIA policy allows the Fund to provide members access to financial support despite being in arrears with private sector creditors. The domestic analogue is debtor-in-possession financing, in which new lending to firms under bankruptcy protection is accorded seniority status comparable to the IMF's preferred creditor treatment under international convention. Prior to the adoption of the policy, the IMF was precluded from making its resources available to a member in arrears to private creditors. This prohibition reflected the Fund's early role in promoting and enforcing members' commitments to current account convertibility under the Articles of Agreement.

19 The use of GDP-indexed bonds could help assuage this problem in the context of post-default restructurings. Haley (2016b) argues that such instruments would likely be less effective in cases of pre-emptive debt restructurings.

20 This consideration is potentially significant in the context of Credit Default Swaps (CDS), which create a separation between ownership of a claim and underlying financial interest. An individual creditor may "own" a particular bond, but stand to benefit if that bond is in default, by virtue of CDS. This individual may therefore seek to avoid a timely restructuring that would avoid the triggering of CDS protection (see the discussion below on unanimity of creditor coordination committees).

21 Recall that the IMF was founded on the wreckage of a dysfunctional inter-war gold standard, which required countries with large external debts to service those claims through a process of "internal devaluation," or deflation and compression of domestic absorption. The economic and social costs of this policy eventually led government to adopt beggar-thy-neighbour trade restrictions that collapsed trade and spread stagnation around the globe. The IMF was created to assist its members to strike a more felicitous balance between "financing" and "adjustment" in order to encourage its members to eschew policies that, in the words of the Articles of Agreement, are "destructive of national and international prosperity." As recent financial turmoil in Europe suggests, that mandate remains relevant 70 years after the Bretton Woods conference.

the IMF cannot provide resources to a program that is not fully financed.[22] Now, since the official creditors who represent the bulk of Paris Club claims also constitute a large block of IMF quotas (ownership shares), IMF programs can be an effective instrument for enforcing the principle of comparability of treatment.[23]

As a result, the IMF can serve as a useful "veil" between creditor countries and their private creditors, applying pressure that their governments may be reluctant to exert. This perspective is not shared by all, however. Borrower countries may view the IMF as a "debt enforcer" for the creditor countries, by virtue of the fact that IMF lending allows some private creditors to escape restructurings unscathed. Implicit in this position is the concern that the status quo fails to provide sufficiently deep restructurings, resulting in the socialization of risk and an excessive adjustment burden on domestic residents. This bifurcation of views underscores the delicate balance the IMF must maintain to preserve its role as trusted adviser to both creditor and borrower members.[24]

The challenge of maintaining this balance has increased over the past two decades as capital account liberalization has increased the size of private claims relative to the resources the IMF can bring to bear. Private claims now dwarf official sector resources, with the relative importance of bonded debt much greater. As a result of these developments, it has become more difficult for the IMF to pursue its mandate of assisting its members to strike a felicitous balance between financing and adjustment.[25]

But at what point does the pursuit of comparability of treatment with Paris Club restructurings cross the line of good faith negotiations? Consider a purely hypothetical example in which a Paris Club restructuring is motivated by political considerations. Should the IMF subsequently support the sovereign with a program if the only way for the sovereign to secure comparability of treatment is through a coercive — to use a pejorative — exchange offer that severely limits the time for creditors to assess the offer and establishes a very low threshold for completion?

Conceptually, the answer is that the IMF should promote *efficient* restructurings that preserve the bonding role of debt and minimize the deadweight losses associated with the too little, too late problem. In practice, however, there is considerable work to do to define what this means and how it is achieved.[26] This determination is made more difficult by the fact that decisions must be made under uncertainty; moreover, even where there is certainty, restructurings are subject to political considerations such as the willingness to accept painful adjustment on behalf of foreign creditors.

Needless to say, the views of creditors and borrowers do not necessarily align. In general, creditors prefer high thresholds for the completion of exchange offerings. This is because the higher the threshold, the more the balance of bargaining power is shifted to creditors. Similarly, creditors recoil from single-shot exchange offers, as this confers leverage to the sovereign issuer.[27]

22 Guzman and Heymann (2015) argue that over-optimistic IMF growth projections skew expectations of debt-servicing capacity and contribute to the too little, too late problem: "In this regard, exaggerated GDP forecasts lead to an underestimation of the need for debt restructuring. This tends to delay the initiation of restructuring processes that may be required for the economic recovery of the debtor." The problem created by the status quo is inter-creditor inequity, as creditors with short-term positions are "bailed out" from resources made available under an IMF-supported program, while the investments of long-term investors are undermined by chronic economic malaise that ultimately ends in default or serial restructurings. There is a related dynamic cost in that such inequities will, over time, discourage long-term investment, that does not benefit from the implicit insurance, and increase short-term investments that are more footloose.

23 It is important to note that the Fund has the capacity to lend to a member in arrears to private creditors to avoid conferring undue negotiating power to creditors. The use of LIA allows the Fund to support a member making good faith efforts to adjust in the face of a recalcitrant creditor. There was asymmetry in the process, however, in that an official creditor could block a program broadly supported by other official creditors. In December 2015, the Fund's board agreed to address this asymmetry by lending to a member with arrears to an official creditor in certain circumcised circumstances in which a number of conditions are met. The LIA strategy is the subject of a forthcoming CIGI policy brief by this author.

24 Of course, not all cases of IMF-supported restructurings entail a reduction in the net present value of outstanding claims. There are circumstances in which a rescheduling — extension of maturities — is warranted. Nevertheless, this discussion underscores the extent to which debates about legitimacy and credibility of are intertwined with the issue of debt. See Haley (2014).

25 A decade ago, the recognition of this new environment led the IMF, under then Deputy Managing Director Anna Krueger, to propose a Sovereign Debt Restructuring Mechanism (SDRM). The SDRM proposal would have replicated key features of domestic bankruptcy regimes; the most important being a mechanism to aggregate all claims against a sovereign. While first- and second-generation CACs address this problem in part, there is a large swath of non-bonded debt that remains outside the scope of these clauses and that can impede efficient restructurings going forward. The SDRM would have equipped the IMF with new instruments so that it would be able to assist its member to deal with the capital account crises of the early twenty-first century, supplementing the tools it was given to combat the current account problems of the mid-twentieth century. In the end, the SDRM did not proceed because it failed to secure the necessary support of IMF members.

26 A key element of the criterion is the efficient bearing of risk; specifically, the higher risk of lending to lower-rated sovereigns is compensated for by higher *ex ante* lending rates. The transfer of that risk to official sector balance sheets would not be consistent with the efficient allocation of capital.

27 See the discussion in footnote 12.

CONCLUSION

Contractual terms under which sovereign issuers bond themselves to their private creditors have evolved significantly in response to underlying changes in the global economy and market practice. In the wake of the recent introduction of second-generation CACs, attention has focused on the possible use of clauses to automatically trigger creditor engagement in the event of a disruption to the stream of payments. Creditors and borrowers disagree on the potential usefulness of such clauses, with the former viewing creditor engagement clauses as necessary to "re-balance" the playing field, and the latter reluctant to accept constraints on an instrument — the unilateral exchange offer — that, from the borrowers' perspective, has led to successful restructurings over the past two decades.

To some extent, the debate can be framed in the context of rules versus discretion. The inclusion of CECs may constrain the ability of a specific sovereign issuer to use exchange offerings to secure a deep cut in the debt burden following a sharp deterioration in debt-servicing capacity. But the rule might also generate lasting long-term benefits to sovereign issuers as a group and promote the asset class. Binding sovereign actions during periods in which time horizons invariably collapse to "here and now" in a tunnel vision of crisis response, could facilitate timely, orderly restructurings through the development of clear rules of the game.

There is scope for creditor-issuer dialogue to foster a common understanding of the principles and practices of efficient re-contracting and benchmarking of international sovereign debt restructuring best practice. By creating a virtual impartial arbitrator, such a process could foster the trust and information revelation that is needed to secure timely, orderly restructurings. The Sovereign Debt Forum, a voluntary association of sovereign borrowers and international creditors, proposed by Gitlin and House (2014) could build the trust needed to identify clear rules of the game.

At the same time, it is clear that the IMF will remain a key player in sovereign debt restructurings, by virtue of its role in providing financial resources to its members in distress. This role has evolved. In an earlier time, the IMF managing director could offer her "good offices" to help resolve payments disruptions. As an impartial arbiter whose objective is to promote global financial stability and long-term growth, she might have encouraged both sides to act reasonably and lengthen their time horizons, avoiding precipitous decisions that could harm both parties.[28] But these discussions were conducted before the return of bonded debt, in the context of sovereign debt problems where bank debt dominated and a few large banks took the lead in coordinating smaller institutions or banks with limited exposures. In a world of bonded debt, in which heterogeneous creditors with different time horizons and investment objectives dominate, the role of the managing director in debt restructuring negotiations is circumscribed.

In this environment, the IMF's influence in the restructuring process can, perhaps, be best understood in terms of creating incentives for the timely resolution of disputes. Contrary to what creditors and borrowers may believe, the IMF's mandate is not tied to the interests of either creditors or to a particular member at any point in time. The Fund's objective, rather, is to promote the *collective* well-being of its members *over time*. This mandate includes safeguarding the international economy from possible financial instability generated by protracted, disruptive debt disputes, but it also includes the promotion of efficient international capital markets that provide access to IMF members seeking to smooth consumption in the face of output shocks or increase investment in order to raise productive capacity. Moreover, the IMF, as a long-lived institution, has a time horizon that extends beyond that of finite-lived authorities or individual investors. In this respect, it has a critical role to play in coordinating the actions of atomistic, disparate agents to achieve mutually beneficial outcomes (i.e., timely restructurings that create the conditions for growth and minimize the dissipation of asset values).

For the IMF to provide this coordinating role, however, sovereign issuers and their creditors should have some degree of certainty about the contingent rules under which it will operate in the event of a payments disruption that puts a member into arrears with its private creditors. In practice, of course, while this need not be (and indeed will not be) perfect certainty, the degree of uncertainty cannot be unbounded. Moreover, to affect behaviour, and to be effective, these rules must be articulated *ex ante*.[29] Credibility, meanwhile, requires that they be consistent with the mandate of the IMF. In effect, the IMF must subject itself to a regime of constrained discretion with respect to its policy interventions in cases of debt restructuring.

To achieve this goal, greater clarity is needed on what constitutes good faith in the IMF's LIA strategy.[30] This is

28 Boughton (2001, Part II) discusses the role of the managing director in the search for a resolution of the debt crisis of the 1980s.

29 The protracted legal dispute between Argentina and holdout creditors waged in the Court of the Second Federal District of New York is instructive. The presiding judge's successive rulings can be viewed as an attempt to enforce norms of good faith bargaining. But as they were issued *ex post*, after the passage of legislation designed to commit the government to a policy of non-negotiation with holdouts, the rulings arguably introduced an element of uncertainty into the restructuring process, without necessarily eliciting the desired change in negotiating tactics.

30 Analogous to rules for IMF lending into financial crises *before* a default event and accumulation of arrears in support of, say, a preemptive rescheduling.

not a trivial assignment. Even at the domestic level, the meaning of good faith negotiations in contractual disputes is unclear, with definitions and concomitant obligations differing across jurisdictions and evolving jurisprudence.[31] Nevertheless, despite the challenges involved, more precision on the benchmarks to be used is required.[32] Given its unique mandate, the IMF good faith criterion cannot be the same as that which might apply to contractual disputes between private sector parties, nor can it unduly relieve borrowers of obligations, consistent with the goal of promoting well-functioning international debt markets for the benefit of all.

Ultimately, the market test will determine whether or not CECs are adopted and become sovereign bond boilerplate, as first-generation CACs have become since their introduction more than a decade ago. In the absence of some market failure or impediment to their incorporation, the presumption for policy intervention is unclear. However, it is possible that uncertainty about the definition of good faith in the IMF's LIA policy blocks their introduction. Greater clarity of good faith is useful in its own right; if it would also reduce deadweight losses through the adoption of CECs, the case for action is even stronger. Achieving this clarity should be a key priority for the IMF's continuing efforts to improve the framework for timely, orderly restructurings. In its absence, the sovereign debt market may well remain subject to a restructuring process that is, as one legal scholar (Gelpern 2013) has put it, "deeply dysfunctional and produces bad law."

31 In particular, recent judicial rulings in the United Kingdom and Canada provide for a more expansive interpretation of the obligations that contracting parties owe to each other. See *Yam Seng v ITC* (2013), EWHC 111 (QB), and *Bhasin v Hrynew*, 2014 SCC 71, 3 SCR 494. In both cases, the courts ruled that there was an "implied" duty of good faith. The UK decision is especially noteworthy, given that courts there have generally been reluctant to assume a duty of good faith in negotiations between parties of comparable bargaining power.

32 In a historical analogue to the problem of defining good faith, Weidemaier (2015) notes that in the nineteenth century, London Stock Exchange (LSE) rules denied listing privileges to a sovereign that had defaulted on its debt, unless the sovereign had reached a "satisfactory arrangement" with its creditors. While countries did not have to issue debt in London or list debt on the LSE, those that wanted to do so had no choice but to abide by this restriction. But that required the LSE to define what a "satisfactory arrangement" entailed. The answer that evolved was that an issuer satisfied the condition by proposing a restructuring acceptable to a qualified majority of affected bondholders — in effect, modern CACs.

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Helpful comments from Martin Guzman, Paul Jenkins, Domenico Lombardi and the insights of an anonymous referee are gratefully acknowledged. The usual *mea culpa* applies.

Author's Note

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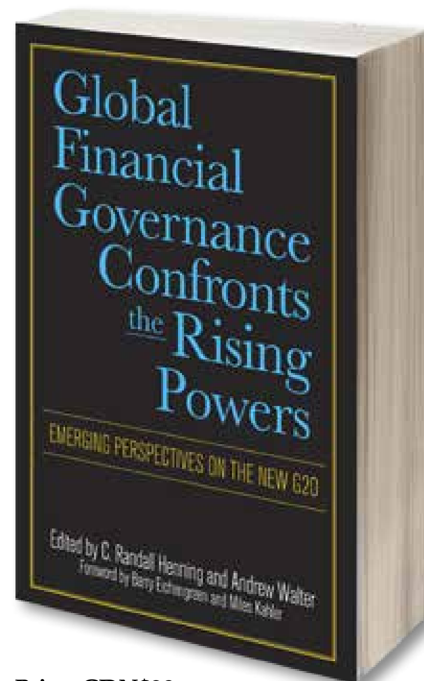

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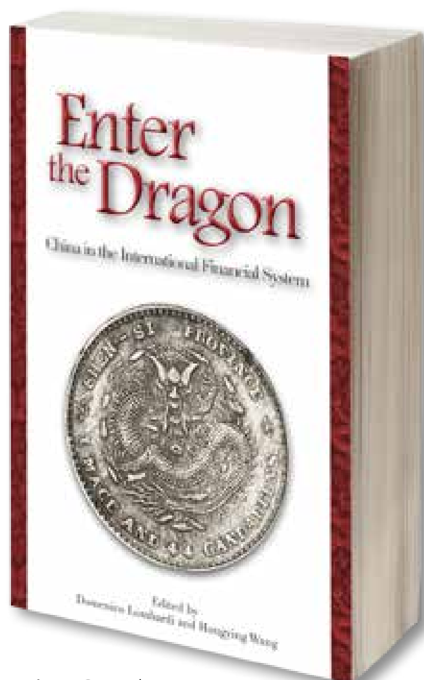

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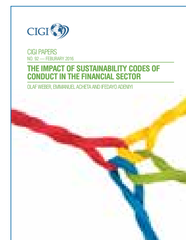

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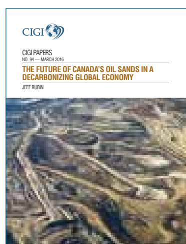

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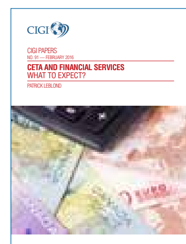

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