Nouriel Roubini *Do We Need a New Bankruptcy Regime?*

RECENTLY THE DEBATE on the reform of the international financial architecture has centered on the development of an appropriate mechanism or regime to ensure orderly sovereign debt restructurings. Recent cases involving sovereign bonded debt restructuring (those of Ecuador, Pakistan, Russia, and Ukraine) have been successfully completed with the use of unilateral debt exchange offers (complemented by a system of carrots and sticks, such as exit consents, to ensure successful deals). But many observers have expressed dissatisfaction with this "market-based" status quo approach. The IMF has proposed the creation of an international debt restructuring mechanism that would have many of the features of an international bankruptcy regime.[1] The papers by Jeremy Bulow, Jeffrey Sachs, and Michelle White are all interesting contributions to this debate.[2] All address the question of whether we need an institutional change in the international financial system that would lead to a new way of providing for orderly sovereign debt restructurings or workouts when they become necessary.

The policy question to be addressed, then, is the following: when sovereign debt restructuring or debt reduction becomes unavoidable, what is the appropriate regime that provides for an orderly restructuring while safeguarding the balance of rights of both the creditors and the debtor? Is it better to continue with the market-based status quo regime and the use of exchange offers? Should we instead move to the wholesale introduction of collective action clauses (CACs) in bond contracts (also described as the "contractual approach")?[3] Or should we consider creating an international bankruptcy mechanism (a "statutory approach") like that proposed by the IMF? Two caveats are in order here. First, the very concept of insolvency is problematic in the sovereign context, because a

1. Krueger (2002).

2. Sachs (1995) was an early advocate of an international bankruptcy court for sovereign debtors, although his contribution to this symposium concentrates on the debt crisis and the debt reduction needs of low-income countries.

3. This approach has been supported by some academics (Eichengreen, 1999) and by the U.S. administration (Taylor, 2002).

restructuring may result either from the sovereign's inability to pay or from its unwillingness to pay. And second, the assessment of the sustainability of a country's debt is always probabilistic, because a sharp adjustment to the primary fiscal balance could in principle make an unsustainable debt path sustainable. These caveats notwithstanding, there is a general consensus that, in cases of sovereign "insolvency," further official finance is not warranted and the sovereign should suspend debt payments and restructure or reduce its debts, while at the same time undertaking serious and credible domestic fiscal adjustment and structural economic reform.[4]

Each of these three approaches just described—the status quo approach, the contractual approach, and the statutory approach—has its pros and cons. One way to think about their relative merits begins by asking what are the market failures that may prevent an orderly and efficient restructuring of sovereign debt when such a restructuring would be beneficial to both debtors and creditors. Several types of externalities might prevent such a restructuring, but three are crucial and have to do with collective action problems among creditors.[5]

The first is the "rush to the exits." As a sovereign debt crisis unfolds, many creditors may try to liquidate their claims at the same time, causing a disorderly crisis that has real and avoidable costs. An example is that of liquidity or rollover runs, in which investors become unwilling to roll over maturing short-term government debt (such as the Mexican *tesobonos*) or short-term cross-border interbank lines of credit (such as in the East Asian crisis). As I will argue below, a debt suspension or standstill (including capital controls, freezes on bank deposits, or both) may avoid such destructive behavior.

The second externality is the "rush to the courthouse" or "grab race." Although a unilateral debt standstill may overcome the inefficiencies of a rush to the exits, creditors may instead initiate litigation to recover their claims. This externality can become a serious problem if creditors can attach the debtor's assets. As discussed below, however, there are important differences between corporate and sovereign debt on this matter, in

4. The issue remains open whether a debt workout regime should also be used to solve liquidity crises and cases where debt restructuring may be necessary but the country is not clearly insolvent.

5. Elsewhere (Roubini, 2002) I discuss other potential market failures besides those analyzed here.

that the ability of creditors to seize or attach sovereign assets is very limited.

The third externality is the "free rider" problem (also called the "holdout" or "rogue creditor" problem). In situations where initiatives to restructure debt require unanimity among the creditors, minority holdout creditors may scuttle a restructuring even though it is advantageous to the majority. Although exchange offers may sidestep the unanimity problem, the holdout problem may remain serious. If a holdout creditor can choose not to accept the offer and then, through later litigation, receive the full amount of its claim while those who accepted the offer receive less, a strong incentive arises for creditors to hold out. If this creditor coordination problem cannot be solved, a disorderly workout will result, even if a cooperative solution would be in the interest of all creditors. Thus making a restructuring plan approved by a majority of creditors binding on all creditors (through a "cramdown" or majority enforcement provision) would solve this externality.

In addition to these three collective action problems among creditors, any efficient mechanism has to deal with a fourth potential market failure on the side of the debtor, namely, the "rush to default." This refers to a debtor's incentive to default opportunistically. As already noted, and as the literature on sovereign debt suggests, a sovereign's decision to default may be due not to inability to pay but to unwillingness to pay. Opportunistic defaults are always a possibility, given that a sovereign benefits from significant (but not complete) sovereign immunity, and thus attaching or seizing its assets is difficult. Therefore an efficient international debt workout mechanism needs to trade off two objectives. On the one hand, it must avoid making workouts too costly, because default may at times be due to inability to pay, and restructuring can thus benefit both the debtor and its creditors. On the other, it must not make workouts too easy, because otherwise the temptation to default opportunistically may increase. I will first analyze how each of the three regimes being considered addresses the three collective action problems on the creditor side, and then consider the question of the rush to default.

Supporters of a new statutory regime—an international bankruptcy mechanism—stress the fact that, although the collective action problems have always existed, they have become more severe in recent years given developments in international financial markets. In the 1980s most sovereign debt was held in the form of medium- to long-term syndicated

bank loans; the covenants in these loans included sharing clauses and other limits to the initiation of litigation that made the rush to the courthouse less of a problem. They also had implicit or explicit majority clauses for dealing with holdout banks. Finally, there was the potential for moral suasion, as repeated interaction among the banks built up relationships that made it easier for the leading banks to dissuade others from holding out. In the 1990s, however, most of the capital flows to emerging-market sovereigns began to take the form of bonds. The number, heterogeneity, and divergent interests of this wider group of creditors made the holdout problem much more severe. And the emergence of new, bondholding creditors with no ongoing relationships with the debtor or other creditors suggests that the presence of aggressive holdouts, or "vulture" creditors, willing to aggressively pursue their claims in court, may have increased.

In summary, the variety of claims (bank loans of various maturities, different types of bonds under different legal jurisdictions and with or without collective action clauses) and of types of creditors (retail investors, investment and commercial banks, diversified pension and mutual funds, hedge funds and other highly leveraged and aggressive creditors, dedicated emerging-market funds) raises a difficult collective action problem of coordinating the interests and actions of these heterogeneous claims and claimants. Investors may rush to the exits in a destructive panic; they may rush to the courthouse and start litigation if the debtor suspends payments; and they may hold out even if a majority of creditors could reach an agreement advantageous to all.

If this view is correct, a new international bankruptcy mechanism could allow for a more orderly restructuring. It would solve the three collective action problems in the following ways. First, it would allow the imposition of a suspension of debt payments and thus stop the rush to the exits. Second, it would impose a stay of litigation following the debt suspension that would be legally binding on all creditors and thus prevent disruptive litigation. And third, it would allow for a majority vote on a restructuring agreement that is binding on all creditors, thus eliminating the free rider problem.

Supporters of the contractual approach argue that most of the benefits of the statutory approach could be achieved through the more widespread use of collective action clauses. Such clauses usually do not allow individual bondholders to start litigation, but instead require that litigation be

voted by a majority of creditors; they may also include sharing provisions that reduce the benefits of holding out and litigating. Also, CACs generally include majority cramdown provisions, so that an agreement reached by a majority of creditors can be made binding on all holdouts, thus solving the free rider problem. Thus, according to their proponents, CACs could solve the collective action problems that prevent an orderly restructuring. And, compared with an international bankruptcy regime that could give new judicial powers to the IMF or a newly established bankruptcy court, this contractual solution could be more market friendly, relying only on agreements reached between the sovereign debtor and its creditors.

It is worth noting that the sovereign debt restructuring regime proposed by the IMF, at least its latest, "IMF-lite" version,[6] would not be substantially different from a contractual approach, as it would be creditor centered rather than IMF centered or bankruptcy court centered. This proposal would give creditors all the rights related to approving, by majority vote, an initial stay of litigation (and its continuation) and the eventual restructuring deal, which would be binding on minority holdout creditors.

Supporters of the statutory approach would argue that their solution is superior to a contractual regime for several reasons. First, there is a transition problem: many outstanding bonds, namely, those issued under New York law, do not have CACs. Therefore, even if new bonds included such provisions, for a long time to come a large part of the stock of outstanding bonds would not. Second, under traditional CACs the vote to start litigation or initiate a cramdown is taken bond issue by bond issue, rather than by a majority of all bondholders together. Therefore holdout problems and litigation problems may reemerge if a majority of holders of one or more issues decide not to cooperate. Although one can imagine some kind of super-CAC that would allow for a supermajority vote of all creditors in a particular credit class (in this case, all bonds), such clauses do not exist at present and are not likely to be introduced in a uniform way any time soon. Third, although CACs could eventually be included in all bond covenants, many other claims on the sovereign, such as bank loans, may or may not have them. And over time financial innovation may lead to the creation of new financial instruments that do not include such clauses.

6. Krueger (2002).

The statutory approach has the advantage that all current and future claims on the sovereign could be included in the same restructuring mechanism and be subject to the same overall majority vote. Fourth, achieving uniformity in the wording and interpretation of CACs issued in very different legal jurisdictions may be very difficult. Costly and protracted legal issues of interpretation and adjudication may arise. A uniform international bankruptcy regime would codify a standard set of rules and interpretations. In short, although some of the difficulties with the contractual approach could be overcome through the use of superclauses, arbitration, and other inclusive mechanisms, such a beefed-up contractual approach would end up being very close to a creditor-centered statutory approach.

Supporters of the status quo regime start from the observation that, although either a statutory or a contractual approach could solve these collective action problems and would therefore be welcome, several thorny issues of political economy make them unlikely to emerge.[7] If that is the case, there is no alternative but to try to use the existing regime to achieve orderly restructurings. In this regard, recent experience suggests that bonded debt restructurings are feasible, even in the presence of hundreds of thousands of heterogeneous creditors, through the use of unilateral exchange offers (along with exit consents when available). Indeed, such restructurings have already been successfully achieved in all four of the recent episodes mentioned at the outset.

Moreover, the collective action problems that seem so intractable in theory may be less serious in reality. First, a sovereign faced with a rush to the exits can stop it by suspending its debt service unilaterally; this collective action problem thus already has a solution under the current status quo. Second, although such a suspension, in the absence of a stay of litigation, may lead to a rush to the courthouse, that collective action problem is not as severe in the case of sovereign bankruptcy as it is in the corporate bankruptcy context. In a corporate bankruptcy the stay of litigation is mostly about protecting creditors' rights: its purpose is to avoid the unfairness of some creditors attaching assets while others do not. In the sovereign context, however, sovereign immunity implies that creditors will have trouble finding any assets worth rushing to claim. Countries typically have few assets subject to the jurisdictions of foreign courts that might be available for creditors to seize or attach. Creditors' ability to

7. Roubini (2002).

attach sovereign assets through early litigation is therefore severely limited. And, indeed, there is little evidence of a rush to litigate when a country suspends debt payments. In the recent case of Argentina, for example, creditors have threatened litigation, but to date none has occurred.

If, under the current status quo, the rush to the exits already has a solution and the rush to the courthouse is not a serious issue, only the free rider problem remains as a major collective action problem that might not be easily solved in the absence of a majority cramdown provision. But under the status quo, even the free rider problem (and the related litigation threat) has not been a grievous one. There are plenty of good ways to overcome or at least minimize the rogue creditor problem even without majority cramdown clauses. Indeed, one can identify at least ten reasons why the holdout problem is not an important one in practice.

First, as already noted, the unanimity problem that arises when bond contracts do not have majority cramdown clauses can be bypassed through the use of unilateral exchange offers. Although these offers do not eliminate the holdout problem, they allow for a great majority of cooperative bondholders to accept new bonds with new payment features even when the old bond required unanimity to change its terms. In recent cases involving thousands of bondholders (Ecuador, Pakistan, Russia, Ukraine), such offers have had overwhelming success, with 99 percent or more of creditors accepting the offer.

Second, exit consents, which allow the nonfinancial terms of a bond covenant to be changed by majority vote, have been successfully used (for example, in Ecuador) to dilute the benefits of being a holdout.

Third, a combination of carrots and sticks can be (and has been) used to dissuade holdouts and ensure the successful completion of deals. Carrots can include sweeteners in the form of cash, release of collateral, and seniority upgrades. Sticks may include the threat of default, ex post use of CACs, and exit consents.

Fourth, the free rider problem is predicated on the assumption that, in a debt restructuring, a creditor who holds out receives more in the end than creditors who do not. But this assumption is flawed in a number of ways. First, one cannot assume that holdouts automatically recover the full value of their claims; a more reasonable assumption is that they will recover something more than the current market value of their claim only after lengthy, costly, and risky litigation. Moreover, under any market-based exchange offer, any investor who marks his or her claim to the market

value will be better off accepting the offer rather than holding out, as long as the value of the new claim at least equals the market value of the old claim. And this is likely to be the case, because no creditor would willingly accept an exchange offer that does not offer at least mark-to-market neutrality. Indeed, in all previous debt exchanges, creditors have enjoyed mark-to-market gains (20 to 30 percent on average); such gains increased the likelihood that the offer would be accepted by a majority of creditors.

Fifth, a creditor may still decide to hold out from an offer that provides mark-to-market neutrality or a mark-to-market gain, if the risk-adjusted expected discounted net value of its original claim is greater, as a result of holding out, than that of the new claim. But each of those adjectives—"risk-adjusted," "expected," "discounted," and "net"—is critical here. Litigation is costly, especially for small creditors, and that affects the "net" calculation. The outcome of litigation is uncertain, and that affects the "expected." Some creditors (small retail creditors, for example) are more risk averse than others; that affects the risk adjustment. And some creditors have a high rate of time preference and will want to avoid the delay costs of protracted litigation; they will apply a higher discount rate. Thus a majority of creditors are likely to accept an offer that is mark-to-market neutral or slightly positive, rather than hold out and incur the costs, risks, and delays of litigation.

Sixth, large financial institutions that have valuable ongoing relations with a sovereign debtor (through the franchise value of their commercial banks in the debtor country or the fees and commissions on their debt underwriting services) are unlikely to hold out and fight. In fact, they may take the lead in coordinating the actions of the other creditors, apply moral suasion on holdouts, and, if necessary, bribe them into accepting a deal. The desire to gain the large commissions involved in a successful deal also leads these intermediaries to design workout packages that minimize such "deal risk."

Seventh, the holdout problem can be minimized through side payments (that is, the bribes mentioned just above) offered by creditors who have a lot to gain from a successful deal, or by the debtor itself (by buying out a limited number of holdouts after the deal has been struck), or by official creditors (through additional official finance that provides enhancements or sweeteners to a deal).

Eighth, the decision in the Elliott Associates case, described by White, was from a legal standpoint highly controversial. The legal doctrine that

the Brussels court accepted in that case interprets "pari passu" as allowing creditors to stop payments to other creditors who have accepted an exchange offer. The logic of this doctrine is likely to be successfully challenged in future court actions.

Ninth, creative variants of the regime of exchange offers can be designed to provide orderly, market-based restructurings that reduce the risks of litigation and free riding. A recent J. P. Morgan proposal describes such mechanisms.[8]

Finally, rogue and vulture creditors are often part of the solution rather than a problem. Vultures are low-risk-aversion speculators who buy low after a default, when debt prices have collapsed, in the hope of getting large mark-to-market gains from a successful deal; this may make them more rather than less likely to accept an exchange offer rather than litigate. For example, the same Elliott Associates that infamously and successfully sued Peru also held some Ecuadorian debt, and in that case the firm decided, along with more than 99 percent of Ecuador's creditors, to accept the exchange offer rather than hold out, because the offer provided significant mark-to-market gains. Moreover, even rogue creditors do not jeopardize the completion of an exchange offer: their incentive to start litigation is triggered by a successful offer, not a failed one. Only after a majority of creditors have accepted a deal does a rogue have the incentive to litigate and attempt to obtain a full claim.

Thus, although the free rider problem cannot be completely solved in the absence of a majority cramdown clause, there are various creative ways to minimize its risks and consequences within the current market-based status quo. And, indeed, recent experience has shown that holdout problems have not prevented the successful achievement of orderly bonded debt restructurings. In most cases the status quo may still work and allow successful exchange offers, with the holdout problem amounting only to a minor nuisance after the deal.

Finally, the rush-to-default problem is of concern to those, like Bulow, who worry about debtor moral hazard. In a world where countries benefit from sovereign immunity and creditors have very limited ability to attach sovereign assets, a sovereign may opportunistically default; that is, default may be driven by unwillingness to pay rather than inability to pay. Thus a restructuring process that is too easy or too orderly (that is, one

8. Bartholomew, Liuzzi, and Stern (2002).

that imposes little cost on the debtor) may not be socially efficient. Indeed, the appropriate costs (in terms of lost access to international capital markets and reduced output and trade) that creditors can impose on debtors are an important component of a well-balanced regime that minimizes the moral hazard of opportunistic default. But just as a default that is too easy may not be efficient, so, too, can a disorderly default (triggered by an inability to pay) impose losses that are socially inefficient. All three regimes discussed above would thus deal with the rush-to-default problem through reputational mechanisms and the various costs of an opportunistic default.

Bulow's paper presents a radical view of debtor moral hazard and the merits (or demerits) of an international bankruptcy regime. He sees debtor moral hazard as a pervasive problem, from two perspectives. First, policymakers in emerging-market economies have a bias toward socially inefficient budget deficits, because many of their policymakers are corrupt and willing to borrow for inefficient reasons. Second, the problem of unwillingness (as opposed to inability) to pay is severe in these economies, where the sovereign has a strong incentive to default opportunistically. Thus Bulow believes that the way to reduce these countries' deficit bias is to provide sovereigns full sovereign immunity rather than the partial immunity that comes from issuing debt in the major financial centers. Sovereign debtors, Bulow argues, should be allowed to borrow only in their own legal jurisdictions where sovereign immunity is close to full. This reform could severely restrict the ability of sovereign debtors to borrow from international investors: only responsible sovereign policymakers following sound policies would be able to sell foreign investors securities issued in the policymaker's jurisdiction. In Bulow's view, an international bankruptcy court is a second-best approach which, by making it easier for a sovereign to default and restructure its debts, would severely shrink the amount of international capital lending to emerging-market sovereign debtors, an outcome that he finds to be socially efficient.

I am not convinced by Bulow's arguments, for a number of reasons. First, reputational mechanisms and the costs of default in terms of forgone trade and output do significantly restrict the willingness even of corrupt policymakers to default. Governments try to avoid a default as much as possible, and for as long as possible, because default is politically, socially, and economically costly. Second, the empirical evidence on moral hazard in international lending is extremely thin; for example,

Olivier Jeanne and Jeromin Zettelmeyer show that domestic taxpayers, rather than the IMF (that is, international taxpayers) or creditors, pay the costs of official support packages.[9] In particular, IMF support is not a debtor bailout—that is, a grant—but rather an unsubsidized loan. Thus the idea that countries would deliberately follow policies that lead to currency and financial crises, in expectation of a bailout, is not supported by the evidence.

Third, a side implication of the point that IMF support is not a debtor bailout but an unsubsidized loan is that Bulow's aversion to lending by the international financial institutions does not have a strong empirical basis. Also, there are many arguments in favor of IMF loans and conditionality and against the "aid, not loans" view. Even Sachs' views on the issue of IMF loans appear to have changed. In his 1995 paper he argued that, rather than organize large bailout packages, the international community could address liquidity runs by turning the IMF into an international bankruptcy court, with the power to restructure sovereign debts.[10] But his later analysis of the Asian crisis as being driven mostly by self-fulfilling liquidity runs returns to the notion that large IMF packages are necessary to deal with destructive liquidity runs. Also, dealing with liquidity crises through standstills and debt workouts could itself be seriously destabilizing. As I have discussed elsewhere,[11] in a world characterized by uncertainty, risk aversion, and imperfect policy credibility, expectations of an imminent standstill may trigger an early and destructive "rush to the exits" that would have serious consequences even if all international financial transactions were subject to the standstill. Thus, at least for the cases that most closely resemble illiquidity runs, there is a consensus that IMF loans, rather than standstills, are the solution.

Fourth, as long as the ability of the private sector to borrow internationally is not restricted, such restrictions on a sovereign will affect neither its ability to accumulate debt nor its cost of doing so: the sovereign will borrow at home, and the private sector will in turn borrow abroad to finance its own lending to the sovereign. For example, in many recent crises (Argentina, Brazil, Mexico, Russia, Turkey) a large fraction of government debt was issued domestically and purchased by domestic

9. Jeanne and Zettelmeyer (2001).
10. Sachs (1995).
11. Roubini (2000).

banks; the banks, in turn, borrowed short term and in foreign currency from investors abroad, who thus financed the government's budget needs indirectly.

Fifth, although it is conceptually obvious that the existence of a third player providing funds, whether it be the IMF or another official entity, may lead to a delay game between the debtor and its creditors aimed at extracting further official resources, the empirical relevance of this problem is small. Because the subsidy component of IMF loans is small,[12] and because IMF loans are senior to private claims, such gaming would be beneficial neither to the debtor nor to the private creditors.

Sixth, an international bankruptcy court, as proposed by the IMF, would not provide new powers to the IMF or to the debtor relative to the current status quo or to a contractual regime. Thus it would not affect debtors' incentives to default, and therefore it would not severely reduce the amount of lending to governments of emerging-market economies. In summary, Bulow's concerns about the evils of sovereign borrowing and of IMF lending do not seem warranted by the facts. And his solution to these alleged problems would not solve the distortions that it is meant to address.

In conclusion, the debate over which of the proposed restructuring regimes would be best at achieving orderly restructurings is still open: all three regimes provide different solutions to the collective action problems inherent in debt restructurings. The statutory approach offers a clean and consistent way of solving collective action problems, but it is unlikely to be implemented in the near future. Similarly, the contractual approach is appealing, but transition problems and the lack of incentives to implement it may be insurmountable. Thus, for the time being, working with the status quo remains the dominant option. There is a strong case for believing that the current market-based regime can minimize collective action problems and provide for orderly restructurings.

12. As shown by Jeanne and Zettelmeyer (2001).

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