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SIMPLIFYING SOVEREIGN BANKRUPTCY
A VOLUNTARY SINGLE HOST COUNTRY APPROACH TO SDRM DESIGN

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ABOUT THE AUTHOR

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EXECUTIVE SUMMARY

This paper presents a new way to design a court-based sovereign debt restructuring mechanism (SDRM). While most proposals for such mechanisms aim to develop a multi-country or global mechanism to restructure sovereign commercial debts, this proposal suggests that a single country could set up a sovereign bankruptcy court and invite debtors to use its legal system to gain the benefit of the mechanism. It is argued that this single country approach substantially simplifies the set up and operation of the SDRM and that it lowers the opportunity for holdout investors to carry out disruptive litigation. The detailed design of the mechanism begins with an analysis of the incentives of debtors and creditors in order to identify a mix of features that could be included to attract both constituents. The proposal would be court-based and grant the judge the power to sanction debtors or creditors should they fail to cooperate in reaching a solution. Legal stays to protect the debtor against holdout litigation would be an important component. One, perhaps unique, feature of this proposal is that payment standstills on affected debt would be structured to allow continued payment of interest from the debtor to creditors during the negotiation of terms, while principal payments would be deferred. The paper also places the proposal in the context of the historic debates in which SDRM has faced off against collective action clauses (CACs) as a policy prescription.

INTRODUCTION

While countries around the world have set up successful bankruptcy systems to handle the reorganization of troubled companies, policy makers have faced tremendous challenges in setting up an analogous system to handle sovereign bankruptcies. This is not for lack of effort. Proposals to set up a sovereign bankruptcy court have been made since the 1930s, and the International Monetary Fund (IMF) undertook a significant effort to set up a system in the early 2000s. But progress in this area has been hampered by some fundamental challenges in resolving sovereign debt problems: there is no objective method for determining the fair trade-off of debt relief versus fiscal adjustment; sovereignty will limit the power of a court to compel debtor actions; and debt will typically involve many different facilities borrowed under a number of different legal jurisdictions. There is also strong resistance to change: creditors are strongly opposed to weakening their rights and many sovereign borrowers are rightly worried that a change in the rules of the game could make the cost of their funds go up. In a word, it is complicated.

In place of a formal system, a pragmatic solution has evolved. Debtors in crisis will typically work with the IMF to develop a plan, and then the debtor will present an offer to creditors. The threat that the IMF will withhold support for the debtor provides some leverage. An exchange offer is used to switch old bonds for new bonds with eased financial terms. This approach allows case-by-case negotiation of terms. And it has been improved in the last decade as CACs have been added to sovereign bond documentation, a feature that allows a supermajority of creditors to sweep non-participating creditors into a transaction. This approach works pretty well, but provides no mechanism to resolve debtor-creditor stalemates. And critics say it leads to "too little, too late" outcomes.

This paper proposes a potentially workable way to set up an SDRM that could be used to help resolve the most challenging situations. The idea is to cut down on the complexity relative to prior proposals and build on what seems to work in the market-based approach. In place of a complicated multilateral mechanism, a single host country simply sets up a sovereign bankruptcy court and invites debtors to borrow under its laws. One country holds the pen and operates the system. Debtors wishing to join the system will issue new bonds governed by the law of the host jurisdiction. No debtor will be forced to use the system if they are afraid it would increase their cost of funds. No creditor will be forced to buy the bonds. All it needs to get going is a single country to set up the system. It is a "build it and they will come" approach.[1]

The proposal is developed in four parts. First, the paper provides some history and sets out how the proposed approach to SDRM would fit into the global financial architecture for resolving sovereign debt crises. Second, using an analysis of the incentives of debtors and creditors, design principles to maximize buy-in from both sides are set out. The paper suggests the principles that should apply in selecting a host country. Finally, likely criticisms and possible next steps are discussed.

THE GLOBAL FINANCIAL ARCHITECTURE

The global financial architecture is essentially a set of tools used to help countries regain their footing after falling into a financial crisis or to avoid them in the first place. The working elements include: economic adjustment programs; market funding and exchange offers; IMF and bilateral loans; and various forms of debt restructuring.

These tools come into play depending on the complexity and severity of a crisis. Moderately severe crises are resolved through fiscal belt-tightening and other reforms.

1 This paper focuses on the commercial fundamentals of how a sovereign bankruptcy regime could be designed to gain the support of creditors, debtors and Group of Seven (G7) policy makers. It may be categorized as a "model law" approach, such as those currently under study in the International Insolvency Institute Working Group on Sovereign Insolvencies and the Centre for International Governance Innovation International Law Research Program Working Group on Cross Border and Sovereign Insolvencies, albeit with non-traditional commercial features.

More severe crises may be resolved with the aid of an IMF loan. Market-based restructurings may come to play in deep crises, and would typically involve a debt exchange offer that includes the use of CACs.

It could be argued that the existing market-based mechanism has severe drawbacks: it is often hard to get debtors and creditors to the negotiating table in a timely fashion, and then there is no way to break a logjam should the debtor and creditors fail to agree on a deal. A stalemate could lead the debtor to precipitously default. The disruption and antagonism surrounding such a default could lead to a long period of non-payment for creditors and economic stagnation for the debtor — an outcome that would maximize damage to all involved. The aim, therefore, is to develop a system that breaks negotiation logjams and lowers the chance of a precipitous default.

SDRM AND CACs: A TWICE-TOLD TALE

Proposals for a formal SDRM date back to the 1930s. SDRMs were first proposed by debtors in the context of a wave of Latin American bond defaults. Academic interest blossomed during the less-developed-country debt crisis of the 1980s. Policy-maker interest came in the wake of Mexico's tequila crisis in the mid-1990s; this interest intensified with the capital account crises and large IMF bailout programs of the late 1990s and early 2000s (Rogoff and Zettelmeyer 2002; Olivares-Caminal 2014).

Most SDRM proposals have included provisions to solve the well-known problems of bankruptcy regimes: legal stays were suggested to counteract the risk of a "rush to the courthouse" following a default; collective voting mechanisms were suggested to solve the "holdout creditor problem"; and payment standstills or moratoriums were suggested to resolve the "rush to the exit problem" (Roubini 2002; Schwarcz 2000). Proposals from the period varied in scope and the usage of the available mechanisms. Some were court-based and others used arbitrators. The original SDRM proposals are often termed "treaty-based" solutions because they would have been implemented by a change in international agreements and the laws of countries (Jewett 2014).

In 2002, the IMF proposed that a comprehensive SDRM be set up under its tutelage (Krueger 2002). The proposal was pretty contentious. It generated a very negative reaction from the bond market and doubts were voiced by large sovereign borrowers who were afraid the mechanism could increase their cost of borrowing from the bond market. The proposal was dropped — but, as a quid pro quo, developing market borrowers and debt investors agreed to support the insertion of CACs into sovereign bonds (Setser 2002). As a result, most sovereign international bonds have been issued with CACs since 2003. The CAC approach is often called the "contractual" or "market-based" approach, as restructurings are implemented via a mechanism built into the debt contracts at the time of issuance.

In the wake of the recent problems with Greek and Argentine debt, policy makers and leading investors agreed in 2014 to enhance the power of CACs. Here is the technical problem that needed to be addressed: 2003-era CACs require a separate vote of holders of each series of eligible bonds to approve of a restructuring — and that provides an opportunity for holdout investors to aim to block the operation of CACs on particular series of bonds. The new CACs address this problem by providing for "aggregated voting," a process whereby a single pooled vote of all affected creditors has the power to approve a binding restructuring agreement (Makoff and Kahn 2015).

It is interesting to note that the first phase of the story above largely repeated itself in Europe over the last few years. The blow-up of the euro-zone debt markets in 2010 led European policy makers to debate how best to restructure euro-zone sovereign debt, should it be required. The idea of a European SDRM was put on the table (Gianviti et al. 2010). As before, it invited extremely negative feedback from the market. And, as before, the agreed solution was to insert CACs into euro-zone sovereign bonds. Since January 2013, all euro-zone sovereign bonds longer than one-year maturity have been issued with CACs.

CACs have, therefore, shown substantial power as a solution. They beat out the SDRM in two intensive reviews of the policy options and they have been readily accepted in the market. Moreover, they have proven to be flexible — witness the recent increase in their powers. But it is not just a story of CACs versus an SDRM, it is a story of convergence, as CACs now embed the single most important feature of the 2000-era SDRM proposals: aggregated voting.

In a new twist, the policy debate has expanded to a new forum: Argentina and Bolivia have championed an initiative for the United Nations to get involved in developing a more complete SDRM. On September 9, 2014, the UN General Assembly approved Resolution 68/304, which provided for hearings to explore the implementation of an SDRM. The voting provides a good measure of the state of play among global policy makers: all the G7 countries voted against it, the Group of Twenty (G20) was split, and the Group of Seventy-Seven offered overwhelming support. With this said, there is little hope for a global SDRM system to come into force without the support of the G7, which controls the IMF board and the UN Security Council.

One consequence of the stalemate on the implementation of an SDRM is that proponents are now looking at incremental approaches. The United Nations Conference on Trade and Development (UNCTAD) has put forth a comprehensive framework for debt restructuring that includes setting up an expert group to assist with restructurings and to possibly serve as mediators (UNCTAD 2015). The legal community has studied a "model law" approach that would rely on countries voluntarily signing up to a common legal framework (Schwarcz 2015). This paper provides a way forward that is similar to these new incremental proposals, but makes a virtue out of its simplicity and voluntary character.

DESIGN PRINCIPLES FOR A SINGLE HOST COUNTRY VOLUNTARY SDRM REGIME

The design process for the single host country SDRM would need to find common ground among debtors and creditors in how sovereign bankruptcies should be handled in order to gain adherents on a voluntary basis. An analysis of the incentives that drive debtors and creditors is shown in Table 1.

Table 1: Debtor and Creditor Incentives to Support SDRM Bonds

Debtor Incentives
• **Legitimacy:** Public officials work better within a formal rather than an informal system. • **Predictability:** Public officials need to be able to anticipate the timeline and process when they commence a restructuring. • **Speed:** Maximum speed is necessary to minimize the knock-on damage to the debtor's economy.
Creditor Incentives
• **Avoid precipitous defaults:** Creditors want to avoid Argentina-like surprise defaults and unilateral offers. • **Reduce market volatility:** Creditors would benefit from reduced bond price volatility. • **Governance:** Creditors need assurances that a country will carry out promised reforms that are needed to boost debt repayment capacity.

This table suggests a bargain that could be cut between the parties: give debtors a court-based system that has some real teeth to compel cooperative behaviour, and give creditors protection from precipitous defaults and assurances that promised reforms will be carried out.

Therefore, the starting point is a court-based scheme. It could be set up in a single country and used in a voluntary format to establish it as a truly market-based option. The risk of precipitous defaults is handled through limitations on payment standstills.

In the proposed scheme, the court will play an important role in overseeing payment flows from the debtor to creditors. Debtors, subject to availability of cash, would be expected to pay all interest due to creditors during the course of negotiations. However, in most cases, the principal would be forcibly rolled over into new short-dated instruments because markets should be shut to the debtor once it enters into the SDRM and to avoid the situation, as in Greece, where the full repayment of maturing short-dated debt increased the share of the burden borne by holders of longer-dated bonds. A helpful by-product of the approach is that the presumption of steady cash flow from the debtor to creditors opens up a tool for possible use by the judge — this cash flow could be increased or decreased to sanction the debtor or creditors should they be uncooperative.

Before going on, it is worthwhile to pause and discuss a bit more the logic behind the proposed approach to payment standstills. It is a novel approach, and is at odds with conventional thinking about sovereign bankruptcy (Miller and Zhang 1999). Here, therefore, are some reasons why the debtor — and not just the creditors — should favour the approach. All considerations derive from the fact that keeping interest payments flowing should reduce the drop in prices of bonds subject to restructuring relative to the drop that would apply in the case of a full payment moratorium. Less price volatility means it will be easier for long-term investors to hold positions and avoid selling out to more aggressive investors. It would help the debtor limit knock-on effects on local institutions and individuals that own the debtor's international bonds and generally help the debtor retain confidence in its economy.

While a bit different from prior proposals, there are some studies that see value in reducing market volatility: in 2001, Adam Lerrick and Allan H. Meltzer proposed a scheme in which the IMF would purchase distressed sovereign bonds at 85 percent of its sustainable value with the objective of stabilizing market prices (Lerrick and Meltzer 2001). And the IMF has recognized that there are trade-offs in implementing payment standstills (IMF 2003, 5).

Table 2: Mechanics of the SDRM

Term	Choice	Rationale
Scope of debt instruments covered	International bonds, loans and derivatives.	Multilateral, bilateral and domestic debt would be issued under their own documentation (and unlikely to be governed by the host country laws) and would be restructured separately.
Entering into the SDRM	Triggered by debtor, subject to acceptance by court.	It would breach the debtor's sovereignty to allow creditors to trigger the SDRM, so this is not permitted.
Terminating the SDRM	Upon conclusion of a restructuring or under the direction of the court.	The court would retain the power to terminate the SDRM if the debtor is uncooperative.
Legal stay	Triggered upon entering the SDRM.	Debtors would need this protection to be willing to use an SDRM process, given a primary concern is the avoidance of expensive and embarrassing lawsuits.
Payment standstills	Scheduled interest would usually continue to be paid during the SDRM. But, maturing debt will usually be rolled into new short-term instruments under court order. Any payments by the debtor will be subject to its ability to pay.	This would stabilize debtor-creditor relations and minimize knock-on effect economic consequences.
Creditor committees	Recognized by debtor and court. Reasonable fees and expenses of the committee will be paid by the debtor.	This is the conventional arrangement in sovereign debt restructurings.
Restructuring agreement	Presented by the debtor to creditors under supervision of the court.	This is the conventional approach.
Creditor approval majority	Seventy-five percent majority of all creditors acting as a single class.	Same as for CACs to avoid supplanting market-based restructurings.
Eligible claims	All debt of the debtor issued under the law of the host jurisdiction and registered with the local clearing system at the time of issuance.	This fully registered system provides for real- time transparency of claims subject to the SDRM.
Claims determination	Claims of investors will be based on the par amount of bonds held plus any accrued and unpaid interest. Special provisions would be designed to determine the claims value of zero coupon bonds, derivatives or other such instruments.	Similar to the treatment under aggregated CACs.

Term	Choice	Rationale
Consideration	Creditors will be offered "uniform consideration," that is, the same instruments or menu of instruments. Exceptions may be defined; for example, creditors holding instruments in different currencies may receive comparable offers of new instruments each in their own currency.	This approach is similar to the treatment under CACs, but has more flexibility to consider exceptions through a ruling of the court.
Time-ordered consideration (alternative)	When the aggregate net present value impact of the transaction is expected to be low (let's say less than 20 percent calculated at a standard discount rate), the debtor will have the option to reprofile the debt in a transaction that effectively extends the maturity or duration of instruments by an equal amount.	This would apply when countries suffer from a liquidity crisis rather than a solvency crisis. Voting for this alternative consideration could involve a two-limb procedure that requires the general approval of creditors as well as support from creditors holding different maturity instruments.
Interim and new money DIP financing	The IMF will be the conventional provider of such lending. When IMF lending or other sources of funding are not available, senior market-based funding may be put in place.	Market-based DIP funding should be discouraged and rarely used. Debt markets thrive on simplicity and the creation of multiple classes of traded sovereign debt would harm liquidity and complicate any future restructurings.
Claims verification	Recognized amounts will be confirmed by the clearing system to the court.	The single host country approach simplifies verification relative to multilateral approaches that accept claims in different forms and from multiple jurisdictions.
Hedging derivatives claims	Procedures will define what amounts, if any, of derivatives contracts will be restructured on a *pari passu* basis with other claims.	This is to avoid derivatives lending structures designed to free ride on the debt restructuring mechanism, although the structure should provide a safe harbour to protect counterparties to bona fide hedging transactions.
Credit default swaps (CDS)	These should be triggered upon entry into the SDRM. As a further protection, creditors could be required to disclose holdings of any credit hedging instruments that have not been triggered to allow a netting of their exposure in the vote counting process.	This is to avoid conflict of interest between creditors with or without a net credit exposure. While subject to potential abuse, the CDS disclosure mechanism would introduce significant legal and financial risk to creditors who fail to disclose positions when they vote in a restructuring.
Post-SDRM conditions on debtor	IMF oversight should be the primary compliance mechanism. Should the IMF not fulfill this role, conditional debt relief may form part of the debt restructuring agreement; the court could agree to oversee debtor compliance with measures designed to serve as conditions precedent for deferred debt writedowns.	This feature should both encourage debtors to undertake IMF reform programs and to deliver on promises made to bondholders at the time of the execution of debt restructuring agreements.

PROPOSED TERMS

This section sets out the technical specifications for the proposed SDRM regime. The detailed terms are set out in Table 2, along with a general description and rationale for each design choice. The specifications cover a wide range of topics, including:

- legal framework;
- scope of debt;
- procedures to enter and exit;
- legal stays and payment standstills;
- senior interim or new money debtor-in-possession (DIP)-style financing;
- creditor committees; and
- voting majorities.

Four areas deserve special discussion:

- **Court-based single host country:** A single host country system should be far simpler to set up and operate than a multilateral scheme. It should be easier for investors to understand and easier for debtors to navigate. A court-based system would be expected to garner greater buy-in from debtors and creditors than a system relying on arbitrators. And a court-based system should allow a build-up of a body of precedent over time.
- **Sanctions:** While the judge would be expected to facilitate the discussion, he or she would also have significant powers to sanction uncooperative debtors or creditors. The judge would have procedural tools, such as control over the use of stays and the entry into and exit from SDRM. The judge would also have a real hammer: the ability to increase or decrease the interest (or principal) paid by a debtor to creditors.
- **Role of the IMF:** The system is designed to maintain the IMF's central role in market-based debt restructurings. No other party can match its technical resources and its ability as a member organization to gain access to the debtor. And its capabilities for emergency lending and program oversight could not be easily replicated in a market mechanism or by a new third-party supervisor. The IMF would be positioned as a supporter of the debtor, while at the same time it could be the preferred expert witness on matters of debt sustainability. However, if the IMF will not fulfill these roles, market DIP lending and court-supervised debt relief conditionality could take their place. For the avoidance of doubt, the proposed mechanism would not require the IMF to change its policies and procedures and the court would have no power to compel the IMF to take any particular actions.
- **Sovereign bond documentation:** The bonds issued under the host regime will contain CACs and all the other conventional features of sovereign bonds. Events of default would need to be designed to mesh with the host country's legal system. Some features of the regime — for example, the seniority of multilateral lending — might be included in the bond documentation as well as in the underlying legal framework.

CHOOSING THE JURISDICTION

A host country is only likely to attract users to its SDRM regime if it has strong rule-of-law credentials. The legal systems most trusted by international bond markets are those of the United States and the United Kingdom, so they would be natural candidates. Many other countries could also credibly set up an SDRM, for example, the Netherlands, Canada, Switzerland, France, Germany or Sweden may be good candidates.

For many countries, a host jurisdiction would be at the state level rather than the national level. In the United States, the obvious candidate is New York Law, as it is used for the majority of sovereign international bonds issued around the world. An alternative could be Delaware, which is widely used for the incorporation of US companies and has a well-respected commercial court system. For Canada, the Province of Ontario would be an obvious choice, given it is the country's commercial centre and is easily accessible from the United States and Europe.

To be sure, a lot of work would have to be done to get a country or state interested in hosting a court and then to put the system in place. There would be significant costs, uncertainties and challenges to setting up a court and maintaining the system. What if investors do not come? What if existing investors flee as a result of the change? And, if the host jurisdiction is New York or England, how would large stocks of existing debt be handled? There is much to study in these areas on a general basis and with respect to specific potential host jurisdictions.

LIKELY OBJECTIONS AND INITIAL RESPONSES

A host of issues and doubts would arise if a country sought to implement an SDRM regime as proposed herein. Here is a discussion of some of the more predictable objections that one might anticipate from debtors, creditors and technical experts.

Possible Debtor Concerns

This scheme is too creditor friendly and therefore risks "too little, too late" outcomes. Unlike CACs, the proposed solution provides for powerful sanctions to be brought to bear on creditors (or debtors) if they are not cooperative in reaching a solution — this should help lower the incidence of "too little" outcomes. The predictability provided by the court-based approach should encourage troubled debtors to seek reorganization at an earlier date than they otherwise would — this should help reduce "too late" outcomes.

Won't the court scheme saddle the debtor with large costs, as seen in commercial bankruptcy courts? Sure, court-based approaches will be expensive. The SDRM should be used as a last resort.

Possible Creditor Concerns

The SDRM regime encourages moral hazard by making it easier for debtors to gain relief. It is true that the scheme would make it easier for debtors to achieve adequate debt relief, but there would be a number of important creditor protections to prevent abuse: the debtor would be expected to undertake deep reforms; the debtor would need to provide detailed disclosure about its planned reform program and economic assumptions; a supermajority vote of creditors would be required to effect a debt restructuring agreement; and to keep the debtor's feet to the fire in carrying out promised reforms after the restructuring, IMF oversight and lending conditionality would usually apply, otherwise court-monitored debt relief conditionality could take its place.

The system adds no value — there is no enforcement mechanism to compel a wayward government to follow directions of the court, and there is nothing to stop a government from defaulting instead of entering into the mechanism. The proposed regime cannot prevent these outcomes, but it would strongly raise the reputational ante on government officials choosing these routes — a government would face a significant loss of credibility among both domestic and international stakeholders if it were to choose a disorderly path when an orderly procedure is available.

Why would you want to reopen old debates by seeking to instill a bankruptcy process through a change of laws? Hasn't it been proven that it is much more efficient to put restructuring mechanisms directly into bond contracts as has been done with CACs? Bond contracts work well for simple, clear procedures, such as aggregated voting, as the process can be described in a few lines; but they are not a natural place to describe a complex multifaceted process, such as a bankruptcy regime that grants discretionary powers to a third party and which needs to cover a wide range of contingencies.

For the avoidance of doubt, for an individual bond to be subject to the SDRM two things need to happen: first, the host country needs to enact the relevant laws, and then the debtor needs to "check the box" to bind-in the mechanism by specifying that its bond documentation will be governed by the law of the host country.

Possible General and Technical Concerns

It will take over a decade for outstanding stocks of long-term bonds to mature and be refinanced in the new format — shouldn't legal mechanisms be used to impose SDRM on existing bonds? There are two issues to address here. First, it will not necessarily take a decade for a given government to move its bonds into the SDRM. A government could choose to issue new bonds in the SDRM regime as soon as the legal system is in place, and, provided that goes well, existing stocks of debt could be moved from their existing format into the new format via an exchange offer or a vote of bondholders — albeit with some costs. Second, a legal mechanism to force the transition would go against the voluntary, market-based and gradualist character of the proposal; it's a virtue of the proposal that it would allow ample time for the fine-tuning of the bankruptcy procedures before it is expected to be widely used.

For the avoidance of doubt, bonds issued under legal systems other than the host country would not be affected when the host country sets up the SDRM. For example, if the Netherlands were to set up an SDRM, only bonds issued under the laws of this jurisdiction would be subject to the court process; bonds governed by the laws of other jurisdictions (such as New York or England) would be unaffected.

Let's say a host country has put in place the SDRM. How, then, do you treat bonds that are already documented under the law of the host country? Are they automatically eligible for the SDRM? This is a potentially contentious and complicated area. Automatic eligibility implies, in effect, that the transition to the SDRM regime requires a retroactive change of outstanding bond contracts, which goes against rule-of-law principles and could be legally challenging in some jurisdictions. But it need not be a big problem; for example, there will be no transition issue if the law of the host country (state or province) is not currently used to document any (or only a small number of) international sovereign bonds. Now, if one of the leading jurisdictions of international bond issuances wishes to set up an SDRM, things will be more complicated. But, where there is a will there should be a way — for example, some combination of legal means and voluntary procedures might allow debtors to opt in or out of the system with the agreement of creditors to mitigate legal risks and creditor concerns.

How would you identify qualified judges? What principles would guide the court? Would appeals be allowed? Much work remains to be done in these areas. Studying Chapter 9 of the US bankruptcy code used to resolve municipal defaults in the United States might be a good place to start (Clement and Black 2014). In any case, the approach to answering these questions would be specific to the host country's legal system.

Why base the mechanism on a single country's court system rather than a neutral multilateral organization? Creditors and/or debtors should prefer the familiarity of working within a known legal system in a process overseen by judges experienced in resolving commercial disputes. Investors would worry that a system run by an international organization may be debtor-biased and/or lead to unpredictable outcomes. In terms of complexity, using an existing court system with the power to enforce its own actions, such as litigation stays, seems a whole lot simpler than a two-step procedure in which an international organization makes determinations that then need to be enforced in one or more jurisdictions under whose laws the bonds are documented.

What if the IMF and the court differ on how a particular sovereign bankruptcy should be handled? The system is designed to facilitate direct debtor-creditor agreement on the terms of a restructuring. The task of the debtor, with the support of the IMF, would be to convince the required majority of creditors of the fairness and benefits of the proposed restructuring. The IMF would have no special powers to dictate outcomes. The judge's primary role would be to facilitate orderly discussions, although the court would have sanctioning powers that could be used to nudge the parties toward an agreement.

Why is it fair to always pay investors contractual interest during the SDRM? What if, just prior to default, the debtor issues a bond at a very high coupon? The system should be designed to usually require payment of contractual interest rates, but should also provide ways to equalize payment to creditors or amend the terms of specific facilities when necessary, to assure inter-creditor fairness. Abusive pre-petition financing agreements should be subject to revision.

The proposal includes the possibility of offering reprofiling-style, time-ordered consideration to creditors. A credible bankruptcy system is based on recognizing par claims in order to treat all creditors on an even-handed basis, so why bring this up here? Reprofiling of bond maturities was proven in various transactions, including Uruguay's highly successful 2003 exchange offer, to be a very powerful solution when a sovereign debtor faces a liquidity crisis instead of a solvency crisis. Reprofiling should be part of the tool kit, although perhaps subject to class voting by maturity buckets to assure inter-creditor fairness when departing from par-based consideration.

Given CACs provide an effective legal mechanism to implement debt restructurings, shouldn't policy makers focus instead on low-cost solutions for helping debtors and creditors come to agreements such as codes of conduct and sovereign debt forums? These soft-skill approaches address some of the human and institutional elements of resolving crises — they get people together more quickly and should help assure a well-mannered and principled dialogue of the issues at hand. But when vast sums of money are at stake, it would be prudent to have hard tools on standby in case the soft approaches fail to get the job done.

The discussion of incentives is incomplete — what about disincentives that may cause debtors or creditors to reject the system? Admittedly, the discussion is limited in this area. But the idea is to use the paper to gather reactions from debtors and creditors before presenting a more definitive analysis. Call the proposed structure a trial balloon or a straw man. To be sure, in the area of sovereign financing, inertia will be the biggest disincentive to advancement.

Would debtors and creditors really trust the mechanism enough for an efficient market to develop in the new SDRM bonds? If the mechanism would help lead to more orderly outcomes, if it balances the interests of debtors and creditors, if it is developed in a broadly consultative process and if it is simple enough for people to understand, it should gain adherents. To be sure, building trust would take time. Some countries are likely to be early adopters and help create an initial market in the new SDRM bonds. Long-term growth of the market for SDRM bonds, however, would depend on the mechanism working well in resolving a number of defaults.

Wouldn't introducing a new class of bonds that are subject to the SDRM unhelpfully fragment global markets? No. The proposal, if implemented, would not change or fragment international bond markets. The only material change in bonds would be the line in the bond documentation specifying the governing law, and that would only be relevant in the case of a default; bonds would continue to be issued in all the same currencies and markets. The governing law and the market of issuance and trading are separable items — for example, there are already quite a few cases where US dollar bonds are sold in global markets governed by English law.

Given the global character of sovereign bond markets, is it realistic to say that the single host country approach avoids the need for complex international agreements? International complexities may be minimized, but cannot be fully eliminated in the proposed approach. While ring-fencing legal relationships (the court, bond contracts, trustees, the clearing system entry point and bond custodians) in a single jurisdiction could minimize the risk of disruptive litigation, there will always be the potential for the attachment of non-immune assets in foreign jurisdictions. The conventional approach to prevent this outcome is for a country to seek international recognition of the authority of its bankruptcy laws, but in the absence of specific rules there is still the possibility that foreign courts would pay deference to the rulings of the host country courts — a principal known as comity. Much more legal analysis would need to be done in this area, but the general conclusion is that international cooperation in this area would be important.

Some model law approaches and the IMF's 2003 proposal are selective on the use of litigation stays (and associated payment standstills), so why are these included in this proposal? The elimination of expensive, embarrassing and unpredictable litigation is a central concern of debtors. Therefore, litigation stays should be part of the system. The typical reason they may be left out is that the granting of a stay on legal actions by an international organization may be challenged when enforcement is sought in relevant jurisdictions. The single host country approach should not have this problem.

Does this approach mean that G7 approval is no longer needed to implement SDRM, as a single host country could go it alone? No. While a single country could technically put in place the relevant laws for an SDRM on its own, it is unlikely to do so without constructive support from the G7 and G20; leading countries generally take a consensual approach to decision making in this area, and the host country will take a high risk that the mechanism will fail to gain adherents if born of dissension. There is also the issue of international recognition mentioned above. With this said, the single host country approach could make it easier for proponents to gain support for an SDRM because it asks policy makers a fundamentally different question: the IMF's 2003 proposal asked leading countries if they would be willing to change their bankruptcy laws all at the same time to support implementation of a global SDRM, while this proposal asks countries whether they object if one of the G7 or G20 members goes ahead and sets up a mechanism on its own turf; the IMF's 2003 proposal asked policy makers for approval to change all the world's sovereign bond markets in one fell swoop, while this proposal asks policy makers, in effect, to approve a beta test of the resolution mechanism among a subset of debtors and creditors who voluntarily agree to be subject to its terms.

DISCUSSION

Restructuring debt contracts is never an easy topic. It is tricky to get the balance between debtors and creditors just right; a successful scheme needs to allow reasonable ease to restructure the debts of troubled countries, while not being so easy it increases the cost of funding to debtors in good standing. Market-based solutions have been shown to work fairly well; CACs have shown an ability to evolve over time, and debtors continue to enjoy very favourable funding costs. But the recent Greek and Argentine debt situations underline the need for continued focus on creative ways to improve the way sovereign debt restructurings are handled.

This paper proposes that a single host country puts in place an SDRM. Set-up and operation would be much simpler than a multilateral approach. It should have greater appeal given its voluntary format: no debtor would be forced to use it and no creditor would be forced to buy the bonds. And it should not be feared as a major change of the balance between debtors and creditors, as restructuring agreements will, like CACs, rely on an affirmative vote of a supermajority of creditors. A characteristic feature of the proposal is that debtors will be asked to continue paying interest to creditors during negotiations (to the extent possible) to avoid disrupting markets as well as the debtor's economy. Finally, the proposal includes a symmetrical sanctioning regime in which the debtor risks the termination of the SDRM, the loss of legal protections and possibly a larger cash flow burden if it is uncooperative, while creditors risk the reduction of interest payments to them if they are uncooperative.

The spirit of the approach resembles a number of past proposals. It follows the current model law and UNCTAD approaches in aiming for incremental implementation. It resembles the "resolvency" regime promoted by Christophe G. Paulus and Ignacio Tirado (2013), as it provides a centralized framework to resolve covered debt. It accepts Charles W. Mooney, Jr.'s (2015) suggestion to "keep it simple, stupid." It is a kindred spirit to the Lerrick-Meltzer (2001) proposal: it uses stabilizing markets as a central objective. It has some similarities to a proposal from Patrick Bolton and David A. Skeel (2004) by relying on the court systems of advanced countries and allowing reprofiling-type solutions. And, as noted above, this proposal could be categorized as one specific way of operationalizing a "model law" approach.

Should a country (or state or province) seek to put in place the proposed SDRM, its success will rely on debtors being willing to use it and creditors being willing to buy the bonds. It should be easy to find the debtors given the support shown at the United Nations for the recent resolution. The crux of the matter will be to find creditors willing to buy the bonds at a reasonable price — and that would depend on designing a system that balances the interests of debtors and creditors.

The SDRM has been an enticing idea for almost 100 years, but it has failed to gain traction as a policy prescription. The history of the last decade saw it lose out twice to CACs, which have enjoyed rapid uptake in the markets. The convergence of CACs toward the SDRM through the recent incorporation of aggregated multi-series voting makes it an even tougher competitor. These observations suggest that if the SDRM wants to become relevant, it needs to co-opt features from the market-based approach. This paper shows one way to do it.

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