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IMF Board Discusses Collective Action Clauses in Sovereign Bond Contracts

On June 27, 2002, the Executive Board of the International Monetary Fund (IMF) discussed the design and effectiveness of collective action clauses, and ways to encourage their greater use in sovereign bond contracts.

Background

As part of its efforts to strengthen the framework for crisis resolution, the Fund has been examining two complementary approaches to creating a more orderly and predictable process for sovereign debt restructuring: (i) a statutory approach in which an amendment of the IMF's Articles of Agreement, or a new international treaty, would create a legal framework within which creditors and debtors could achieve more orderly debt restructuring, and; (ii) a contractual approach, in which debt restructuring would be facilitated by enhanced use of certain types of clauses in sovereign debt contracts. [1]

The official sector has since 1996 encouraged the use of collective action clauses (majority enforcement and majority restructuring provisions) in international sovereign bond contracts. However, there has been little change in market practice. While collective action clauses remain the norm for bonds issued in the United Kingdom, roughly 70 percent of all outstanding bonds have been issued in jurisdictions (mainly New York and Frankfurt) where the use of majority restructuring provisions is not yet the norm.

In this context, the Executive Board discussed two papers. The first paper, "Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use," examined the reasons that collective action clauses have not been used in key jurisdictions, and assessed ways to overcome this resistance to change. Variation in the use of collective action clauses in

[1] See Sovereign Debt Restructuring and Dispute Resolution, speech by Ms. Anne O. Krueger, First Deputy Managing Director IMF, at Bretton Woods Committee Annual Meeting (June 6, 2002)

outstanding international bonds is largely, but not exclusively, due to market practice rather than the requirements of national laws. There is, however, a general perception that the costs of change would be likely to be borne most heavily by the first issuers to include majority restructuring provisions in jurisdictions where such provisions are not the market standard, even if there is no clear evidence that there is a price premium for using clauses in jurisdictions where this is already the norm. The paper considers several ways in which the Fund could promote the wider use of collective action clauses, including through more active bilateral and multilateral surveillance, making the use of clauses a condition for access to Fund resources and/or special facilities, and differentiating the rate of charge or repurchase periods. Efforts that could be pursued outside the Fund include engaging investment grade emerging market countries and advanced economies (on the debtor side) and major issuing houses and institutional investors (on the creditor side) to lead by example, having advanced economies provide financial enhancements to promote the use of such clauses, and amending securities registration and listing requirements.

The second paper, "The Design and Effectiveness of Collective Action Clauses," examined the design and effectiveness of collective action clauses. The paper assessed several possible new provisions as well as existing majority restructuring and majority enforcement provisions. Most important among these new provisions are: representation clauses (authorizing the trustee of a bondholder syndicate, or its delegate, to act as a channel of communication between a debtor and its bondholders as early as possible during the restructuring), initiation clauses (providing for temporary protection against maverick litigation) and aggregation clauses (which would effectively aggregate creditor claims of different bonds for voting purposes). The paper also examined the use of majority enforcement and majority restructuring provisions in different issuing jurisdictions. Such provisions are common in some jurisdictions, but there are important differences in market practice in different markets.

Executive Board Assessment

Executive Directors welcomed the opportunity to discuss ways to encourage greater use of collective action clauses in sovereign bond contracts, and the design and effectiveness of those clauses. There was broad agreement that existing collective action clauses could play a useful role in the orderly resolution of crises and provide a degree of predictability to the restructuring process. A number of Directors noted the complementarity between efforts on collective action clauses and the Fund's ongoing work on a statutory framework for debt restructuring, and they looked forward to the forthcoming discussion on Fund access policy, which is an important element of the Fund's framework for crisis prevention and resolution.

Design and Effectiveness of Collective Action Clauses

Directors agreed that the most useful collective action clauses are majority restructuring and enforcement provisions such as those now existing in many international sovereign bonds. They noted that the voting threshold is critical to the design of the majority restructuring provisions, and most expressed the view that a 95 percent threshold—as has been recently proposed by an investor organization—would be excessively high. Some Directors observed that British-style trust deeds contain an even more effective majority enforcement provision and could serve as a useful model for future issues. Some others, however, expressed concern that the increased costs of using trust deeds may outweigh the benefits.

Regarding the inclusion of innovative provisions in international sovereign bonds, many Directors noted that it is too early to draw conclusions, as a number of design features of these provisions are still unclear and the preliminary market reaction has been mixed. Several Directors made the point that representation clauses could potentially contribute to an orderly and speedy restructuring process by establishing a channel of communication between the debtor and bondholders early in the restructuring process. They saw merit in the further study of the feasibility of including such provisions in future bond issues. Many Directors were of the view that designing and implementing initiation and aggregation clauses would be more difficult, particularly in light of the initial market reaction, but some did not rule out the possibility of progress in this area, particularly in relation with the ongoing work on the Sovereign Debt Restructuring Mechanism.

Encouraging Greater Use of Collective Action Clauses

Executive Directors expressed disappointment that, despite broad agreement in the official community on the merits of collective action clauses, official calls for their broader use have had little impact on market practice to date. However, some Directors noted that recent communication from major private sector organizations suggests growing support for the use of restructuring clauses with high majority thresholds in sovereign debt contracts. Furthermore, many emerging market issuers have issued in jurisdictions where the use of such clauses is the norm, indicating that they do not see a problem with the clauses per se. While the evidence remains inconclusive, the available information on existing collective action clauses suggests there is not a significant price advantage to making use of a particular governing law and jurisdiction. On this basis, Directors considered that there could well be a first mover problem in adopting clauses in jurisdictions where this is not yet the market practice. However, there is less evidence that use of clauses would add significantly to costs once a new market practice is established.

Turning to actions that the Fund might take to encourage the use of collective action clauses, most Directors agreed that it would be useful for the Fund to encourage more strongly the use of such clauses through its multilateral and bilateral surveillance processes, and to monitor the use of these clauses both in new bond issuances and in the outstanding debt stock. A few stressed that surveillance of this area should be exercised over the entire Fund membership.

Many Directors were strongly opposed to the idea of conditioning access to Fund resources on the use of collective action clauses in new bond issues, but some supported the creation of a presumption that countries seeking access to Fund resources would include collective action clauses in their bonds. It was noted that most countries tend to draw on the Fund when they are experiencing difficulties in accessing private financial markets. It was generally agreed that countries facing such difficulties were not in a strong position to change market practice, given the signaling problem. In addition, there is a risk that requiring program countries to adopt clauses would stigmatize the use of such clauses. Some Directors noted that the connection between collective action clauses and safeguarding Fund resources was weak. Others noted that the link between the use of clauses and the macroeconomic objectives of most programs was weak, and requiring the use of clauses would not meet the test of focusing conditionality on measures that are critical to the success of the member's program. Many Directors also considered that withholding resources from a member that was otherwise willing to implement a strong adjustment program would be difficult.

Furthermore, many Directors commented that establishing a presumption for the use of clauses in the event of exceptional access to Fund resources would be difficult to implement consistently. Most Directors indicated that the cost to emerging market countries of a comprehensive exchange to retire existing debt that lacks collective action clauses would be excessive, and considered that introducing collective action clauses in new issues alone would be more realistic.

Most Directors felt that making Contingent Credit Lines (CCL) approval contingent on the use of collective action clauses would reduce demand for this facility. Some Directors, however, noted that a link to the CCL would be consistent with the CCL's aim of promoting best practices in debt and reserve management.

Most Directors were supportive of conditioning the Fund's willingness to lend into arrears on a commitment to use collective action clauses in a comprehensive debt restructuring. This would avoid the difficulty of requiring a country that is not in default to seek a comprehensive change in the legal terms of its outstanding stock. Other Directors, however, were opposed, given the difficulties of securing collective action clause acceptability and their associated costs for members in such circumstances. They also noted that this approach would risk making the use of clauses the mark of a previous default, thus potentially stigmatizing their use.

Most Directors made the point that the inclusion of collective action clauses could not, in and of itself, provide a legal basis for the Fund to offer lower charges or longer repurchase periods. While Directors did not on balance support the creation of a special facility with lower charges or longer repurchase periods to finance those needs that would arise in the context of a swap to retire existing debt that lacks collective action clauses, some Directors encouraged the staff to continue exploring possible incentives for debt swaps. Directors also did not support amending the Fund's Articles to require that members of the Fund use collective action clauses.

There was general agreement that any efforts to encourage the use of clauses would be most effective if supported by intensified efforts outside the Fund. Most Directors agreed that a concerted approach that resulted in consensus among issuers, major issuing houses, and institutional investors on the need to change the market standard in key jurisdictions would be the least costly way of promoting the use of clauses, but several noted that such consensus might remain elusive. Many Directors reiterated the desirability of having industrial countries lead by example, though some questioned whether this would produce much practical effect. Several Directors saw merit in exploring whether securities registration and listing requirements in major jurisdictions could be changed so as to require the use of collective action provisions.

This was viewed as potentially the most effective means of changing market practice, although the difficulties of such an approach were also recognized. In particular, some Directors noted that this would fall outside the mandate of regulators and would require changing national legislation. Coordination among the major financial centers would also be important to avoid regulatory arbitrage.

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