FOR AGENDA

SM/03/301

August 26, 2003

To: Members of the Executive Board

From: The Secretary

Subject: **Progress Report on Crisis Resolution**

Attached for consideration by the Executive Directors is a progress report on crisis resolution, which is tentatively scheduled for discussion on **Wednesday, September 3, 2003**. Conclusions appear on page 12.

The staff proposes the publication of the revised version of this paper after the Executive Board completes its discussion.

Questions may be referred to Mr. Mecagni, PDR (ext. 38202), Mr. Hagan, LEG (ext. 37715), and Mr. Bertuch-Samuels, ICM (ext. 34786).

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INTERNATIONAL MONETARY FUND

Progress Report on Crisis Resolution

Prepared by Policy Development and Review, International Capital Markets, and Legal Departments
In consultation with other Departments

Approved by Gerd Häusler, François Gianviti, and Timothy Geithner

August 25, 2003

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I. INTRODUCTION

1. In its recent Communiqué, the International Financial and Monetary Committee (IMFC) called upon the Fund in the context of its surveillance activities to promote the inclusion of collective action clauses (CACs) in international sovereign bonds in jurisdictions where they are not yet the market standard and to contribute to initiatives aimed at formulating a voluntary code of conduct for sovereign debtors and their creditors. The committee also agreed that work should continue on issues raised during the development of the SDRM that are of general relevance to the orderly resolution of financial crises, including inter-creditor equity considerations, enhancing transparency and disclosure, and aggregation issues.

2. Section II reports on progress in the use and design of CACs and on efforts being undertaken by the Fund toward encouraging sovereign borrowers to include CACs in their debt instruments. Section III reports on progress to develop a voluntary Code of Conduct for sovereign debtors and their creditors. Section IV provides concluding remarks. [1]

II. COLLECTIVE ACTION CLAUSES

3. **Following the first Mexican issue in New York with CACs in March, there has been a clear shift toward the use of CACs in international sovereign bonds issued under New York law, where they had not been market standard.** There are, however, differences in the design of some of them.

A. Developments in Issuance

4. **The first half of 2003 has witnessed a shift in the use of CACs in international sovereign bonds governed by New York law** (Table 1).[2] Most new issues of these bonds

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[1]Other issues relating to crisis resolution, including information disclosure, modalities of dialogue between sovereign debtors and their creditors and coordination, were discussed in a recent paper circulated to the Board. See *Reviewing the Process for Sovereign Debt Restructuring Within the Existing Legal Framework* (SM/03/272, 08/04/03). A paper assessing the benefits, risks, and feasibility of aggregating claims in the context of sovereign debt restructuring will be circulated shortly.

[2]In this paper, the term "collective action clauses" (CACs) is used to refer to clauses that include both majority restructuring and majority enforcement provisions. The term "international sovereign bonds" means a bond that is governed by a foreign law or subject to the jurisdiction of a foreign court. Traditionally, bonds governed by New York law have had majority enforcement but not majority restructuring provisions. For a detailed description of CACs under different jurisdictions see *Collective Action Clauses—Recent Developments and Issues* (SM/03/102, 3/25/03).

since the beginning of March have included both majority restructuring and majority enforcement provisions:

- In March and April 2003, Mexico issued bonds governed by New York law with CACs. Although there was considerable discussion in the markets, particularly relating to the first Mexico issue with CACs, the bonds were issued successfully, with investor demand outweighing the amount on offer. In addition, an analysis of the Mexican sovereign yield curve provided no evidence that the price, either at the launch or in secondary market trading, reflected a yield premium for the inclusion of CACs (Box 1). These results are broadly consistent with the findings of previous studies.[3]

- Subsequently global bonds governed by New York law and containing CACs were issued by Brazil (four issues), South Africa, the Republic of Korea, Belize, and Guatemala.

- Many of these issues were heavily oversubscribed and again showed no evidence of a premium associated with the use of CACs. Furthermore, by the time the Republic of Korea issued its bond, market analysts virtually ignored the inclusion of CACs in the new bond, instead focusing on economic fundamentals and the scarcity of Korean debt instruments in the capital markets. Following these developments, investment bank representatives have indicated that they expect new sovereign issues governed by New York law to include CACs as a matter of course.

- CACs have also been included in the new bonds resulting from Uruguay's recent debt exchange.

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[3]See Eichengreen and Mody, "Bail-ins and Borrowing Costs," IMF Staff Papers, Volume 47, and "Would Collective Action Clauses Raise Borrowing Costs: An Update and Additional Results," Policy Research Working Paper No. 2363, World Bank, May 2000; and Gugiatti and Richards, "Do Collective Action Clauses Influence Bond Yields? New Evidence from Emerging Markets", Research Discussion Paper, Reserve Bank of Australia, March 2003.

Table 1. Emerging Markets Sovereign Bond Issuance[1]

	2001				2002				2003 [4]		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
With CACs [2]											
Number of issuance	14	10	2	10	6	5	2	4	9	17	1
Volume of issuance	5.6	4.8	1.8	2.2	2.6	1.9	0.9	1.4	5.6	12.7	0.3
of which: New York law	...	1.5	...	...	...	...	...	...	1.0	8.1	...
Without CACs [3]											
Number of issuance	16	17	6	18	17	12	5	10	14	5	3
Volume of issuance	6.7	8.5	3.8	6.1	11.6	6.4	3.3	4.4	8.1	3.4	1.0

Source: Capital Data.

[1] Volume of issuance is in billions of U.S. dollars.

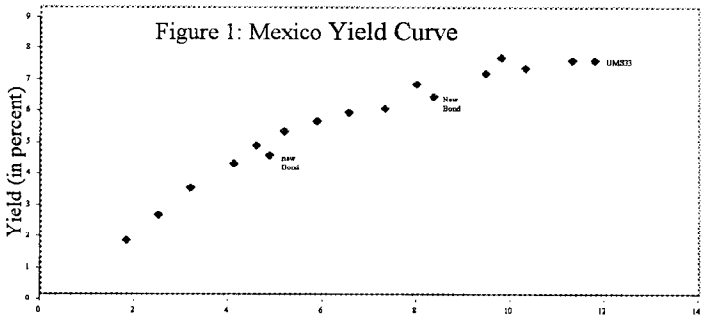
[2] English and Japanese laws, and New York law where relevant.

[3] German and New York laws.

[4] Data for 2003-Q3 are as of August 1, 2003, and do not cover the Brady exchange and a new bond issuance by Brazil on August 7.

Box 1. Pricing of Bonds With CACs Issued Under New York Law

Between March and May 2003, in turn Mexico, Brazil, South Africa, and the Republic of Korea broke market tradition in New York by issuing international bonds that included CACs. Mexico acted toward solving the first mover problem for including CACs in New York law governed bonds by issuing a total of US$3.5 billion of Global bonds with CACs.[1/] Based on analysis of the Mexican sovereign yield curve, there is no clear evidence that the issue price included a yield premium for including CACs (Figure 1).

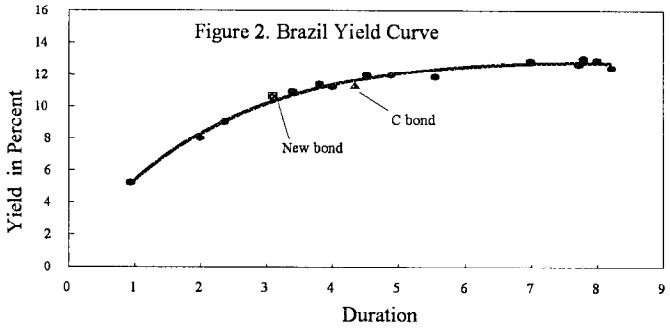


Orders for the first issue reportedly exceeded the amount offered by a ratio of 1.7, while orders for the second issue suggested a bid-to-cover ratio of 2.4.

After a year's absence, Brazil returned to the international capital markets in April by issuing a US$1.0 billion Global bond with CACs.

Demand for the issue was very strong, with a reported bid-to-cover ratio of 6:1. Conversations with market participants confirmed that the bond was very well-received, reflecting renewed confidence in the macroeconomic policies of the government and continued widespread interest in emerging market securities. Based on analysis of the existing sovereign yield curve, evidence did not indicate that the issue price included a yield premium for the inclusion of CACs (Figure 2). Secondary market trading in the aftermath of the issue indicated a yield below that of a similar bond with slightly longer maturity, suggesting that there too investors did not demand any premium for the inclusion of CACs.

South Africa and the Republic of Korea followed with heavily oversubscribed bond issues of €1.25 billion and US$1 billion, respectively. The South African issue was priced in line with the earlier South African 2012 US dollar bond (after adjusting for the increased liquidity and other technical factors). Korea's issue was its first global bond in five years. Its spread at launch was only marginally higher than the 80 basis point spread at which Korea's much shorter maturity 2008 bond was trading on that day, strongly suggesting that the inclusion of CACs did not result in any yield premium.



[1/] Egypt, Lebanon and Qatar had also issued bonds with majority restructuring provisions in New York in 2000-01, but at the time the inclusion of these provisions had gone unnoticed by the international capital markets.

5. **In addition, during the first half of 2003, a number of international sovereign bonds were issued under English and Japanese law including CACs, as has been traditional market practice in these jurisdictions.** The emerging market countries amongst these issuers include Bahrain, Croatia, Hungary, Israel, Lithuania, Morocco, the Philippines, Poland, Romania, the Slovak Republic, Thailand, Tunisia, and Ukraine. Mature market issuers included Austria, Greece, Iceland, New Zealand and Sweden. Table 2 provides information on the outstanding stock of emerging market bonds across various jurisdictions.

Table 2. Emerging Market Sovereign Bonds Outstanding Issuance by Governing Law (as of August 1, 2003)

	Number of Issuance	Number of Issuance	Value of Issuance	Value of Issuance
		(in percent)	(in billions of US $)	(in percent)
New York	292	49	163	56
English	169	28	75	26
German	79	13	33	11
Japan	57	10	19	7
Total	597	100	290	100

Sources: Capital Data; and IMF

6. **A number of mature market countries have also taken steps to introduce CACs in their international sovereign bonds.** In particular, EU member countries have committed to include in bonds issued under a foreign jurisdiction CACs that reflect the recommendations of the G-10 Working Group. Indeed, Italy has already launched such bonds under New York law.[4]

7. **There were also some emerging market issuances since March 2003 that did not contain CACs.** This is the case for the re-openings of old bond issues by Colombia,

[4]In June, the UK issued a US dollar denominated bond governed by English law that contains CACs consistent with the G-10 recommendations. The bond is issued under a trust deed.

Turkey, and Peru; and a new bond issue by the Philippines—all governed by New York law—and a bond issued by Turkey governed by German law.[5]

B. Design of Recent CAC Issues

8. **While recognizing that any decision concerning 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.**[6] Specifically, Directors 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.[7] At the same time, Directors generally viewed as reasonable the thresholds for majority enforcement provisions that have already been generally accepted in bonds governed by New York law, namely a vote by 25 percent of outstanding principal to accelerate the claims following a default and a vote of more than 50 and up to 66 2/3 percent of outstanding principal to reverse an acceleration of these claims.

9. **Regarding majority restructuring provisions, the experience to date has seen differences among the bonds issued by countries**:

- The bond issuances of Italy, Mexico, the Republic of Korea, South Africa, and Uruguay utilized a 75 percent voting threshold.[8]

- Issuances by Belize, Brazil and Guatemala relied on a higher voting threshold of 85 percent for an amendment of payment terms.

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[5]Bonds governed by German law do not include either majority restructuring or majority enforcement provisions. However, the German authorities have confirmed in public the validity of these clauses under German law. Moreover, legislation is being prepared to dispel any remaining doubts on this question.

[6]*Collective Action Clauses—Recent Developments and Issues* (SM/03/102, 3/25/03) and the Acting Chairman's Summing Up (BUFF/03/52, 4/10/03).

[7]Regarding bonds governed by English law, the Board considered it appropriate to continue existing practice in that jurisdiction.

[8]For Uruguay bonds, the threshold is applicable to any amendment of payment terms on an individual series basis.

- All of the recent bond issues governed by New York law contain an expanded disenfranchisement provision that excludes bonds that are held by public sector instrumentalities, in addition to those held by the issuer, for quorum and voting purposes.[9]

10. **With respect to majority enforcement provisions, all recent New York law bonds adopted a 25 percent threshold for acceleration, but they differ on the threshold for de-acceleration.** In particular:

- In the case of Mexico, the Republic of Korea, and South Africa, the threshold for de-acceleration is more than 50 percent of outstanding principal.

- Issues by Belize, Brazil, Guatemala, Italy and Uruguay included a 66⅔ percent threshold for de-acceleration.

- In addition, with the exception of Uruguay's bond issuance, which utilizes a trust structure, the others are issued under a fiscal agency agreement.[10]

11. **The CACs in Uruguay's recent bond issues include a number of novel features.** While some of these features would further reduce the leverage of holdout creditors, others are designed to strengthen the rights of creditors as a group (Box 2).

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[9]The inclusion of public sector instrumentalities, which is consistent with the G-10 recommendations, goes beyond the disenfranchisement provisions that exist in outstanding bonds in trying to address creditor concerns about manipulation of votes by the issuer.

[10]Under a trust structure, 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 instructed to do so by bondholders holding a requisite percentage of outstanding principal. The terms of the trust deed ensure that the proceeds of any litigation (after deducting costs and legal fees) are distributed on a pro rata basis by the trustee among all bondholders. Under a fiscal agency agreement, individual bondholders have the right to initiate legal proceedings against the debtor for the amount that is due and payable and can keep any recoveries from such proceedings.

Box 2. Uruguay: Novel CAC Features in Recent Bond Issues

Bonds issued by Uruguay include novel features. Specifically, the innovative aggregate voting clause included in these bonds provides the option to amend payment terms on the basis of aggregate voting across affected bonds in cases where the amendment affects two or more series of bonds. In particular, the aggregate voting provision enhances the ability to restructure where there is a large number of holdout creditors concentrated in a particular series of bonds, but there is significant support for the restructuring among bondholders taken as a whole.

- If the sovereign chooses to amend the bonds on an aggregated basis, the 75 percent majority needed for changing payment terms on each individual bond issue will be lowered to 66⅔ percent, provided that at least 85 percent of the aggregate outstanding principal of all issues that are proposed to be affected support the amendment.

- The effectiveness of aggregate voting is, however, limited in two respects. First, while the required 66⅔ percent threshold for each individual series is easier to achieve than the otherwise applicable 75 percent, it still enables a creditor to obtain a blocking position with respect to a particular issuance, although it would be more costly to do so.[1/] Second, aggregation applies only to new bonds governed by New York law that are issued under the same trust indenture.

At the same time, a number of features of Uruguay's bonds provide greater investor protection than is available under other sovereign bonds issued recently with CACs. In particular:

- The bonds limit Uruguay's ability to use coercive exit consents in future restructurings of such bonds through an undertaking that no future exchange offer will include amendments to make the current bonds less attractive than the bonds to be offered in the exchange.

- The bonds include strengthened provisions (in addition to the disenfranchisement provisions) to ensure the integrity of the voting process—in particular, Uruguay is required to affirmatively certify in future restructuring the amount of bonds owned or controlled by the government or its public sector instrumentalities, and not to issue new bonds or reopen a series of bonds with the intention of placing bonds with investors that are expected to support a future restructuring.

- The bonds contain a transparency provision which requires Uruguay to provide certain types of information to investors before any future modification of the bonds is sought.

[1/] Although the failure to achieve the 66⅔ percent requirement for any series of bonds would preclude a restructuring from going forward with respect to that series, a restructuring could still be effected for other series so long as it is supported by bondholders of 85 percent of aggregate outstanding principal of all series that are proposed to be affected by the restructuring and of 66⅔ percent of outstanding principal in each series to be restructured.

C. Encouraging the Use of CACs

12. **Staff are taking a proactive role in promoting the use of CACs in sovereign debt instruments.** In response to the request of the Executive Board for the Fund to play a

more active role through its multilateral and bilateral surveillance in promoting the inclusion of CACs in sovereign bond issuances, several initiatives have been undertaken. In particular:

- Staff have held an active dialogue with a number of emerging market issuers, including at headquarters and in the context of missions to encourage the inclusion of CACs in international sovereign bond instruments. These issuers have included countries with a long experience in accessing international capital markets, as well as relative newcomers.[11]

- Staff have intensified their dialogue with private market participants, including investors from the buy and sell sides, underwriters, and legal practitioners. These exchanges have been useful in identifying potential questions and concerns by issuers and investors related to the inclusion of CACs, while also getting informal updates on investors' outlook and priorities, which can in turn inform certain aspects of the Fund's multilateral surveillance.

- In addition to issuing an operational guidance note on encouraging the use of CACs during Article IV consultations, staff from the International Capital Markets and Legal Departments have held a number of internal seminars with Area Departments to discuss design and market-related issues relating to the use of CACs in international sovereign bond instruments. [12]

- In collaboration with the World Bank, staff have also initiated the process of amending the 2001 Guidelines for Public Debt Management to reflect the use of CACs.

III. Code of Conduct

13. **Efforts are underway to improve the process of restructuring sovereign debt within the existing legal framework.** Experience with recent restructuring highlights the diversity of debt restructuring approaches in the current system.[13] This is a necessary and desirable feature of the present framework, but it also entails a degree of uncertainty on how a restructuring process will unfold. Two issues figure prominently in the calls to

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[11]First-time sovereign issuers are encouraged to include CACs in their international bonds—see *Access to International Capital Market for First-Time Sovereign Issuers* (SM/03/218, 6/24/03).

[12]The guidance note was circulated for the information of Executive Directors (SM/03/238, 7/8/03).

[13]*Reviewing the Process for Sovereign Debt Restructuring Within the Existing Legal Framework* (SM/03/272, 08/04/03).

improve the existing process of restructuring sovereign debt—information exchange between debtors and creditors and greater coordination when the restructuring involves a large and diverse group of creditors. In particular, in the context of restructuring, a higher level of disclosure is likely to be required than in normal times, reflecting the heightened uncertainty associated with the restructuring decision and to facilitate the necessary due diligence by creditors. In addition, to ensure widespread support for a debt restructuring proposal, a collaborative and inclusive approach to debtor-creditor dialogue would be important.

14. **Against this background, over the past several months, there has been considerable discussion within both the private and official sectors regarding the potential benefits of a voluntary Code of Conduct (a "Code")**. These discussions have taken place in different fora. One of these is an informal working group—led by the Banque de France and the Institute for International Finance (IIF) and consisting of participants from several emerging market countries, a number of the major economies, and private sector representatives—that has been formed to develop such a Code. Although this group includes only selective representatives, it is attempting to draft a text that could gain wider acceptance in the official and private sectors. Fund staff have participated in these discussions as observers. The principles and best practices that would comprise a possible Code will apply to the actions of private creditors and issuing governments. While they might help inform the approach to be taken by the Fund, the content and application of Fund policies will remain the prerogative of the Executive Board. It is recognized that a Code could *inter alia* facilitate a continuous dialogue between creditors and debtors; promote corrective policy action to reduce the frequency and severity of crises; and facilitate the orderly and expeditious resolution of crises.

15. **The two main challenges, however, have been to bring together representative groups of borrowers and creditors, and to reach consensus on the right balance between a framework that is flexible enough to be applied to a diverse set of country circumstances, and one that is still prescriptive enough to offer a useful guide to how the process should work in practice.** There has been some progress and consensus on the broad objectives of a Code, but discussions to date have highlighted a broad range of views on several aspects. Prominent among the latter are the scope of the Code's application, information sharing and transparency, the modalities of consultation between creditors and debtors, and its monitoring and enforcement.

16. **There are a number of areas where a greater degree of consensus among sovereign issuers and private creditors could help improve the process of restructuring**. In particular:

- It would be helpful to clarify the desirable scope of disclosure of information by the sovereign, prior to and during a restructuring process, modalities for disseminating information, and how best to protect confidentiality. In this context, it would be

useful to examine the scope for improving the quality of investor relations programs across emerging markets.[14]

- There is a wide range of views on the merits of different approaches to consultation and the design of a restructuring strategy. It would be useful to explore whether there is scope for broad agreement on the circumstances in which a negotiated solution may be preferable to the consultation/exchange offer approach. In this context, is there a role for using creditor committees as part of the consultative process even in circumstances where a negotiated solution may not be appropriate?

17. **One issue that has been raised in this context is whether there should be some mechanism for monitoring compliance with the Code and the role of the official sector, including the Fund, in this effort.** The Code is intended to be voluntary, and many observers believe it would neither be necessary nor desirable to establish a formal mechanism to monitor practice against the standards in the Code. The Fund's involvement in assessing progress in creditor-debtor dialogue and negotiations would be guided by the Fund's lending into arrears policy and the recent review by the Executive Board of the application of the good-faith criterion to reach a collaborative agreement.[15] The content and application of that policy, however, may need to be revisited when greater clarity emerges concerning the precise content of a Code.

IV. Conclusions

18. **In sum, rapid progress has been made in promoting the inclusion of CACs in international sovereign bond issuances.** In particular, there is a rising trend in the use of CACs in international sovereign bond issues, facilitated by greater acceptance of these contractual provisions by the markets and by the absence of a premium in pricing. Continued efforts by the international community and greater outreach will further enable CACs becoming standard market practice. Efforts in developing a voluntary Code of Conduct continue. Staff are participating and monitoring progress in this area. If there were to be an agreed Code, staff would provide the Executive Board with a commentary. Staff will also continue to explore other issues relating to the resolution of crises, including aggregation, which will be discussed in a forthcoming paper.

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[14]Investor Relations Programs—Report of the Capital Markets Consultative Group—Working Group on Creditor-Debtor Relations (SM/01/174, 6/10/01).

[15]Fund Policy on Lending into Arrears to Private Creditors—Further Considerations of the Good Faith Criterion (SM/02/248, 7/31/02).