There is a better way to manage debt crises

By Josef Ackermann
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The world has got better at preventing financial crises. Governments have improved data transparency, emerging market countries have strengthened their debt management and the International Monetary Fund and World Bank are now better equipped to assess financial sector stability. But crisis prevention is not enough, as the financial collapse in Argentina makes clear. Better crisis management is also needed. Deciding on the best way forward should be a priority at this weekend's IMF annual meeting.

The private sector plays its part in crisis resolution. Of course, private investors must bear the consequences of their own investment decisions. But to resolve debt crises effectively, we need procedures for intensive dialogue between debtor countries and creditors. Although the IMF is usually involved, debt restructuring must ultimately be agreed between those two parties. For the borrower to impose conditions is unacceptable.

Debt restructuring must be orderly and quick. This is in the interests of both borrowers and creditors. However, the right tools are required, in particular collective action clauses in bond contracts. This is central to the contractual approach to debt restructuring and has the support of the Institute of International Finance and the Group of Seven leading industrial nations.

Collective action clauses, which under English law have been incorporated into bonds since the end of the 19th century, are a market-based instrument for overcoming obstacles to debt rescheduling.

There is now a consensus that such clauses should become the global market standard. This responds to a fundamental shift away from syndicated loans towards bonds in emerging market debt. As the use of bonds has grown, the number, diversity and anonymity of creditors have grown. As a result, it has become much more difficult to co-ordinate divergent interests, making delays to debt restructuring more likely. The shift to bonds also increases the risk that individual creditors, such as "vulture funds", will hold up debt restructuring by taking legal action. A delay will hit a debtor country's credit rating and depress bond prices further.

In practice, these problems have proved surmountable; recent debt restructuring exercises had participation rates of more than 90 per cent of creditors. Still, the multiplicity of investors and the potential for litigation create too much uncertainty. Collective action clauses would help tackle this problem by making possible a majority debt rescheduling agreement that was binding on all bondholders. They provide certainty in cases where debt restructuring is unavoidable. Creditors benefit from an orderly procedure, while borrowers can prevent the crisis from deteriorating further - and for everyone the whole process is shorter.

Governments and international financial institutions generally agree that collective action clauses have advantages. And yet they are also working on a kind of international bankruptcy law for governments, the so-called sovereign debt restructuring mechanism. The IMF and some G7 governments are devoting considerable effort to developing proposals outlined recently by Anne Krueger, the IMF's deputy managing director. However, collective action clauses would be just as effective.

It is now up to the private sector to flesh out precisely how collective action clauses could work in practice. We also need to ensure that they are quickly adopted around the world. The faster this happens, the sooner the majority of debt outstanding will include collective action clauses.

Academic studies suggest that governments with a good credit rating would not see the terms on which they borrow deteriorate as a result of collective action clauses. Still, borrowers appear reluctant to accept the use of such clauses as a binding market standard. All advanced countries should agree to include collective action clauses in future bond contracts, following the example of the members of the European Union. That would help turn them into a market standard.

There is widespread agreement on the usefulness of collective action clauses. Governments and international financial institutions cannot afford to waste any more time.

The writer is chairman of the group executive committee of Deutsche Bank