7 Directions for reforms of sovereign debt restructuring

Introduction

Due to the global financial crisis, external sovereign debt has again become a problem to a broad range of countries – from European high-income countries to the poorest states – even after they had obtained debt relief through existing multilateral initiatives. Despite long-standing experiences with sovereign insolvencies, however, no mechanism presently exists to deal with the complex debt structures of many countries in a comprehensive way. Existing debt workout procedures – such as the Paris Club, the London Club, HIPC/MDRI, or Brady-style debt conversion – have either been one-off exercises not meant to be applied as a permanent mechanism, or they are reinforcing collective action problems for being piecemeal in character.

The aim of the paper is to assess to what extent the most recent proposals for reforming the existing sovereign debt restructuring "system" are relevant to the principles of efficient debt resolution. The main hypothesis is that an application of principles and procedures of domestic insolvency to sovereigns would help to achieve a fair and sustainable debt workouts. The paper is based upon the theoretical literature's survey and upon the case studies of debt restructuring in the period 1980–2015.

The paper is organized as follows. In the first part major shortcomings of the existing system of resolving sovereign debt crises are described. In part two criteria for reforms drawn from the flaws of the current system and the principles of a corporate bankruptcy law are discussed. In the third part we present the most influential proposals to reform sovereign debt workouts and assess them in terms of how they meet the criteria for efficient debt restructuring.

1. Shortcomings of the current system of resolving sovereign debt crises

In this section we will look at the shortcomings in the existing frameworks of the sovereign debt crises resolution and will draw from this analysis the elements of reforms. The following shortcomings will be discussed: 1) the incoherence of the negotiation process, in particular, creditors' collective action and coordination problems; 2) the content of debt restructuring agreements that provides too little debt relief too late; 3) the double role of the Bretton Woods institutions and creditors in debt restructuring negotiations.

1.1. Incoherence between various negotiation fora and collective action problems

The existing system of resolving sovereign debt crises arose as piecemeal and mostly *ad hoc* creditors responses to debt crises as they occurred over the past half-century or so.[1] Creditors organised negotiations with individual countries which needed debt relief in several *ad-hoc* fora that were informal with no legal status or rules to proceed. In the 1980s debtor countries tended to be exposed primarily to one single group of creditors. So this individual group – in some countries private banks, in others governments, sought to restructure their claims on the debtor at the lowest possible cost, not caring too much about the behaviour of fellow creditors from other sectors. The Paris Club renegotiated debt owed to bilateral official creditors, whereas the London Club renegotiated debt owed to private international banks.[2]

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[1] J. Kaiser, *Resolving Sovereign Debt Crises. Towards a Fair and Transparent International Insolvency Framework*, "Friedrich-Ebert-Stiftung Working Paper", September 2010, http://library.fes.de/pdf-files/iez/07497.pdf (accessed 25.07.2015), pp. 11–12.

[2] L. Rieffel, *Restructuring Sovereign Debt: The Case for Ad Hoc Machinery*, Brookings Institution Press, Washington, D.C. 2003.

From the mid-1980s onward things started to become less clear-cut. Middle-income countries in Latin America were still most heavily exposed to private banks, however, the official sector lending gained some importance as well. This was, among other factors, due to the fact that the governments in creditor countries tried to keep exports to the Southern hemisphere going through official financing, while private banks had exhibited reluctance after the 1982 defaults.

With some regional deviations, the following creditor profiles emerged and persisted well into the 21st century: low-income countries – without real access to international capital markets – usually were most indebted to official creditors with a growing multilateral share whereas middle-income countries continued to be attractive for private lenders after the Brady Plan had helped to accommodate the spectacular defaults of the early 1980s.[3] After the mid-1990s, among the private lenders, the emphasis shifted from syndicated bank lending to bonds as the preferred instruments. Bondholders had widely differing institutional characteristics from pension funds to individual "retail holders". There was no unified creditor representation and generally no structured negotiation process. Debt restructurings took the form of take-it-or-leave-it exchange offers, though these were usually preceded by informal discussions with creditors.

In this setup, creditors' coherence started to become a critical issue in international sovereign debt restructuring. It showed that the system of mutually independent piecemeal negotiations implied a strong incentive for holdouts: a small group refuses a restructuring offer, and insists on being paid the original nominal value instead, with the expectation of improved solvency due to the debt reduction. This free riding behaviour can then lead to the remaining creditors, for whom the deal would have been favourable, no longer agreeing to it. Agreement is then prevented or certainly made more difficult or delayed.[4] A coordination problem

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[3] By the mid-1990s multilateral lenders became the most important creditor group for low-income developing countries as a result of the continued re-financing of bilateral debt service by the multilateral institutions.

[4] Famous cases include NML vs. Argentina, in which the 2005 debt restructuring had to be postponed by several months due to seizures by holdout creditors;

between creditors forces up the costs of debt restructuring and worse still leads to the emerging industry of holdout creditors and vulture funds.[5]

Official creditors have tried to meet that challenge by inserting "comparability of treatment" clauses into their Paris Club agreements that oblige the debtor to seek a restructuring with any non-participating creditor, which was not less favourable as the one agreed with the Paris Club. The burden to accomplish such treatment was put upon the shoulders of the debtor who had very little leverage to actually enforce the clause on other creditors (non-Paris Club countries, banks, or bondholders). So compliance tended to be low. When the "comparative treatment model" was enshrined into the Heavily Indebted Poor Countries initiative (HIPC) as well, compliance rates were less than 50 per cent among non-Paris Club official creditors, and below 20 per cent among commercial creditors.[6]

The above flaws in existing system allow us to draw some essential criteria for more efficient debt resolution system. First, once a country has to renegotiate an unsustainable debt, *negotiations should take place in one single coherent forum,* where everybody who holds a claim on the debtor must participate, or at least have the right to be heard. Second, in principle *all creditors need to be treated equally.* There can be no preferred or even exempt creditor status other than by mutual consent. Such a consent could be based, for instance, on some creditors' willingness to support a recovery process with fresh money. Third, comparability

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another example is in Peru where the Brady debt restructuring in the 1990s was initially attacked by US banks and later by the Elliott hedge fund.

[5] A vulture fund buys distressed debt with a huge discount on the secondary market. After the indebted sovereign's ability to service debt has been restored through debt relief by other creditors, the vulture sues for full payment plus interest, compound interest, and eventually, penalties. In some cases vultures profits have been beyond 200 per cent of the invested capital. In others they have been unable to attach any debtor assets.

[6] HIPC initiative was launched in 1996 (HIPC-1) to provide debt relief to heavily indebted low-income countries mainly from bilateral official creditors. Due to its little success it was enhanced in 1999 by providing more and faster debt relief under more flexible framework (HIPC-2). In 2005 HIPC initiative was supplemented by Multilateral Debt Relief Initiative (MDRI) that allowed for a full cancellation of HIPC debt to international financial institutions.

of treatment can only be achieved if decisions are being made by a *neutral decision-making body, or by a creditor mandated to negotiate by all other creditors*. Fourth, just as insolvency law is binding in national law, creditors must be able to rely on an *international treaty that would help to enforce compliance with the negotiated solution in national courts*, where necessary.

1.2. The content of the restructuring agreement: Too little debt relief provided too late

Until the end of the 1980s, the practice of dealing with sovereign debt defaults was based on the assumption that "states do not go bankrupt". As a result, settlement of defaults generally took the form of an agreement on re-financing and rescheduling current debt service, rather than providing the haircuts to creditors' claims, which are a normal element of any individual or corporate insolvency regime. When it became apparent at the end of the 1980s that continuous re-financing would only contribute to the ongoing pileup of ultimately unpayable external debt, creditors decided to enter into an incremental process of granting piecemeal debt service alleviation, and from 1990 onwards limited debt stock relief. Both types of treatment functioned on the basis of pre-defined debt relief quotas, rather than on an individual assessment of the need for debt relief in order to restore debt sustainability. This quota-based system of the Paris Club was initiated with the "Toronto Terms" of 1989, which allowed the poorest countries to obtain a reduction of 33 percent of debt service falling due in a limited time frame. Those quotas turned out to be insufficient in restoring debt sustainability and were revised.[7] As a consequence, many countries had to return to the Paris Club to renegotiate debt relief agreements several times.

The history of debt relief schemes since the outbreak of the Mexico crisis in 1982 shows that ample debt relief, at least for some countries, can

[7] From 1991 onwards debt relief terms allowed for not only a debt service reduction but also a reduction of a country's debt stock: up to 50 percent (London Terms, 1991), 67 percent (Naples Terms, 1994), 80 percent (Lyon Terms, 1996), and 90 percent (Cologne Terms, 1999).

be agreed by the creditors. However, the poorest people in the indebted countries have paid a very high price for the 20-year-long history of too little relief being provided too late. Thus, the challenge in the current situation of the possible re-emergence of a broader sovereign debt crisis is whether the international community will be able to draw the right conclusions from the existing mechanisms' shortcomings, and whether they can be drawn in a speedy and efficient process. Or will debt relief again be withheld for years and years because of individual creditors' desires to maintain their hegemony over any debt restructuring process?[8]

1.3. The double role of the BWI/creditors in sovereign debt management

Any debt restructuring needs to be based on an assessment regarding the debtor's future capacity to repay – if a new over-indebtedness post-relief is to be avoided. The current system of debt renegotiation process is based on opinions and assessments provided by the two Bretton Woods institutions: the IMF and the World Bank. The strong position of the BWI was driven even further when Paris Club debt relief was complemented by the HIPC and MDRI initiatives. They controlled the whole process of debt restructuring, and their boards even decided upon HIPC/MDRI relief based solely on their staff's own assessments.[9]

The BWI role in debt restructuring process is problematic. First, it is always controversial if institutions have a monopoly on expertise and ultimately on decision-making. *Debt sustainability assessments need to be made by an independent entity, over which neither the debtor nor the creditors exert any influence.* This very fundamental principle of the rule of law must be applied to sovereign debt negotiations as well as to any other debtor-creditor conflict. Second, the BWI are creditors themselves. As their assessments have a direct influence on the recoverability of their own claims, there is a classic conflict of interest. In Paris Club negotiations outside HIPC, which do not imply a reduction of international

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[8] J. Kaiser, *op. cit.*, p. 10.
[9] *Ibidem*, pp. 13–16.

financial institutions claims, they do have an incentive to enforce as much relief as possible onto Club members in order to safeguard their own repayments. This conflict of interests implies that in the long run, the *mandates of the World Bank and the IMF need to be separated:* an institution can either be a creditor or an independent expert.

Another problem is that creditors act as party and judge in the debt negotiation process. This has two very practical consequences. One is that the creditors may interfere with the debtor's domestic policy issues. Creditors like the IMF demanded good behaviour from debtors in return for debt relief. This good behaviour has in the past led to the debtor's acceptance of conditions that had nothing to do with the individual debts at stake nor even with the common interest in improving the debtor's fiscal situation in order to allow the servicing of more debt in the future. It is related to things like opening markets to creditor countries' exporters and investors or even to make political concessions in return for debt relief.[10]

The second is the interference of political interests in the resolution of debt problems. For example, after the Gulf War of 2003, it was solely the political pressure of the Bush administration that assured Iraq an 80 per cent debt relief. No debt sustainability analysis would ever have demonstrated why exactly 80 per cent relief – rather than, for example, 50 per cent or full cancellation – was necessary in order to restore Iraq's external and fiscal sustainability.[11]

This double role played by creditors should be abandoned. Sovereign debt negotiations need to be conducted under the leadership and the decision-making power of an impartial entity that is economically and politically independent from both the sovereign debtor as well as its creditors.

[10] One spectacular case in point was Egypt's 50 per cent debt cancellation in 1991, which was much beyond the maximum 33 percent of debt reduction provided by Paris Club at that time, and ultimately a remuneration for the country's good behaviour during the Kuwait war.

[11] J. Kaiser, *op.cit.,* p. 13–16.

2. Criteria for efficient sovereign debt workouts

From the flaws in the existing system the following principles for a sovereign debt resolution framework can be drawn:

- the need for a comprehensive treatment, that is, all claims on a sovereign need to be treated in one single process,
- an independent decision-making body,
- independent assessment of the debtors fiscal and economic situation,
- legal basis for enforcement of the negotiated solutions.

Additional principles could be "borrowed" from corporate bankruptcy codes like Chapter 11 of the US Insolvency Code. Experience with corporate reorganization has demonstrated that three elements are needed to give both the opportunity and the incentives to achieve efficient restructuring of outstanding debt obligations:

- to stop a creditor grab race for the debtors' assets before an orderly process of restructuring starts, *an automatic legal stay* on the enforcement of lawsuits and claims against the debtor is needed,
- to provide the debtor with liquidity and to finance its reorganization, preferred status should be given to creditors providing new money – so-called *debtor-in-possession (DIP) financing*,
- to prevent collective action problems that occur during negotiations (the problem of "holdouts"), *supermajority voting* that would bind minority creditors to accept the agreed settlement, should be included in debt contracts.

All these elements ought to be present in some form in any sovereign debt restructuring procedure, even if important differences exist between corporations and sovereign states.[12]

[12] P. Bolton, *Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice Around the World*, "IMF Staff Papers" 2003, Vol. 50, Special Issue.

3. Main proposals for reforming sovereign debt restructuring system

The shortcomings in the current system motivated a large set of policy initiatives focused on mitigating collective action problems in sovereign debt restructurings, ranging from issuing new sovereign bonds with collective action clauses to the creation of new institutions such as an international bankruptcy mechanism for sovereigns.[13] The policy proposals differ in opinions on how best to address the perceived shortcomings in the current system. Some authors such as Krueger, Hagan, Weder di Mauro and Zettelmeyer, and Gianviti with the co-authors, suggested that it could be best achieved via statutory means (*statutory approach*).[14] Others, e.g. Eichengreen and Portes, Group of Ten, Rieffel, Roubini, maintained that a statutory framework would be difficult to implement, and thus more decentralized, market-based approach is more promising avenue for reform as it could suffice to alter the documentation of bond or loan contracts to regulate the restructuring process in a more efficient way (*contractual approach*).[15] However, the reality does not confirm the latter view. The current market-based system leaves much to be desired.

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[13] See K.S. Rogoff, J. Zettelmeyer, *Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976–2001*, "IMF Staff Papers" 2002, Vol. 49, No. 3 for a survey of policy proposals.

[14] A. Krueger, *A New Approach to Sovereign Debt Restructuring*, IMF Washington, D.C. 2002, www.imf.org/external/pubs/ft/exrp/sdrm/eng/index.htm (accessed 25.07.2015); S. Hagan, *Designing a Legal Framework to Restructure Sovereign Debt*, "Georgetown Journal of International Law" 2005, vol. 36, No. 2; B. Weder di Mauro, J. Zettelmeyer, *European Debt Restructuring Mechanism as a Tool for Crisis Prevention*, VoxEU.org, 26 November 2010, www.voxeu.org/index.php?q=node/5929 (accessed 25.07.2015); F. Gianviti, A. Krueger, J. Pisani-Ferry, A. Sapir, J. von Hagen, *A European Mechanism for Sovereign Debt Crisis Resolution: A Proposal,* Bruegel Blueprint, 10 November 2010.

[15] B. Eichengreen, R. Portes, *Crisis? What Crisis? Orderly Workouts for Sovereign Debtors,* CEPR, London 1995; Group of Ten, *Resolving Sovereign Liquidity Crises*, Washington, D.C. 1996; L. Rieffel, *op.cit.*; N. Roubini, *An Orderly Market-Based Approach to the Restructuring of Eurozone Sovereign Debts Obviates the Need for Statutory Approaches,* RGE Analysis, 15 November 2010, www.roubini.com/analysis/138863.php (accessed 25.07.2015).

3.1. Contractual approach to sovereign debt restructuring

Initially, the emphasis was put on including collective action clauses (CACs) in bond documentation to facilitate debt exchanges. More recent proposals suggest including clauses for dispute resolution via arbitration as proposed by Kargman and Paulus or clauses for the appointment of trustees to represent bondholders in times of crisis as suggested by Häseler.[16] The former will be discussed in the next section in a broader context of establishing a sovereign debt tribunal. Here we concentrate on CACs and the latest initiatives to improve their functioning.

CACs allow a supermajority of bondholders to agree to a debt restructuring that is legally binding on all holders of the particular bond, including those who vote against the restructuring. Bondholders generally opposed CACs in the 1980s and 1990s, fearing that it gave debtors too much power. However, following Argentina's December 2001 default on its debts in which its bonds lost 70% of their value, CACs have become much more common, as they are now seen as potentially warding off more drastic action, but enabling easier coordination of bondholders. While emerging countries have increasingly been using CACs since 2003, European sovereign bonds did not usually include them.[17] In accordance with the ESM (European Stability Mechanism) Treaty all new bonds issued in the euro area after January 1, 2013, have a mandatory collective action clause.[18]

However, some problems remain. The clauses often only encompass investors in individual bonds. This can lead to holdout creditors blocking a debt restructuring despite the presence of CACs. More than €6 billion of Greece's foreign-law bonds did just that, and are getting paid in full, while approximately €200 billion of the rest had to give up more than half

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[16] S.T. Kargman, Ch. Paulus, *Reforming the Process of Sovereign Debt Restructuring: A Proposal for a Sovereign Debt Tribunal*, UNDESA, 8–9 April 2008; S. Häseler, *Trustees Versus Fiscal Agents and Default Rrisk in International Sovereign Bonds*, "European Journal of Law and Economic" 3 January 2010.

[17] With exception of bonds issued under English law.

[18] See europa.eu/efc/sub_committee/cac/index_en.htm, and the ESM contract, preamble, No. 11.

of their claims.[19] In the case of Argentina, the country recently fell back into default on $30 billion of debt issued to participants on its 2005 and 2010 restructuring as a consequence of a lawsuit by a group of holdout investors.[20]

While the holdout problem in bond restructuring had been well-known for years, it was only the Argentine and Greek debt defaults that created broad-based interest among sovereign borrowers and lenders in doing something about it. The International Capital Market Association (ICMA) and the US Treasury stepped in to lead an effort to reduce the ability of holdout investors to disrupt future debt restructurings through improving the design of two important features of sovereign bond contracts: CACs and the *pari passu* clause.[21] The result was a new set of model clauses published by ICMA on August 30, 2014.[22]

To mitigate the problem of holdouts, ICMA has proposed three voting options that can be presented to the creditors. Apart from a traditional bond-specific vote, in which 75 percent of creditors must vote on each bond, it is also possible to implement an aggregated vote on multiple bonds. In the second voting option, changes to the payment terms of a bond become binding for all investors if two majorities are reached: two-thirds of the aggregated nominal value of all outstanding bonds and 50 percent of the nominal value of individual bonds. Third voting option allows a restructuring to be imposed on all creditors if an aggregate majority of 75 percent of the total nominal value of the outstanding debt agrees to it.

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[19] J. Zettelmeyer, Ch. Trebesch, M. Gulati*, The Greek Debt Restructuring: An Autopsy*, Peterson Institute of International Economics, Working Paper Series, 2013, No. 13–8.

[20] L. Burn, *Pari Passu Caluses: English Law after NML v Argentina*, "Capital Markets Law Journal" 2014, Vol. 9, No. 1, http://cmlj.oxfordjournals.org/content/9/1/2.full (accessed 25.07.2015).

[21] *Pari passu* ("equal footing") clauses promise an "equal" treatment of the various creditor classes within a defined group of debt types.

[22] ICMA, *Standard Aggregated Collective Action Clauses for the Terms and Conditions of Sovereign Notes*, May 2015, www.icmagroup.org/resources/Sovereign-Debt-Information (accessed 25.07.2015).

In addition, ICMA has proposed clarifying and standardizing the *pari passu* ("equal treatment") clause in sovereign bonds to preclude courts from ordering debtors to pay holdout creditors whenever they pay restructured creditors. US federal court decisions in October 2012 invoking this clause in Argentina's contracts required it to pay holdout creditors in full when it paid interest on restructured debt, leading the country to default on $30 billion of new debt on July 30, 2014, and triggering fresh lawsuits around the world.[23]

The ICMA's model clauses mark major progress. If adopted, the new CACs would make it much harder for holdout creditors to disrupt future bond restructurings or to be paid in full after the other bondholders receive haircuts. Neutralizing holdout creditors in this fashion is of immense economic importance. It should facilitate more predictable outcomes for debtors and creditors, and fairer outcomes among creditors in situations that require debt restructuring. However, it would be a mistake to expect that the proposed clauses fix all or even most of the dysfunctions of sovereign debt. They are voluntary in nature, so debtors and creditors are not compelled to adopt them in new bonds, even if they are endorsed by the IMF and its biggest shareholders. It is likely that many will adopt some version of the clauses in due time, but neither the content nor the timing is guaranteed. Change may well be partial and fragmented. Contract change also takes time. The new terms would only be included in new bonds. Hundreds of billions of dollars in old bonds without the recommended clauses will remain outstanding for years or even decades. This means that the danger of holdouts in sovereign bond restructurings will remain for the foreseeable future.

3.2. Statutory approach to sovereign debt restructuring

Since contractual changes for sovereign bonds will presumably not solve all coordination problems among creditors, more institutional solutions such as an insolvency regime need to be introduced to make

[23] G. Affaki, Revisiting the *Pari Passu Clause*, in: *Sovereign Debt Management*, eds. R.M. Lastra, L. Buchheit, Oxford University Press, New York 2014.

debt restructuring legally possible. We will present four main options for a sovereign insolvency framework that have been discussed for the last two decades and evaluate them in terms of the identified criteria for efficient sovereign debt resolution.

Two of these proposals are statutory mechanisms: a) the IMF's proposal for *Sovereign Debt Resolution Mechanism* (SDRM), which was proposed by this multilateral body for the first time in 2001, but later rejected by the IMF board in 2003,[24] and b) the *European Crisis Resolution Mechanism (ECRM)* proposal suggested by the think-tank Bruegel, which has received considerable attention.[25] The other two rely on dispute resolution via means of arbitration: a) the S*overeign Debt Tribunal* under the auspices of the United Nations suggested by German legal scholars Christoph Paulus and Stephen Kargman,[26] and b) the proposal on a *Fair and Transparent Arbitration Process* (FTAP) suggested by Kunibert Raffer[27] and many NGO activists, e.g. Jürgen Kaiser.[28]

In terms of the level of formalization, at one extreme is the ECRM proposal and at the other extreme is the FTAP proposal. The ECRM is a full-fledged statutory framework which is legally binding on the European level and which would require its own European Union treaty. According to Gianviti and co-authors, the mechanism would consist of three main components: (a) a legal body to be responsible for sorting out disputes (e.g. the European Court of Justice); (b) an economic body for guiding the negotiations, assessing debt sustainability and providing expertise (e.g. the European Commission), and (c) a financial body for providing interim financing (e.g. the European Stability Mechanism). The SDRM proposal is less comprehensive and differs from the ECRM model in several important ways.

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[24] A. Krueger, *op.cit*.

[25] F. Gianviti, A. Krueger, J. Pisani-Ferry, A. Sapir, J. von Hagen, *op.cit*.

[26] S.T. Kargman, C. Paulus, *op.cit*.

[27] K. Raffer, *The Present State of the Discussion on Restructuring Sovereign Debts*: *Which Specific Sovereign Insolvency Procedure*?, in: *Proceedings of the Fourth Inter-regional Debt Management Conference,* United Nations, Geneva–New York 2005.

[28] J. Kaiser, *op.cit.*

First, it did not foresee an automatic payment suspension once the mechanism had been initiated. Second, the SDRM was not anchored in a supranational legal body. Instead, a Dispute Resolution Forum (DRF) was to be created, similar to a court-like arbitration panel. However, DRF arbitrators would not be independent but selected by the IMF (board or director). Third, the SDRM proposal envisaged a substantial role for the IMF, while the ECRM does not rely on formal IMF participation. According to the SDRM model, the IMF would have been responsible for interim financing, as well as for assisting in the restructuring process and for assessing debt sustainability.[29] Finally, the IMF's proposal was intended for debt crises globally, and not targeted to a single region such as the European Union.

A main feature contained in both the SDRM and the ECRM is the possibility of majority voting by creditors. According to the proposals, a supermajority of creditors should be enabled to make decisions on behalf of all creditors, thus binding in potential holdouts. Aggregation occurs across all creditors' claims. This is different from CACs, which pertain only to individual instruments, so that voting on a restructuring has to take place bond by bond.

The proposals by Paulus and Kargman (Sovereign Debt Tribunal), and by Raffer and Kaiser (FTAP) are much less formalized. They do not require a change in international law, nor do they foresee the creation of any new international institutions. Instead, they rely on arbitration mechanisms, similar to the dispute resolution procedures currently applied to cross-border investment.[30] A further important difference is that they aim to include a broader spectrum of debt instruments. While the SDRM and the ECRM are tailored to sovereign bond restructurings, and thus restricted to only one debt instrument, the arbitration proposals aim for a more comprehensive solution. They are designed as an alternative

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[29] In its first draft, the SDRM proposal also gave the IMF the power to approve or reject the debtor country's restructuring plan or a debtor request for a payment standstill, but this requirement was later dropped. See A. Krueger, *op.cit.*

[30] M. Waibel, *Opening Pandora's Box: Sovereign Bonds in International Arbitration,* "American Journal of International Law" 2007, Vol. 101, No. 4 for a critical discussion.

approach, and could replace all existing *ad hoc* fora including the Paris Club, the London Club and MDRI.

Paulus and Kargman propose a permanent Sovereign Debt Tribunal, consisting of a pool of arbitrators, but with only one full-time arbitrator (the president) who may be assisted by a small secretariat. The authors underline that the system can only be introduced in case of consent between lenders and borrowers, possibly by adding "arbitration clauses" in all future sovereign bond or loan contracts. This gives the Tribunal a formal legal status. Once the system is established, its procedures may become more widely accepted and possibly create spillover effects on the legal treatment of all types of sovereign debt, even if these do not explicitly contain arbitration clauses.

The FTAP is even less institutionalized. In essence, it aims for an ad hoc arbitration mechanism applicable to all types of sovereign debt exchanges, including debt owed to bilateral creditors or the IMF. Arbiters are chosen on a case-by-case basis. Creditors and debtors each propose two arbitrators, and the chosen arbitrators jointly choose a fifth arbiter to head a panel. Once the panel of arbitrators is established, they evaluate and approve a restructuring solution. In addition, the mechanism would be supported by a small secretariat to assist in technical matters.[31]

Table 1 provides a comparison of all four proposals with respect to the seven criteria identified above for efficient sovereign debt workout system. The SDRM proposal – the best known reform concept – meets only three criteria (DIP financing, supermajority voting, and legal enforcement of the negotiated solution). Therefore it seem fortunate that it has been shelved. The other three proposals, on the other hand, fulfil most of the efficiency criteria, and thus require more attention from international community. If they were implemented, they would allow for fairer, more orderly, comprehensive and sustainable sovereign debt workout.

[31] U.S. Das, M.G. Papaioannou, Ch. Trebesch, *Sovereign Debt Restructurings 1950–2010: Literature Survey, Data, and Stylized Facts,* "IMF Working Paper" 2012, No. 12/203.

Table 1
Criteria for efficient sovereign debt restructuring:
a comparison of proposals

Criterion	SDRM	ECRM	Sovereign Debt Tribunal	FTAP
Independent decision-making	No, no supranational legal body	Yes, by a legal body	Yes, by an arbitration	Yes, by an arbitration
Independent assessment of debt sustainability	No, provided by the IMF	Yes, by an economic body	Yes, by an arbitration	Yes, by an arbitration
Comprehensive treatment	No, mainly bondholder debt	No, mainly bondholder debt	Yes, all external sovereign debt	Yes, all external sovereign debt
Legal enforcement of the negotiated solution	Yes, once approved, all IMF members are bound to legal provisions of SDRM	Yes, the procedure is governed by supranational law and its provisions are fully enforceable	Yes, legal enforcement secured via universal adoption of the model law	No, final award not necessarily enforceable
Automatic legal stay	No	Yes	Not specified	Yes
DIP financing	Yes, via IMF facilities	Yes, via a financial body	Not specified	Not specified
Supermajority voting	Yes	Yes	Not specified	Not specified

Source: own elaboration based on J. Kaiser, *op.cit.*; U.S. Das, M.G. Papaioannou, Ch. Trebesch, *op.cit.*

Conclusions

The above considerations aiming at assessment to what extent the most recent proposals for reforming the existing sovereign debt restructuring "system" are relevant to the principles of efficient debt workout, allow for drawing a rank of conclusions and recommendations, which should be helpful in achieving a fair and sustainable debt workout.

First, it can be observed that the existing procedures and mechanisms of sovereign debt restructuring should be changed due to their inefficiency in the past debt restructuring cases as well as inadequacy to challenges of contemporary debt problems both of developing and developed countries.

Second, one of the main flaws of the earlier approaches to the sovereign debt is lack of creditors' coordination in restructuring process – the London Club, the Paris Club, the IMF, the World Bank and bondholders.

Third, the debt relief provided in the debt restructuring programmes was usually insufficient not in reference to the claims by debtor countries but in reference to their development capabilities.

Fourth, an unclear role of the Bretton Woods institutions in debt restructuring process (as creditors, independent experts and judges) led to a classic conflict of interests and contributed to inefficient debt workout.

Fifth, contractual approach seems to be one of the most effective ways of regulating sovereign debt restructuring but it would be a mistake to expect that it will fix all or even most of the dysfunctions of sovereign debt workout.

Sixth, contemporary theories of international and corporate finance provide instruments allowing for improvement of sovereign debt restructuring. By applying principles and procedures of domestic insolvency to sovereigns, and by securing legal enforcement of negotiated solutions, a fair and sustainable debt workout could be reached.

The further research should be focused upon the following issues:

– development of creditors' coordination mechanisms (legal, political and institutional),
– elaboration of more efficient methods of coordination of activities between public and private creditors,
– applications of ideas drawn from corporate finance and corporate governance, and especially the agency relation, to sovereign debt management.

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