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Sovereign Debt Restructuring
Good Faith or Self-Interest?

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Acronyms and Abbreviations

AIP	approval in principle
CACs	collective action clauses
DIP	debtor-in-possession
DSA	debt sustainability analysis
EAP	exceptional access policy
ECB	European Central Bank
ESM	European Stability Mechanism
IIF	Institute for International Finance
ILLR	international lender of last resort
IMF	International Monetary Fund
LIA	lending into arrears
SDF	Sovereign Debt Forum
SDRM	Sovereign Debt Restructuring Mechanism

Executive Summary

Sovereign debt restructuring has long featured on the international policy agenda. This paper reviews past efforts to improve the framework for the timely, orderly resolution of cases of sovereign debt distress; it notes that important progress has been achieved toward that goal through the development of a so-called "voluntary" approach. The paper is motivated, however, by concerns that this progress is threatened by several recent difficult cases that could set the precedent for the future.

The problem these cases highlight is a fundamental tension between the good faith needed to secure more timely, less disruptive restructurings and the self-interest of creditors and borrowers. At the national level, this tension is managed by bankruptcy regimes that provide a legal framework for voluntary settlements made in the "shadow of the courthouse." The threat of a court-imposed restructuring acceptable to most — but not necessarily all — creditors aligns incentives for good faith in the pursuit of self-interest.

No such legal framework exists at the international level. The International Monetary Fund (IMF) has therefore attempted to fill the legal lacunae, consistent with its mandate to facilitate a felicitous balance between financing and adjustment for its members. In the wake of recent difficult cases, international attention is once again focused on the IMF's role in sovereign debt restructuring; in particular, how best to facilitate creditor-borrower engagement in debt restructuring negotiations.

This paper seeks to contribute modestly to the debate. Its review of past practice is, admittedly, unsatisfying: there is no simple, foolproof means by which to reconcile the need for good faith with the pursuit of self-interest. Nevertheless, the conclusion that the paper draws out is stark. Creditors seeking to impose prescriptive standards for borrower good faith, either through the adoption of creditor engagement clauses or limitations on borrowers' access to IMF resources, may have to accept some limitations on contract enforcement as quid pro quo. It makes little sense to enforce standards of good behaviour on borrowers in an environment in which a small subset of creditors can disrupt a restructuring that is broadly acceptable to most creditors in an attempt to extract rents from non-cooperation. Later versions of the Sovereign Debt Restructuring Mechanism (SDRM) proposed by the IMF provided such a trade-off.

At the same time, any review of creditor-borrower engagement should consider the question of IMF lending. After all, the size of IMF assistance and the conditions under which members access Fund resources can influence incentives of both creditors and borrowers. A key factor driving development of the SDRM was the official sector's dissatisfaction with the choice between bailout and sovereign bankruptcy, which could generate large negative effects to creditors and borrowers as well as to the global economy.

The implication of these observations is potentially controversial. If private creditors want good faith from sovereign borrowers, they may have to accept limitations on self-interest. In other words, they may want to reconsider the case for the SDRM.

Introduction

> Sovereign debt is restructured in multiple *fora*, loosely linked through financing conditionality and informal undertakings, such as the promise of comparability. Short of blowing up the entire restructuring, there is no way for one group of creditors to ensure that another participates in burden-sharing, and is treated equitably relative to the rest. The legal regimes governing different categories of debt are very different, spanning the national laws of many sovereign states, public international law, the charters of international organizations and the domestic law of the borrowers.
>
> — Anna Gelpern (2013a, 1106-107)

Gelpern's pithy assessment of the challenges involved in restructuring sovereign debt accounts for her conclusion that "the existing system for restructuring sovereign debt is deeply dysfunctional and produces bad law" (Gelpern ibid., 1097-98). It is unclear if she refers here to the legal maxim "hard cases make bad law," by which jurists explain that extreme cases are a poor basis for making general rules. However, as her article cited above reflects on the — then unresolved — legal quagmire between Argentina and its holdout creditors before New York courts, the reference is appropriate even if unintentional.

In many ways, the Argentine debt debacle represents an extreme case. Following its 2001 default, Argentina completed a debt exchange in 2005 that restructured three-quarters of total outstanding private claims. A later exchange in 2010 raised that figure to over 90 percent of claims. Nevertheless, a small subset of holdout bondholders initiated legal action in the Second District Court of New York, claiming that Argentina had violated a clause entitling them to treatment *pari passu* with other creditors. Because many of these investors bought up bonds at deeply discounted prices after the initial default, they stood to profit handsomely even if they merely succeeded in securing the same terms that other bondholders had accepted, not to mention the original contractual terms, an outcome the Argentine authorities adamantly refused to consider, much less negotiate.

The presiding judge ruled in favour of the holdouts, but stayed enforcement of his ruling to give the government time to negotiate with its recalcitrant private creditors. In the end, a new government in Buenos Aires, one intent on regaining access to international capital markets, opted to settle with the creditors in early 2016, a decade after the launch of litigation and a full 15 years after the 2001 default. Regardless, the court's unique interpretation of *pari passu* and the ruling's potential to increase the bargaining power of holdout creditors led to concerns that it would become far more difficult to complete debt restructurings through voluntary debt exchanges going forward. Concerns remain that the court's ruling could have a chilling effect on future sovereign debt negotiations. The potential for "bad law" haunts debt restructurings, a pernicious legacy of an extreme case.

From the perspective of sound jurisprudence, bad law is clearly undesirable. But in the sovereign debt space, bad law can be detrimental to borrowers and their private creditors alike. This is because protracted negotiations that reflect the existing debt restructuring status quo may entail large costs to both sides, as investments that raise the debtor's debt-servicing capacity are cancelled and policy adjustments deferred. These effects can lead to a severe deterioration in economic prospects and trigger a dissipation of asset values harmful to creditors. In extreme cases, the public good of "order" is lost and governments embrace financial autarky and adopt beggar-thy-neighbour policies that in the words of article I of the IMF's Articles of Agreement are "injurious to national and international prosperity."

The IMF was created to prevent these effects, reflecting the sad experiences of the 1930s, when high debt burdens and dysfunctional monetary arrangements combined to propagate international economic stagnation. So, it is not surprising that the IMF has long played an important role in sovereign debt restructuring. The nature of its role has evolved over time, reflecting changes in the global economy. As its role has changed, IMF policies and procedures have had to adapt. With private capital flows that today dwarf the resources available to the official sector, the IMF's ability to assist its members in severe financial difficulties is strained. It must now use its limited financial resources to catalyze private sector lending to avert a liquidity crisis. When these efforts prove unsuccessful, or the member is in severe financial distress akin to sovereign insolvency, the IMF attempts to promote a timely, orderly restructuring of public and private claims.

The measures used by the IMF to achieve this goal are intended to facilitate and encourage effective creditor-debtor engagement. The objective, however, is to ensure that sovereign borrowers and their private sector lenders avoid protracted delays in restructuring that can lead to large output losses, the erosion of asset values and, ultimately, generate international financial instability. This can be a formidable challenge. In part, the challenge is that while the debtor and the creditors both share a common interest in avoiding this outcome, their bargaining is subject to information asymmetries that create incentives for dissembling and strategic behaviour (Haley 2017). But the IMF's role is made more challenging by the simple fact that while negotiations should ideally be conducted in good faith, both sides are driven by self-interest.

This distinction is important. "Good faith" negotiations are a critical condition of IMF engagement when sovereigns are in arrears to private sector creditors. The case of Argentina, which creates the potential for Gelpern's bad law, figures prominently since private creditors claim that techniques used by Argentine authorities to secure a high participation rate in its initial debt exchange constitute bad faith. These legal manoeuvres were cited by the holdout investors in their pleadings before the New York court. In ruling for the holdout creditors while staying enforcement, the presiding judge may have been hoping to oversee a judge-mediated settlement that would replicate the outcome of good faith negotiations — in effect filling the void created by the absence of a sovereign bankruptcy regime (Miller and Thomas 2007). In any event, with the extreme case of Argentina now resolved, the IMF is likely to revisit its policies and protocols for promoting effective debtor-creditor engagement.

This paper outlines the evolution of the IMF's approach to good faith negotiations in the context of lending into arrears (LIA), which is intended to strike a felicitous balance in bargaining power between sovereign debtors on the one hand and private creditors on the hand. In contrast to disinterested judges in domestic bankruptcy proceedings, the IMF may also be a major creditor, having provided financial assistance before the suspension of payments in the hope of preventing a crisis or the equivalent of debtor-in-possession (DIP) financing after a default. Such lending can affect relative bargaining power in restructuring negotiations. As such, it raises serious issues of transparency and fairness in the restructuring process. These concerns are particularly acute when other official creditors are also major creditors. The paper explores how these issues come together in the "hard" cases of Argentina, Greece and Ukraine, which are likely to affect the modalities of Fund engagement in the resolution of future debt crises.

The results of this discussion are, admittedly, unsatisfying — there is no simple, foolproof formula to reconciling good faith and self-interest. That said, two conclusions stand out. First, creditors who seek stronger good faith provisions for sovereign borrowers, either through the adoption of creditor engagement clauses or restrictions on access to IMF resources, may have to accept some limits on contractual enforcement. As discussed more fully below, this trade-off reflects the inherent tensions between good faith and the self-interest of the parties.

How this quid pro quo should be achieved is debatable: it may occur through a "hard" statutory (or treaty-based) approach or through "soft law" embodied in restructuring practices and conventions. Earlier attempts to introduce a formal legal framework for restructuring sovereign debt failed owing to a lack of political support. The necessary support probably remains elusive. But the case of Argentina illustrates the challenges of the current contractual approach in that a small group of creditors successfully blocked a final resolution and exit from default, even after a sizeable supermajority of creditors accepted the terms of restructuring (albeit under protest over the use of aggressive tactics by the borrower). Private creditors are likely to balk at formal statutory measures to restrict their contractual rights. However, continuation of the current ad hoc approach to sovereign debt restructuring implies attendant uncertainties for debtors and creditors alike, which recent hard cases have elevated. While creditors may deem this uncertainty to be an acceptable trade-off, it is unclear if this outcome is consistent with good public policy, especially the IMF's fundamental mandate to promote a judicious balance between financing and adjustment.

The second conclusion that follows from this review of debt restructuring practice is that past IMF involvement in sovereign debt negotiations can be viewed as promoting soft law to facilitate the timely, orderly resolution of debt crises. In the wake of recent hard cases, these efforts to fill lacunae in the legal structure for sovereign bankruptcy should continue. In this context, it is unclear if it is meaningful to discuss creditor engagement without considering the potential role of access to IMF financing (or official sector resources more broadly). Access to such financing has the potential to distort incentives of borrowers and creditors alike to seek and to engage in good faith negotiations to resolve debt problems. The recent case of Greece has likely put access limits back on the international agenda.

The next section of the paper reviews the evolution of IMF engagement in debt restructuring and the tools used by the IMF to put members on a sustainable trajectory while minimizing losses to creditors and potential disruption to the international financial system. In the third section, the key factors behind the IMF's engagement with sovereign debtors and their creditors are considered. To advance its objective, the IMF must maintain a delicate balance of bargaining power. In a sense, the challenge facing the IMF is to design a system that incentivizes good faith, recognizing that in the bargaining game between debtors and their private creditors, both sides are motivated by self-interest. The fourth section examines the challenges arising from the difficulty of reconciling good faith with self-interest and presents possible policy proposals to promote effective creditor-borrower engagement and facilitate timely, orderly sovereign debt restructuring, thereby reducing the impact of possible bad law. The fifth section concludes the paper with reflections on the likely impact of the hard cases represented by Argentina and, more recently, Greece and Ukraine. These cases will continue to pose significant challenges to the IMF.

The IMF's Evolving Role in Debt Restructuring

For much of its first 50 years, the IMF facilitated balance-of-payments equilibrium and exchange rate stability by promoting a judicious trade-off between financing and adjustment. The ubiquity of capital controls and the dominance of bilateral official financing enhanced its ability to pursue this objective. By providing access to short-term balance-of-payments support, the IMF encouraged its members facing balance-of-payments difficulties to undertake domestic policy adjustments needed to close balance-of-payments gaps and avoid large exchange rate changes.[1] Typically, policy adjustments focused on fiscal consolidation, leading to the doggerel that IMF stands for "it's mostly fiscal." In any case, the combination of limited financing and domestic policy adjustments secured the restructuring of bilateral official claims, which took the form of rescheduling maturities.[2]

For the past quarter century, however, the ability of the IMF to assist its members to strike a felicitous balance between financing and adjustment has been strained by private capital flows that dwarf the resources of the official sector. In some respects, the IMF has had to assist in capital account crises using the tools it employed to resolve current account problems in the halcyon days when capital controls were in general use. The IMF's task today is far more complex because of private capital flows. In effect, the Fund must use its limited financial resources to catalyze private capital flows to stave off a crisis, or use the instruments available to it to promote timely, orderly restructuring of private claims when its crisis prevention efforts prove insufficient.

Experience has shown that restructuring private claims of sovereign borrowers can be a lengthy and costly process in which losses accrue on both sides. Such deadweight losses increase the risk that countries in severe payments difficulties may adopt policies detrimental to the global economy. Efforts have therefore been made to foster timely, efficient bargaining between the sovereign borrower and its private sector creditors. The official sector has traditionally exhorted both sides to come to a speedy resolution of payments problems, citing the corrosive effects of uncertainty generated by protracted payments disruption and the possibility of contagion as justification.

Beyond the use of moral suasion, the official sector also directly affects key parameters of the bargaining process through the treatment of official bilateral debt. This reflects a common pool problem. At any point in time, there is a quantum of resources available to service outstanding claims, but the more resources allocated to service official sector claims, the fewer are available to meet private sector claims.[3] There is an incentive for official sector creditors to "over harvest" the pool of available resources, leaving insufficient resources to service private claims. However satisfying this may be for official creditors in a one-shot context, this approach would prove harmful in a dynamic setting given that it would likely undermine private lending to sovereign borrowers. At any rate, this adding-up constraint may lead readers to think that the debt restructuring process is straightforward, an agreement among official lenders, followed by an equitable distribution of the residual among private creditors.

Paris Club Rescheduling

1 While the Bretton Woods system was not specifically designed to support irrevocably fixed exchange rates, the experience of the 1930s, during which large exchange rate movements were thought to be destabilizing and the source of protectionist trade measures, strongly influenced its operation. Modest adjustments to exchange rate parities of up to 10 percent were permitted without reference to the IMF. Larger adjustments to correct cases of "fundamental disequilibrium" in a member's balance of payments required IMF approval. In practice, however, exchange rates became ossified as governments viewed stability as an important indicator of credibility.

2 Such operations provided short-term liquidity relief, but did not necessarily address cases of more fundamental balance-of-payments problems involving sovereign insolvency. Official rescheduling frequently took on a serial nature, with distressed borrowers repeatedly seeking relief from their official creditors.

3 The problem arises because weak contract enforcement of sovereign debt implies that the various creditors do not have well-defined property rights over the stream of resources available to service claims. At the national level, bankruptcy courts adjudicate conflicting claims over such resources.

In theory, the debt restructuring process is straightforward. For the past 60 years, official bilateral debt has been restructured following established principles and subject to consensus in the Paris Club, so-called because it is hosted by the French Trésor in Paris.[4] Once a restructuring has been arranged, the terms of the agreement form the basis for discussions with private sector creditors. In fact, under the principle of comparability of treatment, the sovereign debtor is barred from providing private creditors treatment more favourable than the Paris Club terms. As such, it can be a powerful mechanism for promoting timely, orderly debt restructurings. In practice, several factors make the process considerably more complex.

Getting agreement among official sector creditors can be difficult. Political considerations may be brought to bear, particularly if a country is following heterodox policies contrary to the shared interests of the international community. Such considerations can result in delays as official creditors refuse to consider or delay consideration of a request for restructuring. Moreover, official creditors can have widely different claims on a sovereign in distress. The principles of inter-creditor equity and comparability of treatment can help identify a proposed treatment consistent with Paris Club principles. But applying these concepts can be difficult because of the bespoke nature of some claims, which may have been taken on for opaque political reasons. The opacity and unique terms of such debt may create incentives for side deals between the borrower and a specific official creditor.

This is where the requirement that a sovereign debtor needs to have an IMF agreement before a Paris Club restructuring comes in. The Fund helps assuage the common agency problem, or potential coordination failure, that might otherwise hold up a restructuring. The IMF program ensures that all creditors have access to the same information and the same analysis with respect to the debtor's capacity to repay. Traditionally, the Fund has provided leadership in the process of sovereign debt restructuring by determining the size of the resource envelope from which private claims are serviced.[5] Once the IMF has determined the level of debt service that the sovereign borrower can reasonably make consistent with the objective of balancing financing and adjustment, official creditors are bound together. Preferential treatment to one would require a disproportionate burden being placed on the others (or, in the post-capital-controls world, private creditors). That outcome is ruled out by comparability of treatment and inter-creditor equity.[6]

At the same time, the IMF plays a unique role in the process in that it conditions access to its resources on policy actions of the sovereign, which influence the size of the pool of resources available for debt service, provides incentives for creditors and debtors to restructure, and exerts a senior claim on debt-service. But for the IMF to play an effective role in coordinating the restructuring process, it must be a leader in the negotiation process. In this respect, delays in negotiating and implementing IMF programs can impede sovereign debt restructuring (Dooley 2000).

Inter-creditor Coordination

Yet, even after agreement is reached with the Paris Club, there are two distinct problems to overcome: inter-creditor coordination and the bargaining process itself. The first of these problems refers to the difficulties of organizing different private creditor groups — which hold instruments of different maturity, return structure, currency of denomination and laws of the jurisdictions in which they were issued — into a cohesive decision-making body. The bargaining problem refers to

4 Originally, the Paris Club only permitted the rescheduling of debt to extend the maturity to relieve temporary liquidity problems, but keeping the net present value of the debt constant. Restructurings terms have evolved over time, however, to include debt relief in recognition that there may be cases in which a debt overhang distorts incentives for investment or beneficial adjustment.

5 The critical role of the IMF in the process underscores the importance of the Fund's perceived legitimacy, credibility and effectiveness: if the IMF is viewed as too responsive to the interests of creditor countries, members in severe distress will seek other options (for example, non-Paris Club creditors); if it is viewed as overly sympathetic to the needs of debtor countries, private creditors will be loath to accept its debt sustainability analysis (DSA), complicating the restructuring process.

6 These norms are important for reasons of efficiency and participation. Efficiency requires that claims of comparable risk characteristics receive comparable returns, while borrowers should be prevented from discriminating against some creditors (or favouring others); otherwise, creditors would be reluctant to participate in a process that is perceived to be manifestly unfair. But as some observers have noted, the rise of non-Paris Club creditors may undermine the principle (Gelpern 2016). Ousmène Jacques Mandeng (2004) documents violations of the principle of inter-creditor equity and suggests that the lack of clear guidelines for the distribution of resources among creditors may delay the restructuring process.

the challenge of securing agreement between the sovereign borrower and its private sector creditors.[7]

The inter-creditor coordination problem derives from the "public good" nature of debt relief. If a creditor provides debt relief, the market value of remaining creditors increases. This creates an incentive for creditors to free ride on the adjustment efforts of others. In the sovereign debt crisis of the 1980s, bank advisory committees, typically led by the largest bank in each geographic region, were organized to corral smaller banks with less exposure, and thus were more susceptible to the temptation to free ride on the adjustment efforts of others. When moral suasion proved insufficient, incentives to induce participation in restructuring agreements were improvised. These incentives included threats to exclude free riders from future syndications, terminate correspondent banking facilities and cut interbank lines.

The change from intermediated sovereign lending to bonded debt that followed the debt crisis of the 1980s raised new concerns. Most troubling was the fear that atomistic heterogeneous investors would prove far more difficult to organize into a cohesive creditor mass capable of making decisions. This could lead to opportunistic behaviour on the part of a few creditors that mean to block a restructuring to extract higher payouts. Such concerns were fuelled by perceived problems of holdout investors and litigious creditors. The problem is that the threat of litigation by holdout creditors can impede restructuring negotiations; any individual creditor has an incentive to wait until others restructure, increasing the expected returns to holding out and litigating. But other creditors, recognizing the potential for litigation, will be reluctant to restructure. This is because doing so may increase the probability that holdout investors will receive better treatment in violation of the principle of inter-creditor equity.[8] This is the sovereign lending analogy of the race by creditors to grab corporate assets.

At the domestic level, bankruptcy regimes have been developed to deal with the challenges of inter-creditor coordination. Patrick Bolton (2003) identifies three common principles and three common elements in bankruptcy regimes around the globe. The first principle is the need to preserve asset values while creditors' claims are assessed. This is addressed by a court-enforced stay on debt payments or litigation while the bankruptcy court is considering a request for reorganization or liquidation. Enforcement of priorities, in particular with respect to lending after the firm has sought protection from the courts, is the second principle. This condition is critical for efficiency reasons, since it preserves the bonding role of debt and supports debt markets. While it would be inequitable for creditors holding identical claims to be treated differently, it would be equally unjust for senior creditors to be treated identically with junior creditors. Moreover, DIP financing supports asset values generally, as it allows for the valuation of the firm as an ongoing concern. The third principle of bankruptcy frameworks is the discharge of debts subject to the agreement of a supermajority of creditors, with the result binding on dissenting creditors.

There is no comparable counterpart to domestic bankruptcy frameworks at the international level. Nevertheless, efforts to improve the process for sovereign debt restructuring have been motivated by these principles. Jonathon Thomas (2004) identifies three key characteristics of domestic bankruptcy frameworks. First, they resolve collective action problems that can arise as creditors grab assets (for example, in a race for the exits or failure to extend new credits or roll over existing short-term debt) and adopt a holding out strategy, blocking a restructuring beneficial to most creditors to extract rents. Second, they provide a fresh start to an insolvent debtor through the

7 Haley (2017) reviews the bargaining problem and the possible use of guarantees on debt that is to be restructured to assuage information asymmetry and other obstacles to the timely, efficient resolution of restructuring negotiations.

8 The potential role of holdout creditors in enforcing the bonding role of debt must also be weighed against this inefficiency. For example, Jill Fisch and Caroline Gentile (2004) note that while holdout investors may present a risk of interference with the restructuring process, holdouts also provide a valuable function in this process since they serve as a check on opportunistic defaults and unreasonable restructuring terms. By litigating to enforce sovereign debt obligations, holdouts increase the investment value of such debt as an asset class.

Table 1: Common Principles and Elements of Bankruptcy Frameworks

Common Principles	Common Elements
Address a "common pool" or "race to the courthouse" problem arising when multiple creditors have conflicting claims on a distressed firm's assets.	A stay on part or all debt payments and collection actions to prevent a run on a firm's assets.
Enforce "absolute priority." Claimants with a secured interest or higher priority are paid first, with lower-ranked claimants receiving the residual value of the reorganized or liquidated firm.	Some form of DIP financing to preserve the going-concern value of the firm.
Cancel or discharge of debts following liquidation to allow for a fresh start.	A debt restructuring agreement approved by some form of majority voting among creditors in different classes that is generally binding on the dissenting minority.

Source: Bolton (2003).

discharge of unsettled claims.[9] Third, bankruptcy regimes contain a potential moral hazard. This problem can arise when *ex ante* commitments not to bail out creditors — often used to encourage the market discipline required for efficient risk bearing — may become prohibitively costly and thus, incredible, *ex post*. Legal frameworks that reduce such costs address time inconsistency problems, allowing for more efficient outcomes.[10]

The perceived importance of these elements with respect to sovereign debt has changed over time, and the IMF's efforts to improve the framework for the timely, orderly restructuring of sovereign debt have reflected these changes. Historically, the threat from creditor races and litigation was judged to be modest. Sovereign borrowers were largely immune to litigation and could enforce a standstill on creditor runs through the exercise of *force majeure*. This immunity has been degraded over time through legislation and practice, although recent cases may auger an upswing in the use of litigation.[11]

In the wake of the Asian financial crisis, the primary concern was to unify a disparate group of heterogeneous creditors into a cohesive group to minimize the collective action problems noted above; in particular, the incentive that individual creditors have to free ride on the willingness of other creditors to restructure their claims. Efforts to address these problems have a long pedigree, extending back to the debt problems of the 1930s (Rogoff and Zettelmeyer 2002). They were revived after the Mexican peso crisis

9 There is an important efficiency objective behind debt discharge in that it allows a firm exiting bankruptcy to invest by dispelling the cloud of uncertainty regarding possible claims hanging over future revenue streams. In the sovereign context, this is analogous to a debt overhang that distorts incentives for private investment and public adjustment efforts. While measures have been introduced to address the first two elements, less progress has been made in terms of provisions for a fresh start. Recent empirical work highlights the importance of debt relief and a clean start for highly-indebted sovereign borrowers. Carmen Reinhart and Christoph Trebesch (2014), drawing on three historical episodes of debt problems, conclude that decisive restructurings result in improved economic conditions in terms of growth, debt servicing burdens, debt sustainability and international capital market access. Rodrigo Mariscal et al. (2015) document serial restructurings, which may be evidence of the problems associated with inadequate debt relief: an overhang of debt that distorts incentives for investment and adjustment, with negative consequences for growth, which ultimately leads to additional debt-service difficulties. Meanwhile, Lorenzo Forni et al. (2016) conclude that, while growth generally declines in the aftermath of a sovereign debt restructuring, agreements that allow countries to exit a default spell (final restructuring) are associated with improving growth.

10 These considerations account for proposals for a pan-European mechanism for sovereign bankruptcy. See François Gianviti et al. (2010) and Lee Buchheit, Mitu Gulati and Ignacio Tirado (2013).

11 Gelpern (2013b, 133) notes: "Although the immunity shield is imperfect, it was good enough for decades to help deflect calls for sovereign bankruptcy. But it has also pushed holdouts to pursue odd theories to recover, while transactional lawyers (for reasons of their own) have preferred indirect ways of patching the fraying contract fabric."

(1994-1995) and gained additional momentum from the Asian financial crises that shortly followed. These efforts focused on two approaches.

The first approach reflected efforts to develop an international analogue to domestic bankruptcy frameworks. Because the legal basis for international bankruptcy was to be either enshrined in a stand-alone treaty or effected through a change in the IMF Articles of Agreement, this approach was quickly dubbed "statutory." The statutory approach reached its apotheosis in the development of a supranational bankruptcy regime, such as the SDRM proposed 15 years ago by then IMF First Deputy Managing Director Anna Krueger.

The SDRM proposal evolved in response to comments and criticisms from the official sector and private creditor groups. From an initial centralized model of international bankruptcy, in which the IMF's role was much like that of a disinterested bankruptcy judge, a later version vested considerable power in the hands of (a supermajority) of private creditors. Throughout the proposal's development, the underlying objective remained constant: to address the key principles underlying domestic bankruptcy frameworks. Notwithstanding strong support from several advanced economies, the SDRM failed to get backing from both the United States and many important emerging market economies and so it was put aside.[12]

The SDRM proposal was shelved in favour of a so-called "voluntary" approach based on the adoption of collective action clauses (CACs) in bond contracts that would facilitate the timely restructuring of sovereign debt. These clauses allow the amendment of key payment terms by a supermajority of creditors in contrast to the requirement of unanimous agreement that had become the practice under New York law. The use of CACs quickly became accepted market practice, and today these clauses represent standard contractual "boilerplate" in sovereign bond documentation. In part, CACs may have found widespread acceptance as an alternative to the SDRM.[13] Despite their rapid acceptance, however, initial versions of CACs suffered from a critical shortcoming. Because they applied to individual specific bond issues, creditor coordination problems can emerge when bond issues are aggregated in the context of a possible restructuring. Individual creditors are loath to agree to restructure their claims unless other creditors are likewise prepared to write down the value of their claims. In this respect, if an investor or group of investors acquires a blocking share of any one bond issue, they can impede the entire restructuring by refusing to accept a haircut on their claims. Recognition of this aggregation problem led to a "second generation" of CACs that aims to reduce the potential for this holdup problem by allowing supermajority voting across different bonds issues (Kahn and Makeoff 2015).[14]

Although second-generation CACs represent an important step forward, it is premature to declare the creditor coordination problem resolved. To begin, there is a stock-flow issue: while new bond issues may include second-generation CACs, a large stock of bonds without such provisions remains outstanding. The "legacy risk" posed by these older vintage bonds will depend on how New York court decisions are interpreted in future litigation (Hagan 2014). Moreover, CACs can be a double-edged sword: while they can reduce the expected returns from acting opportunistically, CACs can create an incentive to free ride on negotiation costs by preventing the use of discriminatory settlements to compensate bondholders that lead negotiations and bear a disproportionate share of such costs. These negotiation costs can be significant, difficult to verify and, therefore, often difficult to compensate directly through reimbursement of expenses (Pitchford and Wright 2012). At the same time, the closer to the supermajority required for a restructuring and

12 Sean Hagan (2005) discusses the evolution of the SDRM in detail. He argues that the official sector was prepared to consider a formal statutory process in the wake of the Argentine default given the economic dislocation to the sovereign and the deterioration in the value of creditors' claims. Brad Setser (2008), meanwhile, contends that the proposal progressed as far as it did largely for idiosyncratic reasons — then US Treasury Secretary Paul O'Neil's frustration with the lack of policy options for dealing with sovereigns in severe financial distress and his willingness to consider innovative approaches. Another factor was the overrepresentation of European members on the board of the IMF, most of whom supported the SDRM proposal. While the SDRM lacked the necessary support to proceed, legal scholars and practitioners continue to explore legal frameworks to reduce the costs of state insolvencies.

13 In effect, discussion of the SDRM created a space in which CACs were viewed by market participants and by some large emerging market issuers as an acceptable alternative to the more formal statutory approach. As one referee has noted, while it is impossible to prove the point, the introduction of the SDRM proposal created an incentive to adopt CACs.

14 Another possible contractual innovation proposed by some creditor groups is a clause requiring debtors to convene bondholder councils to facilitate information and ensure timely negotiation. Bondholder councils were a common feature of efforts to resolve protracted debt problems of the 1930s (Eichengreen and Portes 1990).

without some cram-down provision that binds dissenting creditors, the greater the incentive for a creditor or group of creditors to block the process through litigation. That is one lesson from the recent Argentine case. The conclusion that can be drawn is that CACs are at best an incomplete analogue for international bankruptcy.[15]

Bargaining Problems

Regardless of how the intra-creditor coordination problem is resolved, the fundamental bargaining problem remains. In this respect, even if the creditor coordination problem does not exist where the limit is only one creditor, there is no guarantee of an immediate restructuring, since both sides will seek to advance their interests at the other's expense. This pursuit of self-interest results in a negotiation game in which both sides have an incentive to dissemble and enhance their bargaining power.[16] So, where does this leave the Fund?

In a sense, the IMF has tried to fill the void created by the absence of a clear legal framework for international bankruptcy by creating a quasi-bankruptcy process that aims to resolve creditor co-ordination problems and facilitate the bargaining process.[17] The absence of a legal framework is critical: at the domestic level, bankruptcy courts guide voluntary negotiations conducted in the shadows of the courthouse. The failure of the SDRM proposal means that the IMF must use ad hoc methods. In effect, the Fund has encouraged efficient bargaining using the same basic set of policy instruments it has had since its inception. How it has used those instruments has changed, however, while the resulting system lacks the legal consistency of a formal bankruptcy regime. Moreover, recent extreme cases create the potential for bad law that might stymie future restructurings.

15 More generally, the argument that the voluntary or contractual approach is a substitute for a more formal bankruptcy framework may be based on a false dichotomy (Haley 2016). The two approaches are complementary in that a legal framework creates incentives to find voluntary solutions, while such resolutions reduce the need to utilize the formal system, which is costly to both sides of the dispute.

16 Haley (2017) reviews the bargaining in more depth, noting the unique features of sovereign debt contracts — incompleteness and weak enforcement — that can result in protracted disputes and deadweight losses.

17 Rachel Thrasher and Kevin Gallagher (2015) contend that international investment agreements, which have addressed some aspects of sovereign debt restructuring, could provide a more general legal framework for restructurings.

Balancing Negotiating Power in Sovereign Debt Restructuring

The IMF's efforts to help its members deal with payments difficulties include surveillance and lending, both of which have been a part of the Fund's tool kit since it was created more than 70 years ago. More recently, DSA, which seeks to assess a member's debt capacity, and IMF LIAs, under which the Fund lends to members with outstanding payments to private sector creditors, have been used to promote timely sovereign debt restructurings. The Fund uses these instruments to promote a balance of negotiating power to secure an equitable agreement that respects the bonding role of debt, promotes an early resumption of market access and avoids too onerous an adjustment burden on the debtor that could incite the adoption of policies harmful to the country and the international community more broadly. The way in which the Fund has used these tools to achieve a felicitous balance between financing and adjustment has not always been welcomed by its member countries or private creditors. These measures are discussed below in the sequence in which they are typically applied.

Surveillance

IMF surveillance over members' economic prospects and policies is critically important in the context of access to private capital markets. Lacking high-quality information and analysis of a country's economic situation, creditors may follow the market adage "buy on fact, sell on rumour." Such behaviour could introduce greater volatility in private capital flows and possibly exacerbate a country's financial difficulties if, for example, it transforms what would otherwise be a short-term liquidity problem into a solvency problem as the country, unable to secure stable financing, is forced to suspend or liquidate investment projects that would have raised debt-servicing capacity. These considerations explain the importance of improving information flows to bridge information asymmetries. Efforts in the wake of the Asian financial crisis to encourage the adoption of the special data dissemination standards are particularly noteworthy. These standards provide critical information on a range of variables that can reduce the risk of investor flight by reducing gaps in investors' knowledge.[18] If investors all have access to a common information set, there may be less of a temptation for any individual investor, fearing that other investors are better informed, to flee.

IMF surveillance is also critical in another respect. The Articles of Agreement dictate that IMF resources should only be extended to members in financial difficulty under adequate safeguards of their timely repayment. Fund management is enjoined against proposing, and the IMF executive board from approving, programs that fail this test. Effective surveillance over members' prospects and policies is therefore a critical element of the Fund's efforts.

Ex Ante Lending

The potential for liquidity problems to transform into problems of sovereign insolvency provides a strong justification for IMF lending. This is because the IMF can help assuage agency problems that would otherwise limit sovereign borrowers' access to private capital markets (Tirole 2002).[19] But this lending is not without potential problems. Stephen Morris and Hyun Song Shin (2003) demonstrate in the context of global games models that the window for catalytic lending by the IMF may be rather narrow.[20] IMF lending can have the desired effect if the country's fundamentals are quite poor, but not hopelessly so. Under such conditions, IMF lending is likely to encourage adjustment on the part of authorities, which in turn induces private creditors to roll over their claims. Where underlying fundamentals are significantly more unfavourable, however, IMF lending can serve as a strategic substitute for borrower adjustment and the rollover of private claims. These conditions create the potential for borrower moral hazard, in which access to financing leads distressed borrowers to the defer policy adjustments as governments "gamble for redemption."[21]

By the late 1990s, many in the official sector were concerned that the frequent use of exceptional access IMF programs for countries experiencing capital account crises threatened to propagate moral hazard and undermine market discipline. These concerns led to efforts to establish credible limits on the size of Fund programs and clear guidelines under which exceptional access would be deemed appropriate. In 2002, the Fund adopted an exceptional access policy (EAP) that required that a member's debt be sustainable with high probability before a request for exceptional access would be considered. If this condition was not met, the guidelines allowed for exceptional access if, and only if, accompanied by a restructuring sufficiently deep to restore sustainability with high probability.[22] In effect, the 2002 policy recognized that, to encourage the timely, voluntary restructuring of private claims, expectations of official sector financing had to be contained.

At the same time, the IMF's ability to influence members' policies so that their actions are consistent with the mitigation of creditor coordination and bargaining problems is key to the timely resolution of payments difficulties. When a member finds itself without access to private capital markets, the IMF exerts considerable influence on policy actions, including the rate of debt accumulation. Traditionally, this leverage reflected the convention that an IMF program is required by other official sector lenders (for example, international development banks) as a precondition for lending. But when a member has ample access to private capital flows, the IMF's

18 Sean Hagan (2005) notes that collective action problems may be especially acute in the pre-default stage.

19 This role is complementary to the Fund's role in addressing coordination problems among official creditors in the context of Paris Club restructurings (as discussed above).

20 The literature analyzing international financial crises and possible mechanisms to reduce the costs of sovereign debt restructuring is too voluminous to review here. Key contributions include: Corsetti, Guimaraes and Roubini (2003); Gai and Vause (2003); Haldane, Irwin and Saporta (2004); Irwin and Vines (2005); Kumar, Masson and Miller (2000); Miller and Zhang (2000); and Sachs (1995, 1999).

21 A related problem is the potential for the creditor moral hazard that can arise if private lenders are willing to finance highly distressed sovereign borrowers, regardless of the increased probability of default, secure in the knowledge that access to IMF resources will allow them to "exit" the country unscathed.

22 Other elements of the policy included requirements that the member is experiencing "exceptional balance of payments pressures on the capital account resulting in a need for financing that cannot be met within normal access limits," the program had a "reasonably strong prospect of success," and the member has "good prospects" of regaining access to private capital markets over the expected time in which Fund resources are outstanding (see IMF 2002). The policy was modified in 2010 in the case of Greece to allow exceptional access in circumstances of a "high risk of international systemic spillovers." IMF (2015) reviews the evolution of the exceptional access policy. Susan Schadler (2013) provides a detailed discussion of these issues.

leverage over a member's borrowing dissipates.[23] The problem with this scenario is that individual lenders may not internalize the effects of their lending on the debt-servicing capacity of the economy when assessing the risk of their specific loans. All borrowers acting in the same fashion could therefore create an externality in sovereign lending that results in over-indebtedness.

DSA

The potential for countries to become over-indebted explains the 2002 EAP requirement that debt be sustainable with a "high probability." The difficulty here is that debt burdens that are sustainable under one (optimistic) set of conditions may become onerous in the event of a negative shock or under another (less favourable) set of conditions. In that event, the country may be confronted with the difficult choice between default or draconian adjustment. Neither option is attractive. Default poses potential risks to the international financial system and is harmful to the country itself and other sovereign borrowers, which would be faced with higher borrowing costs or reduced access to capital markets. Excessive adjustment burdens, meanwhile, could undermine the domestic political and social consensus in favour of sound policies and result in the adoption of policies "injurious to national and international prosperity."

As noted above, the IMF was created to assist its members to strike a judicious balance between financing and adjustment to avoid negative outcomes. In this regard, the IMF has long experience with DSA in the context of Paris Club agreements, setting the parameters for reschedulings of official claims. But in a world in which the Fund must try to bring private creditors to the bargaining table with their sovereign borrowers, there is a greater need for transparency with respect to methodology and results. If the IMF is to resolve common agency problems in sovereign lending markets, it must communicate its DSA findings and the underlying assumptions.[24] Moreover, if it is to guide bargaining outcomes, this analysis must be credible with the sovereign borrower and its private sector creditors alike.

This is a difficult assignment. DSA based on overly optimistic assumptions may result in insufficient debt relief that is unlikely to restore growth (unless favourable productivity or terms of trade shocks intervene). Creditors would likely welcome the results of the analysis since the "haircut" or writedown in the value of their claims, required to restore sustainability and regain access to private markets, would be lower. However, such DSA could lead to subsequent debt problems and the phenomenon of serial restructurings associated with the catchphrase "too little, too late."

From the perspective of the borrower, an appropriate degree of debt relief should restore growth. But DSA that supports such outcomes are subject to potential criticism from creditors, who might argue *ex post* that the relief was too generous because of flawed analysis.[25] (These concerns are likely to be magnified if positive unanticipated shocks raise the country's output after the restructuring is completed.) After all, the fundamental concern of banks and bond fund managers is maximization of returns, consistent with self-interest and their fiduciary obligations.

The IMF, in contrast, must incorporate broader considerations, including the need to sustain broad political support for an appropriate level of adjustment effort. This may entail widening the net of potential stakeholders beyond private creditors to include, for example, the interests of domestic pensioners.[26] Such an approach may be required since the set of debt-service

23 As Stanley Fischer (2006) noted, "So long as a country is in an IMF program, the Fund has been able to exert some — though not necessarily a decisive — influence on the rate of government borrowing from the private sector. If the country has exited from an IMF program, it is left to market and internal fiscal discipline to control its rate of borrowing." The problem he identifies is that private capital markets can be fickle, and that a country faced with a surfeit of capital inflows one day may be confronted with a "sudden stop" the next.

24 Paul Bedford, Adrian Penalver and Chris Salmon (2005, 103) analyze seven sovereign debt restructuring cases, in six of which the IMF "provided market participants with at least partial information regarding DSA or made some form of public statement concerning the financial terms of the restructuring."

25 Similarly, it is possible that the IMF can skew incentives to restructure by lending in cases of pre-emptive restructuring: creditors may require default and the disruption that results as a signal of the seriousness of the sovereign borrower's payments difficulties. In this case, IMF lending may inadvertently delay restructuring.

26 At the domestic level, there is a legal basis for broadening the definition of stakeholders (for example, Chapter 9 of the US Bankruptcy Code does not permit the liquidation of a municipality or sale of its assets, as that would imperil the provision of local public goods). See Martin Guzman and Domenico Lombardi (2017) for a complete discussion of the need to incorporate broader political constraints with economic and financial constraints on debt service.

payments that might be possible from a purely economic or financial perspective may be wholly unsustainable when viewed through the lens of political feasibility. More generally, it can be argued that DSA should be robust to a range of adverse shocks rather than have debt sustainability rest precariously on a razor edge of favourable growth and interest rate assumptions consistent with a possible, but improbable, scenario (Haley 2017). Such an approach would, arguably, avoid the serial disappointment that has characterized IMF projections for Greece since 2010.[27]

Conceptually, the IMF can be viewed as a means by which incomplete sovereign debt contracts subject to agency problems are made more (not fully) state-contingent. In effect, the Fund uses its influence and policy instruments to facilitate timely, orderly restructurings that correspond to a borrower's (reduced) capacity to repay.[28] In this framework, there must be sufficient conditionality to increase the certainty that the restructured debt will be serviced as promised as the quid pro quo for creditors' willingness to accept reductions in the value of their claims. This militates for a very robust approach to DSA and the application of strong conditionality to ensure that needed policy adjustments are adopted. The question, though, is how can the IMF exercise leverage over a member that is in formal default or has suspended payments to its private creditors and thus has relaxed its external financial constraint?

LIAs

The answer to this question is through its lending decisions.[29] In the 1970s, IMF policy with respect to lending to a member already in arrears to private creditors was clear: arrears would be tolerated provided they were eliminated in the context of the Fund program. In other words, IMF resources were not to be used to evade payments discipline. The onset of the debt crisis in the 1980s led to a hardening of the Fund's position. The IMF refused to lend to members unless and until the debtor country had cleared its arrears with private creditors.[30] As the debt crisis of the 1980s dragged on, however, it become increasingly clear that this provision conferred enormous bargaining power on creditors since they could, in effect, reject any offer to restructure their claims that they deemed unacceptable, secure in the knowledge that their actions would elicit further adjustment efforts on the part of sovereign borrowers. By the end of the decade, with no growth in sight and growing populist pressures in many highly indebted countries, the need for change was clear. The Fund therefore revised its LIA policy in 1989 to allow it to lend to members with arrears to private creditors without a programmed reduction in the level of arrears. The key condition of the new policy was that the country negotiate in good faith with its creditors.

In a sense, LIA is analogous to DIP financing in the context of domestic bankruptcy legal frameworks. In this regard, it forms a key element of the Fund's quasi-international bankruptcy regime.[31] But there is a limit to how far this analogy can be pushed. The IMF faces a difficult dilemma: if it lends too little in the face of a serious deterioration in a member's financial situation, it risks forcing the country into default; if it lends more expansively, and the member nevertheless defaults, the Fund's large exposure potentially subordinates private creditors given its senior creditor status. This seniority is asserted on all IMF lending, not just LIA. In contrast, absolute priority in the domestic context is only accorded to DIP financing made after the firm has sought the protection of the courts. The effect of the IMF's preferred creditor status could undermine the institution's effectiveness as a provider of DIP financing, weaken the credibility of its DSA analysis and impair its role in assuaging agency problems. Private creditors were quick to point this out as a fundamental flaw of the SDRM proposal. In contrast to a disinterested

27 See IMF (2016) assessment of the Greek program for more details.

28 The distinction between willingness and ability to repay, while clear in theory, may be rather opaque in practice. That said, if it is a problem of willingness, the sovereign borrower is attempting to evade payments discipline and should not receive succor from the IMF.

29 Lee Buchheit and Rosa Lastra (2007) provide an authoritative discussion of the evolution of the IMF's LIAs policy. A critical insight of their analysis is the relationship between LIA and the requirement that the Fund provide resources only under adequate safeguards.

30 The concern was that IMF resources might be used to reduce commercial bank exposures, bailing out private creditors and replacing private debt with official sector debt, leaving the IMF as one more creditor with claims against highly indebted sovereign borrowers and lacking adequate safeguards for Fund resources.

31 Structural adjustment under IMF-supported programs can likewise be thought of as the counterpart to corporate reorganizations designed to improve profitability and restore value to creditors' claims under domestic bankruptcy protection (for example, Chapter 11 of the US bankruptcy code or similar provisions in other national jurisdictions). In both cases, the objective is to increase the stream of resources available to service debts and investment purposes, raising the value of claims and restoring finances to a sustainable footing.

bankruptcy judge, they argued, the IMF had a vested interest in the outcome of its DSA, which define the parameters for debt restructurings.

The case of Greece illustrates the point. Rather than represent *de minimus* claims on the sovereign's debt-service envelope consistent with a catalytic role in mobilizing private lending and a return to market access on normal terms, the size of official sector lending (IMF, European Central Bank [ECB] and European Stability Mechanism [ESM]) poses a threat of subordination of private claims that is only partially assuaged by the ECB's disavowal of senior status.[32] Sven Steinkamp and Frank Westermann (2013) document a close relationship between an increase in senior lending and the interest rates of countries in crisis. The result is the unintended consequence that official sector interventions aimed at stabilizing interest rates may have the opposite effect, as private creditors are pushed into a junior position.[33]

Despite these limitations, the IMF LIA represents an important instrument by which the Fund can affect the balance of bargaining power between creditors and sovereign borrowers. It has evolved in response to changes in sovereign lending practices and specific cases (Buchheit and Lastra 207). These changes include: broadening the policy's coverage from bank debt to bonds and other claims as well as arrears incurred from the imposition of capital controls on a case-by-case basis; requiring the member to be pursuing appropriate policies and making good faith efforts to reach a collaborative agreement with its creditors; and, more recently, the application of the policy to arrears with official creditors under the presumption of rare cases, confined to situations in which the debtor does not have the capacity to repay and debt is unsustainable. In addition, the principle of good faith has evolved.

Principles for Good Faith

A key challenge in the application of LIA is that the meaning of good faith is subject to different interpretations, while the principle itself can be manipulated in the pursuit of self-interest. As Buchheit and Lastra (2007) point out, efforts in 2002 to prescribe a precise definition to the term or identify actions that constitute good faith are problematic. The initial meaning ascribed to good faith in the Fund's 1998 policy, they note, is whether the debtor is trying to regularize creditor relations. There is no prescription on how that is achieved, only that negotiations not be a charade.[34] This changed in 1999 with the formulation that the debtor is making a good faith effort to reach a collaborative agreement with its creditors. But because there is no legal test for what constitutes collaborative efforts, the Fund was forced to provide some body to the skeletal frame in 2002.

These efforts were fraught with pitfalls. If the provisions are too loosely defined, they would do little to influence behaviour and anchor expectations. However, defining good faith narrowly and with very specific expectations would create incentives for gaming, in which parties strive to meet the letter but not the spirit of the provisions. In the context of employment relations, for example, workers can modify their behaviour to induce their dismissal with redundancy payments, while a firm can — through subtle ways — incite workers to quit to avoid such payments. The point is succinctly expressed by Cox (1958, 1438-39): "The decisions imposing an obligation to bargain in good faith have often been criticized on the ground that since it is futile to legislate a state of mind, the duty is easily

32 To mitigate this risk, Ugo Panizza (2013) proposes an international insolvency mechanism to deal with sovereign debt restructuring based on limited access to official sector lending and in which the international lender of last resort (ILLR) shares in potential haircuts. Under his approach, seniority depends on the difference between market rate of interest paid on private claims and the lending rate of the ILLR. The procedure used to calculate haircuts first determines the amount of debt service that the sovereign can sustain. It then calculates the present value of one dollar of claims using the interest rates on ILLR advances and the (higher) interest rate on private sector claims. The procedure multiplies these present values by the stock of debt owed to the ILLR and private creditors to obtain the total amount of discounted debt. Finally, it applies the respective shares of the ILLR and private claims in that total to the amount of sustainable debt service to determine final allocation of the haircut.

33 While these higher interest rates reflect compensation for the risk of insolvency and possible subordination, they can complicate debt restructurings because the size of haircuts is typically calculated by comparing the market value of rescheduled debt with its original face value. Yet, if the restructuring achieves the goal of sustainability and eliminates (or greatly reduces) the risk of subordination, the rescheduled debt should be valued using lower interest rates. Julie Kozack (2005) discusses the choice of discount rates for the evaluation of sovereign debt restructurings and the impact of the asymmetric treatment of new and old debt. These effects can generate large discrepancies between the size of haircuts and effective debt relief: Federico Sturzenegger and Jeromin Zettelmeyer (2006) calculate that the size of debt relief in their sample of debt exchanges over 1980–2007 was 20 percent lower than the estimated haircut.

34 Legal scholarship supports this contention. Though dated, and dealing with the then-nascent case law of labour relations, Archibald Cox (1958) identifies a parsimonious set of conditions, namely that negotiators must have the authority to negotiate and that there is a modicum of information to inform negotiations.

evaded. ... The law can influence men's attitudes, up to a point, by declaring a higher standard of conduct than the legal machinery can enforce."

It should not be surprising, therefore, that courts are reluctant to imply an obligation of good faith and fair dealing in debt restructurings if doing so would significantly alter the rights of the parties and impair the ability of the debtors and creditors "to order their relationships through contractual agreements."[35] In the case in question, the plaintiff was seeking to accelerate (or bring forward all current and future payments) restructured debt that had previously been in default. Acceleration required a majority vote, which was blocked because the sovereign retained a majority share of the debt, albeit indirectly, in the earlier restructuring. This, the claimant alleged, represented a bad faith manoeuvre designed to block acceleration that is contrary to an implied covenant of good faith and fair dealing. The court denied the plaintiff's argument, noting that "it is axiomatic that an implied covenant cannot override the express provisions of a contract."

This is not to imply that US jurisprudence is wholly silent on the duty to bargain in good faith.[36] Chapter 9 of the US bankruptcy code imposes a duty to negotiate in good faith on municipalities seeking bankruptcy protection. But, it is reasonable to conclude, this is quid pro quo for the fact that the law shields from seizure and sale municipal assets used for the provision of public services and for the limited role accorded to creditors in the proceedings, including the waiver of creditors' rights to propose a counter offer. In the corporate context, Chapter 11 requires that petitioners make "good faith filings" for protection to complete a reorganization. In effect, solvent firms are barred from using the law for strategic litigation purposes or to evade their obligations. That said, some courts have criticized the good faith filing requirement for its imprecision, with one bankruptcy judge referring to the requirement as "an amorphous *gestalt*, devoid of reasoning and impenetrable to understanding."[37]

Regardless, the 2002 clarification of good faith contained three elements. First, where a member determines that a restructuring is necessary, early dialogue would continue until a restructuring is completed. Second, an expectation of sharing all relevant non-confidential information and proposed treatment of all claims. Third, that creditors be given an early opportunity for input, with the IMF retaining jurisdiction over the design of the program.

The IMF's "clarification and guidance" led private sector creditor groups to contribute to the debate. The Institute for International Finance (IIF) in 2004 developed Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets.[38] The principles are intended to provide greater structure and thus predictability in the restructuring process. In this respect, they are largely focused on bridging information asymmetries that can result in costly delays in debt restructuring negotiations (Haley 2017). The principles highlight the importance of transparency and information exchange, both before and during a crisis. At the same time, the principles could promote inter-creditor equity through a commitment to fair and equal treatment across creditors, thereby reducing restructuring delays by eliminating possible incentives for some creditors to gain at the expense of other creditors.

The principles were presented as an innocuous evolution of soft law through the adoption of voluntary guidelines beyond provisions delineated in bond contracts. Nevertheless, they led to criticism from some borrowers that their effect would be to unduly favour private creditors and, if adopted, would represent an abdication of the IMF's responsibility to assist members to strike the right balance between financing and adjustment. The requirement for early engagement, for example, was viewed as an attempt to rebalance the playing field from take-it-or-leave-it offers via bond exchanges that had been used

35 See *CIBC and Trust Co. (Cayman) Ltd. v Banco Central do Brasil*, 886 F. Suppl. 1105 (SDNY 1995), online: <law.justia.com/cases/federal/district-courts/FSupp/886/1105/1796735/>.

36 While courts in other jurisdictions may adopt a more expansive interpretation of the duty of good faith bargaining, US practice is a critical consideration given the dominance of bond issues under New York law and the still-considerable, yet diminishing, influence of the United States in international policy circles.

37 See *In Re Victoria Ltd. Partnership* Bankruptcy No. 95-42667-JFQ, United States Bankruptcy Court, District of Massachusetts (October 5, 1995), online: <www.leagle.com/decision/1995241187BR54_1230/IN%20RE%20VICTORIA%20LTD.%20PARTNERSHIP>.

38 More information on the principles can be found at: www.iif.com/topics/principles-stable-capital-flows-and-fair-debt-restructuring. Jean-Claude Trichet, then ECB president, also proposed a "code of conduct" to govern debt restructurings (Couillault and Weber 2003).

effectively in several cases. As Bedford, Penalver and Salmon (2005) argue, this may represent an *ex ante* attempt to strengthen enforcement.

Although private creditor groups acknowledge the potential need for "prompt and adequate" sovereign debt restructurings when warranted, they are steadfastly opposed to the use of unilateral offers by sovereign debtors in such circumstances. Such techniques could, one group has warned, lead to low investor participation, result in persistent litigation, undermine market confidence in the economic reform efforts of the debtor and delay the regaining of market access (IIF 2014, 4). While such views are entirely understandable from a creditor's perspective, the sovereign borrower utilizing a take-it-or-leave-it offer could note in rebuttal that if the offer is insufficiently attractive to most creditors the exchange offer would likely fail. This would require a reformulation with improved terms more favourable to creditors' interests.

This might suggest the participation rate at which the exchange is considered closed as a possible condition for gauging fairness of a sovereign debt restructuring executed through an exchange offering. To some extent, the Fund is already implicated in the process.[39] There are trade-offs involved in setting the participation rate. Too high a rate could be indicative of a generous offer that attracts broad creditor support, but which provides insufficient debt relief to a sovereign suffering from severe debt distress. The result could be temporary respite from servicing difficulties quickly followed by another round of debt-service problems. Setting too low a participation rate for the completion of an exchange offer, meanwhile, could be consistent with efforts on the part of the sovereign borrower to impose a large haircut, possibly in circumstances that are not warranted by the underlying economic prospects of the country and the government's adjustment effort.[40]

Moreover, adjudicating the fairness of an exchange offer is problematic for the Fund and would necessarily depend on the circumstances. If the country needs official sector financing, for example, the Fund can influence authorities through its LIA strategy. But this need not be the case. In Argentina's default, the IMF was criticized by some creditors for exerting insufficient pressure on the government to improve its offer or eschew measures that created a de facto unilateral offer. However, because the authorities repaid Fund loans ahead of schedule, the IMF's leverage was minimal. In effect, the authorities immunized their negotiating strategy from considerations such as good faith. With a free hand over the terms of their debt exchange offering, the authorities were credibly able to present bondholders with a de facto take-it-or-leave-it offer. In an early assessment, Gelpern (2005, 24) observed: "Proxies for good faith, such as the level of creditor participation in a debt exchange, are ultimately circular—they outsource the good faith determination back to the creditors and ignore any coercion factor that might have affected participation. In Argentina's case, the Fund appears both compelled and ultimately unable to judge fairness."

More generally, for a country facing a prospective debt-servicing crisis, there is a basic dilemma in initiating negotiations on a possible bond exchange. Overtures to discussions on a possible exchange could lead almost immediately to the presumption that the government is trying to extract concessions from its creditors. This outcome might reflect information asymmetries that the government is unwilling or unable to bridge, genuine differences in views regarding the expected evolution of the economy or, for governments

39 In the case of Uruguay (2003), the IMF made completion of the third program review conditional on a high participation rate in the bond exchange. Failure to complete the review would have likely led to default and possibly larger losses to creditors. Similarly, a high participation rate was prior action for the IMF's stand-by arrangement with Jamaica in 2012.

40 Andrew Haldane, Adrian Penalver, Victoria Saporta and Hyun Song Shin (2004) explore optimal voting thresholds for CACs based on the sovereign borrower's risk aversion and creditworthiness. They find that the choice of optimal thresholds entails a balance between the insurance benefit of a lower threshold, in terms of ease of restructuring in response to a crisis, and the increased likelihood that creditors will "rush for the exits" before the restructuring process is initiated (i.e., the possibility of triggering a liquidity problem). Strongly risk-averse debtors who value payoffs in crisis periods favour lower thresholds than less risk-averse borrowers. However, the worse the creditworthiness of risk-averse borrowers, the higher the thresholds they would choose.

with a history of defaults, reputational effects.[41] Regardless, the announcement of negotiations could trigger a payments disruption if short-term creditors refuse to roll over claims coming due.

The question of whether the principle of good faith imposes a duty on borrowers to negotiate with creditor committees and prescribes the modalities of such engagement is not clear cut. Such duties are the intent of proposed creditor engagement clauses. Debtors fear that such an interpretation would neutralize their ability to use debt exchanges to secure timely restructurings. For their part, private creditors can point to the fact that in the nineteenth century, ad hoc bondholder groups and the Corporation of Foreign Bondholders advised the London Stock Exchange as to when a negotiation in good faith had been concluded so that new issues could be listed (Wright 2012). But an important distinction regarding the historical experience is that the role of creditor committees in the nineteenth century was after a restructuring had been completed and the sovereign borrower was seeking to list new securities. In other words, the prescribed role of creditor committees increased borrowing costs to a debtor deemed to have negotiated in bad faith; it did not endow creditors with the power to block a proposed debt exchange. The opportunity cost to the borrower of disruptive uncooperative behaviour would have been measured in terms of the extra basis points in borrowing costs on its illiquid debt. From an economic perspective, this is a more efficient mechanism in that the potential for creditor committees to block an entire restructuring increases the incentive for borrowers to adopt measures to prevent this outcome. Such effects can lead to costly protracted delays.[42]

Private creditors today may also harken back to the role of bank advisory committees in the debt crisis of the 1980s. There is an important difference between historical episodes, however. In the 1980s, advisory committees represented banks that had to preserve ongoing lending relationships with their sovereign borrowers and creditors with relationships with private sector entities. These connections created relationship capital that reduced information asymmetries and established trust between the parties.

In the early days of the debt crisis, these committees facilitated timely rescheduling of bank claims. While these reschedulings averted widespread defaults, capitalization of missed interest increased debt stocks and undermined confidence, thereby reducing investment. Over time, the need for more fundamental restructuring was recognized. In the end, the crisis was resolved through a combination of "carrots" (IMF and other international financial institution lending) and "sticks" (LIA policy that weakened banks' leverage over the negotiation process).[43]

In contrast, creditor committees today are more likely to comprise the representatives of atomistic bondholders with no long-term relationship to the country and who may not meet in subsequent sovereign debt workouts. The point here is that effective bargaining in an environment of asymmetric information and competing self-interest requires a modicum of trust. In the absence of trust, negotiations are subject to possible protracted delays as sovereign borrowers dissemble and different creditor classes jockey for advantage.[44]

In such circumstances, the potential for a subset of creditors to disrupt restructuring through litigation cannot be discounted. As Mark Wright (2012, 192-93) suggested in applying the lessons of historical experience, "a desirable reform of the debt restructuring process would be the

41 This response also reflects the bonding role of non-state-contingent debt. Such contracts bind the government to a stream of payment obligations that is either serviced in full and on time or not. If not, the borrower is deemed to be in default, allowing the creditor to exercise acceleration and cross-default clauses. In environments of costly state verification, in which creditors cannot easily validate borrowers' claims of material change in key economic conditions, these contracts have the virtue that they are easily monitored: the creditor simply monitors whether the payment is made. Simple debt contracts thus reflect the monitoring and evaluation problems that exist in the presence of asymmetric information and transactions costs. Weak contract enforcement, meanwhile, creates an incentive to dissemble.

42 The use of such strategies by Argentina led ultimately to an extreme case and bad law. Two measures stand out: the most-favoured-creditor clause, which sought to assure participating creditors that holdouts would not get a better deal, and the lock law, which prevented the government from reopening the exchange offer to non-participating creditors. See Guzman (2016) for a comprehensive discussion of the Argentine experience.

43 Charles Collyns and Mohamed El-Erian (1993) note that restructuring followed a predictable pattern: broad agreement with bank advisory committees on a general approach with treatment of arrears subject to a comprehensive restructuring; agreement on a menu or "term sheet" of options tailored to the needs of different banks and the regulatory regimes under which they operated; marketing of the term sheet to the universe of creditors; and signing of the deal once the bulk of eligible claims assent to the deal.

44 These considerations underlie the Sovereign Debt Forum (SDF) proposed by Richard Gitlin and Brett House (2014). The SDF would provide a repository of sovereign debt restructuring experience and foster trust between private creditors and sovereign borrowers through ongoing exchanges of information and analysis.

establishment of an institution or a procedure for designating good faith negotiations, one that could be combined with conditional protection from asset seizure." In other words, some combination of both sticks and carrots, which is vaguely reminiscent of proposals in the SDRM.[45]

Policy Proposals and Possible Paths Forward

The notion of good faith reflects the debt restructurings of the 1980s, which entailed a comparatively small number of banks, each of which could expect to meet around the same table in the not-too-distant future to discuss other rescheduling in a repeated game. In this environment, good faith negotiations implied obligations on creditors to adhere to cooperative outcomes as much as borrowers. The notion of good faith negotiations is less clear today given the heterogeneity of creditors and the myriad of different bond issues in different currencies and legal jurisdictions.

All of this suggests that the usefulness of principles of good faith negotiation may be limited in practice. The notion of good faith may be helpful in establishing and guiding creditor-borrower dialogue under relative benign conditions, but are unlikely to be sufficiently robust to address the collective action problems inherent in large unwieldy debt restructurings involving many different instruments held by heterogeneous investors. Almost by definition, voluntary principles will not be effective in resolving coordination failures where one or more party is acting opportunistically to secure rents from non-cooperative behaviour or simply protecting self-interest.

45 As an alternative, Buchheit and Lastra (2007) had proposed a "candid and symmetrical LIA" policy under which the IMF would enjoin sovereign borrowers to conduct negotiations in good faith. This was assessed on the basis, for example, of whether the sovereign has engaged with creditors in a timely manner and has abided by any arbitral or court decisions. Failure to meet that standard would block access to IMF resources until arrears have been cleared. At the same time, the Fund would impose a standard on private creditors by which it would reserve the right to assist a member through LIA and legal support (*amicus* briefs) to defend against creditors seeking preferential monetary recovery if that member has acted in good faith and made a financial offer consistent with the Fund's stabilization program.

The conclusion seems to be that the IMF's LIA strategy is incapable of bridging the divide between good faith and self-interest. But, if that is the case, what is the way forward for those who seek to improve the process for sovereign debt restructuring? Consider the challenges below.

First, there are issues of precedent and dynamic inconsistency. If the IMF continues LIA in the case of an exchange offer with a very low participation rate, other countries would be tempted to default and follow that example. The offer may be warranted in the first case, given very poor economic prospects, for example, but not for those who follow. Moreover, there is a question of how to deal with holdouts. A timely voluntary agreement with holdouts is unlikely without better terms. But providing a sweetener to the original offer to make it more attractive, or indeed simply re-opening the offer, is problematic in that either would establish a precedent for future debt restructurings. This conclusion reflects a basic time inconsistency problem: if holdouts receive the same (or better) terms as bondholders that take up the original offer, what incentive is there for creditors to tender bonds in future restructurings. Rather than participate, bondholders would be better off by holding out and waiting for an improved offer — the exchange would fail.[46]

The presence of this problem explains the cram-down provisions of domestic bankruptcy regimes whereby courts force a restructuring on holdouts that is broadly acceptable to a (super) majority of creditors. The absence of a direct analogue in the sovereign debt space explains why Argentina introduced the most-favoured-creditor clause and introduced a lock law — the authorities recognized that the success of the offer depended on their ability to constrain their future discretion to reopen the terms of the offer. Given the absence of a de jure legal cram down, creditor country governments could intervene to affect the probability distribution function of the

46 Consider the case of LIA that prevents a death spiral in the economy harming all parties. Individual rationality could lead most creditors to support LIA since expected (eventual) recoveries may be greater. But this does not preclude some individuals acting opportunistically from blocking LIA to extract side payments. This underscores the need for majority voting rule, not unanimity, among private sector creditors. The goal is not to infringe on the rights of all creditors, only those who pose a collective action problem. At the same time, there is a risk that creditors may punish a borrower negotiating in good faith to affect play in future re-contracting games; in effect, to take a loss in one problem situation to raise the expected cost of default to future potential defaulters.

expected value of litigation (i.e., *amicus* briefs), but as the extreme case of Argentina demonstrated, such arguments need not sway the courts.

Second, while the IMF has the capacity to make de facto case law with respect to the international bankruptcy regime through its LIA policy, this need not be the case. In the case of Argentina, the Fund was largely excluded from the drama since the authorities repaid IMF resources ahead of schedule, effectively eliminating the Fund's leverage over the authorities' decisions.

Third, the IMF (and its executive board) must be wary of their fiduciary obligation to ensure that its engagement with a troubled member is protected by adequate safeguards. The challenge for the Fund is to preserve an exit strategy using limits on *ex ante* lending to preserve the *de minimus* nature of its exposures and protect its preferred creditor status, rigorous DSA and an adroit use of LIA to facilitate timely restructurings consistent with the goal of the borrower regaining early access to private capital markets.

It is not a coincidence that these challenges correspond to the problems that domestic bankruptcy frameworks are designed to address. Yet, past efforts to construct an international counterpart to bankruptcy through the SDRM proposal lacked the support necessary to proceed; prospects for a formal statutory approach remain remote. In this environment, possible measures that may garner the support needed can be divided into measures to a further develop the quasi-bankruptcy process or soft law approach in which the IMF plays a critical role, on the one hand, and incremental changes to bonding technology through contractual innovations, on the other.

Further Evolution of the Quasi-Bankruptcy Process

Gelpern (2013a, 1122) highlights a fundamental paradox of sovereign debt — it is simultaneously unenforceable and non-dischargeable. "The process for its restructuring," she contends, "is fragmented, its coverage is selective, and it lacks an accountability mechanism to verify claims and establish the necessary level of relief." While a self-proclaimed skeptic of sovereign bankruptcy, she advances a possible approach forward that combines three elements: first, clearly circumscribed access to state assets (through the selective waiver of sovereign immunity) and revenues (by way of bond issues secured by readily identifiable revenues); second, payment priorities among a diverse set of claimants, including bondholders, pensioners, trade creditors and other governments that balance the interests of domestic stakeholders with foreign bondholders; and third, a claims verification process and expert judgments on debt sustainability and economic policy that are widely viewed as independent and disinterested.[47]

Another path toward quasi-bankruptcy could entail a reconsideration of IMF lending. One such approach would limit Fund *ex ante* lending to modest programs associated with current account imbalances, consistent with past practice in the era before capital account liberalization. The objective of such restraint would be to preserve the *de minimus* status of IMF exposure, thereby promoting IMF preferred creditor status. This could open the door to larger programs under LIA, where appropriate, on which preferred creditor status would be asserted and endorsed by all creditors and (ideally) recognized in national law. This approach would allow the Fund to promote timely, orderly restructurings through the preservation of asset values and the provision of delegated monitoring function.[48]

A further evolution in the quasi-bankruptcy process through so-called soft law is the renewed

47 Elsewhere, Gelpern advances incremental steps to support restructurings. These steps include the creation of an independent body to conduct DSA, greater contract standardization and coordination among public and private creditor groups to dissuade free riding, measures to protect market infrastructure from enforcement actions initiated by holdout creditors and elaboration of a common set of norms to guide national court decisions. See Gelpern (2016).

48 At the same time, consideration could be given to modifying (but not necessarily revoking) the seniority accorded to IMF lending before default or the suspension of payments. This would reduce the risk of subordination, enhancing the catalytic effect of Fund interventions. Such a step would represent a marked departure from established practice and raises several important issues, not the least of which are the implications on the requirement that Fund resources be extended under adequate safeguards and the IMF's ability to assist members in different economic and financial circumstances. Any possible change would therefore have to be subjected to careful analysis and review. However, in a model in which the size of Fund programs is subject to strict limits, such a policy would represent a return to the *status quo ante* which prevailed prior to the debt crisis of the 1980s and the adoption of the preferred creditor convention. A critical question (not addressed here) is whether such a model is consistent with the IMF's role in the context of capital account liberalization and large private capital flows.

use by the IMF of approval in principle (AIP).[49] Used extensively in the 1980s' debt crisis, AIP allows the Fund to signal its support for members' economic policy framework and indicate access to IMF resources conditional on a debt restructuring (in cases of over-indebtedness) or new financing (where the sovereign is confronted by a liquidity problem). AIP can unblock debt restructuring negotiations in cases where creditors are reluctant to agree to a debt writedown without assurances of IMF engagement and monitoring of the authorities' economic framework, consistent with the delegated monitoring view of the Fund, and the IMF is unable to approve a program without adequate safeguards of repayment.

The use of AIP can allow the IMF to balance bargaining power to promote a more timely restructuring. Specifically, when applied to cases of severe over-indebtedness akin to sovereign insolvency, it creates an expectation of good faith on the part of creditors to recognize the reality that existing debts are unsustainable and must be reduced if they want the credit enhancement associated with IMF monitoring and deployment of Fund resources. At the same time, the policy can modify creditors' perceptions of self-interest to the extent that it has a catalytic effect for credit involvement. The decision to invoke AIP with respect to Greece could represent an important development in the evolution of an international quasi-bankruptcy regime.

Further Contractual Innovations

Further contractual innovations represent a second approach to enhancing the process of sovereign debt restructurings. Fisch and Gentile (2004) identify three possible changes to existing bonded debt contractual terms that could promote more efficient sovereign debt restructuring.

First, align fiscal agency agreements with trust indentures, in which the right of individual bondholders to sue sovereign debtors is limited to interest and principal amounts not paid on their respective due dates, rather than the full amount of outstanding obligations under acceleration. The trustee, rather than bondholders, possesses the right to sue for unmatured amounts. This contractual innovation could mitigate the effects that are associated with the repeal of the Champerty doctrine in New York law, under which creditors were formerly enjoined from acquiring bonds for the sole purpose of litigation. By limiting the potential returns from such litigation, this measure could reduce the incentive for holdout investors to disrupt restructurings by initiating litigation.

Second, adjust thresholds for acceleration in fiscal agency bonds. At present, while a voting threshold of 25 percent of outstanding bonds is required to accelerate, a smaller threshold is typically specified for the initiation of litigation. Raising this threshold could likewise affect the attractiveness of litigation and reduce the likelihood that holdout investors would pursue disruptive litigation to extract rents.

Third, amend fiscal agency agreements to allow a subset of bondholders discriminated against by the debtor to accelerate the unmatured principle on the bonds. For example, the threshold for acceleration might be applied on the bonds for which payments have been withheld, rather than the entire stock of outstanding bonds. This modification would provide protection against strategic behaviour on the part of the debtor and promote the principle of comparability of treatment and non-discrimination.

In addition to these three proposals, creditor groups have raised the possibility of creditor engagement clauses triggered by default or a payments suspension that would set key terms for negotiations and exchange of information between the borrower and its private creditors. Such clauses would ascribe important status to creditor committees. However, the effectiveness of these committees may be constrained when, as is generally the case, they are limited to an advisory capacity in making recommendations to bondholders and so lack the power to commit to a restructuring deal. Moreover, while early communication and exchange of information are undoubtedly important in facilitating the restructuring of sovereign debt, it is not clear that the implicit duty to bargain in good faith they represent can be reconciled with the pursuit of self-interest.

49 I am indebted to an anonymous reviewer for pointing out the recent reactivation of AIP and its potential to promote debt restructuring. In July 2017, the IMF board approved in principle a new stand-by arrangement with Greece with financing conditional on continued implementation of the program and specific and credible assurances regarding debt relief from Greece's European partners sufficient to restore debt sustainability. See IMF (2017) for an explanation of AIP.

Conclusions: Dealing with Hard Cases

For much of the past 70 years, the IMF has led international efforts to resolve payments difficulties in a timely and orderly manner.[50] This role has evolved over time. At times, it has required the use of the managing director's "good offices" to bring parties to the table to resolve coordination failures or to highlight their shared interests. In some respects, the debt crisis of the 1980s was a defining moment for the Fund.[51] The process is described by James Boughton (2004, 12): "The Fund's Managing Director, Jacques de Larosiere, intervened personally by refusing to approve stand-by arrangements for the crisis-hit countries until he received written assurance from bank creditors that they would share the burden by increasing their lending exposure. This 'concerted lending' tactic was the first instance of what later became known as 'private sector involvement' in debt workout procedures. Over time, the specific tactics changed in response to evolving circumstances, but the role of the IMF as the central agency for coordinating the resolution of financial crises remained."

The concerted lending strategy that Jacque de Larosiere defined in the 1980s debt crisis put the IMF at the centre of the debt restructuring process. While that role has been criticized over the years, there is little doubt that the approach he pioneered, with the IMF providing a mix of finance, policy advice and moral suasion, served as a model for dealing with subsequent debt problems. This approach has evolved over time, responding to the challenges posed by crises and the needs of its members.

Recent cases underscore the need to reconsider the process for sovereign debt restructuring. A troubling legacy of the Argentine debt debacle, for example, is a ruling in which the court, unable to enforce payments to holdout investors, employed injunctions to punish a recalcitrant borrower. While the ruling ultimately brought the borrower back to the table to settle with the holdouts, it did so by harming the interest of third parties and interfering with the international payments system, including bondholders who had agreed to a substantial reduction in the value of their claims. Meanwhile, a precedent has been set with respect to the interpretation of *pari passu*, possibly emboldening future holdouts that are holding bonds with similar clauses and, potentially, making it more difficult to secure timely, orderly restructurings going forward.

The Greek debt crisis presented new problems for the IMF. Boughton (2015) argues that, as a member of the troika of official creditors along with the ECB and the ESM, the IMF's ability to unilaterally set the ground rules for engagement is constrained. At the same time, questions can be legitimately asked how the IMF can judge good faith when a subset of Greece's creditors constitute an important voice in the decision-making process. And questions arise with respect to the role of the Fund. Meg Lundsager (2017) contends that IMF engagement in the euro-zone crisis was contrary to the principle of uniformity of treatment for its members.[52] As she puts it: "In the Eurozone crisis…key policies were set by European institutions, leaving the IMF little room to design a program that could create conditions for Greece's recovery." This had led to a situation in which the IMF was unwilling to join a new lending program without European creditors first clarifying how debt sustainability would be achieved. For their part, European officials reject direct debt reduction, but are open to further debt relief delivered through maturity extensions at lower interest rates, reducing the net present value of the debt. The problem with this approach is that it leaves a large stock of outstanding debt that generates uncertainty over the distribution of future economic growth which can distort incentives to save and invest, notwithstanding very large net present value reductions already taken. This effect is magnified by the probable duration of IMF and other official lending to Greece.

50 Gelpern (2016) provides a detailed discussion of the debt restructuring process, which until recently, she contends, was marked by three features. The process was modular, relied on cross-conditionality and featured repeat players invested in the process. The emergence of new players, for example, official creditors not members of the Paris Club and investor funds specialized in distressed bonds, have reduced the cohesiveness of the process.

51 See Collyns and El-Erian (1993) for an early analysis of commercial bank debt restructuring.

52 A related issue is the complication of providing financial resources to a member of a currency union. Because any member lacks control over monetary conditions, the necessary coordination between monetary and fiscal authorities needed to achieve a felicitous balance between financing and adjustment may be elusive. This has likely been a factor in the Greek case; it militates for new guidelines for IMF involvement with members suffering from a high debt burden who also belong to currency unions.

On another front, the case of Ukraine highlights the issues raised by the expanding universe of non-Paris Club official creditors, whose interests may not be aligned with those of the rest of the international community. The IMF's LIA strategy was amended in 2015 to permit Fund lending to a member in arrears to an official creditor.

These cases generate uncertainty with respect to the process for restructuring sovereign debts in which the IMF must employ its policy instruments to fashion good outcomes. Against this background, the adoption of a new program under a policy of AIP represents an important development in efforts to balance good faith and self-interest. It will take time to assess the effectiveness of the policy in terms of extending the soft law of sovereign restructurings. In any event, by itself, AIP does not constitute a magic bullet. Efforts to enhance creditor-borrower engagement should continue. However, the current quasi-bankruptcy system lacks the logical and legal consistency of a formal bankruptcy regime, while recent extreme cases create the potential for bad law that could stymie these good outcomes. Meanwhile, private creditors have consistently rejected the analogy between domestic and international bankruptcy, fearing the possible usurpation of their contractual rights by the IMF (or other supranational body). And they have criticized past IMF efforts as arbitrary and a source of delay and a succor to bad faith behaviour on the part of sovereign borrowers.

Going forward, therefore, the Fund will be asked how it can better mobilize the instruments at its disposal to facilitate sovereign debt restructurings. One question is how or whether it is possible to balance between good faith and self-interest in sovereign debt restructurings to facilitate timely, orderly resolutions. The search for such a balance may be quixotic. This is because the concept of good faith has meaning in the domestic context in which a disinterested bankruptcy judge oversees the liquidation of a debtor and settlement with its various creditors in the wake of a failed voluntary negotiation in the "shadow of the courthouse." In the context of the US bankruptcy code, Chapter 11 reorganizations are possible because of the threat of a Chapter 7 liquidation. To put it bluntly, the threat of involuntary solutions is required to secure voluntary agreements.

At the international level, in contrast, where there is no final resolution and discharge of unsustainable debts by a disinterested judge, the notion of good faith in negotiations loses its meaning. The closest analogy to the domestic good faith modalities was the SDRM proposal, in which a supermajority of private creditors had a voice over LIA. But that voice came with a formal standstill, consistent with one of the four universal principles of good faith identified by Matthias Goodmann (2016). This suggests that if private creditors want good faith, they may have to be prepared to accept limitations on self-interest. In other words, they may want to reconsider the case for the SDRM.

Author's Note

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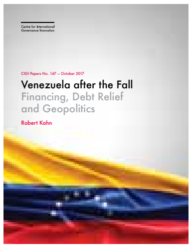

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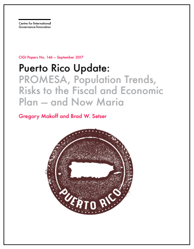
CIGI Paper No. 147
Robert Kahn

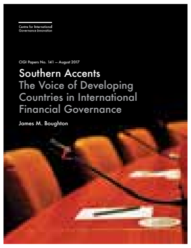
Venezuela's economic and political crisis continues to deepen, exacting a growing humanitarian toll and devastating an economy that was once Latin America's most prosperous. After a brief overview of the current economic situation, the paper presents the core elements of a comprehensive international rescue effort, and explains why such a program is likely to produce financing needs that outstrip the resources available from the official community. Any program will require an urgent effort to address humanitarian needs as well as long-term financing, and there are important steps that can, and should, be done now to prepare. Given the scale of the financing required in the medium term, an ambitious adjustment program backed by generous financing and debt relief is needed to get Venezuela back on its feet.



Puerto Rico Update: PROMESA, Population Trends, Risks to the Fiscal and Economic Plan — and Now Maria

CIGI Paper No. 146
Gregory Makoff and Brad W. Setser

The damage from Hurricane Maria may push Puerto Rico into a worst-case scenario of accelerating decline and ever-falling tax revenues if the loss of housing and a sustained power failure lead to large-scale outmigration. Given the need to alleviate immediate suffering, the potential loss of near-term tax revenues and the risk to medium-term stability, the federal government should assure adequate access to emergency funding and the Financial Oversight and Management Board, for its part, should be prepared to make appropriate adjustments to the fiscal plan. Even before the hurricane, Puerto Rico was in the midst of a deep fiscal, economic and social crisis. This paper provides a critical review of Puerto Rico's fiscal and economic plan, with analysis that was carried out prior to Hurricane Maria.



Southern Accents: The Voice of Developing Countries in International Financial Governance

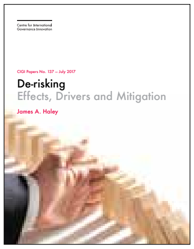
CIGI Paper No. 141
James M. Boughton

This paper examines that process by which the developing countries have come together as a group to try to influence the evolution of the financial system. It then reviews some of the successes of that effort. The effort to regain and preserve influence and the reasons that it became increasingly difficult are then examined. The paper concludes with some reflections on the challenges going forward.

European Capital Markets Union Post-Brexit

CIGI Paper No. 140
Miranda Xafa

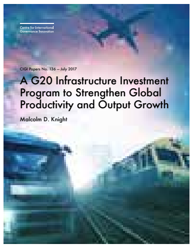
This paper covers four main areas: the motivation for capital markets union (CMU) and the expected benefits for the functioning of the European economy and financial system; the road map for its implementation and the obstacles and challenges the CMU project is facing in view of the Brexit vote; the role of the European Securities and Markets Authority versus national supervisors; and the steps taken so far in implementing the European Commission's action plan aimed at identifying and removing obstacles to cross-border capital markets transactions, as well as the policy priorities and the sequencing of reforms given the complexity of the task ahead. The paper concludes that Brexit clearly represents a setback, as the United Kingdom has by far the deepest and most liquid capital markets in the European Union, but it also provides an opportunity to launch a more ambitious CMU agenda encompassing the remaining 27 EU members.



De-risking: Effects, Drivers and Mitigation

CIGI Paper No. 137
James A. Haley

This paper examines the phenomenon of derisking, or the loss of financial services as large international banks close or curtail correspondent banking relationships with banks in smaller jurisdictions. It outlines the effects of de-risking and identifies a range of possible measures to mitigate them. While affected jurisdictions bear the financial costs, de-risking is a shared problem, requiring a shared response. This response includes efforts by affected countries to comply with international anti-money laundering (AML) and combatting the financing of terrorism (CFT) standards. As the country with the largest financial system and the leader among AML/CFT standard setters, the United States has a key role to play; however, it is not the only country with an interest in maintaining the integrity of the global financial system.



A G20 Infrastructure Investment Program to Strengthen Global Productivity and Output Growth

CIGI Paper No. 136
Malcolm D. Knight

In addition to the weak growth of domestic demand that has persisted in many countries since the onset of the global financial crisis in 2007, another crucial macroeconomic policy issue is the need to modernize and expand the international network of basic infrastructure to foster stronger long-term global growth of productivity and output capacity. This paper describes the nature of the supply-side issue and outlines the key policy elements that are needed in each G20 country to design and implement a successful National Infrastructure Investment Program could play in carrying out the program of infrastructure renewal and expansion.

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Our research programs focus on governance of the global economy, global security and politics, and international law in collaboration with a range of strategic partners and support from the Government of Canada, the Government of Ontario, as well as founder Jim Balsillie.

À propos du CIGI

Au Centre pour l'innovation dans la gouvernance internationale (CIGI), nous formons un groupe de réflexion indépendant et non partisan qui formule des points de vue objectifs dont la portée est notamment mondiale. Nos recherches, nos avis et l'opinion publique ont des effets réels sur le monde d'aujourd'hui en apportant autant de la clarté qu'une réflexion novatrice dans l'élaboration des politiques à l'échelle internationale. En raison des travaux accomplis en collaboration et en partenariat avec des pairs et des spécialistes interdisciplinaires des plus compétents, nous sommes devenus une référence grâce à l'influence de nos recherches et à la fiabilité de nos analyses.

Nos programmes de recherche ont trait à la gouvernance dans les domaines suivants : l'économie mondiale, la sécurité et les politiques mondiales, et le droit international, et nous les exécutons avec la collaboration de nombreux partenaires stratégiques et le soutien des gouvernements du Canada et de l'Ontario ainsi que du fondateur du CIGI, Jim Balsillie.

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