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Task Force 03

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Proposals to Strengthen the Sovereign Debt Restructuring Framework

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Abstract

The developing world is once again facing unsustainable sovereign debt levels that threaten to erase several years of progress on development agendas. The COVID-19 pandemic, Russia-Ukraine war, and high interest rates are the latest in a series of events that have contributed to the recent build-up of debt and raised the cost of debt financing for developing countries. The G20's Common Framework (CF) for debt treatments is a welcome initiative but it has not been effective. Protracted debt negotiations reveal the challenges presented by new lenders, notably private creditors. Private creditors hold more than a quarter of the external debt stock, up from only 10 percent in 2010, and the cost of servicing private-sector debt makes up more than two-thirds of total debt-service payments. Absent a central sovereign bankruptcy regime, debt restructurings arrive too late, with elevated risk premia and high socio-economic costs. In support of the CF's aims, we propose a G20-backed effort to incentivise private-sector participation in sovereign debt restructurings. The laws governing sovereign debt fall under a few jurisdictions, all of them in G20 countries who could enact legislation to encourage private-sector participation in debt restructuring. New York and U.K. lawmakers have already begun to propose such legislation. This policy brief elaborates on the deficiencies of the current architecture for sovereign debt restructuring and proposes that the G20 develop a framework to help harmonize and strengthen domestic sovereign debt restructuring laws.

Diagnosis of the Issue

Forty years after the debt crisis of the 1980s, the developing world is once again facing unsustainable sovereign debt levels that threaten to erase several years of progress on development agendas. Over the past two decades, a series of shocks – starting with the 2008 financial crisis, followed by the 2009 European debt crisis, and the 2014-2016 oil price plunge – contributed to wider budget deficits and the gradual build-up of debt in developing countries. The emergence of China as a major bilateral creditor as well as the ultra-low global interest rate environment further facilitated the debt built up.[1] The situation changed as the COVID-19 pandemic caused a global economic slowdown and as interest rate increases raised the cost of financing sovereign debt and thus exposed countries' debt vulnerabilities. According to International Monetary Fund estimates, over half of low-income countries (LICs) are in debt distress or at high risk of debt distress.[2] In the past three years alone, 18 developing countries have defaulted on their debts, outstripping the total of the previous two decades.[3] More defaults are expected this year, as borrowing costs remain elevated and financing needs – for health, education, and climate – are growing.

Preventing debt crises and resolving them quickly and efficiently have been longstanding concerns of the G20. During the COVID-pandemic, the G20 Debt Service Suspension Initiative (DSSI) suspended $13 billion in debt payments, providing low-

[1] https://www.brookings.edu/wp-content/uploads/2019/04/africa_sovereign_debt_sustainability.pdf

[2] https://www.imf.org/en/Publications/DSA

[3] https://openknowledge.worldbank.org/handle/10986/40670

income countries with liquidity relief to fight the pandemic.[4] Relief from the DSSI was intended to be temporary, and its expiration in 2021 resumed the debt service burden in 2022 onwards. In 2020, the G20 adopted the Common Framework for debt treatments (CF) as a medium-term solution to help low-income countries restructure their debts and address protracted liquidity problems. The CF, however, is facing serious operational challenges. Only four – Zambia, Ghana, Ethiopia, and Chad – of the 36 countries at high-risk or in active debt distress have requested treatment so far and the treatment has proved to be arduous and slow. In the case of Chad, an initial agreement with official creditors was reached in June 2021 but debt restructuring was delayed by an additional 18-months until Chad reached an agreement with its private creditors.[5] Zambia only recently cemented its status as the second country to reach a debt treatment agreement through the CF, following almost three years of negotiations and after its official creditors effectively blocked two versions of a deal reached by Zambia with its bondholders in November 2023.[6][7]

[4] https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative

[5] https://www.reuters.com/world/africa/exclusive-glencore-chad-creditors-agree-principle-terms-debt-treatment-source-2022-11-10/

[6] https://blogs.law.ox.ac.uk/oblb/blog-post/2024/01/zambia-piece-will-break-international-financial-architecture

[7] https://www.bloomberg.com/news/articles/2024-03-25/zambia-agrees-deal-with-bondholders-key-win-in-years-long-saga?embedded-checkout=true&sref=a9fBmPFG.

The experiences of low-income countries seeking treatment under the CF reveal the challenges of creditor coordination, particularly with reaching an agreement with bondholders. In the past, debt rescheduling only required an agreement with the Paris and London Clubs. Now it requires an agreement with many disparate bondholders with widely different interests, constraints, and incentives. Private creditors hold more than a quarter of the external debt stock, up from only 10 percent in 2010, and the cost of servicing private-sector debt makes up more than two-thirds of total debt service payments.[8] Yet, private sector participation in the CF remains largely elusive. Outside the CF, the only other mechanism to facilitate private sector debt restructuring is through enhanced collective action clauses (CACs), a rule binding all bondholders to any deal agreed to by a supermajority of bondholders. Private-sector coordination challenges, however, still prevail for middle-income countries with sovereign debt contracts that include enhanced CACs (e.g. Sri Lanka). The shift away from syndicated bank loans toward traded securities as the principal instrument for sovereign financing, and the greater diversity of claims and interests has made it more difficult to secure collective action from creditors when a sovereign's debt is unsustainable.

[8] https://www.brookings.edu/articles/addressing-the-looming-sovereign-debt-crisis-in-the-developing-world-it-is-time-to-consider-a-brady-plan/

Recommendations to the G20

In support of the G20's aim to promote fiscal sustainability in the developing world, there is a clear need to urgently strengthen the infrastructure for sovereign debt restructuring by providing incentives for bondholders to participate. The absence of rules mandating bondholder participation in debt restructuring creates inefficiencies with creditor coordination and strengthens the hands of holdout creditors, delaying critical debt relief. One option could be to create a sovereign bankruptcy regime, which is an idea that has been around for more than 20 years but is yet to be accepted by the international community. The U.N. Secretary General Antonio Guterres has returned to this idea,[9] echoing the 2002 IMF proposal and the 2009 Stiglitz Report recommendations on establishing a universal sovereign bankruptcy system.[10]

In the absence of universal sovereign bankruptcy procedures, the laws governing sovereign bonds fall under a few jurisdictions, all of them in G20 countries. In the event a debtor defaults on its sovereign debt obligations, private bondholders can sue the debtor under the law which governs the debt instrument. To protect sovereigns from litigation and encourage private creditor cooperation in sovereign debt workouts, New York and U.K. legislators have begun to consider legislation that strengthens and facilitates debt restructuring with bondholders.[11] The New York State Legislature, beginning in 2021, has

[9] https://www.un.org/sites/un2.un.org/files/our-common-agenda-policy-brief-international-finance-architecture-en.pdf

[10] https://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf

[11] https://committees.parliament.uk/work/6664/debt-relief-in-lowincome-countries/publications/

gone so far as to introduce bills that strengthen its own sovereign debt restructuring laws. In 2024, New York lawmakers introduced a new bill titled the "Sovereign Debt Stability Act" (A2970A[12]), combining elements of two bills introduced in the 2023 legislative session.[13] The proposed legislative reforms would have major implications for sovereign debt restructuring, as New York law governs around $800 billion in outstanding debt.[14] This policy brief proposes the G20 create a working group to develop and refine a framework for sovereign debt restructuring laws that promotes private creditor participation, which all G20 countries could agree to incorporate into domestic law as applicable. This framework would serve as guidance for lawmakers in jurisdictions, at both the local and national level, seeking to enact legislation to strengthen the architecture for sovereign debt restructuring.

First, sovereign debt restructuring law should codify a duty on creditors to participate in sovereign debt restructuring processes and negotiations. The practice of holdout creditors refusing to engage in debt treatment talks threatens the economic recovery of sovereigns and the well-being of its citizens. Further, holdout creditors disadvantage official bilateral creditors and other private creditors, delaying debt treatment and creating

[12] https://www.nysenate.gov/legislation/bills/2023/A2970/amendment/A

[13] Three bills were originally introduced by New York lawmakers in 2023 but were never voted on. Two of the bills were combined into one revised bill titled the "Sovereign Debt Stability Act" (A2970A) which was reintroduced in February 2024. The third bill (A5290) was also reintroduced in March 2024.

[14] https://www.washingtonpost.com/business/2023/06/06/how-a-new-york-bill-could-help-fix-the-sovereign-debt-crisis/21ea9df2-046a-11ee-b74a-5bdd335d4fa2_story.html

uncertainty around when a debtholder may recoup its claims. In the proposed New York "Sovereign Debt Stability Act," a duty is codified on debtholders to participate in restructuring sovereign debt claims if the sovereign's debt is deemed unsustainable by the IMF.

Second, sovereign debt restructuring law should immunize sovereign debtors' assets from seizure where the debtor has initiated an orderly debt restructuring process and is actively participating in debt treatment negotiations. When a private creditor litigates to immediately collect on their sovereign debt claims, this detracts from the resources a sovereign can dedicate to debt negotiations with other creditors. Moreover, if litigation is successful, those creditors would receive priority in recovery of sovereign debt claims. This has the negative implication of unfairly denying a sovereign much-needed debt relief, and disadvantaging official bilateral and other private creditors who are participating in good-faith debt treatment negotiations.

Third, sovereign debt restructuring law should limit the amount that a creditor can recoup from a sovereign if an agreement is reached with a majority of creditors. This proposal is also reflected in the New York "Sovereign Debt Stability Act" which limits how much private creditors are allowed to recoup from governments participating in international initiatives for debt relief. This bill would effectively mandate that private creditors comply with "comparable treatment"—a central tenant of the CF that requires a government to obtain equivalent debt relief from other creditor groups. U.K. lawmakers have also suggested enacting similar legislation that prevents creditors from suing a sovereign for any amount greater than the creditor would have received if they participated in the CF.

Fourth, enhanced CACs should be retrofitted into all existing sovereign bonds contracts. Enhanced CACs bind all bondholders to any deal agreed to by a supermajority

of bondholders; they are designed to minimize holdout risk and have seen success in facilitating major restructurings in Argentina, Ecuador and Ukraine. Most sovereign bonds issued since 2014 include enhanced CACs, however, the IMF estimates that the share of the outstanding stock of sovereign bonds without enhanced CACs remains high at over 50 percent.[15] U.K. and New York lawmakers have suggested legislation in line with the principle of enhanced CACs, binding private creditors to any agreement that is agreed to by two-thirds of creditors.

Fifth, sovereign debt restructuring law should strengthen protections for sovereigns seeking debt treatment through international debt relief initiatives. A second New York State bill (A5290[16]) introduces protections for sovereigns from litigation by predatory and holdout creditors. Specifically, the practice of vulture funds and other predatory private creditors, who have a known history of purchasing distressed or discounted debt for the sole purpose of bringing legal action to collect on that debt, would no longer be allowed. This bill is similar in intent to the Belgium law passed in 2015 that limits the practice of vulture funds profiting off sovereign debt.

Sixth, the G20 should evaluate the merits of alternative processes for sovereigns to request debt treatment. For example, the New York "Sovereign Debt Stability Act" proposes a new restructuring mechanism for sovereigns with New York law-governed debt claims. Under this mechanism, the sovereign may file a petition with New York

[15] https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/21/Fourth-Progress-Report-on-Inclusion-of-Enhanced-Contractual-Provisions-in-International-46671

[16] https://www.nysenate.gov/legislation/bills/2023/A5290

State, self-certifying that its debt is unsustainable and that it would like to seek debt relief. Similar to the CF, the sovereign must also agree to work with the IMF to restore debt sustainability. Once a petition is filed and approved by an independent monitor, the sovereign may seek debt treatment through the State of New York or an international debt restructuring initiative.[17] Under the State of New York, the sovereign would submit a proposed plan to its creditors to make its debt sustainable. If the plan is agreed to by creditors holding two-thirds in amount and more than one-half in number in each class of claims, all creditors are bound by the agreement. The independent monitor would be appointed by the governor of New York and would be charged with streamlining the process to reach an agreement between sovereigns and debtholders. If an agreement is reached that meets burden-sharing standards, creditors cannot sue the sovereign under New York law to enforce claims more than the amount that would have been recoverable had the U.S. been a creditor.

[17] International debt restructuring initiative which is broadly defined to include the CF or any similar or successive initiatives.

Scenario of Outcomes

The New York State Legislature will continue to discuss and potentially vote on its proposed legislation to strengthen its sovereign debt restructuring laws. It is uncertain whether the bills will become law this year. Even if the proposed laws are not passed during the 2024 legislative session, New York lawmakers are likely to continue to refine and push for these key legislative reforms to revitalize sovereign debt restructuring.

While the "Sovereign Debt Stability Act" is a welcome initiative from lawmakers, the legislation has a few weaknesses. First, the required credentials and terms of reference for the independent monitor are not delineated in the legislation. Minimum qualifications and expectations for an independent monitor should be specified so as to minimize political considerations in the appointment process. Second, the bill lacks clear criteria (other than lack of good faith) for the independent monitor to accept or dismiss a sovereign's petition for debt treatment. The provision allowing the sovereign to self-certify that its debt is unsustainable is at odds with current practice which involves the IMF conducting a debt sustainability analysis. This lack of criteria could become the source of legal challenge if a country says its debt is unsustainable but an IMF analysis says otherwise. Third, although the bill calls for the sovereign to work with the IMF to restore debt sustainability, it does not stipulate that the agreement needs to be aligned with IMF program parameters. Alignment between the debt treatment agreement and IMF program is important to help sovereigns make progress to a stable macroeconomic position. The G20 working group proposed by this policy brief could help address deficiencies in current and future legislation, brought forth by New York or other jurisdictions, by developing pillars to strengthen and harmonize sovereign debt restructuring laws.

The success of any proposed sovereign debt restructuring law is also contingent upon cooperation and coordination between jurisdictions where sovereign bonds are issued. According to IMF estimates, New York law governs around 52 percent of the total stock of outstanding sovereign bonds and English law governs around 45 percent.[18] Without coordination between jurisdictions, private creditors could switch to debt issuance to another jurisdiction's laws, depending on which laws allow debtholders to recoup greater amounts of debt claims. While some variance between laws may be appropriate, convergence in sovereign debt restructuring rules and procedures would lend itself to strong sovereign debt regime. The proposed G20 working group could help facilitate such coordination and the adoption of similar reforms by G20 countries.

Opponents of strengthening sovereign debt restructuring legislation argue that it will reduce the liquidity of sovereign debt and increase the cost of borrowing. A key feature of the New York legislation is that it will apply retroactively, overriding any pre-existing contractual protections. Critics have raised concerns about the risks to holders of pensions and mutual funds, who may see the present value of their debt claims reduced substantially.[19]

Private-sector participation in the debt-restructuring process is critical given the outstanding stock of private-sector debt and its relative importance in the cost of debt

[18] https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/21/Fourth-Progress-Report-on-Inclusion-of-Enhanced-Contractual-Provisions-in-International-46671

[19] https://www.iif.com/About-Us/Press/View/ID/5405/ACLI-The-Credit-Roundtable-ICI-ICMA-IIF-and-LICONY-Oppose-New-York-Legislature-Bills-on-Sovereign-Debt

servicing. The approach to private-sector participation in debt restructuring should also be thoughtful to preserve the countries' hard-fought access to private financing. The G20 working group will need to take such concerns into consideration and can act as a forum to coordinate and refine the framework for legislation that encourages private sector participation in debt restructuring.

As international debt-relief initiatives remain lethargic, a wave of sovereign defaults is looming. Now more than ever, the global architecture for sovereign-debt restructuring needs to be strengthened. This will require political buy-in and good faith participation from governments and the private sector. With G20 backing and coordination support, legislative reform could revitalize the architecture for sovereign debt restructuring.

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