SM/03/238

July 8, 2003

To: Members of the Executive Board

From: The Secretary

Subject: **Operational Guidance Note for Staff on Collective Action Clauses**

Attached for the **information** of the Executive Directors is an operational guidance note for the staff on encouraging the use of collective action clauses in the context of Article IV consultations. This note, which was circulated to Departments on June 12, 2003, is based on the principles outlined in the paper on recent developments and issues relating to collective action clauses (SM/03/102, 3/25/03), which were supported by the Executive Directors at the Executive Board Meeting on April 7, 2003 (BUFF/03/52).

The paper is intended for guidance of the staff's operations and the staff does not propose publication.

Questions may be referred to Ms. Psalida, ICM (ext. 35360) and Ms. Liu, LEG (ext. 37643).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

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Department Heads

INTERNATIONAL MONETARY FUND

Operational Guidance Note for Staff on Collective Action Clauses

Prepared by the International Capital Markets and Legal Departments

(In consultation with other Departments)

Approved by Gerd Häusler and François Gianviti

July 7, 2003

A. Background and Context

1. The Fund has been actively engaged in finding ways to improve the crisis resolution framework and, in particular, the means by which unsustainable sovereign debt can be restructured in a rapid and orderly manner. It is generally recognized that collective action problems can impede the debt-restructuring process. In the absence of a legal framework that resolves this problem (also referred to as the "free rider" problem), a sovereign confronting an unsustainable debt burden will find it more difficult to secure support for a restructuring agreement from a diverse group of creditors. Even though creditors, as a group, will recognize that support for a rapid restructuring of unsustainable debt may be in their own interest, they may be hesitant to agree upon a restructuring out of a concern that holdout creditors will successfully press for full payment after the agreement has been reached.

2. The Fund and other international fora have long recognized that the inclusion of "collective action clauses" (CACs) in international bond instruments would contribute to resolving this problem.[1] For this reason, the Board agreed—in July 2002—that the Fund should encourage the inclusion of such clauses through multilateral and bilateral surveillance. In light of the recent inclusion of these clauses in bonds issued in New York by several emerging market issuers and the growing consensus as to how these clauses should be designed, the Board has recently asked the staff to engage in a more active dialogue with members on this important issue.

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[1] In its April 12, 2003 Communiqué, the International Monetary and Financial Committee reiterated its support for CACs by welcoming the announcement that by June this year those EU countries issuing bonds under foreign jurisdictions will include CACs. The Committee welcomed the work of the G-10, emerging markets, and the private sector in contributing to the development of CACs. It looked forward to the inclusion of CACs in international bond issues becoming standard market practice, and called on the IMF to promote the voluntary inclusion of CACs in the context of its surveillance.

B. What are CACs?

3. CACs are provisions in bond contracts that enable the sovereign and a qualified majority of its bondholders to make decisions that become binding on all bondholders within the same issuance. Perhaps the most important provision is the *majority restructuring provision*, which enables a qualified majority of bondholders within the same issuance to bind all bondholders to the terms of a restructuring agreement, either before or after default. In addition, *majority enforcement provisions* enable a qualified majority of bondholders to prevent individual creditors from taking disruptive legal actions prior to reaching a restructuring agreement. While majority restructuring provisions currently exist in sovereign bonds governed by English law, bonds governed by New York law (which represent the largest portion of the emerging market sovereign bond market) have not traditionally included these provisions. For this reason, the recent inclusion of these provisions by Mexico, South Africa, Brazil, and the Republic of Korea in their New York law bond issuances represents an important breakthrough in this area (see Appendix II for additional information regarding the design of CACs).

C. What is the Fund Policy on CACs?

4. As noted above, the Fund supports the wider use of CACs in international sovereign bonds through its bilateral and multilateral surveillance. For purposes of the Fund's policy, "international sovereign bonds" comprise bonds issued or guaranteed by the government or the central bank, and which are either (i) governed by a law other than the law of the sovereign issuer, or (ii) subject to the jurisdiction of a court outside the territory of the issuer.[2] To the extent that a member issues—or intends to issue—such bonds, the inclusion of CACs should be encouraged, irrespective of whether the member is a mature or emerging market country.

5. While recognizing that any decision as to the design of CACs will ultimately be made by the issuer and its creditors, the Executive Board encouraged the use of those CACs in the New York market that are "broadly in line with" the provisions included in the bonds recently issued by Mexico and recommended by the G-10 Working Group (which are described in some detail in "Collective Action Clauses—Recent Developments and Issues," SM/03/102) and the Summing Up (Buff/03/52).[3] Most importantly, the Board expressed the view that, with respect to majority restructuring provisions, it would be reasonable to set the voting threshold at 75 percent of outstanding principal. Regarding bonds governed by

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[2] This definition is based on the fact that a holdout creditor holding this type of bond is more likely to have the legal leverage to disrupt the restructuring process.

[3] The text of the paper and the PIN can be accessed from the Fund's external website: http://www.imf.org/external/np/psi/2003/032503.htm.

English law, the continuation of existing practice in that jurisdiction was also considered appropriate (see Appendix II).

6. There is no evidence of a cost associated with using CACs in international bonds. Nevertheless, there may be cases where the inclusion of CACs that are consistent with those endorsed by the Board is resisted by the sovereign's underwriters or investors. In such cases, issuers will need to consult with their investor base to determine the cause for the concerns and decide how best to address them when preparing the bond issue. For example, with respect to the design of the majority restructuring provision, an emerging market sovereign should not assume that the voting threshold will need to be higher than the 75 percent threshold (included in the Mexico, South Africa, and the Republic of Korea bonds) solely because it is a noninvestment grade issuer.

D. What Should Article IV Missions Do?

7. Article IV missions should encourage the use of CACs by all members that issue or are considering issuing bonds that are either governed by foreign law or subject to a foreign jurisdiction. In that regard, Appendix I contains a list of questions that could guide the discussion undertaken by missions. The mission may also wish to provide the authorities with a copy of the most recent Board paper and Summing Up (see Paragraph 5 above). To the extent that the authorities have detailed follow-up questions regarding either the marketability of CACs or their design, the mission should draw upon the resources of ICM (with respect to marketability) and LEG (regarding design). Since ICM and LEG are building a comprehensive database on the use of CACs, the mission should, upon its return, provide ICM and LEG with any relevant information as to the activities or intentions of the authorities in this area.

E. What Should be Included in Article IV Reports?

8. For countries that issue or are considering issuing bonds governed by foreign law or subject to the jurisdiction of a foreign court, Article IV staff reports should note that the subject was discussed with the authorities, and they should include the authorities' views and plans with respect to the use of CACs. The staff report should also discuss the authorities' experience with CACs in cases in which members have issued bonds that contain CACs during the current consultation cycle.

Promoting the Use of CACs Through Bilateral Surveillance

As part of bilateral surveillance, Article IV missions have been asked to engage in a dialogue with country authorities on the inclusion of collective action clauses (CACs) in international sovereign bonds. At the outset, the staff should remind the authorities about the Fund's most recent discussions regarding CACs and the position that the Executive Board has taken regarding their promotion in the context of surveillance. For this reason, it may be helpful to provide the authorities with a copy of the most recent Board paper and Summing Up (*Collective Action Clauses—Recent Developments and Issues (SM/03/102, 03/25/03)).* In addition, the following questions should be asked:

- Do you issue international bonds that contain CACs (i.e., bonds that are either (i) governed by a law other than the law of the sovereign issuer, or (ii) subject to the jurisdiction of a court outside the territory of the issuer)?

- If you are not currently issuing international bonds, are you considering including CACs in future international bond issuances, including in possible refinancings, bond exchanges, or swaps?

- If you plan to issue bonds with CACs, in what jurisdiction are you intending to issue them?

- If you are not considering including CACs, what are the reasons?

- Who, within the government, is responsible for examining issues relating to the inclusion of CACs in your international sovereign bonds? Are these officials and their lawyers engaged directly in discussions on CACs?

- Can the Fund help in informing these key officials of the importance of CACs?

- Have the responsible officials talked to market experts, such as legal advisors, underwriters, and creditors, about this? If not, we encourage you to do so. If yes, what was the response of the market experts and creditors?

- Would you find it useful to speak with other issuers who have successfully issued international sovereign bonds with CACs?

- Can the Fund help to arrange such discussions?

For more specific discussions on CACs, the mission can offer to put authorities in touch with Effie Psalida (ICM, ext. 35360) on market-related issues, and Yan Liu (LEG, ext. 37643) on design issues.

Selected references

1. Fund Documents:

Collective Action Clauses—Recent Developments and Issues (SM/03/102, 03/25/03), inter alia explains the main features of CACs in market practice today, as well as proposals for model clauses by the G-10 and a private sector group; and Summing Up (Buff/03/52).

Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use (SM/02/175, 6/7/02); and Summing Up (Buff/02/99).

The Design and Effectiveness of Collective Action Clauses (SM/02/173, 6/7/02), discusses in detail the features of the different provisions; and Summing Up (Buff/02/99).

2. Other references:

Becker, Richards, and Thaicharoen, "Bond Restructuring and Moral Hazard: Are Collective Action Clauses Costly?", IMF Working Paper WP/01/92 (July 2001).

Buchheit and Gulati, "Sovereign Bonds and the Collective Will", Emory Law Journal, Volume 51, Issue 4 (Fall 2002).

Dixon and Wall, "Collective Action Problems and Collective Action Clauses, Bank of England Financial Stability Review (June 2000).

Eichengreen and Mody, "Bail-ins and Borrowing Costs," IMF Staff Papers, Volume 47, pp. 155–188 (2001).

Eichengreen and Mody, "Would Collective Action Clauses Raise Borrowing Costs: An Update and Additional Results," Policy Research Working Paper No. 2363, World Bank (May 2000).

Gugiatti and Richards, "Do Collective Action Clauses Influence Bond Yields? New Evidence from Emerging Markets", Research Discussion Paper, Reserve Bank of Australia (March 2003).

Petas and Rahman, "Sovereign Bonds—Legal Aspects that Affect Default and Recovery", *Global Emerging Markets—Debt Strategy*, Deutsche Bank (May 1999).

Report of the G-10 Working Group on Contractual Clauses, September 26, 2002.

Tsatsanoris K., "The Effect of Collective Action Clauses on Sovereign Bond Yields", in Bank for International Settlements, *International Banking and Financial Market Developments*, Third Quarter, pp. 22–23 (1999).

A Summary of the Key Features of Collective Action Clauses[4]

During its most recent discussion of collective action clauses (CACs), the Board encouraged the staff to hold a more active dialogue with emerging market issuers, with a view to encouraging the use of CACs in the New York market that are broadly in line with those issued by Mexico and recommended by the G-10 Working Group, as well as in other markets, such as Germany, where CACs are not yet the norm. Directors agreed that progress by mature market economies in the use of CACs in future international bond issuances would further strengthen these efforts.

In light of the above, set forth below is a summary of the design of CACs, taking into consideration the recommendations of the G-10 Working Group and the CACs that have been recently incorporated into bonds issued by Mexico, Brazil, South Africa, and the Republic of Korea.

Majority Restructuring Provision

Perhaps the most important feature of a CAC is the majority restructuring provision, which enables a qualified majority of bondholders to bind all bondholders within the same issue to the financial terms of a restructuring, either before or after a default. This provision currently exists in bonds governed by English law, where the required majority is normally set at 75 percent. For these bonds, the vote is typically calculated on the basis of the claims of bondholders present at a duly convened meeting. A meeting is considered to be duly convened if it satisfies the specified quorum requirements (typically, a quorum of two or more persons holding 75 percent of outstanding principal for the first meeting and, if this quorum rule is not satisfied at the first meeting, 25 percent for an adjourned meeting). Bonds governed by New York law (which represent the largest portion of the emerging market sovereign bond market) have not traditionally included the majority restructuring provision.

The G-10 Working Group endorsed the 75 percent voting threshold that is normally used in bonds governed by English law. However, to address the concerns expressed by U.S. institutional investors (who mainly purchase New York law governed bonds) regarding the quorum approach used in English law governed bonds, the G-10 Working Group proposed that it would be acceptable for the voting threshold to be based on either the quorum requirement or the outstanding principal amount of the bond.

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[4] This summary focuses on provisions that address the most significant collective action problems. While the G-10 Working Group also recommended an engagement provision that would promote dialogue between the sovereign and the bondholders, such a provision has not yet been incorporated into international sovereign bonds.

Recent bond issues of Mexico, South Africa, and the Republic of Korea adopted the 75 percent voting threshold, while Brazil's bonds rely on an 85 percent voting threshold. All of these bonds, which are governed by New York law, rely on the outstanding principal amount approach for purposes of calculating whether the relevant voting threshold has been met.

Majority Enforcement Provisions

Majority enforcement provisions are designed to limit the ability of a minority of bondholders to disrupt the restructuring process by enforcing their claims after a default but prior to a restructuring agreement. Two of these provisions can already be found in bonds governed by English law and New York law: (i) an affirmative vote of a minimum percentage of bondholders is required to accelerate their claims after a default, and (ii) a simple or qualified majority can reverse such an acceleration after the default on the originally scheduled payments has been cured. For these bonds, the voting threshold for acceleration is normally set at 25 percent of outstanding principal. For bonds governed by New York law, a vote of more than 50 percent is typically needed for reversal of an acceleration.[5]

An even more effective type of majority enforcement provision can be found in trust deeds governed by English law, where the right to initiate legal proceedings on behalf of all bondholders is conferred upon the trustee, who is required to act only if, among other things, it is requested to do so by the requisite percentage of bondholders. Moreover, the terms of the trust deed ensure that the proceeds of any litigation are distributed ratably by the trustee among all bondholders.

The G-10 Working Group endorsed the 25 percent voting threshold for acceleration but proposed a range from more than 50 percent to a maximum of 66⅔ percent for de-acceleration. In addition, the G-10 Working Group recommended the use of trust deeds as described above or equivalent legal structures.

The recent bonds issues of Mexico, Brazil, South Africa, and the Republic of Korea adopted the 25 percent voting threshold for acceleration. With respect to de-acceleration, Mexico, South Africa, and the Republic of Korea utilized the more than 50 percent voting threshold, while Brazil used the 66⅔ percent voting threshold. All of these bonds are issued under a fiscal agency agreement, rather than a trust deed.

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[5] For bonds governed by English law, de-acceleration is typically achieved through the majority restructuring provision, using the quorum approach.

Disenfranchisement Provision

To address creditor concerns about manipulation of votes by a sovereign issuer, many international sovereign bonds contain a provision that excludes bonds "held by or on behalf of the issuer" for quorum and voting purposes. The G-10 Working Group recommendations expand the scope of such "disenfranchised" bonds to those owned or controlled, directly or indirectly, by the issuer and its public sector instrumentalities. This expansion is designed to provide investors with a greater assurance that the issuer will not be able to manipulate the voting process as a result of the ownership of bonds by state-owned institutions.

Consistent with the G-10 recommendations, the bonds issued by Mexico, South Africa, Brazil, and the Republic of Korea contain an expanded disenfranchisement provision that covers bonds that are held by public sector instrumentalities.