IMF's SDRM Proposals: An Updated Critique of Conceptual Issues

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I. Introduction

The spate of financial crises in the nineties has unambiguously established the fundamentally heightened vulnerability in the international financial system brought about by widespread financial sector deregulation and liberalization. However, the prevailing structure of financial markets, with conflicts of interests among a growing number of independent private players who have come to dominate the global debt market, makes it extremely difficult to carry out sovereign debt restructuring even in situations of financial crises.

While this could force debtor nations into default as well as make it impossible for them to remain open to and integrated with the global financial system - an outcome not preferred by either the Fund or the private creditor (financial market players) community - the IMF has thus far managed to prevent any major default by financing large rescue packages that bail out creditors who had not exercised due diligence when lending to public and private agents in emerging markets. Given the increased prevalence and severity of crises in recent years, and the large and increasingly unfeasible debt workouts that the IMF has had to coordinate and part-finance consequently, the IMF has therefore been looking at options for 'crisis prevention and crisis resolution'.[1]

However, most Fund discussions on 'crisis prevention' continue to remain focussed on putting the onus solely on the debtor countries for 'sound macroeconomic management, prudent fiscal policies,' etc., the same array of inflexible Fund policies that have time and again been established to be one of the underlying causes of crises. There is continued emphasis also on good governance and transparency, the lack of which, the multilateral agencies have suggested, results in crisis. Meanwhile, the Fund is also examining the possibilities of a clearer policy on access to IMF resources, a more comprehensive framework for making judgments on debt sustainability, and greater selectivity in IMF lending. Underlying all these is the role given for increased Fund surveillance (read stricter conditionalities). All of these, the Fund claims, would reduce the possibilities for the emergence of unsustainable sovereign debt situations and financial crisis. These issues would require a detailed analysis of their own, which is not attempted here.

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[1] See a more detailed discussion on the evolution of the sovereign debt market, the motivating factors underlying the IMF's proposals for an international sovereign debt restructuring mechanism and their implications for sovereign debt restructuring in C. P. Chandrasekhar, Jayati Ghosh and Smitha Francis, 'SDRM: Insolvency or Liquidation?', March 31, 2003, available at www.networkideas.org

On the other hand, the key element in the IMF's discussion on 'crisis resolution' has been the debate on how best to deal with sovereign debt restructuring when the threat of sovereign default is real, in spite of Fund-steered 'crisis prevention' measures. As mentioned above, the central challenge to successful sovereign debt restructuring under the present system has been that the failure of 'collective action' by a sovereign's diverse creditors complicates and delays the process of finalising a restructuring agreement, causing severe economic havoc to the debtor country and eroding the value of the creditors' claims in the process. Problems of lack of transparency and predictability in the restructuring process and the difficulties in achieving adequate inter-creditor equity have also inhibited creditors from accepting proposed restructurings, thereby prolonging the process and exacerbating the costs involved for the debtor, creditors, international financial institutions and the international economic community at large.

The IMF has thus been authorized by the International Monetary and Financial Committee (IMFC) of its Board of Governors to adopt a 'twin-track' approach for improving the framework for the resolution of sovereign debt restructuring cases. In the Fund's scheme of things, the first is to seek to create a universal statutory framework. Consequently, the Fund has been advocating the scheme titled the 'Sovereign Debt Restructuring Mechanism' (SDRM) to ensure the 'prompt' and 'orderly' resolution of problems of unsustainable sovereign debt. The second approach would involve incorporating comprehensive restructuring clauses called 'collective action clauses' (CACs) in sovereign bond contracts, to limit the ability of dissident creditors to block a widely supported restructuring of individual bond contracts. The Fund realises that it is very difficult to deal with the issue of coordination of a diffuse and diverse creditor base, with different creditors able to seek enforcement of their rights in different legal jurisdictions, by relying entirely on collective action clauses. The statutory approach of the SDRM is believed to resolve this coordination problem through the creation of a framework that would aggregate claims across instruments for voting purposes, while paying due regard to the seniority of certain creditors and, more generally, to creditors' varying economic interests.

Building on an earlier paper on the SDRM proposals,[2] the attempt in the present paper is to explore the extent to which the Fund's SDRM proposal has undergone changes in order to incorporate and protect the interests of the private creditor community and to get the Fund's own role in member country policies more entrenched than ever before.

II. The Current Status of the SDRM Debate

Originally at least, the IMF discussions on SDRM were guided by the central tenet that the international financial system lacks a strong legal framework for the prompt, predictable and equitable restructuring of sovereign debt. This called for a framework that would not only enable rapid debt restructuring but also enable the country to arrive at a sustainable debt situation, balance the interests of the sovereign debtor and its creditors, maintain the debtor's developmental needs, and help rejuvenate its economy. Unfortunately, the

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[2] See C. P. Chandrasekhar, Jayati Ghosh and Smitha Francis, 'SDRM: Insolvency or Liquidation?', opcit.

subsequent debate has degenerated entirely into attempts by the Fund to consolidate its own role in global finance and in the financial affairs of the debtor countries, and to tilt the balance totally in the interests of creditors.

In a nutshell, it can be said that the SDRM as proposed by the IMF has only shown signs of retrogression. Firstly, contrary to the need for an independent international insolvency procedure, the Fund has carried out the entire discussion of the SDRM in the context of making it applicable through an amendment of its own articles of agreement, thus giving the central role to itself, often the most dominant creditor of a sovereign borrower. Secondly, the SDRM has been designed based on corporate insolvency laws (in a national context) and does not recognise the debtor country's sovereignty. Thirdly, it fails in balancing the rights and responsibilities of the creditors with those of the obligations of the sovereign debtor in trouble.

In the place of a strong legal framework that would ensure a timely and orderly debt workout, the evolving framework of the SDRM is now designed to 'reinforce incentives for countries and their creditors to reach voluntary, market-oriented solutions to their financing problems'. The Fund believes that the existence of a predictable framework should in most cases be sufficient to encourage voluntary agreement 'in the shadow of the law', without formal activation. However, while it is to constitute a significant element of a broader plan to strengthen the Fund's framework for crisis prevention and resolution, (which includes the Fund policies on lending into arrears and on exceptional access to Fund resources), the SDRM, as conceived now, will not constitute a comprehensive debt restructuring framework. The current SDRM proposal offers a rather limited protection for debtors, with private creditors having a key role in the decisions regarding stays, among other things. The SDRM is now heavily loaded against the debtors and in favour of creditors.

The latest version of the SDRM proposal has three key elements.[3] (1) In order to overcome the collective action problem, a super majority of creditors across aggregated claims would vote to accept new terms under a restructuring agreement, thereby binding all affected creditors. However, there are a large number of problems in the way this is envisaged, due to classification of claims. (2) The Fund does not consider a generalised stay on creditor litigation of debt payments necessary. Secured creditors are allowed to enforce their contractual rights. The latest version of the SDRM would just contain provisions that the Fund expects to prevent creditor enforcement actions from disrupting the negotiating process, or from delaying agreement on a restructuring that could be acceptable to a broad majority of creditors. (3) An independent dispute resolution forum would be established to verify claims, ensure the integrity of the voting process, and adjudicate disputes that might arise following activation of the SDRM. But, ironically, the Fund would play a crucial role in the setting up of this 'neutral' dispute resolution forum, and will have ruling powers over the latter's decisions.

[3] Based on the Report of the Managing Director to the International Monetary and Financial Committee on a Statutory Sovereign Debt Restructuring Mechanism, April 8, 2003 and Report of the MD to the IMFC on the IMF's Policy Agenda, April 11, 2003. The current position of the Fund is formulated in the attached 'Proposed Features of the SDRM'. The Proposed Features paper was prepared by the Fund staff in response to the IMFC's request to the Fund to develop a concrete proposal for a statutory sovereign debt restructuring mechanism before its April 2003 meeting.

II.1 Scope of Claims to be Covered Under the SDRM [4]

All features of the SDRM are now shrouded in the Fund's efforts to formulate a statutory debt restructuring mechanism that interferes the least with creditors' rights and the existing ways of operations of the financial market players. In fact, they look set to offer the same or higher level of protection from sovereign default risk to the latter than they already enjoy through official (bilateral as well as multilateral) bailouts. The following discussions on the scope of debt that are deemed by the Fund to be eligible for restructuring, the process of voting on claims meant for restructuring, the setting up and powers of the proposed dispute resolution forum, etc. would help to make this clear.

II.1.1 Identity of the Debtor

For purposes of the mechanism, a specified debtor would be the central government of the country activating the mechanism. However, according to the Fund's proposals, subject to the 'consent' of the debtor in question and the attitude of the sovereign's creditors who might insist on including these claims, a specified debtor under the SDRM framework could also include: (i) the central bank or similar monetary authority of the member; and (ii) any local governments or public entities within the territory of the activating member that are not subject to a domestic insolvency framework.

Typically, debt incurred by none of these three debtors would constitute a claim on the central government, in the absence of a guarantee. However, the Fund has attempted to bring in everything under the scope of the SDRM, by linking up these debts (particularly the claims on state-owned enterprises and sub-national governments) to the viability of the combined fiscal position of the central government as well as through the definitions of the identity of the debtor and the nature of claims that would be brought under restructuring, which includes guarantees by the central government. Thus, the creditors of a sovereign would have the option to include claims on the central bank and those on public entities or sub-national governments that have attached government guarantees on them when the underlying debt goes into default, if they are not subject to domestic insolvency laws.

Again, even if the SDRM were limited to sub-national governments or public entities that are not subject to domestic insolvency laws, the framework of the SDRM process requires parallel restructurings of those claims that are governed by domestic law. Further, the transparency requirements would require that when holders of external claims vote on a restructuring agreement, they be provided the information of the terms being offered to holders of domestic claims. Also, it is stated that unless the government actually assumes the debt of these entities upon activation, creditors could ask each of these debtors (the central bank, public entities, or a sub-national government) to carry out the restructuring decisions described under the SDRM, in a manner similar to that for the central government.

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[4] The ensuing analysis is based on the discussion provided in IMF, 2003, Proposed Features of a Sovereign Debt Restructuring Mechanism, February 12, 2003 and IMF, 2002, The Design of the Sovereign Debt Restructuring Mechanism- Further Considerations, Prepared by the Legal and Policy Development and Review Departments, November 27, 2002 .

It can be seen that this expansion of the identity of the debtor to include sub-national governments fits the new policies of the multilateral funding agencies, which are increasingly bypassing the central governments to offer loans to sub-national governments. These are for reasons such as: a decline in the demand for external funds by central governments over the years due to the strict monitoring of central fiscal deficit by these same organisations, squeeze in the availability of central funds for sub-national governments and their consequent increased demand for credit, and increase in the decentralisation process giving more and more financial rights to the latter, etc. Thus, a combination of all these factors and the lack of direct surveillance of sub-national governments by the multilateral bodies have lead to an expanding market for loans at the sub-national level, which these organisations are aiming at. This means that while the central government feels content that their external liabilities are under 'satisfactory limits', the proposed scope of the SDRM could enable bringing all the above-mentioned liabilities on the central government as a sovereign, in the event of a default. Apart from the fact that this leads to another instance of moral hazard problem by delineating the original borrowers from the risks of their external borrowing even as it protects the lenders from their credit risk, combined with the definition of 'eligible claims' described below, this could have serious implications for debtor countries' sovereignty.

II.1.2 Nature of Eligible Claims

The Fund's definition of the scope of 'eligible claims' is being guided by the following underlying 'principles',[5] which have been agreed to by the majority stakeholders: (1) SDRM should only be used to restructure debt that is judged to be unsustainable by the debtor, and should neither increase the likelihood of restructuring nor encourage defaults. (2) Any measure to resolve collective action problems must ensure minimal interference with contractual rights and obligations. (3) Since the framework is intended to fill a gap within the existing financial architecture, it should not displace existing statutory frameworks.

While a basic definition of claims on the sovereign would have involved defining them in terms of claims arising from the extension of credit to, or the guarantee of credit by, a sovereign, this was considered inadequate to bring a wide range of contractual claims, such as those involving the use of insurance contracts as well as financial derivatives within the ambit of the SDRM. Indeed, keeping the latter type of claims out of the definition would have led to the exclusion of a large majority of private financial market players from within the ambit of the SDRM framework.

Thus, the Fund has proposed a very broad definition of eligible claims. Eligible claims would consist of rights to receive payments from the specified debtor (subject to the identity of the debtor as defined above): (i) that arise from a contract relating to commercial activities of the specified debtor; and (ii) that are neither governed by the domestic laws of the member activating the SDRM, nor subject to the exclusive jurisdiction of a tribunal located within the territory of that member. However, according to the Fund, any activity of

[5] Both the above-mentioned papers list out a set of 10-12 principles, which the Fund agrees on as being the underlying guidelines for the SDRM.

the sovereign would be considered "commercial" if it could be conducted by a private party, and thus would be an eligible claim for restructuring.[6] That is, claims covered by this definition would include, but not be limited to, the following contractual rights:

- Repayment of money lent or credit advanced;
- Receipt of deferred purchase price of goods or services;
- Payments under bonds, notes or similar instruments;
- Amounts payable under interest rate and currency swaps, and other financial derivatives;
- The right of an issuing bank to be reimbursed for payments made under a letter of credit, bankers acceptance or bond;
- Payments due under leases;
- Guarantees or insurance contracts (direct or indirect) of the indebtedness of another party (subject to the exclusions below).

Traditionally, apart from official bilateral and multilateral loans, the external debt of a sovereign is defined to consist of commercial bank loans, debt securities issued abroad through various money market instruments, bonds and notes by both public and private sector borrowers, and official and officially guaranteed non-bank trade credits.[7] But, under the proposed SDRM, the scope of external debt has been given a new validation through the definition of the identity of the debtor and the inclusion of government guarantees. This reflects the fundamentally wide and open-ended scope afforded by this definition, which may have grave implications for a sovereign nation in default or a payment crisis.

The inclusion of guarantees means that government guarantees extended to state-owned or other enterprises, which can involve those for credit risk (i.e. the risk of default rising from the financial weakness of the obligor) or transfer risk (i.e. the risk of default arising from the imposition of exchange controls)[8], will all become eligible for restructuring, if the underlying debt goes into default.

The Fund itself acknowledges that irrespective of whether a financial crisis originated in the public sector or the private sector and was because of liquidity problems or actual insolvency, the liquidity problem leading to threat of default has been observed to quickly spread across and engulf other sectors as well and lead to a general payments crisis. Further, as has been seen in the recent East Asian financial crises too, a currency crisis can quickly turn into a payments crisis due to the sudden acceleration of debt payment obligations upon drastic currency depreciation. Thus, it is clearly foreseeable that as per the proposed nature of the SDRM, many of the sovereign's guarantees could be called upon, even in cases where these might have been sustainable in a normal economic scenario.

Thus, by making government guarantees eligible for restructuring if the underlying debt goes into default at the same time as 'secured claims' are kept out of the restructuring process (see the list of exclusions from eligible claims below) giving the latter the right to

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[6] See IMF, 2002, opcit.
[7] See IMF and World Bank statistics on external debt.
[8] Credit risk and transfer risk as defined in IMF, 2002, opcit, p. 18.

call upon the underlying assets to meet contractual payments, the SDRM would provide a veiled mechanism for the transfer of resources to the foreign sector, particularly if there are no clear-cut rules on what kind of national assets can be called upon in such a manner. For instance, in the event of a financial crisis, eligible claims could even include government guarantees involving the obligations of the entire banking system, provided to prevent a run on deposits and inter-bank credit lines. This would surely involve settling the underlying claims by throwing the domestic banking sector open for foreign equity participation and control (as seen most recently in the crisis-hit East Asian countries too) and would only serve to further alienate the operations of the banks away from the country's requirements and priorities.

On the one hand, the scope of eligible claims and the identity of the debtor under the proposed SDRM could provide scope for the creditor community to call upon even the public assets or public goods of a sovereign through the contractual rights upon public entities and sub-national governments, as though the sovereign and the non-sovereign contexts could be equalised. This reveals an unjustifiable contradiction of the sovereign character of indebted countries and of the developmental responsibilities of a sovereign nation. On the other hand, the Fund under pressure from the financial community declines to provide the sovereign debtor with legitimate protection from creditor litigation and a moratorium on external payments at the point of default, citing convoluted and faulty reasoning. Thus, the sovereign is denied the necessary policy flexibility to deal with the consequences of a financial crisis and to restrict the spread of the crisis (or liquidity problems) to other domestic sectors of the economy.

This could therefore lead to masked attempts to push through precisely the GATS-kind of agenda for service sector privatisation and for granting national treatment to foreign investors. The SDRM may serve to achieve the kind of foreign penetration of debtor country public sector, on which the WTO process has been failing to make substantial progress due to opposition from the developing countries. There is much concern that the current negotiations in the WTO GATS will lead to widespread privatisation of vital public services in developing countries, and sweep away existing controls on foreign private sector involvement in the provision of vital services in developing countries. The SDRM could provide another forum for achieving similar results through the definition of the 'identity of the debtor' and scope of 'eligible claims' for restructuring.

To further complicate the process, the present Fund proposal is that while the SDRM will identify the types of debt that could "potentially" be subject to restructuring, whether all or only some of that debt is restructured would depend on the outcome of negotiations. It is not clear how all these uncertainties created by leaving the outcome of even which kind of debts will be restructured to the negotiation process- wherein the creditor committees will necessarily yield the maximum power- will enable the debtor to arrive at anything that is significantly different from the existing long-drawn debt restructuring negotiation processes.

On the other hand, by definition, the Fund excludes the following from the list of "eligible claims":

1. Secured claims or privileged claims that benefit from a statutory, judicial or contractual privilege, to the extent of the value of such a privilege, would be outside the restructuring process. As proposed by the Fund, only those privileged claims that were created after the SDRM activation and that arise from legal enforcement proceedings against a specified debtor outside of the territory of the member activating the SDRM, would be considered under the SDRM restructuring list. Again, to the extent that the value of the claim exceeds the value of the privilege, the "unsecured" portion could be subject to restructuring under the SDRM.

   In general, secured claims cannot be restructured without the individual consent of the creditor in question. Thus, whatever the nature of such "privileged claims", all of them give creditors an advantage over general unsecured creditors in the event of a default. Privileged creditors not only have the right to collect upon certain pre-specified assets, but often they also have the right to do this in the event of default without obtaining prior judgement from the judiciary.[9] Therefore, the Fund argues that if these secured claims are treated under the SDRM in a manner that erodes the value of such privileges, it would make borrowing more difficult for the sovereigns that are unable to borrow without granting these privileges. Both the Fund as well as the creditor community also construe bringing secured claims under a common restructuring to constitute a significant breach of contractual relations.

   If debtors offering collateral assets are indeed being offered better terms by the creditors who obtain such secured claims and the latter are getting lower interest payments in comparison to unsecured creditors, obliging the contractual terms of secured creditors in the event of default, could be justifiable. But, evidently, this would limit the flexibility of a sovereign during a restructuring process, as it would need to continue the payments to secured creditors or should proceed with the sale of its assets to the secured creditor, in the event that the sovereign defaults and the creditor calls upon the collateral. Further, unless the proposed framework explicitly considers the sovereignty of the indebted country and includes unambiguous rules and definitions on the kind of assets that can be attached as collateral, leaving out secured creditors out of an SDRM restructuring could lead to an increased demand for collateral from more creditors. This could cause severe impairment to national ownership of assets, as mentioned in the earlier section too.

   Further, as the Fund itself points out, an unsecured creditor may also choose to accelerate its claim following a payment default. It may then initiate legal proceedings to obtain a court judgement for the full amount of the debt. Even though the ability of creditors to initiate legal proceedings and to enforce judgements against sovereigns is

[9] Secured or privileged claims are those which, based on contractual terms or statutory provisions, have the right to collect upon certain pre-specified assets of the sovereign in the event of a default (even though this may involve *limited recourse financing* -that is, the creditor has no right to proceed against the sovereign if the value of the collateral is less than the value of the claim at the time of default). Contractual terms may also involve the establishment of an escrow account through which proceeds of the sovereign's revenues are deposited until the payments on the underlying credit are made. A different type of arrangement used by banks involve "acceleration and set off" i.e. in the event of default, the bank may apply any amounts that the sovereign has deposited with it in satisfaction of its claim. Source: IMF, 2002, opcit, p. 20.

subject to the constraints of varying national procedural rules, including those on sovereign immunity, if such a judgement on liability is awarded, the creditor may proceed to attach available assets of the sovereign (or to obtain court orders directing repayment by the sovereign). While these procedural hurdles can present substantial expenditure of resources in litigation for the enforcing creditor towards highly uncertain recovery, according to commonly held legal principles, the Fund opines that only the reserves held by central banks and assets deposited in jurisdiction or institutions (such as the BIS) that recognise or enjoy enhanced protections from legal process, would normally be unavailable for satisfaction of claims against the sovereign.

Thus, it is most imperative that any suggestion to keep secured creditors out of the proposed SDRM is accepted only after clear-cut rules on the type of assets that could be used as collateral, are included. To protect the sovereign's assets, the latter would necessarily have to be limited in scope. In particular, natural resources will have to be explicitly excluded from the list of assets that can be attached for meeting contractual payments. Further, the sovereign borrowers should have the sole prerogative for the preparation of such a list.

2. Contingent claims[10] that are not due and payable, unless such contingent claim possesses a market value, are also excluded from the restructuring.

3. Claims held by international organisations are also to be excluded from the restructuring, seemingly to reflect the unique role these institutions play in the existing international financial system.[11]

4. Claims held by official bilateral creditors, will also be excluded or treated as a separate class. Although this would enable each class to receive different terms, approval by the requisite majority in both classes would be necessary for the overall restructuring agreement to become effective. This would only help lead to unjustified creditor discrimination.[12]

5. Non-contractual claims and claims arising from non-commercial activities such as wages, salaries and pensions, subscriptions to international organisations, etc. are to be excluded as well. This seems to one of the very few instances in the proposed SDRM where the Fund has acknowledged the basic welfare-oriented responsibilities of a sovereign borrower. However, excluding war crime and human rights violation claims out of the restructuring in a similar manner bodes well, provided they are considered 'odious debts'.

By creating different classes of creditors and keeping out certain groups of creditors out of the restructuring process, the Fund has thus rendered the concept of 'inter-creditor equity' a

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[10] These are payments falling due as a result of financial derivates such as currency and interest rate swaps, and forward contracts.

[11] See a detailed discussion on the problems of leaving out this creditor class in C. P. Chandrasekhar, Jayati Ghosh and Smitha Francis, 'SDRM: Insolvency or Liquidation?', March 31, 2003, at www.networkideas.org

[12] Ibid.

new level of meaning, by treating creditors with varying economic interests differently. Through this, the Fund separates out the concept of inter-creditor equity from those of the needs of an international insolvency procedure to balance the former with those of finding an appropriate solution to the collective action problems and the debtor's need for a stay on enforcement and payments.

II.2 Activation and Consequences

Based on the 'principle' that the mechanism should not interfere with the sovereignty of debtors, the most important protection offered to the sovereignty of debtors is that the sovereign can activate the mechanism unilaterally. For purposes of the legal effectiveness of activation, this representation would not be subject to challenge.

However, the member activating the mechanism has to form the judgement that its debt is unsustainable. While earlier the Fund expected another party to provide an independent confirmation of the accuracy of this representation of unsustainability as a condition for activation itself, this has now been removed. This is a significant change of heart in a sense. However, it is evident that the Fund, through its existing financial powers and its decisions on providing finance, will almost surely influence the question of sustainability of a member's debt and hence, its decisions as to whether and when it will activate the mechanism. Moreover, as a disincentive against unjustified activation of the SDRM by debtors, where creditors have formed the view that activation was unjustified, they can vote (by majority) to terminate the mechanism once their claims have been registered and verified.

The creditors are facilitated in doing this by relying on the 'principle' that the SDRM should promote greater transparency in the restructuring process. Accordingly, the activating member, upon activation of the SDRM, would be required to provide all information regarding its indebtedness and the indebtedness of all specified debtors to the Dispute Resolution Forum (DRF) such as: (i) a list of claims for which restructuring is sought under the SDRM ("SDRM Restructuring List"); (ii) a list of claims for which restructuring is sought outside of the SDRM ("Non-SDRM Restructuring List"); and (iii) a list of claims for which no restructuring is sought. Such information shall be published by the DRF, while a debtor (at the insistence of creditors) may modify these lists during the restructuring process.

Further, at the completion of the verification process, to the extent that forty per cent of creditors is against a restructuring under the SDRM, they could vote to terminate the mechanism. This clearly gives a decisive control to a set of powerful (larger) creditors who may not want to advance through a particular 'unfavourable' restructuring agreement, to bring the negotiations to an end unilaterally. This would not be very different from the unpredictability of the current disorderly debt workout negotiations and would in fact leave the sovereign in a clearly worse off position financially and economically. Therefore, eventually, the usefulness of a member country's sovereignty in making the decision to activate the SDRM is not that unambiguous.

This is also true because, the design of the SDRM has been changed in such a manner that "the incentives for unjustified activation"[13] have been made minimal, by tilting the entire mechanism in favour of the creditors' interests. One such disincentive is that the activation of the SDRM will not automatically trigger an automatic stay on debt payments or on creditor litigation, as the Fund reckons both to constitute significant interference with contractual relations of the creditors. Another additional disincentive that has been considered to prevent the abuse of the SDRM was the possibility of requiring the debtor to bear all costs arising from an activation of the SDRM (including costs arising from the operation of the proposed dispute resolution forum, which would normally be borne by the Fund).

II.3 Verification of Claims and the Issue of End-Investors

To ensure early and active creditor participation during the restructuring process and to enable the restructuring process to be completed within a reasonable time frame, the Fund suggests the formation of creditor communities. A representative creditor community would be given the role under the SDRM to address both debtor-creditor and inter-creditor issues, while disputes on whether the committee was sufficiently representative is to be resolved by the SDDRF.

Once the activating member provides the above-mentioned information on all its outstanding debt, a registration and verification process would take place that would enable creditors to be in a position to vote on an aggregated basis 'for each specified debtor'. Only those creditors whose claims are included on the SDRM Restructuring List and who wish to participate in the voting would need to register. Creditors whose claims are on a SDRM Restructuring List, but who fail to register within the specified period would not be entitled to vote, but their claims would be restructured on the terms approved by the required majority of holders of verified claims ("verified claims").

Related to the verification of claims, an issue that remains unresolved is the question of the identity of the end-investor. Clearly, only if the identity of the end-investor is known can be the claims be verified. However, the Fund's discussion of the identity of end-investors is convoluted and deliberately mixed up with the problem of 'fictitious claims' and claims held by 'related parties'. While the former is brought up in the context of Fund's suggestion that a sovereign could create fictitious claims to inflate its debt burden and to show its unsustainability so as to activate the SDRM, the latter is related to the suggestion that there could be creditors under the control of the sovereign through the issue of 'special purpose vehicles' by the sovereign. It does suggest that one way to solve the problem of claims verification is to require end-investors- rather than the lenders of record- to register their claims.

But, in its expectation that the SDRM would prompt a debtor and its creditors to complete negotiations prior to activation, the proposed solution is that the creation of standing private

[13] According to the November paper, it may be difficult for the sovereign to resist domestic pressures to activate the mechanism in cases where the member's debt situation is sustainable, either due to liquidity constraints or the debtor's willingness to cease making contractual payments because of a change in domestic priorities.

organisation would assist in pre-registering claims prior to activation. This is another typical instance of the Fund neglecting an opportunity to undertake a structural change to the way in which the private sector financial community carries out its activities. The Fund could, for instance, call for the harmonisation of the periodic settlement of claims across various countries so that the identification of end-investors at the point of default can be made smoothly. This would also help control the speculative elements in the sovereign bond market and in fact go a long way towards addressing the collective action problems at its roots.

On the other hand, the suggestion that a private organisation may be entrusted with claims registration and verification process are clearly part of the attempts to ensure the Fund's and the private sector's continued dominance over the financial market transactions, while leaving the identity of the end-investors a secret. Clearly, the Fund cannot bring about any change in the way of operations of the financial sector. Nor can it be expected to address the conflicts of interests between the developmental credit needs of a sovereign and the speculative interest of financial market players. Thus, the above loopholes have been left in place to ensure that the SDRM framework needs to be sufficiently flexible to accommodate the operation and evolution of financial markets.

II.4 Payments Cessation and Creditor Enforcement

The entire purpose behind the creation of a new international insolvency procedure is to avoid the irreparable damage imposed on a debtor economy announcing default, because of the absence of a stay on creditor enforcement that leads to stretched out negotiations process due to creditor litigation, holding out by rogue creditors and continued payment obligations. However, the complicated procedure that the Fund has now proposed looks set to be an overly protracted restructuring process that will help achieve precisely the same outcome.

Under most corporate insolvency laws, an automatic stay on litigation is accompanied by a requirement that the debtor cease making any payments to *all c*reditors. Together, the stay on enforcement and the general cessation of payments put in place a two-way "standstill" that, among other things, ensures inter-creditor equity. A creditor has the assurance that during the period when it is unable to enforce its rights, the debtor will be precluded from dissipating assets by making payments to other creditors; i.e. that all creditors will be treated equally.

As expected, the private sector creditor community is against any generalised stay on creditor enforcement, either automatically activated upon SDRM notification or activated upon an affirmative vote of a qualified majority. But, the absence of a generalised stay on creditor enforcement would severely undermine the capacity of the debtor and its creditors to reach a rapid restructuring agreement.

The Fund's position is that the objective of restructuring debt, while limiting the costs of economic ramifications, would be best served by securing agreement on a restructuring prior to a default. To this end, the SDRM has been designed with a view to creating incentives for a debtor and its creditors to use the period before the onset of a full-blown crisis to reach agreement on a restructuring that could pave the way toward a restoration of sustainability. Clearly, this is problematic given that the limited financial resources available to sovereigns, the pace at which crises unfold, the speed with which authorities recognize the need for decisive action, and the time taken to secure agreement with creditors, all have a bearing on the feasibility of a pre-default restructuring strategy. Thus, any discussion for addressing the sovereign's debt difficulties would inevitably trigger an abrupt shift in sentiment, stimulating capital flight and thereby accelerating the downslide towards default.

Further, faced with the prospect of a process involving a restructuring agreement that can be made binding on all creditors, creditors may consider that they have a limited window of opportunity to enhance their position through litigation. The goal of the litigation would be, prior to the imposition of a stay, either to have obtained full repayment with the aid of national judicial processes or at least to have obtained the status of a secured creditor by virtue of obtaining a judicially ordered collateral on the sovereign's assets. Thus, the risk is that the non-imposition of an automatic stay would fuel a race to the court among unsecured creditors and this would result in a highly disorderly period. Recent country experiences have clearly shown that a default or a restructuring in the shadow of default leads to drainage of the country's reserves in the attempt to stem pressures from capital outflows, and more generally a significant decline in economic output from sharply curtailed private investment, financial sector difficulties, and declining real incomes. Delays in debt restructuring magnify these costs.

But, the proposal of the Fund to discourage litigation without imposing any limitation on enforcement rights is tailored to address the problem of disruptive litigation from an inter-creditor - rather than a debtor vs. creditor – perspective. According to the Fund, the "hotchpot rule" provides creditors exercising forbearance with an assurance that litigation prior to the restructuring would not provide the litigant with an undue advantage. But, clearly, a litigant could attach assets of such a significant value that they could circumvent the operation of the "hotchpot rule". Further, the fact that the rule would come into force only if the creditors and the debtor actually reached a debt restructuring agreement, also implies that creditors might have some incentive to go ahead with litigation ahead of a restructuring agreement. The Fund hopes to address this problem by stating that the SDDRF would have the authority –only with the approval of the creditors- to enjoin specific enforcement actions, if a determination was made that such actions seriously undermined the restructuring process. Since obtaining a qualified majority of creditors to approve such an SDDRF decision would necessarily involve delay, the Fund suggests conferring this authority on a representative creditors' committee.

But, such a mechanism would ensure inter-creditor equity only among claims that are subject to the restructuring. It would not provide a means by which either a sovereign debtor or creditors that are outside the mechanism could address disruptive litigation. Accordingly, where a private creditor initiates litigation against a sovereign debtor that is negotiating a restructuring agreement with official bilateral creditors, these creditors would be able to take advantage of this feature only if official bilateral creditors were subject to the mechanism. It would not also be used to address cases where the litigation undermines the debtor's normalization of its relations with international financial institutions.

By the same reasoning, it would not provide means to prevent creditors that are outside the SDRM process from demanding accelerated payment or from undertaking disruptive litigation. For example, for privileged claims, this would not be applicable. Upon an event of default, a privileged creditor will be able to exercise its contractual rights to seize the pre-specified assets and secure its claim. Where the assets in question secure the full amount of the claim, an acceleration of all amounts due and payable may have an immediate impact on the financial position of the debtor. To the extent that the enforcement of the claim against the collateral further diminishes resources available for future debt services, such action will also be detrimental to unsecured creditors.

Notwithstanding the above analysis, the staff continues to be of the view that the SDRM should not contain a generalised stay on payments, but should contain features that prevent enforcement actions from disrupting the negotiating process and delaying the conclusion of a restructuring agreement. The Fund therefore, envisages supplementing the hotchpot rule with a form of creditor-approved stay. The proposed 'general stay on enforcement' would be approved by a qualified majority of creditors with verified claims and would stay all enforcement actions of creditors whose claims are on the SDRM Restructuring List, for very brief periods (e.g., 60 days), subject to renewal. But, fundamentally, this would not serve the purpose of providing protection to the debtor economy, as it could not be applied immediately after activation. Clearly, creditors would not be in a position to vote until the registration and verification process had been completed.

The proposed 'targeted stay on enforcement' on the other hand, could only prevent specific enforcement actions that are determined to seriously undermine the restructuring process. While the DRF would be responsible for making this determination, again, it could not do so on its own motion. This would only stay enforcement actions that are perceived by the debtor and creditors as being disruptive to the restructuring process. Prior to the completion of the registration and verification process, creditor approval will be evidenced by approval of a representative creditors' committee; thereafter, the issuance of any new order or the continued effectiveness of an existing order will require the approval of creditors holding 75 percent of outstanding principal of verified claims.

II.5 Restructuring Agreement

That the proposed SDRM framework has been complicated by the differentiation of creditors is further confirmed by the manner in which the Fund proposes the final restructuring agreement to be voted on. The Fund proposition is that holders of verified claims would vote on a proposed restructuring agreement and once certified by the DRF, the agreement would become binding with respect to all registered claims and all claims that appeared on an SDRM Restructuring List but were not registered. Evidently, this is applicable only for the claims that are on the 'eligible list'. But, at the same time as it leaves out several classes of creditors out of the restructuring process, it is proposed that a separate restructuring agreement would be proposed for each 'specified debtor', clearly insisting on parallel restructurings of the debt of sub-national governments and public entities, along with that of the central government.

While the central tenet of the SDRM remains that the agreement reached between the sovereign and a qualified majority of creditors would be binding on all creditors that are subject to the restructuring process, by insisting that there should be minimal interference with contractual rights and by creating three different classes of claims and leaving out official debtors and the multilateral organisations from the ambit of restructuring, the Fund thus makes a pretence of dealing with collective action problems for existing claims.

Again, at one place, the Fund states that all holders of eligible claims would have to be offered the same restructuring terms or the same menu of terms. But, at another place, it is also proposed that as a means of facilitating a restructuring agreement amongst creditors with different preferences, a debtor would have the option--but not the obligation--of creating different classes of registered claims, wherein, holders of claims in different classes could be offered different terms. Further, the approval of 75 percent of outstanding principal of verified claims in each class would be a condition for the effectiveness of the overall agreement. All these would serve to make the functioning of the proposed SDRM very time-consuming and complicated and may work against the basic objective to provide a rapid restructuring mechanism for sovereigns in distress or default.

II.6 Dispute Resolution Forum

The integrity of the decision making process under the mechanism is to be safeguarded by an efficient and impartial dispute resolution process. But, the independent dispute resolution forum envisaged to verify claims, ensure the integrity of the voting process, and adjudicate disputes that might arise following activation of the SDRM, ironically, is to be set up by the Fund.[14] Further, the responsibilities of the DRF would be limited. It would have no authority to challenge decisions of the IMF Executive Board or make determinations on issues relating to the sustainability of a member's debt.

III. Conclusion

The Fund now expects that ideally, a member will have both entered into and completed its negotiations with its creditors before having activated the SDRM, during which time it may try to stay current on all of its obligations. In these circumstances, the SDRM will be used solely for the purposes of making the agreement that the member has reached with the qualified majority binding on the entire creditor body. In this sense, the Fund believes the "shadow" of the SDRM to benefit the member's negotiations. The convoluted logic offered is this: potential holdouts will be more reasonable during the negotiations since they will know that, if they are inflexible, the debtor and creditors will be able to use the mechanism to bind them to an agreement. Thus, it seems that the purpose of SDRM has itself been reduced to a shadow of its original intentions. Against this backdrop, the relevance and usefulness of adopting the SDRM in the present format becomes fundamentally questionable.

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[14] See the detailed discussion on the dispute resolution forum (SDDRF) in C. P. Chandrasekhar, Jayati Ghosh and Smitha Francis, opcit.

Meanwhile, the IMF-World Bank Spring Meetings during April has revealed that although there is substantial convergence of views within the IMF's Executive Board on the key features of the SDRM, differences remain on a number of issues. A number of Executive Directors are in fact of the view that a general cessation of payments and a temporary automatic stay should be a feature of the mechanism. More fundamentally, however, not all Directors agree on the desirability of a statutory sovereign debt restructuring mechanism.

For example, while Russia is in favour of continuing work on the SDRM, some other emerging market countries like Brazil supports a more extensive use of existing collective action clauses in new international bond issues, to be decided voluntarily by the debtors and creditors themselves, rather than the SDRM's statutory approach.[15] Several emerging market economies have expressed reservations about the proposed SDRM, while remaining open-minded on the incorporation of collective action clauses into new international sovereign bond contracts (as demonstrated recently by Mexico). Opposed to a statutory mechanism completely biased against them, they reiterate their preference for voluntary, market-friendly approaches to debt restructuring, with due consideration to member country circumstances.[16] On the other hand, the European Commission strongly believes that the IMF should continue with its work to develop the SDRM.[17]

However, the US - the Fund's most powerful shareholder, has rejected the IMF's exploration of a statutory sovereign debt restructuring mechanism. The US is not interested in a centralised mechanism to resolve issues connected with sovereign debt restructuring. According to the US Treasury Secretary John Snow, the source of collective action problems lies in the relationships and agreements of debtors and their creditors, and it is these parties, not an international organization, which must assume responsibility for the solution. Therefore, it is neither necessary nor feasible to continue working on the SDRM.[18]

This stance of the US on the SDRM clearly indicates how the US government's policies are stakeholder-driven. The financial sector is one of the largest and most influential businesses in the US along with defense, and the government works very closely with the industry. Wall Street's big institutions, led by investment banks, were heavily opposed to the original SDRM concept on the grounds that it would interfere with their contractual rights.[19] However, given that the Fund has gone so far to accommodate private creditor interests as we have discussed in this paper, it now seems that the Wall Street is wary of

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[15] See Statement by Aleksei L. Kudrin, Governor for the Russian Federation, Deputy Prime Minister, and Minister of Finance of the Russian Federation, IMFC Meeting, and Statement by Antonio Palocci Filho, Minister of Finance, Brazil IMFC Meeting, Washington, D.C., April 12, 2003.

[16] See Intergovernmental Group of Twenty-Four On International Monetary Affairs And Development Communiqué, April 11, 2003 at www.imf..org.

[17] Statement by Pedro Solbes, Member of the European Commission to the International Monetary and Financial Committee, *Washington DC, 12-13 April 2003.*

[18] Statement by Secretary John W. Snow, United States Treasury, at the Meeting of the IMFC, Washington D.C., April 12, 2003.

[19] See C.P. Chandrasekhar, Jayati Ghosh and Smitha Francis, opcit.

any multilateral bureaucratic procedure,[20] which would interfere in any manner with their way of operations. Further, they could potentially incur heavy costs, since official creditors and the multilateral funding agencies insist on full repayment of their debts and expect the private creditors alone to be involved in the SDRM restructuring. The private financial sector players are thus still opposed to the SDRM, saying the use of specific clauses in bond contracts would be a simpler solution. The rejection of the SDRM by the US at the Spring Meetings therefore, clearly reflects the reluctance of the US Treasury and the White House to confront this powerful Wall Street lobby.

The US Treasury Secretary has in fact stated that the emerging markets, which regularly access international financial markets, need to assume rightful ownership of the issues related to debt restructuring. While this may sound as if the developing countries stand to gain from this stance of the US, it only goes to confirm how the US, which has a very powerful position in bilateral arbitrations, prefers to retain it that way, rather than be engaged in a statutory multilateral negotiation process. Retaining the status quo would enable the powerful private sector creditors to litigate and obtain what they want from the debtor countries or continue to be bailed out by the multilateral bodies' refinancing packages when debtors are in crisis.

The US thus expects the work to strengthen the crisis resolution framework to continue through broad voluntary approaches. They are only interested in moving forward on such issues as how best to promote more widespread inclusion of collective action clauses and enhanced transparency and disclosure.

Thus, at this stage, the requisite high level of support among the Fund's membership to establish the SDRM through an amendment of the Articles of Agreement is lacking. The Fund now proposes to cooperate actively in the efforts to design and promote the use of collective action clauses (CACs) in sovereign debt contracts. But, the adoption of CACs alone will not alter the fundamental hurdles facing a sovereign debt restructuring process currently. This is because the inclusion of CACs in sovereign debt contracts will enable only specific debt contracts to be restructured through an all-binding majority agreement. Further, even if new sovereign issues are made to include CACs, the range of such debt instruments containing contractual provisions that could facilitate a restructuring may remain narrow for a long time to come, and may provide only limited help in achieving rapid agreement in cases where the sovereign has substantial indebtedness (from the past) that does not include such provisions. Most importantly, the aggregation of claims on a sovereign and an automatic stay on debt payments during the process of restructuring, both of which are necessary to ensure a rapid and equitable debt restructuring, are absent in this option. Thus, CACs cannot solve the "collective action problem" for multiple sovereign debts, and this is one of the major reasons for the emergence of the statutory approach, i.e., the SDRM, in the first place.

[20] On Wall Street opposition, see Mark Egan, 'IMF's sovereign bankruptcy plan meets opposition', Reuters, January 22, 2003 and Gary Duncan, **'**US blocks IMF debt proposal'**,** The Times, April 14, 2003.

While the adoption of the SDRM through an amendment of the IMF's articles cannot proceed without the US approval, the Fund has insisted that the background work would continue. Surely, work on an international insolvency procedure should continue, in order to formulate a refined mechanism that would take place in agreement with the legitimate developmental and sustainability concerns of the debtor countries. What matters is whether or not the final agreement reached can be formulated to achieve a better scale of balancing between debtors and creditors, and retain the sovereign powers of debtor nations. The purpose of future work should be to advance towards this, and debtor countries should guard against being unwittingly bound into a statutory debt restructuring framework that would subsequently limit their powers.

May 20, 2003.