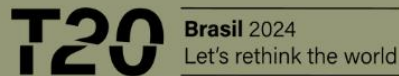
T20 Policy Brief



Task Force 03

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Sovereign Debt Workouts: The role of legislation in New York and the UK

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Abstract

Recent experience illustrates the severe challenges in restructuring external sovereign debt after a default, especially given the multiplicity of creditors. Private creditors accounting for more than 60 per cent of public and publicly guaranteed (PPG) external debt of low and middle income countries (LMICs) have been unwilling to settle for restructuring terms negotiated with bilateral creditors. And even when the possibility of such a settlement arises, the process can be scuttled by one or more hold-out vulture funds that want repayment in full.

This is surprising because 96 per cent of the $1.3 trillion worth of sovereign bond debt outstanding at the end of March 2020 included collective action clauses (CACs) in contracts meant to force creditors to the table. The inadequacy of these CACs has triggered efforts to find alternative ways of enforcing debt renegotiation terms.

Since almost all developing country sovereign bonds are subject to New York or English law, changes in the relevant laws in these two contexts may assist successful restructuring within a reasonable timeframe. A law currently under discussion in the legislature of New York, if passed, would force private creditors to accept the same terms as negotiated with creditor governments. Similarly, in the UK, a House of Commons Committee report has made a case for legislation that would force private creditors to join negotiations over and participate in debt workouts. However, these legislative reforms are facing opposition from private creditors, who argue that such laws would force a retreat of creditors from developing country sovereign bonds as well as raise the cost of any debt that may be provided.

This brief examines the legislative changes proposed, assess their adequacy and the obstacles to implementation, and recommend measures and means that would help put in place a framework of law to facilitate and accelerate restructuring in jurisdictions that cover much of developing country debt.

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The issue

The vulnerabilities created by a large burden of external debt have grown dramatically in recent years. The ongoing debt crisis, which is affecting many low and middle income countries (LMICs) has serious consequences not only because of the financial and economic consequences of actual default episodes but because the burden of debt servicing diverts scarce fiscal resources away from essential public spending even in countries that are apparently not experiencing "debt distress". This affects public spending for crucial services like education, healthcare, infrastructure, and social protection, as well as necessary investments for dealing with climate change. Debt relief would free up public resources for all of these essential investments and public spending in a wide range of LMICs.

There is still no international mechanism for debt workouts for sovereign debt, even though most countries have internal legal frameworks (bankruptcy laws) to restructure unpayable debts. This is an even greater challenge today because of the difficulties of bringing together very diverse creditors, including older bilateral lenders like the Paris Club, newer bilateral lenders like China, multilateral banks and various private holders of debt and sovereign bonds. While bilateral and multilateral creditors have at least been brought together under the G20's Common Framework for Debt Treatment, that experience has thus far not been very successful, with only 4 countries requesting debt relief, and of those, only one (Zambia[1]) even approaching anything like resolution.

[1] https://www.ft.com/content/b15eb6bc-de7f-4883-8b90-ffb534e23d3b?segmentId=3f81fe28-ba5d-8a93-616e-4859191fabd8

The involvement of multiple creditors of different types creates several collective action problems (Berensmann 2003). First, there is the rush to exit: once creditors anticipate repayment problems or default, they may seek to sell their claims, making bond prices fall and costs of borrowing go up, thereby creating or precipitating a debt crisis. Second, if creditors take legal action to recover their claims, this could lower the market values of such bonds, thereby affecting all creditors. Third, there is the problem of holdouts, since any debt restructuring supported by a majority of creditors can still be blocked by a minority of creditors, effectively blocking any speedy and orderly settlement. Finally, in recent years the lack of engagement of some creditors (typically private creditors) allows them to become free riders on debt relief provided by other creditors. This was evident during the Covid-19 pandemic and its aftermath, when private creditors who did not participate in the G20's Debt Service Suspension Initiative continued to be paid in full by debt-stressed countries that did not wish to get involved in potential legal disputes.

Private creditors, particularly bond holders, now account for more than 60 per cent of public and publicly guaranteed external debt of LMICs. They have been unwilling to settle for restructuring terms similar to those negotiated with bilateral creditors. Moreover, as recent experiences in countries like Sri Lanka[2] have shown, even when the

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[2] In Sri Lanka's case, one such creditor, Hamilton Reserve Bank, which holds more than $250 million of Sri Lanka's 5.875 per cent International Sovereign Bonds that fell due on July 25, 2023 has filed a suit in a New York federal court seeking full payment of principal and interest. Some of these holdouts often tend to be vulture funds who buy doubtful debt at a massive discount (Sri Lankan bonds were selling at around 25-30 cents to a dollar) and push for full payment. Their demands are not open for negotiation.

possibility of such a settlement arises, the process can be scuttled by one or more holdout vulture funds that insist on repayment in full or on much better terms.

This problem of dealing with holdouts was supposed to have been addressed by including collective action clauses (CACs) in debt contracts, that would force all creditors to the negotiating table. As a result of the experience of Argentina[3] and other countries with holdout private creditors in the mid 2000s, most sovereign debt contracts began to include such clauses. By end-March 2020, 96 per cent of the estimated $1.3 trillion outstanding sovereign bond debt included CACs. However, this has not made debt resolution involving private creditors easier or faster, largely because of the difficulty of enforcing this across many different creditor classes. This apparent failure has triggered efforts to find alternative ways of enforcing debt renegotiation terms.

One strategy is to bring in legal changes in the jurisdictions where sovereign debt contracts are registered. It is an advantage that more than 90 per cent of developing country sovereign bonds are subject to New York or United Kingdom law. If the relevant laws in these two contexts can be changed, it may be possible to force successful restructuring that includes private creditors within a reasonable time frame.

There are ongoing efforts towards this goal. The state legislature of New York is considering the "The Sovereign Debt Stability Act"[4], which in its essence would force private creditors to accept the same terms that have been negotiated with official government creditors. Similarly, in the UK, a House of Commons Committee report has made a case for legislation that would force private creditors to join negotiations and

[3] https://www.washingtonpost.com/news/business/wp/2016/03/29/how-one-hedge-fund-made-2-billion-from-argentinas-economic-collapse/

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

participate in debt workouts. These legislative reforms are facing opposition from private creditors, who argue that such laws would force a retreat of creditors from developing country sovereign bonds, reducing access and raising costs of the foreign debt that could be taken by such governments.

The New York law

Currently, around 52 percent of the world's private debt, including sovereign debt held by private creditors, is governed under New York law. Therefore, the law currently under consideration by the New York Senate[5] would have a significant impact on possibilities for debt restructuring for many sovereigns. According to the sponsors of the Bill, "This bill provides effective and orderly mechanisms for restructuring sovereign and subnational debt for foreign governments and US territories against which there are one or more claims governed by or enforced under New York law."[6]

The Sovereign Debt Stability Act, if passed, would mandate "equitable burden-sharing between public and private creditors" for all future bonds, as well as existing emerging-market hard-currency bonds governed by New York law. The principle of comparable treatment would relate to any international initiative for debt reduction in which the US government is involved. Of course, this means that the law must specify what exactly the burden-sharing among creditors implies, and link the maximum permissible amount

[5] This is an amalgamation of two separate bills that were independently brought to the legislature.

[6] https://assets.nationbuilder.com/jubileeusa/pages/1690/attachments/original/1710361216/Bill_Memo.pdf?1710361216

recovered by any creditor to the amounts recovered by other creditors in the debt restructuring process (Buchheit and Gill 2024).

This law can play a major role in changing the incentives of private creditors to hold out, and of sovereign debtors to postpone necessary restructurings, because it would immediately provide protection for borrowers seeking to renegotiate their debt (Guzman, Stiglitz and Ocampo 2023). By reducing the incentive for private creditors to drag out debt talks or seek higher payouts through litigation, it could speed up negotiations that were accordingly delayed, and thereby reduce legal costs as well as total debt service for governments in default.

At the moment, private bond holders benefit from higher coupon rates (supposedly based on higher risk premia) and therefore receive higher returns on their investments than public creditors. They also gain because of delays in the restructuring process, because the unpaid interest accumulates to add to the debt stock. In fact, it has been noted (Zucker-Marques 2023) that in debt restructuring cases like those of Suriname and Zambia, even after default, bondholders have received far higher returns—often several multiples—than they would have received by holding risk-free assets like US Treasury bonds. These amount to excessive returns that are hard to justify by any rational criteria because the financial corporations holding these bonds have been charging more for higher risk while refusing to actually bear any risk.

By effectively forcing all creditors to the negotiations, this law could speed up the process, thereby benefiting debtor nations and creditors looking for certainty. Further, it could deter vulture funds from buying up sovereign debt in secondary markets and then seeking to recover the full value through various means, by making them also participate in the haircuts. Indeed, another bill is likely to be introduced in the New York legislature,

addressing concerns with the "champerty" provision.[7] This explicitly addresses the problem of private investors like vulture funds that buy up debt at low prices in secondary markets with the purpose of enforcing repayment and maximizing their returns through all possible means. Citizens of creditor nations would benefit, since the law would also protect the taxpayers who fund the bilateral official creditors in international debt relief initiatives from bailing out private creditors.

Critics of the law—most of whom represent private investors (such as Institute for International Finance 2023) —argue that it will make financial investors less willing to buy the sovereign bonds of developing countries, which would make it harder and costlier for those governments to raise external financing. They note the possibility of jurisdiction-hopping to avoid the restrictions of the New York law, with new bonds being issued in other places like Texas or Singapore. They suggest that investors will demand higher interest rates and more security before taking on debt contracts in New York.

These criticisms are easy to counter. While the impact of forcing haircuts on private investors cannot be gauged before the fact, it is clear that higher risk premia have meant that bond holders have already made excess returns on much of the sovereign debt they hold. In any case, private market participants would also experience the benefits of an orderly and efficient debt resolution process. In particular, inter-creditor equity and protection against potential free-riding by other creditors typically have very positive effects for most creditors.

Jurisdiction-hopping is expensive, especially when there are large sunk costs associated with particular locations. If both New York and the UK (where most of the

[7] https://www.nysenate.gov/newsroom/press-releases/2024/liz-krueger/legislators-announce-updates-champerty-bill

other sovereign debt contracts are made) come up with similar legislation, as seems increasingly possible, then this is likely to become the global standard. Indeed, such a law has already been proposed by the International Development Committee of the House of Commons in the UK (International Development Committee 2023)[8].

Empirically, there is little to suggest that this law will necessarily raise costs of borrowing. The inclusion of enhanced Collective Action Clauses on sovereign debt since 2014 has not led to rising borrowing costs for debtors, but rather was associated with lower borrowing costs for both non-investment-grade and investment-grade issuers (Chung and Papaioannou 2020). Past experience of episodes of enforced participation of private creditors through laws or policies, such as the US government's significant restructuring of Iraq's privately-held debt after 2003 (Hinrichsen 2020) and the UK Law of 2010 that forced private creditors to participate in the HIPC initiative[9], showed that they did not derail financial markets or even lead to increased borrowing costs.

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[8] https://committees.parliament.uk/committee/98/international-development-committee/news/195542/debt-relief-in-lowincome-countries-uk-government-must-bring-the-fight-to-a-global-stage/

[9] The Debt Relief (Developing Countries) Act 2010 passed by the UK Parliament was designed to include private creditors in HIPC debt restructuring and to stop them from using the UK courts to extract harsh and inequitable payments from poor countries for debts in HIPC countries that that were benefiting from official debt relief.

Recommendations

1. The passing of the New York Bill is an important measure that must be lobbied for, supported, and pushed. This requires greater public knowledge about the implications of these laws and the benefits they can provide, and mobilization by civil society to support the legislation.
2. It is also important for the UK to enact similar legislation. This is another area for active civil society interventions to ensure greater public knowledge about this issue and bring more pressure upon the UK government, as it would provide a relatively costless way of addressing some very significant concerns relating to the international debt crisis.
3. In debt negotiations, introducing a debt standstill, whereby all repayments are halted and the value of the debt does not increase over the course of the negotiations, would act as a powerful incentive for speedy resolution on the part of the creditors.
4. One major failing of the current law in New York is the heavy and uncritical reliance on the IMF's Debt Sustainability Assessments for the debtor countries. These are currently opaque in terms of methodology and have been found wanting, even misleading, in several cases already, especially in terms of an over-optimistic assessment that effectively reduces the required amount of debt reduction. Since this is a crucial element of the debt workout process, it is important to have a more transparent, widely accepted and reliable framework for evaluating the amount of debt that needs to be reduced. This must become an important area of public discussion and reform.
5. It is important for different debtor countries facing similar sets of creditors to co-ordinate their strategies so as to achieve better bargaining conditions.
6. One proposal for reducing the problem of free riders and ensuring greater transparency even in the absence of such laws could be for debtor countries to introduce

a Most Favoured Creditor clause, as suggested by Buchheit and Gulati (2023). This would involve including, early in the debt restructuring process, a binding and enforceable provision ensuring that if another creditor group later succeeds in extracting better terms from the borrower, those sweeter terms will retroactively benefit the creditors that had already signed a restructuring deal.

Outcome scenario

It is hard to make a definitive prediction on the fallout of the enactment and implementation of such laws. But there is good reason for optimism, despite fears raised by private creditors. After suitable corrective laws are enacted in one or more jurisdictions, they can be tweaked over time to ensure realisation of the intended benefits and pre-empt adverse fallout. This will strengthen the case for enacting similar laws in 'competing' jurisdictions. And the freeing up of foreign exchange and fiscal space in debtor countries would have major benefits for debtor countries and positive spillover effects for the rest of the world.

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