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Sovereign Debt Restructuring:

The Need for a New Approach

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Abstract[1]

High debt levels after the pandemic raised concerns about a wave of sovereign defaults. A focus has been on low-income countries, but several middle-income nations also face high debt burdens and recent restructurings in Latin America and the Caribbean revealed both unresolved problems and new concerns. In this paper, we document how LAC has been at the center of restructuring innovations and discuss the predicaments of countries with increasingly diverse creditors and instruments. We argue for a regional hub and spoke institutional arrangement to complement existing global initiatives to harness regional knowledge and to speed progress to improve restructuring processes.

JEL classifications: F34, H63, K19, K41, N16, O19
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1. Introduction

High debt levels after the COVID-19 pandemic raised concerns about a possible wave of sovereign defaults. Sovereign debt in default worldwide rose sharply to over US$400 billion in 2020 and Standard Poor's assigned a record seven sovereign default ratings in that year.[2] Since then, the Russian invasion of Ukraine, sharp increases in energy and food prices, inflation, rising global interest rates and strains in the US banking sector have added further uncertainty.

Sovereign default and debt restructuring are contentious topics in theory and in practice. When a government borrows money, it promises to repay according to the terms of an agreement. For the purposes of this paper, debt restructuring is a change in those terms that reduces or postpones the debt servicing obligations for the borrower and the present value of the claim for the lender.[3] Restructurings can occur without missing a payment, or after a period of nonperformance under the agreement. Definitions of default vary. Winkler (1933) lists 15 possible ways a sovereign can default depending on the design of the credit instrument.[4] Credit rating agencies tend to assign default ratings to sovereigns that miss debt payments or pursue debt restructuring to avoid missing payments (a "distressed" restructuring), even if it is consensual.[5]

Default and the restructuring of public debt are not new. Defaults across borders have been documented from ancient Greece, through the middle-ages and into the modern era.[6] No international bankruptcy regime exists for sovereign states; yet sovereigns may issue debt under the laws of domestic and multiple foreign jurisdictions. Buchheit (2013) observes that sovereigns borrowing abroad are "uniquely vulnerable and they are uniquely protected," in that it is generally easy to obtain a court judgement against a sovereign that has defaulted, but typically hard to extract payment.[7] National courts tend to have limited enforcement power over foreign governments and sovereign assets may be explicitly protected under national and international law. Still, some creditors specialize in finding mechanisms to disrupt a sovereign's trade or financial flows in order to enforce repayment.[8] This attempt at coercion may result in a type of cat and mouse game in

[2] The US$400bn figure is sourced from the Bank of Canada – Bank of England sovereign default database. Note that the definition of default varies across the types of claims in this database. See Standard and Poor's (2021) for details on sovereign ratings.

[3] The value of a debt claim is normally considered in terms of *present value*. This definition excludes liability management operations that may change terms with no loss in value for creditors.

[4] Rating agencies normally define a default as a change in the terms of the credit that lowers its value to creditors, even if those changes are agreed upon by creditors.

[5] For example, Standard and Poor's uses a D rating if default is on the majority of claims and SD if default is on selected claims and states that a distressed restructuring is considered a default. Source: Global Ratings on www.spglobal.com. Moody's rates according to the likelihood of economic loss to the lender (probability of default multiplied by loss given default) and assigns a Ca rating if the borrower is in or likely to default but there is some prospect of recovery of principal and interest. On the other hand, a C rating is assigned typically when the borrower is in default and there is little prospect for recovery. Definitions are available on www.moodys.com

[6] See Winkler (1933), Rheinhart and Rogoff (2011) and Eichengreen et al. (2020). There have been many examples of defaults on domestic obligations as well, not covered in detail in this chapter - see Rheinhart and Rogoff (2008) and inflation has been a common way to lower the real value of nominal claims in domestic currency – see Estes and Eichengreen (2022) and Powell and Valencia (2023).

[7] See Buchheit (2013) page 107.

[8] A colorful example was a hedge fund in 2012 requesting the government of Ghana to impound an Argentine training sailing vessel (see Financial Times, "Argentina seeks to free bond-row ship" Dec. 16,[h] 2012).

courts around the world, between creditors pressuring sovereigns for payment and sovereigns claiming immunity.[9]

The form of a restructuring generally depends on the instruments being restructured, which in turn may depend on the type of creditor. Middle and high-income countries tend to owe a larger share of their debt to commercial creditors, with bonds being the main instrument of choice. Low-income countries tend to owe a larger share debt to official lenders, including national public banks, export credit agencies, and international financial institutions. But many low and lower-middle-income countries started to issue more commercial debt in the 2000s, spurred by ample international liquidity and low interest rates. Another significant shift has been that traditionally bilateral lending came overwhelmingly from G-7 countries—all members of the Paris Club—while now more credit is sourced from China and other non-Paris Club lenders.[10] It has also become harder to distinguish official from commercial lending as state-owned institutions (or even governments) are more commonly structuring their claims on other governments (or state-owned enterprises) as commercial loans. Debt trading, repackaging debt, and guarantees offered by official creditors on commercial lending further muddle any simple classification. Creditor composition has then become richer and more blurred.

The international response to the pandemic included both new funds for all developing countries and debt suspension initiatives aimed largely at low-income ones. Accelerated disbursements from international financial institutions and an extraordinary allocation of Special Drawing Rights (SDRs) provided fresh funds[11] while the Debt Service Suspension Initiative (DSSI) allowed 73 eligible low-income countries to apply for a pause on debt payments from official bilateral lenders due from mid-2020 through the end of 2021. Forty-eight countries applied for and received relief.[12] The DSSI's successor, the Common Framework for Debt Treatments beyond the DSSI (hereafter the Common Framework), added a more structured creditor coordination process modeled on aspects of the Paris Club. As of March 2023, four countries had applied for relief since the launch of the initiative in November 2020.[13]

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[9] "Hold-out" creditors may have incentives to disrupt a debt restructuring so they can free-ride on the concessions of cooperating creditors (see below for further discussion of hold-out dynamics).

[10] The Paris Club began meeting in the 1950s, with the French Treasury serving as secretariat. Its permanent members are 22 mostly high-income economies. Russia and Brazil are members, but China, India, and the Gulf states are not, although they are major lenders to low- and middle-income countries. Nonmembers may participate in negotiations on a case-by-case basis. See Paris Club, "Permanent Members," https://clubdeparis.org/en/communications/page/permanent-members

[11] The SDR allocation was US$650 billion with the majority distributed to high income economies with larger IMF quotas. The Poverty Reduction and Growth Trust and the newly created Resilience and Sustainability Trust (RST) allow for some reallocation and discussions continue on alternative mechanisms to reallocate SDRs (see, for example, the African Development Bank's proposal to use SDRs as hybrid capital: https://www.afdb.org/en/news-and-events/interviews/leveraging-power-special-drawing-rights-how-developed-countries-can-help-boost-africas-development-51910)

[12] Four countries in the Caribbean participated in the DSSI: Dominica, Grenada, St. Lucia, and St. Vincent and the Grenadines. Eligible countries that chose not to participate included Guyana, Haiti, Honduras, and Nicaragua.

[13] Those countries were Chad, Ethiopia, Ghana and Zambia. The debt treatment process has been relatively slow for each of these cases for a variety of reasons. In Latin America and the Caribbean, Argentina, Barbados, Belize, Ecuador, and Suriname restructured debt since the 2020 start of the pandemic.

Meanwhile, middle-income and even some high-income countries have faced stiff economic challenges. Much of the recent progress in the debt restructuring architecture relevant to them had focused on bond contract reforms. While some evidence suggests that these reforms have helped reduce hold out problems in restructurings, they have left significant challenges unaddressed.[14]

This paper analyzes debt restructuring developments with a focus on the middle-income countries. In the next section, we outline the prominent role Latin America and the Caribbean has played in the evolution of sovereign debt restructuring.[15] Section 3 considers a selected set of issues with the current processes for a sovereign to restructure its debt. Section 4 develops the idea of a regional coordination mechanism that would build on and complement the existing financial architecture and provide a link to global initiatives. Section 5 concludes proposing a global hub and spoke arrangement to harness regional knowledge and refine global recommendations to fit regional characteristics and to promote inclusive discussions.

2. Latin America and the Caribbean as a Pioneer in Debt Restructuring

A good case can be made that the institutional architecture of sovereign debt restructuring today owes more to Latin America and the Caribbean than to any other region. Most of the main innovations in restructuring processes were tried and tested in the region. In recent restructurings from 2020, this innovation has continued. This section sets the scene and discusses the main innovations in debt restructuring from the 1980's highlighting the central role of Latin America and the Caribbean.

The 1980s: A Decade Lost, New Instruments Found

In the early 1980s, dozens of countries around the world were plunged into debt distress as global interest rates spiked, the dollar soared in value, and commodity prices fell. In August 1982, Mexico attempted to roll over its syndicated loans from hundreds of commercial banks (Kraft, 1984), marking the first in a cascade of crises with Latin America at the epicenter. Almost a decade later, the region led the way out of the crisis, and sparked the revival of the emerging market bond market. The main developments in the 1980s include:

- Paris Club – Net present value (NPV) relief, elaborating conditionality, and comparability principles
- London Club – Bank advisory committees, NPV, and principal reduction
- The Baker Plan
- The IMF assumes a central coordinating role
- Precedent-setting litigation
- Brady Bonds and beyond
- State-contingent debt and value recovery instruments
- The IMF "lends into arrears" on loans

[14] See IMF (2020) for an earlier discussion.

[15] In a recent survey of sovereign bond defaults dating back to 1815, the region featured with the unenviable record of the largest number of credit events (Meyer, Reinhart, and Trebesch, 2022).

In the 1980s, the Paris Club emerged from three decades of relative inactivity. Latin American sovereigns accounted for more than 40 percent of the debt treated in the 1980s. Despite a relatively small share of total claims, the Paris Club played an important role in the region's debt workouts (Cheng et al., 2016).

The London Club process emerged to tackle the formidable challenge of bank creditor coordination. Brazil and Mexico each had hundreds of commercial bank creditors. Banks as a group did not have enough capital or loan loss reserves to absorb losses and were reliant on regulatory forbearance. This fueled fears of contagion, limited banks' restructuring options and gave advanced economy governments (primarily the G-7) a role in the process (Cline, 1995).

Bank Advisory Committees (BACs) had been used in the 1970s, including in Jamaica and Peru (Devlin and Ffrench-Davis, 1995), and became the principal coordination mechanism among commercial banks. The London Club was a somewhat misleading term for the committee process because there was no membership organization. Instead, the practice was to replicate committee organization across borrowing countries. BACs were effective thanks to creditor homogeneity.

The (October 1985) Baker Plan envisaged lower interest payments linked to structural adjustment for 15 heavily indebted nations, including 10 in Latin America, in exchange for US$9 billion in additional loans from the World Bank and US$20 billion from commercial banks over three years. Latin American governments argued that this was too little given the depth of the crisis. Debtors and creditors worked on a growing repertoire of innovative restructuring techniques including debt buybacks at a discount, debt-for-equity and debt-for-nature swaps, and debt conversions.[16]

At the outset of the crisis, the BIS mobilized short-term liquidity support for distressed sovereigns, hoping for a quick rebound (Truman, 2021) but as the magnitude of the problems became apparent, the role of the IMF grew (Boughton, 2001). Paris and London Club creditors linked concessions to macroeconomic adjustment programs. At the same time, the IMF's insistence on financing assurances and its initial refusal to tolerate arrears empowered creditors. By the mid-1980s, creditors had coalesced into relatively cohesive groups, allowing the IMF to seek financing assurances in a relatively efficient manner.

The crisis led to precedent-setting debt litigation. For governments in Latin America and the Caribbean, which borrowed primarily in the New York market, a succession of U.S. federal court decisions filled out the legal framework for sovereign borrowing, clarifying and sometimes changing the rules. Jurisprudence emanating from creditor lawsuits against Argentina, Brazil, Costa Rica, Nicaragua, and Peru, among others, established that i) foreign sovereign borrowing was a commercial activity that brought sovereigns under the jurisdiction of U.S. courts, ii) investors that bought at a discount could recover in full on par with original lenders, iii) international comity did not shield sovereigns from debt collection lawsuits, and iv) dissenting minority creditors could not challenge a restructuring vote based on general principles like inter-

[16] Debt buybacks became controversial and sparked a fascinating debate. Focusing on Latin America, Bulow and Rogoff (1988) argued that there were normally better ways for the borrower to deploy valuable resources.

creditor good faith.[17] By the mid-1990s, it had become relatively easy to sue a sovereign in a foreign court, but not to collect on a judgment.

Most sovereign assets that could be used to satisfy a judgment were either inside the borrower's borders or behind a wall of immunity that protected central bank assets, diplomatic property, and military installations. Holdout creditors with judgments scoured the world for sovereign assets to attach or attempted to keep the debtor out of global markets. At the start of the crisis, most foreign sovereign debt was presumptively unsecured, unsubordinated, and ranked equally—or *pari passu*—with similarly situated debt. Loan contracts with commercial banks normally spelled this out. Debtors usually promised both public and private creditors not to take on new senior or secured debt.[18]

After nearly a decade of regulatory forbearance and moral suasion to build up capital and reserves, the conditions were ripe to seek a more sustainable solution. The Brady Plan was announced in March 1989, launching a new era for the emerging market bond market. Beginning with Mexico, banks exchanged distressed floating-rate loans for long-term fixed-rate bonds. Brady debt exchanges delivered case-by-case principal and interest relief using a menu of customizable transaction structures, usually a mix of par and discount bonds. Zero-coupon US Treasury securities collateralized principal payments due some 20 years later; high-grade short-term securities partially collateralized two to three interest payments. Borrowers financed collateral accounts with IMF and other official support.

Also in 1989, the IMF began considering arrears on commercial bank debt as part of the financing package for its programs. The so-called "Lending into Arrears" policy took away banks' ability to hold up country programs. However, the policy excluded arrears to official creditors, where the IMF could in theory obtain financing assurances from the Paris Club, and arrears on bonds, which were thought to be too much trouble (or, in the case of the Brady's, simply wrong) to restructure.

The Brady Bonds helped catalyze market re-entry but quickly lost popularity. Their convoluted design and collateral arrangements made them hard to value, weighed on market liquidity, and were not conducive to developing a clean yield curve. As interest rates fell, borrowers hurried to retire the Brady's in favor of simple unsecured fixed-rate debt securities.

Still, the Brady Bonds left a lasting impact. They also introduced contingent debt and value recovery instruments, such as oil price warrants in Mexico and Venezuela, payments linked to a

[17] See, e.g., Argentina v. Weltover, Inc., 504 U.S. 607 (1992) (U.S. courts have jurisdiction over domestic-law bonds payable in New York; debt issuance is commercial activity outside the scope of sovereign immunity); Allied Bank Int'l v. Banco Credito Agricola de Cartago, 733 F.2d 23, 1984 U.S. App. LEXIS 23237 (2d Cir. 1984) (available on LEXIS but removed from bound Federal Reporter 2d), vacated, 757 F.2d 516 (2d Cir. 1985) (rejecting comity and act of state doctrines as defenses to sovereign payment default); Elliott Assocs. v. Banco de la Nación, 194 F.3d 363 (2d Cir. 1999) (effectively eliminating the champerty defense in sovereign debt); CIBC Bank and Trust Co. (Cayman) v. Banco Cent. do Brasil, 886 F. Supp. 1105 (S.D.N.Y. 1995) (limiting inter-creditor duties and rejecting the argument that public sector entities holding Brazilian government debt should be disenfranchised in a creditor vote based on principles of good faith).

[18] The IMF and the most established Multilateral Development Banks are considered preferred creditors and do not participate in debt restructurings and normally considered exempt from such promises.

basket of export revenues in Uruguay, and GDP-linked repayments in Costa Rica (Buchheit et al., 2020).

The 1990s: The Tequila and the 1990s Crises

The 1990s marked the launch of the modern-day emerging market bond market and, only a few years later, a new era of bond restructuring. The main developments were:

- Restructuring widely held bonds
- Proposals for collective action clauses (CACs)
- Two significant Paris Club reforms (Debt reduction and comparability for bonds)
- Extension of IMF lending into arrears
- New enforcement tools
- Further experimentation with debt-for-nature exchanges

The Brady Plan actively reinforced a perception that restructuring widely held bonds would be hard, especially as creditors were numerous, lightly regulated, and widely dispersed. Unanimous consent was generally required to amend payment terms on bonds issued in New York, making restructuring potentially more onerous. Mexico's Tequila Crisis in 1994-1995 centered on domestic dollar-indexed *tesobonos*—not international bonds. Nonetheless, widespread fears of disorderly bond default and market contagion helped mobilize a multilateral rescue package, unprecedented at the time.

Political backlash against "bailouts" and in favor of "private sector involvement" motivated innovation. Policymakers quickly coalesced behind two approaches: treaty-based sovereign bankruptcy and contract reform (Eichengreen and Portes, 1995; Group of 10, 1996). Both drew objections on the grounds of debtor moral hazard.[19] Of the two approaches, treaty-based bankruptcy was seen as less market-friendly with potential implementation problems;[20] it struggled to gain support from emerging market governments and the United States (Setser, 2010; Hagan, 2005). Contract reform initiatives focused on proposals for Collective Action Clauses (CACs) in New York; they had been the norm in London since the 19th century.

Two significant Paris Club reforms in the 1990s included allowing actual debt reductions: comparability of treatment was extended to bonds in 1999 (previously seen as too cumbersome to touch), and the Club endorsed the HIPC initiative for low-income countries.[21] A G-7 summit statement clarified that comparability should apply to all sovereign debt, except for preferred multilateral creditors. Comparability emerged as an important principle to promote inter-creditor equity.

The IMF also extended its lending into arrears policy to include bonded debt in 1998, and further refined its approach in 1999 and 2002, when it began requiring debtors' good faith engagement

[19] On the other hand, creditor moral hazard would decrease if bailouts were to be credibly ruled out.
[20] The IMF's Sovereign Debt Restructuring Mechanism proposal drew particularly severe criticism for potential conflicts among the Fund's interests as preferred creditor, arbiter of debt sustainability, and administrative hub of a bankruptcy regime—even after the proposal had been modified to minimize its role.
[21] Earlier in 1999, the Paris Club conditioned its relief for Pakistan and Ukraine on bond restructuring.

with creditors (IMF 2002). Thus, while the Paris Club could undo official bilateral debt relief if bondholders did not cooperate,[22] the IMF eased the pressure on borrowers to keep servicing bonded debt. Arrears could take the place of financing assurances, as long as debtors and creditors were engaged in good-faith talks.

Ecuador in 2000 was the first country to restructure previously issued Brady Bonds. Ecuador's operation pioneered a new enforcement tool, importing exit consents from corporate into sovereign bond exchanges (Buchheit and Gulati, 2000). Exit consents took advantage of the fact that unanimous creditor consent requirements in the New York market applied only to amending bond payment terms; changing the rest took a simple majority.[23] Governing law, submission to jurisdiction, immunity waivers, exchange listing, and other terms essential to contract enforcement and bond liquidity could be stripped from the old bonds by cooperating bondholders as they tendered their old bonds in a distressed exchange. Potential holdouts risked being left with illiquid and practically unenforceable bonds. These and other transactional innovations, such as minimum participation thresholds, incentivized creditor participation, and facilitated bond restructuring became ubiquitous (Bi et al. 2016).[24]

The 1990s marked the beginning of a new era in sovereign debt litigation focused on enforcement tools. Cases against Nicaragua and Peru by Elliott Associates in 1998 and 1999 used the promise of equal (*pari passu*) ranking in their bank loan contracts to demand full face value recovery and block payments on newly restructured debt. Unlike the 1980s cases that established government liability and the creditors' right to sue in foreign courts, these cases focused squarely on enforcement. With few assets available to satisfy creditors' judgments, enforcement was indirect: it entailed finding creative ways to pressure the government into settlement to preserve market access (both Peru and Nicaragua settled). After a commercial court in Brussels had blocked Peru's payments in Euroclear on the *pari passu* enforcement theory, observers and some market participants publicly criticized the creditors' tactics; however, debtors' incentives to settle delayed any meaningful judicial resolution of the matter.

The 1990s also brought further experimentation with debt-for-nature exchanges, primarily in Latin America and the Caribbean (see CRS, 2018). These transactions usually took one of two forms. First, a conservation NGO—sometimes with support from the U.S. government—would buy private or official sovereign debt at a discount and cancel it on condition that the debtor commit local currency funds in excess of the NGO's purchase price, to local conservation groups and projects. Second, the United States or another creditor country would replace existing bilateral official debt with a new agreement that required the debtor to make interest payments into a fund

[22] The threat remained theoretical—no restructuring has been undone on these grounds.

[23] Sovereign bonds governed by English law have included majority amendment provisions since the late 19th century (Buchheit and Gulati 2002).

[24] When a sovereign debtor announces it would only proceed with a bond restructuring if it reaches a minimum participation threshold (e.g., 90 percent of outstanding principal), it reassures participating bondholders that the operation would produce a certain level of debt relief, with limited scope for free riding. Such minimum participation thresholds are specific to restructuring operations and announced in conjunction with them; they do not require any particular terms to be included in the debt contract *ex ante*. In contrast, CACs—clauses permitting creditor majorities to modify bond payment terms over minority objections—must be in the debt contract before the restructuring.

for conservation purposes.[25] A 2018 review estimated debt-for-nature exchanges generated more than US$500 million for conservation from 1987 and that the second model delivered even more debt relief with greater environmental impact.

Argentina's Crisis and Developments Prior to the Pandemic

Argentina's default in 2001-2002 was the largest on record at the time. The protracted restructuring negotiations with foreign creditors were unusually contentious, prompting many lawsuits and new thinking on bond contracts. While the IMF staff proposal for a Sovereign Debt Restructuring Mechanism (SDRM) was rejected, new CACs were deployed and institutional developments in Iraq and Europe provoked wider discussion. Several domestic debt restructurings prompted new thoughts on the globalization of markets and as the climate debate warmed up, state contingent climate instruments grew in popularity. Developments from 2000 to the COVID-19 pandemic included:

- Argentina's 2001/2002 crisis and restructuring
- A concrete SDRM proposal
- CACs as the new market friendly flavor of the day
- Litigation against Argentina: Pari passu and statutory interest
- ICMA single-limb aggregated CACs
- Iraq restructuring and asset shield
- Domestic debt restructuring
- State-contingent debt (climate)

Argentina's 2001/2002 crisis, default, exit from the currency board, devaluation, and forced asymmetric *pesification*, led to a deep recession and a financial crisis.[26] The last (August 2001) IMF Agreement before the default recognized that a debt restructuring was required, but gave little indication of how that was to be done.[27] It took more than three years for Argentina to produce its first offer to creditors in 2005, and another five years for it to fashion a second offer that pushed creditor participation rates above 90 percent. Some creditors who rejected Argentina's offers proceeded to file thousands of lawsuits and chase assets around the world.

The two-year debate over the proposal for a treaty-based SDRM (Krueger, 2001, 2002, IMF 2003, Hagan, 2005) also began in 2001 and resulted in a specific and detailed institutional proposal. Then-U.S. Treasury Secretary O'Neill called for sovereign bankruptcy immediately after approving Argentina's August 2001 IMF program, in an effort to curtail large IMF rescue packages. Given political and market resistance, successive proposals were watered down to little more than a retrofitted aggregated majority bondholder vote, until eventually the project was shelved.

CACs gained popularity as a tool to achieve an efficient and orderly restructuring and for some, to minimize the need for large bailouts. In February 2003, Mexico became the first sovereign issuer

[25] Eg, the Tropical Forest Conservation Initiative.
[26] On the Argentine crisis, see for example Cline (2003), Powell (2003) and IMF (2004).
[27] On this point see Mussa (2002).

in New York to adopt CACs, with a 75 percent amendment threshold. Meanwhile, the crisis in Argentina had spread to Uruguay, and prompted the government to launch a bond reprofiling in conjunction with an IMF program. Uruguay introduced CACs with aggregated voting across multiple series in all of its new debt. Under the new contracts, if the holders of 85 percent of the principal of *all* affected bonds and the holders of two-thirds of the principal of a *single* affected bond series voted to amend its payment terms, the amendment would be effective for *that* series over the objections of the remaining third. The general bondholder population could effectively trump the votes of a large minority of single-issue bondholders.

The flood of lawsuits against Argentina featured a diverse cast of plaintiffs ranging from large U.S. Funds to Italian retirees as well as hedge funds specializing in distressed assets. By March 2005, Argentina's creditors were suing to block its bond exchange, and predictions of widespread disruption no longer looked far-fetched (Schumacher, Trebesch, and Enderlein, 2021, Makoff and Weidemaier, 2022). Two aspects merit special mention: creditors' successful use of the *pari passu* clause as an enforcement tool, and the strategic use of statutory pre-judgment interest in New York to boost recoveries for a subset of creditors.

U.S. federal courts agreed with holdout creditors that the *pari passu* clause in Argentina's defaulted bonds promised proportional repayment—a flow concept—rather than proportional distribution in a hypothetical asset liquidation. To enforce their orders, the courts blocked Argentina from paying its participating and new creditors until it paid the holdouts in full.[28] The proportional (ratable) payment injunctions owed some of their policy and market impact to the ubiquity of the *pari passu* clause in sovereign debt contracts. Despite plaintiffs' and court protestations that Argentina was unique, most sovereigns active in international financial markets had the same contracts and could be at risk from this remedy in default. Exposing trustees, fiscal agents, custodian banks, and international payments infrastructure to lawsuits in New York progressively limited Argentina's ability to borrow in international markets (Levine, 2015). U.S. court decisions substantially narrowed the application of the *pari passu* clause but only after Argentina and its holdout creditors had reached settlement.[29]

In addition, some creditors waited to sue on a portion of their bond holdings until the last possible moment, taking advantage of New York's 9 percent statutory pre-judgment interest rates set in the early 1980s. In some cases, this multiplied creditor recoveries and helped finance large litigation expenses (Makoff and Weidemaier, 2022). Argentina's 2016 debt exchange paid (2005 and 2010) holdout creditors more than US$10 billion to settle all the enforcement lawsuits.

[28] The appeals court observed that widespread adoption of CACs would foreclose similar use of the pari passu clause in the future, perhaps assuming (incorrectly) that the CACs guaranteed the success of a restructuring vote.
[29] Although the scope for future use of *pari passu* to collect sovereign debt has narrowed, the tool remains theoretically available to holdout creditors in exceptional cases (vaguely defined).

Box 1: The Greek and European Debt Restructuring Architecture

In 2010, growing Greek fiscal problems cast doubt on the government's ability to pay its debts. Like other euro area sovereigns, Greece had borrowed almost entirely in euros under its own law, but it also had a smattering of bonds governed by English, Swiss, and Japanese law. The English-law bonds already had first-generation "series-by-series" CACs, but lacked aggregation capacity.

The prospect of a debt restructuring prompted European policymakers to adopt modified Uruguay-style "two-limb" aggregated CACs in their domestic debt securities, but not soon enough for Greece. When Greece launched its restructuring in 2012, it used national legislation retroactively to insert a one-step ("single-limb") aggregated majority amendment mechanism in its Greek law bonds, effectively achieving full participation among domestic bond holders (Trebesch et al., 2013). However, the holders of US$5 billion in its English-law bonds mobilized enough votes to block restructuring for their series and were paid in full. Holdout success demonstrated the flaws of series-by-series CACs against determined holdouts alongside the relative virtues of single-limb aggregation and informed the next round of debt architecture reforms.

The issues raised by Argentina's "case of the century" prompted discussions on how to change bond contracts. While the *pari passu* battles raged in court and Greece teetered on the brink of default, the International Capital Market Association (ICMA) joined forces with bilateral and multilateral officials to commission a more robust version of CACs that would allow sovereign debtors to pool multiple bond series with a single limb aggregated CAC vote, *provided* they observed safeguards to protect creditor minorities from abuse.[30] The contract reform package included a new version of the *pari passu* clause, which rejected the proportional payment interpretation. These developments coincided with the Eurozone debt crisis (see Box 1), which underlined the need for single-limb aggregation.

[30] Safeguards included additional disclosure, a 75% supermajority threshold, and the requirement that any single-limb vote be "uniformly applicable"—offer the same restructuring terms of menu of terms—to all affected bondholders.

Box 2: Iraq's UN Asset Shield

Iraq's debt restructuring unfolded roughly in parallel with Argentina's case of the century and the CACs vs. SDRM debate, and introduced a qualitatively different tool in the restructuring toolkit: a public international law shield for debtors' assets. On May 22, 2003, the UN Security Council voted to block creditors from accessing Iraq's oil and the proceeds of its sale and, crucially, the United States and the United Kingdom adopted domestic measures to implement the Security Council Resolution. They later extended these measures past the resolution's expiration (Bolton et al., 2020; Buchheit and Gulati, 2019). Unlike CACs, the asset shield went beyond facilitating a smooth restructuring process. As the *pari passu* collection tactic gained currency, the UN measure made it much harder for holdout creditors to collect. In a departure from contract reform initiatives, the Security Council Resolution did not tweak contracts; it overrode them.

Again, Mexico was among the first to adopt the new model CACs and *pari passu* clauses in November 2014, and switched to a bond trustee structure to bolster coordination.[31] The ICMA-model CACs, published in 2015, tightened the two-limb aggregation mechanism pioneered by Uruguay in 2003, so that a single series that failed to receive more than 50 percent of the bondholder vote would block the restructuring of *all* series in the pool.[32] When Argentina emerged from 14 years in default in 2016, it adopted the latest version of ICMA CACs alongside two-limb aggregation in its exit instruments.

While the focus here has been changes in the debt restructuring architecture pushed by events in Latin America and the Caribbean, crises elsewhere in the world suggested new possibilities. An interesting example is the case of Iraq, which sought to restructure approximately the same size debt stock as Argentina after the fall of Saddam Hussein (see Box 2).[33] Although it garnered little media attention at the time, Iraq's asset shield was the closest the international community had come to sovereign bankruptcy protection within a public international law framework.[34] Iraq's experience highlights the potential of a legislative approach when there is political will to advance in that direction.

[31] ICMA eventually issued two versions of its CACs for English law (2014) and New York law (2015) contracts.
[32] In Uruguay in 2003 and in the English Law version of ICMA CACs in 2014, a dissenting series could drop out and let the rest proceed with the restructuring. This became a challenge for Argentina and Ecuador in 2020.
[33] A second example was the legal framework passed in the United States to deal with the debt of US Overseas Territories such as Puerto Rico.
[34] Its low profile in the sovereign debt mainstream may be due to the association with military conflict and regime change (Gelpern, 2006).

Restructuring in the Time of COVID

Latin America and the Caribbean has continued to innovate with debt restructurings in the COVID era in the presence of the new generation Collective Action Clauses (CACs) and is seeking new ways to link debt relief with climate change and environmental protection. In addition, new creditors outside of the traditional Paris Club members and bond holder coordination techniques, have introduced new challenges.

Experience with New Generation CACs

Argentina and Ecuador became the first countries to test the latest ICMA CACs in 2020.[35] Both countries' restructurings closed within months of announcing and securing more than 90 percent creditor participation (98 percent for Ecuador, 94 percent for Argentina). Surprising analysts and policy observers, neither government chose to use its single-limb aggregation clauses, reportedly because designing "uniformly applicable" exit instruments to attract 75 percent of creditors holding a variety of bonds across the maturity spectrum was harder than meeting the lower 50 percent per-series voting thresholds in the two-limb procedure.

Both countries introduced new transactional techniques to prevent a dissenting series from blocking a two-limb aggregated vote, although this proved controversial with creditors.[36] The new CACs afforded borrowers flexibility to tailor offers to diverse creditor preferences, and left room for creditors to demand new safeguards as a condition of participation. Contracts adapted dynamically. Nonetheless, some creditors complained that the flexibility was entirely one-sided, and used against them. Whether the new generation CACs and the safeguards adopted in Argentina and Ecuador will be accepted, ignored, or further refined in new issuances remains something of an open question.

China Lending: The Case of Ecuador

When Ecuador restructured in 2020, debt was 64 percent of GDP. Bonds were slightly less than half of the government's foreign debt stock. Chinese lending, largely from public banks and linked to oil, infrastructure, and other commercial projects was some 16 percent. After the bond restructuring, Ecuador secured an IMF Extended Fund Facility and reached an agreement to reschedule more than US$800 million in debt payments on loans due in 2020 and 2021 to the China Development Bank and China ExIm Bank. About two years later, in September 2022, another agreement lowered interest rates and rescheduled payments to the same lenders.[37]

The experience highlights the growing complexity of sovereign debt restructuring in middle-income countries, where some debt may be secured and beyond the scope of the Paris Club (even

[35] Fang et al (2021) found 16 international bond restructurings between 1994 and the onset of COVID-19 that used CACs including three in Latin American and Caribbean. None of the 16 used the 2014-2015 ICMA CAC.

[36] Controversial actions included reshuffling bonds into different pools after the votes had been cast (re-designation) and repeated polling of investors to absorb more dissenting bond series (De La Cruz and Lagos, 2021, Clark and Lyratzakis, 2021).

[37] See IMF (2022)2 and "Ecuador reaches $1.4bn debt restructuring deal with China" Financial Times, September 20th 2022.

if formally subject to comparability of treatment), not always fully transparent to all creditors, and not readily susceptible to state-of-the-art contractual tools like CACs.

Linking Debt and Climate Change

Heightened awareness of both debt and climate vulnerabilities has motivated governments, markets, and civil society stakeholders to seek ways of dealing with both. The region was at the forefront of debt for nature swaps in the late 1980s and 1990s and therefore has considerable experience in these types of transactions. Not surprisingly, Latin America and the Caribbean has remained at the cutting edge of innovation in this area, as reflected in the recent developments in Barbados, Belize and Ecuador.

Barbados restructured US$5.95 billion in domestic and more than US$800 million in foreign sovereign and sovereign-guaranteed debt between June 2018 and December 2019 in conjunction with an IMF Extended Fund Facility.[38] Legislation to retrofit majority amendment mechanisms in domestic-law debt, similar to the Greek restructuring in 2012 but reaching a broader set of instruments at higher voting thresholds, helped the government secure 97 percent participation between the launch of the exchange in September and its close in November. The creditors were overwhelmingly domestic regulated institutions and individuals in Barbados, and the treatment was tailored to their circumstances, with an estimated reduction in present value of the claims of between 28 to 76 percent, and 43 percent on average. Including short-term treasury bills and central bank holdings was unusual, but appeared to have no material adverse impact on domestic financial stability (Anthony, Impavido, and Van Selm, 2020). In addition to the domestic restructuring, more than 93 percent participation was achieved for the English-law, U.S. dollar-denominated debt with an estimated 44 percent in present value debt relief, using first-generation CACs and exit consents.[39]

The new debt issued as part of these exchanges included a natural disaster clause covering a broad range of events including hurricanes, floods, and earthquakes, and allows the government to postpone payments on the exit instruments for up to two years.[40] Postponed amounts would be distributed proportionally over the remaining repayment period, avoiding sharp payment spikes. The new clause employs triggers defined in the Caribbean Catastrophe Risk Insurance Facility (CCRIF) coverage. Barbados's natural disaster clause introduced a novel override mechanism, which would allow holders of 50 percent of outstanding debt to block a payment deferral (Ho and

[38] Subsequently Barbados issued a Blue Bond with a co-guarantee structure (US$50 million guarantee from The Nature Conservancy plus a US$100mn guarantee from the IDB) to substitute US$150 million of debt. The conversion aims to facilitate the expansion of the country's marine protected areas from virtually zero to approximately 30% and improve management for all marine waters within its jurisdiction. The idea is to free up approximately US$50 million to support environmental and sustainable development actions over 15 years – see https://www.nature.org/en-us/newsroom/tnc-announces-barbados-blue-bonds-debt-conversion/

[39] Use of exit consents outside the context of bonded debt in a CSFB syndicated loan was novel and led to full participation in the restructuring. The NPV relief figure for foreign debt assumes a 12 percent discount factor used by the parties. A 7 percent discount factor was used in domestic debt. Barbados did not restructure multilateral or official bilateral debt, which stood at about 2 percent of GDP. Project-linked debt to the Chinese government was also excluded from the general restructuring.

[40] These build on Grenada's 2015 bond clauses and ICMA 2018 suggested terms.

Crane, 2020). The sovereign has the initiative in this structure, but creditors retain the potential to block invocations of the disaster clause.[41]

In November 2021, Belize bought back its entire outstanding "superbond" of US$553 million, or roughly 25 percent of its external debt. The superbond itself was the product of prior distressed exchanges. The buyback was executed at a 45 percent discount with the proceeds of a US$364 million "Blue Loan".[42] The loan was financed with a "Blue Bond" issued by a special-purpose vehicle sponsored by The Nature Conservancy, a well-known environmental non-governmental agency. The transaction resulted in debt relief estimated at 12 percent of Belize's GDP, with part of the savings committed to endowing a US$23.5 million marine conservation fund. The central role of the Nature Conservancy bolsters the credibility of the government's conservation commitments, placing some 30 percent of Belize's ocean area under protection (The Nature Conservancy, 2022).

In May 2023, Ecuador bought back some US$1.63bn of debt in the largest debt for nature swap in history to date. Ecuador raised some US$656mn dollars for the buy back through a loan arranged by Credit Suisse and on improved terms due to a US$656mn political risk guarantee from the US's Development Finance Corporation (DFC) and an US$85mn guarantee provided by the Inter-American Development Bank (IDB). A part of the reduction in debt service will be used to finance some US$12.05mn per year of spending for 18 and a half years on marine conservation in the Galapagos Islands plus an additional US$5.41mn to capitalize a fund that has been created (the Galapagos Life Fund) to finance further spending beyond that period. The total spending on marine conservation is estimated to be US$450mn.[43]

These debt buybacks adapt earlier Latin American innovations dating back to the 1980s. They are particularly attractive as, at the same time, they reduce the face value of debt, lower interest payments and enhance the commitment funds environmental spending and may boost monitoring and transparency regarding the objectives and results of those expenditures. Still, such deals are not without their critics. Criticisms have included that the deals do not go far enough, that they should be scaled up in some fashion, that there should be more debt relief involved in the operations and that the commitments on environmental spending are relatively small compared to the face value of debt that is purchased. There are also concerns that the commitments, which may lock in fiscal spending for very long periods of time, threaten a country's sovereignty.[44]

Chamon et al. (2022) reviews the economic arguments for and against such debt for nature swaps. Following the literature regarding debt buy backs of the 1980's, they argue that as a portion of the

[41] Barbados has since launched a liability management operation to buy back up to US$70 million of the exit instruments with the proceeds coming from a bond issuance backed by a partial guarantee from the Inter-American Development Bank and The Nature Conservancy. The savings from this operation are to be dedicated to marine conservation.

[42] The blue loan was arranged by Credit Suisse and had additional credit enhancements in the form of political risk insurance from the U.S. Development Finance Corporation and a commercial parametric insurance policy covering a principal and interest payment in the event of certain natural disasters.

[43] See the IDB's "Fact Sheet. Debt for Nature Conversion Ecuador (Galapagos)" for further information.

[44] See for example, Are debt-for-nature swaps the way forward for conservation? | Conservation | The Guardian The Guardian, June 21st 2023.

benefits of the buyback accrues to other creditors, the attractiveness of this type of operation for the borrower may fade, and that in general there are other mechanisms for providing debt relief combined with new resources, that would dominate such deals. But that argument presumes that those other mechanisms are feasible. For example, if such deals attract guarantees from international development institutions that are on very good terms or that may not be available otherwise then this may invalidate this argument. Linking buybacks to climate and environmental targets may attract new investors more willing to provide greater relief, and hence allow for more ambitious operations. Moreover, alternatives may not enhance the transparency and monitoring of environmental goals in the same way. Linking the debt operation with the climate and environmental targets may then make for an attractive package which might be further enhanced by mechanisms to bolster the credibility of future fiscal targets. As climate change demands grow, it seems likely that more countries will explore mechanisms to address both high debt levels and the need to address climate and environmental challenges. Debt for climate swaps should be analyzed carefully, taking into account all of the resources employed by the country including support from outside agencies, and the results compared to alternative mechanisms to reduce debt and pursue climate goals.

3. Selected Outstanding Issues

The previous section outlines recent innovations in debt restructuring processes and the central role played by the Latin America and the Caribbean region. These innovations have tended to be reactive to developments in sovereign debt markets and to particular cases and events. But the sovereign debt market continues to evolve, and new issues are always coming to the fore. It is then unsurprising that there are a set of issues that are unresolved, some of these might be categorized as old issues, perhaps with a new twist, while others are prompted by new developments and challenges. In the following subsections, we discuss a number of issues to motivate areas which continue to merit discussion.

Are Debt Restructurings Successful?

A first question is whether debt restructurings are actually successful, not in the narrow sense of getting a deal done, but whether they reduce debt to GDP and restore growth. Powell and Valencia (2023) find that relatively few significant debt reduction episodes were associated with debt restructurings, and that debt restructurings were only rarely a main driver of the debt reduction.[45] Still, Figure 1, Panel A illustrates that debt ratios rise before a restructuring and then fall significantly when there is a nominal haircut. But most restructurings are reprofilings (meaning that maturities are extended but there is no reduction in principal), in where the rise in debt is milder, and then debt ratios on average fall back to the same level a few years after the reprofiling is finalized. Do restructurings enhance growth? In restructurings with a nominal haircut, growth dips just before the restructuring but then rises thereafter providing some mild evidence for a

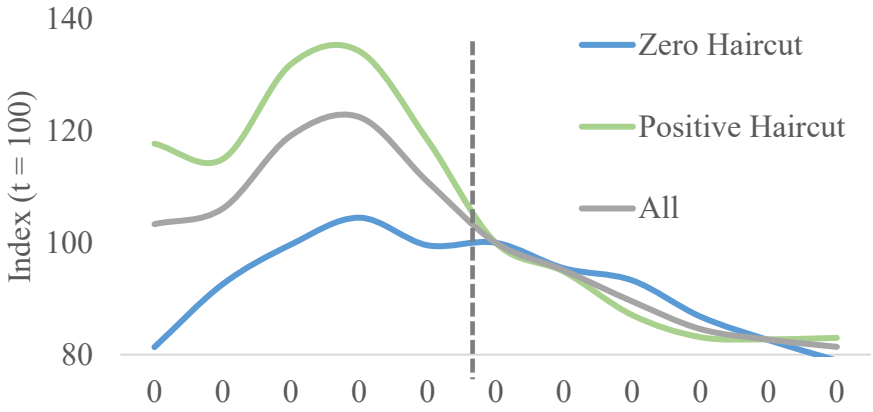
[45] Significant here refers to the main drivers of 10th and 20th percentile debt reduction episodes (the top 10% and 20% of episodes in terms of the reduction of the debt to GDP ratio among all identified episodes).

positive impact on growth (see Figure 1 Panel B. In the case of reprofilings, growth rises as the restructuring is finalized, but then falls back relatively quickly.

Given small sample sizes and the particular features of each event, it is a challenge to sort through competing perspectives but two conclusions emerge. Restructurings with nominal haircuts appear to be more successful in terms of debt reduction and in terms of boosting growth. Reprofilings have little sustained impact on growth and hence do not appear to be successful in reducing debt ratios.

Figure 1: Are Debt Restructurings Successful?

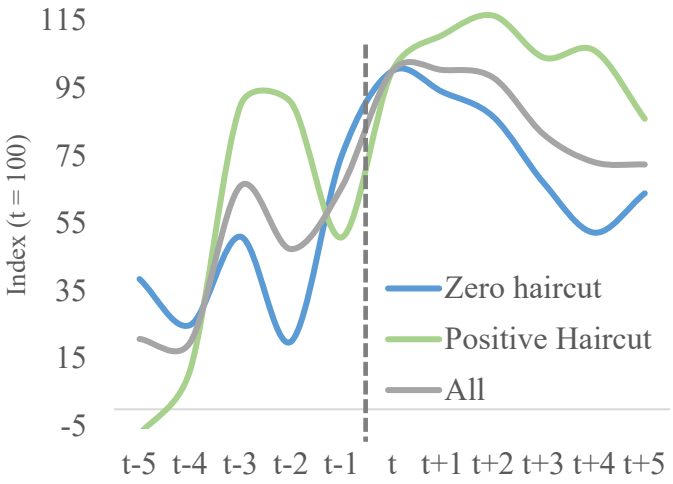
Panel A: Debt-to-GDP ratios around restructurings



Source: Authors' calculations based on the World Economic Outlook from the IMF, and Cruces and Trebesch (2013 and 2014 update).

Note: Donor funded (HIPC) restructurings are excluded. Zero and positive haircuts refers to nominal or face value haircut. The x axis is in years and t is defined as the year in which the restructuring was finalized.

Panel B: Growth around debt restructurings



Source: Authors' calculations based on the World Economic Outlook from the IMF, and Cruces and Trebesch (2013 and 2014 update).
Note: Donor funded (HIPC) restructurings are excluded. Zero vs. positive haircut refers to nominal or face value haircut. The X axis is in years and t is defined as the year in which the restructuring was finalized.

Costs and Delays

Several authors suggest that debt restructurings take too long and that they may be very costly.[46] Benjamin and Wright (2013) claim that the average delay (the time from when a country enters defaults and the time it escapes that rating) is over eight years. The devil is in the details for these types of estimates which depend critically on definitions and the sample considered. Employing the Cruces and Trebesch (2013) database and the definitions therein and excluding HIPIC/MDRI restructurings, we find an estimated delay a bit less than three years, with some significant outliers that impact the average.[47]

Approximately half of all debt restructurings are preemptive—concluded without any missed payment (see Asonoma and Trebesch, 2020). International organizations tend to recommend this route, since preemptive restructurings are associated with lower (deadweight) costs; however, it is hard to tell whether this is due to the speedy negotiation per se, or to greater certainty (in economic, political, or legal circumstances), which then allows the parties to reach a swift preemptive agreement (See IMF, 2013, and Pitchford and Wright, 2013).

Delays may occur for several reasons. If a sovereign's future economic conditions are highly uncertain and cast doubts on its commitment to honor any new debt agreement, then a new agreement that can be sustained over time may not be possible without additional information (Bi, 2008, Benjamin and Wright, 2013). The COVID-19 crisis put some debt renegotiations on hold given the uncertainty surrounding the pandemic. Debt renegotiations in Ecuador and Suriname are

[46] See for example IMF (2013), Benjamin and Wright (2013), Ghosal and Miller (2017).
[47] HIPC/MDRI refers to the Heavily Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative (MDRI) which provided debt relief for 36 low-income countries (see IMF, 2019).

two examples (Clark et al. 2021). If general elections come up against the backdrop of political polarization, creditors may choose to wait to negotiate with the new government. The same may apply if information about the value of newly discovered reserves of natural resources is expected.

A government may also delay for other reasons. It may put off a politically or economically costly restructuring hoping for some good luck to come along; at the same time, it may borrow at progressively higher rates, thereby taking riskier and riskier policy decisions. This is known in the economic literature as "gambling for resurrection" and is a concept well-known in the ambit of banking. If the good luck arrives and restructuring is avoided, this strategy might be seen as a success, but it may well end up saddling the population with higher economic costs and successor governments with the political, market, and policy challenges of a deeper required restructuring.[48]

Coordination Problems

Coordination failures among creditors can hamper debt crisis resolution. As discussed above, Argentina's protracted 2001-2002 default was the largest and most complex in history at that time, with many instruments held by diverse creditors across the world. Fears of disruptions from "holdout" litigation appeared to exacerbate the coordination problems.[49] Theory suggests that a relatively small and patient creditor may wait until the remaining parties reach an agreement with the sovereign to sue it to seek better terms (Pitchford and Wright, 2012, Ghosal and Miller, 2019). This strategy is particularly attractive if holdout creditors can threaten to impose large costs on the sovereign, such as impeding debt payments to new creditors or to creditors that choose to participate in the restructuring.

Most restructurings (and almost all preemptive ones) are reprofilings, providing liquidity relief but have a zero nominal haircut. They may then reduce the present value but not the nominal (dollar) value of the debt. More generally, Mariscal, Powell, Sandleris, and Tavella (2015) suggest that creditors face a choice: they can either opt for a relatively fast and less costly "reprofiling" (with a relatively small present value haircut) or attempt to negotiate a deeper haircut, and then face longer and more costly negotiations, with greater divisions among creditors and potential litigation.

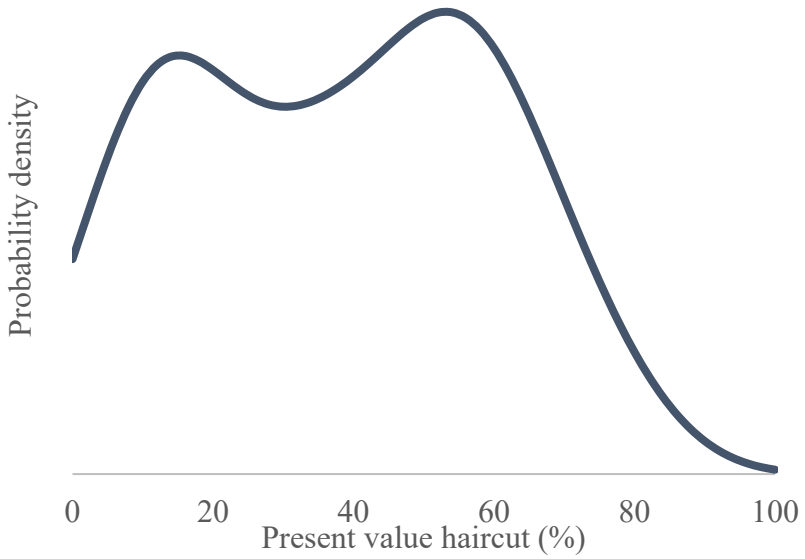
It is telling that the distribution of haircuts is skewed to the left and appears to be bimodal (see Figure 2 that illustrates the probability distribution for bond restructurings). In other words, more restructurings have relatively low (present value) haircuts and relatively few cases have haircuts deeper than, say 60 percent.[50] Approximately two thirds of all restructurings have a zero principal haircut with a median present value haircut of about 22 percent.

[48] In the sovereign context see for example the discussion in Powell (2002) regarding Argentina and in Schmidt (2016) regarding Jamaica. In the banking context see for example Dewatripont and Tirole (2012) who argue that a role of banking regulation is to prevent this behavior.

[49] See Schumacher, Trebesch, and Enderlein (2021) and Alfaro (2015).

[50] Assuming economic distress events are independent, the law of large numbers indicates that the extent of the distress should have a normal distribution; thus, if the distribution of haircuts is skewed towards zero, this may reflect something about the restructuring process or costs, rather than the extent of the problem to be solved. Of course there may be several reasons why such events are not independent but still a bimodal distribution of economic distress would be difficult to motivate (see Powell, 2011 for further discussion).

Figure 2: Probability Distribution of Present Value Haircuts in Bond Restructurings



Source: Authors' estimates employing data from the 2014 update of the dataset published with Cruces and Trebesch (2013).
Note: The present value measure is based on the Sturzenegger and Zettelmeyer (2008) methodology.

Relatively fast reprofilings may provide beneficial temporary liquidity relief. The downside is that they may not solve the underlying problem. Mariscal, Powell, Sandleris, and Tavella (2015) highlight the number of re-restructurings (a second restructuring that quickly follows a first) and suggest that a re-restructuring is more likely after a reprofiling than after a restructuring with a deeper present value haircut.[51] Mariscal, Powell, Sandleris, and Tavella (2015) suggest that creditors face a choice: they can either opt for a relatively fast and less costly "reprofling" (with only a small present value haircut) or attempt to negotiate a deeper haircut, and then face longer and more costly negotiations, with greater divisions among creditors and potential litigation. Coordination problems, associated with the threat of prolonged legal disputes and lengthy delays, may then push sovereigns, eager to maintain their reputations, to seek relatively fast reprofilings that provide temporary relief, but these arrangements may not create conditions for sustained growth and are so with a high likelihood may be followed by further restructurings.

Creditor Diversity

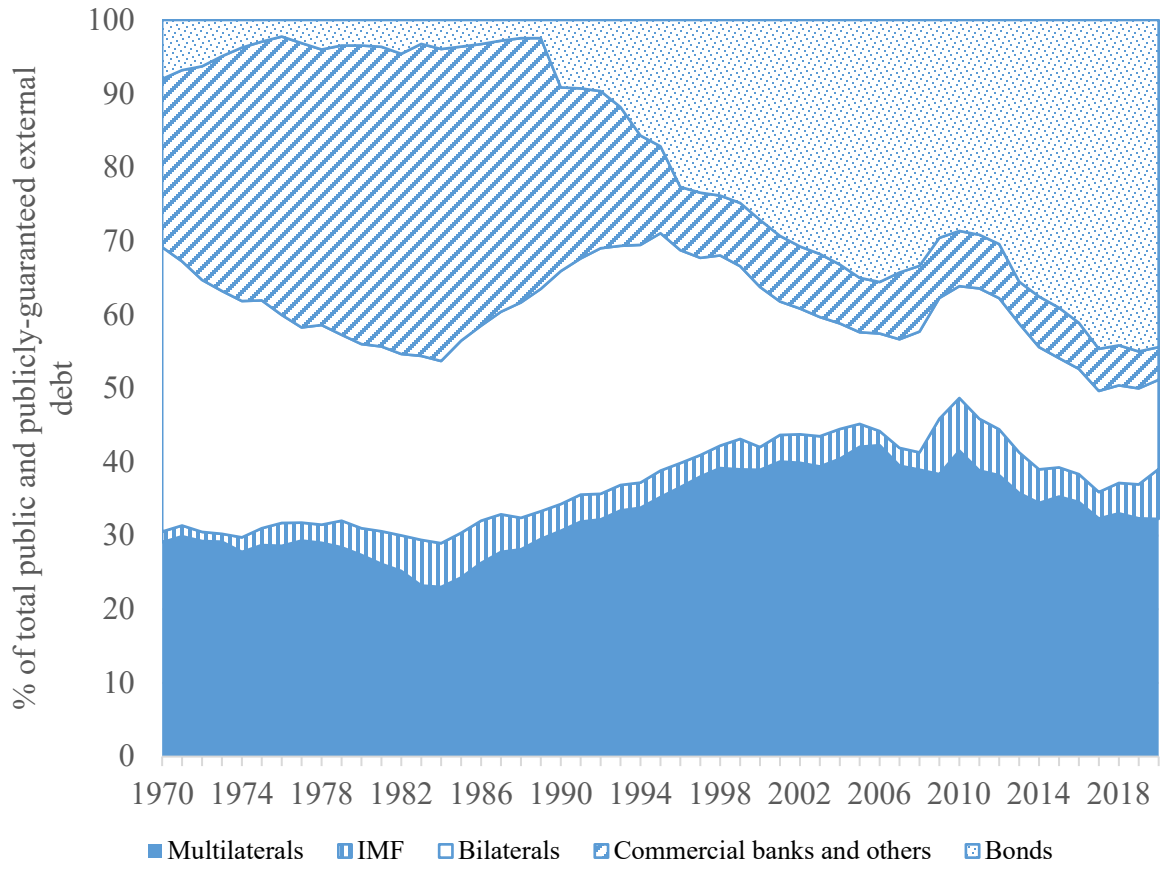
The diversity of creditors and instruments has been a perennial topic of discussion. The greater the diversity of creditors and the instruments that are employed then in general the more difficult it will be to coordinate across them. Figure 3 Panel A illustrates the share of external debt of the

[51] Bi, Chamon, and Zettelmeyer (2016) argue that most restructurings, especially in the post Brady deal era, have been relatively fast and that on the whole, creditor coordination was "the problem that wasn't." The arguments here suggest a somewhat different interpretation, namely that its relatively easy and fast for a country to pursue a reprofiling but that rarely solves the underlying problem and frequently leads to a re-restructuring.

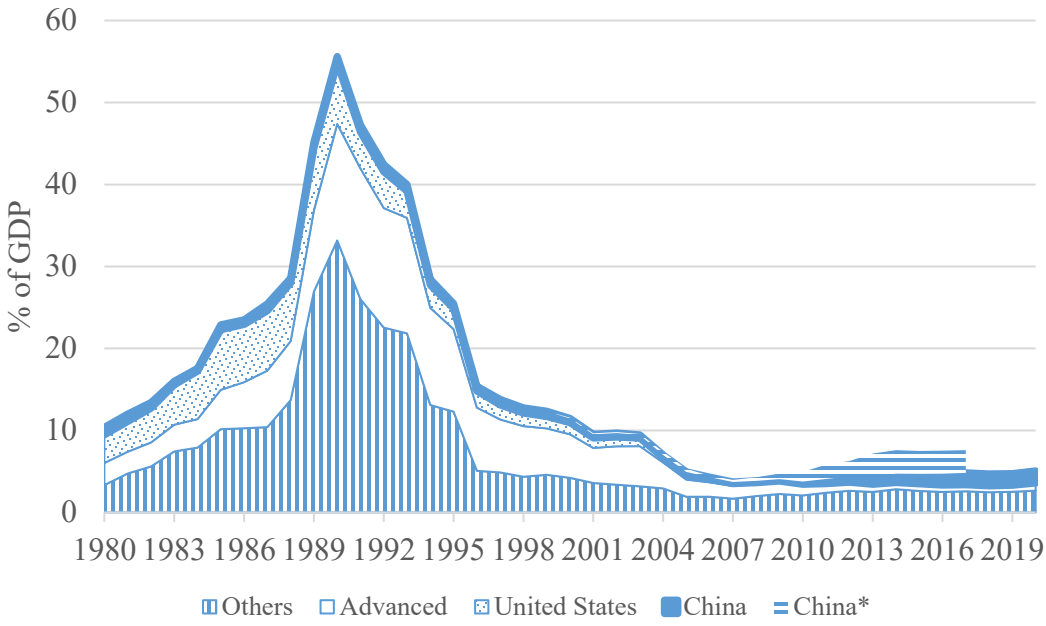
typical country in LAC held by MDB's, the IMF, bilaterals, banks, and bondholders. This graph illustrates the rise in bonds as the instrument of choice but that there remains a significant amount of debt held by bilaterals and multilaterals. Figure 3 Panel B illustrates the changing nature of bilateral debt. This graph illustrates the rise of China as a bilateral lender as well as a small rise in Other bilateral lenders. While middle income country governments tend to be more reliant on bond finance, there remains a significant amount of lending from bilateral and multilateral lenders. The source for these graphs is the World Bank's external debt database but it should be noted that this data may exclude some lending and may categorize lending by some countries' official banks as commercial lending (and hence included in banks) rather than bilateral lending (see Horn et al 2019 and Gelpern et al. 2021).

Figure 3: Diversity of LAC Creditors

Panel A: Shares of Outstanding Debt by Type of Creditor (Typical Country in LAC)



Panel B: The Changing Nature of Bilateral Debt (Typical Country in LAC)



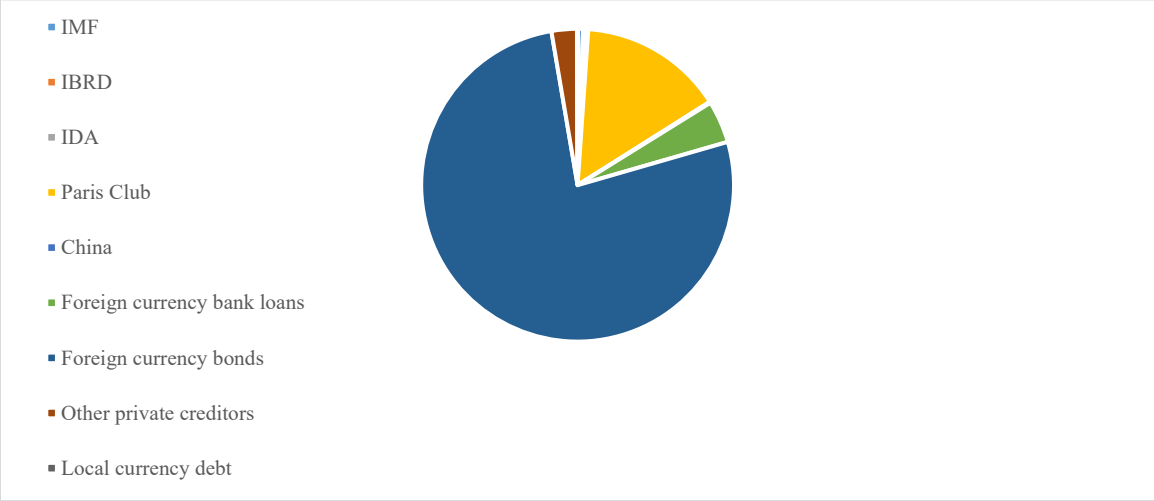
Source: Powell and Valencia (2023) Chapter 7, from World Bank debt statistics.
Note: The graphs are for the typical or average country in Latin America and the Caribbean.

Given the diversity of lenders there is also diversity of the debt in default follows. Figure 4 illustrates the share of debt in default by creditor in 2012 and in 2021. Over this time period, there is a notable decrease in the share of debt held by bondholders in default and an increase in the share held by Paris Club bilateral creditors and by China.[52]

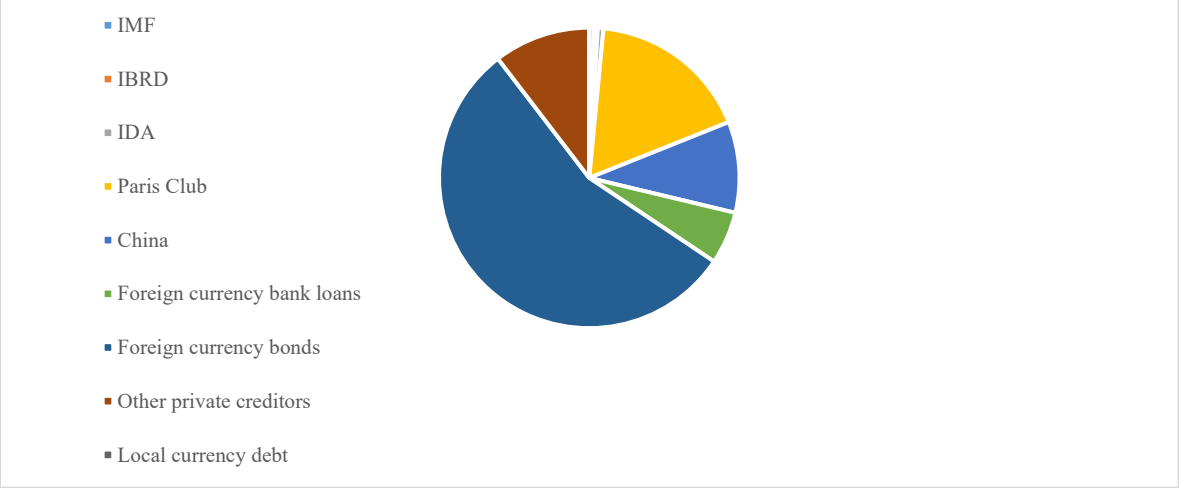
[52] The joint Bank of Canada and Bank of England sovereign debt database has a wide definition of default and, for example, includes debt in arrears to international financial institutions as default (see Chapter 7 for more on the role of official creditors).

Figure 4: Increased Diversity of Debt in Default

Panel A: 2012



Panel B: 2021



Source: Sovereign Debt Default Data from the Bank of Canada and Bank of England (2022 Edition).
Note: These two figures illustrate the 2012 and 2021 share of debt in default across the world as defined by this database. The category "other official creditors" is excluded.

Given the extent of creditor diversity and of the diversity of debt in default, it is clear that the challenge of coordinating creditors goes well beyond securing bondholder majorities to clear a given CAC threshold. There is then a need for a wider mechanism to coordinate creditors including private creditors, Paris Club and non-Paris Club lenders and multilateral institutions.

In cases where the country solicits an IMF Agreement, the IMF can naturally play a type of coordinating role. But the IMF has no real powers in this regard and can only rely on voluntary

actions by creditors. Delays in ensuring adequate financing assurances may provoke costly delays in finalizing an IMF Agreement.

Moreover, financial innovation is a continuous process. If there are incentives to free-ride, contractual innovations are likely to continually appear, such that subsequent agreements on standard clauses within any contract (including bonds and loans) to enhance coordination may be always one step behind. A lack of transparency regarding debt contracts is one possible way creditors may attempt to hide from any potential restructuring.[53] Insisting on moveable collateral to back loans is another obvious way in which a creditor may seek to enhance its particular claims in the hierarchy of seniority.[54] Coordination at a higher level among interested parties would then be helpful monitor developments in the sovereign debt market and consider new coordination approaches as deemed necessary.

A challenge that has become increasingly urgent in recent years is that of climate change, and the need for both mitigation of emissions and adaptation to the new climate realities. Mitigation and adaptation both require substantial financing and countries with relatively high existing debts face particular problems in financing the required investments. As reviewed above, Latin America pioneered debt for nature swaps in the 1980's and several countries have now conducted debt for climate or environment type operations or are interested in doing so. The proposed group might also play a very useful role in discussing these issues, developing consensus between borrowers, creditors and other stakeholders on the best approaches, and agreeing on how international financial institutions may best assist.

In summary, there remain a set of unresolved issues that deserve deeper discussion among stakeholders to find lasting solutions. A short list of these issues would include the following:

- Incentives for governments to postpone recognition of debt problems and to continue to finance at high and increasing interest rates and with a decreasing probability of escaping a debt restructuring.
- Delays in debt restructuring, even after the problem has been acknowledged, or opting for relatively fast reprofilings, which may not provide sufficient relief to restore sustainable growth.
- Limited process and data transparency, which undermines inter-creditor and debtor-creditor trust and taints the legitimacy of a restructuring.
- The challenge of creditor coordination including the experience and use of new generation Collective Action Clauses, mechanisms to coordinate across Paris Club and non-Paris

[53] The recent majority voting clauses (MVPs) produced by a public-private sector group led by the UK's HM Treasury and endorsed by the International Capital Markets Association (ICMA) for loan contracts is a welcome advance – see https://www.icmagroup.org/News/news-in-brief/icma-publishes-new-majority-voting-clauses-for-commercial-loans-to-sovereign-borrowers-to-facilitate-sovereign-debt-restructuring As per CACs for bonds, such clauses may need to adapt in time as financial innovation continues and new contract forms are deployed.

[54] MDB guarantees also impact the seniority of claims. So while they may crowd in private sector lending, particularly where risks are high, they should be used with care to ensure they do not simply delay a required restructuring and that any impact on seniority is not an impediment to a restructuring if that is required. MDBs will also wish to ensure their own claims are maintained as preferred.

Club creditors, commercial loans from official actors, collateralized lending and incentives for free-riding.

- Ensuring adequate financing across creditors participation in debt restructuring and in particular in the context of an IMF Agreement.
- Developing consensus on whether and how to best tackle debt and climate challenges.

4. Why a Regional Group?

The 2020 launch of the Common Framework attests to the perceived need to develop mechanisms to deepen coordination between borrowers, creditors and other stakeholders. Building on the experience of the Paris Club, the Common Framework recognizes that coordination from the official sector is valuable to ensure a comprehensive approach with both private and official participation. Key features of this approach include: i) the comprehensive coverage of official claims and general debtor eligibility; ii) robust inter-creditor information sharing and internal coordination; iii) credible linkage of official and private creditor relief, and with IMF and other IFI financing; and iv) momentum provided by external coordination, as well as peer country and G7 participation.

The Common Framework has been focused largely on low-income countries and three years since its launch, progress has been relatively slow. While there may be advantages to a global approach there are also three distinct disadvantages. First, countries are different, and the particular challenges faced by low-income countries may vary considerably from the middle income and high income vulnerable countries. Second, any global mechanism is very likely to become hostage to wider political forces. A regional group focusing on the common challenges of a set of more homogenous countries may have a greater chance of remaining pragmatic. Third, a challenge of a global initiative is to determine who is invited. The Global Sovereign Debt Roundtable is a welcome new initiative at the global level but has restricted invitations to borrowing countries that have been identified as at risk of restructuring plus a selection of other nations.[55] A regional initiative could invite all borrowing countries in that region rather than a selection of borrowers that might be deemed "at risk". This would eliminate any perceived negative signaling effect of participating in the group. It would also allow countries actively and successfully borrowing in debt markets to have a voice and interact with countries that face potential sustainability problems.

A hub and spoke arrangement could take advantage of both a global coordinating body and then a set of regional initiatives. In the case of Latin America and the Caribbean, a regional group could build on existing regional structures and exploit the deep knowledge built though the experiences of the region, and coordinate its standard-setting work with global initiatives such as the Common Framework (or any successor) and focus on the challenges of countries in the region. The group would include the countries of the region, representatives from the private and official creditors, the IMF, and the main multilateral development banks active in the region.

It would complement existing regional platforms to increase capacity in *ex ante* contract negotiations and *ex post* contract renegotiations, thereby developing generally accepted practices

[55] See Questions and Answers on the Global Sovereign Debt Roundtable (imf.org).

and norms. It would work with the IMF, MDBs, the Paris Club, and non-Paris Club lenders to elaborate and publicize the application of core concepts including sustainability and comparability in regional cases and help solidify the norms on creditor classification. It could assist in the design and oversight of climate contingent contract terms, and even provide input on trigger design and use in contingent debt. It could also help elaborate standards on dealing with collateralized and resource-backed lending in restructurings. None of this would put the proposed forum actually in the middle of debtor-creditor negotiations. Instead, it would leverage the region's existing institutions and deep history of dealing with debt crises to fill gaps in the existing architecture, building on the experiences of existing institutions.

The idea would not be to supplant any existing group or initiative such as the Paris Club or the Common Framework but to try to improve how they function, taking into account the unique characteristics of countries in the region. Given the history and experience with debt restructurings, a regional body might be able to smooth the path towards restructurings where they were considered necessary as a last resort. It could serve as a repository of information about restructuring experiences, allowing for swifter and constructive dialogue.

Such a platform would fill three key gaps:

First, it would focus on facilitating cooperation among debtors and creditors common to countries in the region.

Second, it would become the repository of expertise on matters most relevant to the countries in the region, with large-scale commercial financing needs as well as official sector borrowing. For example, it could work with multilateral institutions to develop reporting, data sharing, and debt treatment mechanisms for hybrid creditors, identifying and accounting for debt-equivalent transactions, secured and project-linked debt, guarantees, contingent debt triggers, comparability standards, experiences with different types of CAC and with domestic debt restructuring, among other issues.

Third, the platform would build on and benefit from existing regional debtor cooperation structures and provide a bridge between those and global initiatives such as the Sovereign Debt Roundtable and G20 type discussions. For example, the IDB has a longstanding and highly successful Debt Managers Group that maintains a database of (domestic and external) public debt in the region (disaggregated by currency, maturity and instrument), and which holds regular meetings to discuss pertinent issues. This group is an excellent mechanism to exchange of ideas, enhance debt transparency, to disseminate knowledge and to build trust and common views across the countries in the region. The proposed new regional group would then allow those views to be discussed with creditor representatives and multilateral bodies to seek new approaches to resolve the outstanding issues and provide a bridge to both discuss advances from and provide inputs to discussions at a global level.

Potential objections to such a platform might include the risk of fragmentation, duplicating effort, and debtor moral hazard. The first two concerns could be addressed by specifying that the regional body should coordinate its standard-setting work with the global one, such as the Common Framework or a successor, expanded to include middle-income countries, and universal

membership institutions such as the IMF. Restructurings would continue to be negotiated case by case. Concerns about debtor moral hazard in a debtor-dominated coordination mechanism are likely misplaced. Recent history suggests that sovereign debtors—particularly those with market access—are generally reluctant to initiate a restructuring, and wary of restructuring mandates. Establishing a coordination process with shared reputational stakes could help anchor expectations and discipline outliers.[56]

A regional approach would be able to harness the experiences of a group of more similar countries and create a mechanism for mutual learning and a repository of information while at the same time, sharing information and building trust with creditors and other stakeholders. A regional group would be more cohesive than a global one and that could create greater peer effects that might be more effective at influencing both borrowers and creditors to accept pragmatic solutions that would favor the common good.

What would be the objectives of such a regional approach? Among other goals it could conduct or sponsor analysis and produce white papers on relevant topics, develop sound practices, create a space for regular creditor engagement. It would provide a mechanism for borrower and creditor groups to present perspectives on outstanding issues to find common ground, which in turn might feed into the work of global initiatives including the Common Framework. The objective would be to produce analysis that would lead to the discussion of solutions to real issues and that would lead to actual decisions, and not just a forum for discussion. It would be complementary to existing initiatives at a regional level (such as the IDB's Debt Managers' Group) and global initiatives such as the Common Framework and provide a bridge between the two.

5. Conclusions

The rise in sovereign debt following the pandemic combined with the uncertainty created by the rise in global interest rates, the Russian invasion of Ukraine and financial sector strains in the US and in Europe have increased the risk of sovereign defaults.

Latin America and the Caribbean has played a central role in the many innovations in the process of sovereign debt restructuring going back to the 1980's and continuing right through into the post pandemic era. For example, considering the five restructurings in the region since 2020, they have included the use of new generation collective action clauses, negotiations and financial assurances with Paris and non-Paris club bilateral creditors, debt for nature swaps and the introduction of innovative disaster clauses in new bond contracts.

At the same time, a number of unresolved issues remain. A central issue is how to best assure the required creditor coordination to allow for a satisfactory restructuring that has the potential to reduce debt and boost growth in a sustainable way, given the diversity of creditors relevant for middle and high-income, vulnerable countries. This issue is compounded by the use of diverse instruments and linked to the perennial question of where to place the perimeter of debt to be

[56] Practical issues such as who would organize and act as secretariat and who would finance would also need to be surmounted.

included in a restructuring. Sovereigns may also delay restructurings and the combination of those delays and a lack of an adequate coordination of creditors may result in doing "too little too late". In addition, an issue that has become increasingly important in recent years is whether and how to best link debt and climate challenges. At the same time, international initiatives have rightly focused on the urgent plight of low-income countries.

In this discussion paper, we therefore advocate for the creation of a regional group to make advances in these and other critical areas. A regional group for Latin America and the Caribbean could focus on the unique challenges of the countries in the region and draw on the deep experience that the region has enjoyed over the last 30 plus years. It would not seek to replace international initiatives such as the Common Framework and the recently formed Sovereign Debt Roundtable but rather the idea would be to seek complementarity with these global initiatives. It could both take into account the deliberations at the global level but also channel valuable experience and lessons from Latin America and the Caribbean to these global forums. The regional group would build on existing regional initiatives such as the IDB's Debt Managers' Group and provide a bridge from that group to international discussions.

The idea would be to include both representatives from countries in the region and from the main creditors and other stakeholders. The objective would be not just to discuss the issues but also to conduct analysis and to produce white papers and make tangible advances in areas of importance. These could include recommendations to refine the standardized new generation collective action clauses given recent experiences, agreements on data transparency, recommendations on the use of collateralized debt, standard triggers for contingent debt contracts including natural disaster clauses, the design of debt for nature swaps and the role of international financial institutions to stimulate new lending and innovative liability management solutions.

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