June 17, 2003
Approval: 6/24/03

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 03/33

12:30 p.m., April 7, 2003

Contents

EXECUTIVE BOARD ATTENDANCE

A. Krueger, Acting Chair

Executive Directors	**Alternate Executive Directors**
S.M. Al-Turki	A.S. Alazzaz
	E. Nyambal, Temporary
	C.A. Gust, Temporary
M.J. Callaghan	
F. Zurbrugg	W. Szczuka
K. Bischofberger	
P.C. Padoan	
S. M. Indrawati	I. Alowi
Y.V. Reddy	
W. Kiekens	
V. Egilsson	
N. Jacklin	M. Lundsager
	S. Boitreaud
	S. Rouai, Temporary
A.V. Mozhin	
	M. Beauregard
	R. Calderón-Colin, Temporary
	M.A. Brooke
M. Portugal	
I. Usman	P. Ngumbullu
	S.S. Farid, Temporary
Wei Benhua	
	M. Abbing, Temporary
K. Yagi	
G.R. Le Fort	

A.S. Linde, Acting Secretary
Z.R. Ahmed, Assistant

Also Present

IBRD: B. Mierau-Klein, Credit Risk Office. Asia and Pacific Department: C. Beaumont. European I Department: H. Flickenschild. External Relations Department: P. Reynolds. International Capital Markets Department: G. Haeusler, Director; A. Bertuch-Samuels, C. Blitzer, J. Kong, C. Medeiros, E. Psalida, K. Srinivasan. Legal Department: S. Hagan, T. Laryea, Y. Liu. Middle Eastern Department: A. Bennett, L. Soderling. Monetary and Exchange Affairs Department: S. Wajid. Policy Development and Review Department: T. Geithner, Director; M. Allen, Deputy Director; T. Arvanitis, M. de Bolle, L. Ebrill, A. Kapteyn, A. MacArthur, M. Mecagni. Secretary's Department: P. Ramlogan. Western Hemisphere Department: V. Mercer-Blackman. Office of the Managing Director: R. Moghadam. Advisors to Executive Directors: B. Bossone, C. Duriyaprapan, D. Farelius, P. Gitton, F. Haupt, K. Kanagasabapathy, F. Manno, T. Miyoshi, J. Milton, T. Moser, C.E. Pereyra, C. Sia, A.A. Tombini. Assistants to Executive Directors: N.J. Davidson, C. Josz, J.W. Ralyea III, A. Stuart, S. Wolff-Hamacher, A.Y.T. Wong, Yu J., I. Zakharchenkov.

1. COLLECTIVE ACTION CLAUSES—RECENT DEVELOPMENTS AND ISSUES

Documents: Collective Action Clauses—Recent Developments and Issues (SM/03/102, 3/25/03; Cor. 1, 4/3/03; and Sup. 1, 4/2/03)

Staff: Haeusler, ICM; Hagan, LEG; Fisher, PDR

Length: 1 hour, 50 minutes

Mr. Kremers submitted the following statement:

The Board should endorse a standard set of clauses that can then be recommended as best practice in our bilateral surveillance. I support the G-10 clauses. The Fund could do more to promote the collective action clauses, through its bilateral and multilateral surveillance and by organizing outreach meetings.

Collective action clauses (CACs) can usefully contribute to our crisis-resolution toolkit. They are not a quick fix (as it will in any event take many years before the bulk of contracts contain CACs), nor a completely comprehensive solution (unlike the SDRM, the CACs discussed cannot aggregate among different types of debt instruments, or even among different bond issues, nor do they apply to the existing stock of debt without CACs). Nevertheless, CACs provide a market-based solution to some of the problems for which the SDRM is designed and the Fund should strongly promote the use of CACs among its membership.

In parallel with our work on the SDRM, I thus believe there is an important role for the Fund in promoting CACs. In this respect, paragraph 62, claiming that, "it would not be advisable at this time for the Fund to endorse a set of model clauses", did not strike me as sufficiently ambitious. The suggestion that it might be too early to endorse clauses seems odd, given that CACs were recently used successfully by Mexico and have been used by many countries –including many in my constituency- for a long time. I fail to see what further developments could significantly change our views on how the clauses should be drafted and suggest that we try to endorse a set of clauses as soon as possible.

I support the G-10 model clauses—designed under the stewardship of Mr. Quarles and together with the world's most renowned legal experts—as best practice. The Mexican clauses can be seen as a version of (a subset of) the G-10 clauses, adjusted to the country-specific situation, as I expect will be done in most cases. In the end, it remains up to the issuer, in cooperation with market participants, to decide on the most appropriate legal language. Endorsing the G-10 clauses as best practice would still allow for ample flexibility in individual cases and we could make this explicit in our decision.

It is important that we agree on a set of clauses as we can then promote these as best practice among the entire membership. At our discussion in June last year, the Board 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 issues and in the outstanding debt stock.’ To date, the progress to this end—in particular in bilateral surveillance—is somewhat disappointing: a recent Article IV staff report on the emerging market country perhaps most likely to start using CACs, was completely silent on the issue, as are unfortunately most other Article IV staff reports. I understand this is partly because at this stage the staff does not know precisely what clauses to promote. I would reiterate the Board’s call for promoting more strongly CACs through our surveillance. I agree with the proposals to organize several forms of outreach meetings.

I agree with the staff that, for several reasons, the G-10 clauses are preferable to the Industry Associations Draft. In particular, the Industry’s proposed voting threshold of 85 percent, combined with a 10 percent blocking minority, might not solve collective action problems. However, some of the legal arguments against the Industry Associations Draft in paragraphs 37 and 39 did not strike me as completely convincing. First, although UFR documents are of course formally owned by the Fund, in practice, under our current publication policy they are published if the country in question consents to it. Creditors are right to demand from the debtor that it is transparent and facilitates publication of relevant Fund documents—and something to this end could be included in bond documentation. Second, paragraph 39 states that it might be illegal (under the U.S. ‘Securities Act’) for a sovereign to publish twelve month projections on government budget and inflation figures. This is a rather intriguing statement, as it would seem to imply that a sovereign could not publish its Article IV staff reports, or even its own budget. I understand that there are complicated legal technicalities underlying the statements in this paragraph, but especially as we are constantly promoting transparency, paragraph 39 might create unnecessary confusion and I suggest the staff has another look at it, before we publish the document. If it could indeed be illegal under US legislation for a sovereign issuer to publish budget and inflation projections while issuing bonds in the United States, I suggest the staff work together with the U.S. authorities to reverse this impediment to transparency.

Finally, the staff proposes publication of the document and I naturally support this. As the paper repeatedly refers to the clauses designed by the G-10 and Industry Associations, I suggest including internet links to these papers, as they might not easily be available to everybody reading the paper. The G-10 clauses are now available through www.bis.org/publ/gten08.htm and I suggest that the staff discusses with the IIF what link to include to the

'Industry Associations Draft' (currently, the Draft seems only accessible to IIF members).

Mr. Callaghan submitted the following statement:

There have been some positive steps in the promotion of CACs. The G-10 proposals are useful, but the Mexican issue shows that countries need not hold off from using CACs because they are waiting on an agreed set of model clauses. The Fund should not attempt to design, dictate, or promote a particular set of model clauses. However, it should encourage and educate issuers and investors. There is a particular need to educate investors that CACs should not increase borrowing costs. There is more recent evidence, not cited in the paper, that even after the intense debate about sovereign debt restructuring through 2002, the inclusion or absence of CACs still had no economic or significant impact on yields as of January 2003.

The G-10 Working Group proposals and the recent bond issue by Mexico have been positive steps in the promotion of CACs. The debate over the SDRM has clearly provided impetus in progress over the use of CACs.

The fact that demand for the Mexican issue was strong and that the paper was well priced is evidence that an appropriate balance was achieved between resolving collective action problems and protection of creditors' rights. The Mexican issue has demonstrated that it is possible for an issuer to draw on existing clauses and come up with a set of clauses that are acceptable to the market.

The Fund has a role to play in encouraging the use of CACs, but this essentially amounts to one of education. The Fund is encouraging issuing countries through surveillance to use CACs, but it is equally, if not more important, to educate the markets about the use of CACs. Ultimately, it is essentially a matter that has to be resolved between creditors and issuers; it is not for the Fund to attempt to design CACs nor promote any particular model over another.

Whether CACs increase the cost of sovereign issues is the key. It is one thing for the Fund to encourage sovereigns to incorporate CACs in bond issues, but we need to take into account that underwriters and investment banks continue to advise sovereigns that CACs will increase issue costs. The Fund needs to educate both investors and issuers that CACs are already widely used, have not hitherto been used to undermine creditors' rights, and there is no evidence that they should add to borrowing costs.

The staff paper notes that existing evidence does not suggest that the use of CACs raises borrowing costs. In support, it cites studies that are mostly three or more years old but does not mention the very recent published study by Gugiatti and Richards, which provides new evidence on the pricing of a large sample of bonds in the secondary market as of January 31, 2003 ("Do Collective Action Clauses Influence Bond Yields? New Evidence from Emerging Markets", Reserve Bank of Australia Research Paper, March 2003).

It is important to look at this more recent evidence, given the intense debate over the past 12 months or so on sovereign restructuring and the resulting increased investor awareness over the existence of CACs in sovereign issues. As the paper notes, at the time of the issuance of bonds by Egypt and Lebanon in the New York market, there was no discussion about CACs and investors may not have focused on their inclusion. The recent data in the Gugiatti and Richards study shows that, notwithstanding the increased focus on CACs, the inclusion or absence of CACs still had no economically or statistically significant impact on yields as of January 2003.

The staff paper raises the issue of possible differential market treatment between investment grade emerging market CAC issues (such as Mexico) and 'non-investment graded' emerging market issues. However, this matter could have been addressed more unequivocally. The paper leaves open the notion that lower credit quality issuers might need to pay a yield premium to issue bonds with CACs. The Gugiatti and Richards research documented that 17 out of the 20 largest issuers of emerging market debt (including many with credit ratings below Mexico) have issued bonds with CACs and it found there to be no statistically significant evidence that CACs have been (at the time of primary issue), or are currently (based on secondary market pricing data in early 2003), associated with higher yields for low-rated issuers. It is hard to see that the situation will change following the Mexican issue.

As regards some of the details of CACs, if the market has evolved away from the use of trust structures, it may prove counterproductive if the Fund pushes too hard for their inclusion, notwithstanding their potential benefit. To do so may put unnecessary impediments in the wider acceptance of CACs, given they are not currently accepted in the United States.

The use of engagement clauses was left aside by the Mexican bond issue, as was the question of transparency clauses. As to the former, effective lines of communication between a sovereign debtor and its creditors are more likely to facilitate a prompt, predictable restructuring outcome than by leaving it to develop in the midst of a crisis. Ideally, the focus should not be solely on the appropriate 'engagement' in the event of a crisis event, but also 'engagement' during times of market tranquility, as proposed by the G-10. In the immediate aftermath of a default, it seems intuitive that it would be more useful to have simple modes of communication so that critical information can be exchanged without delay. Subsequently, during any restructuring phase, there is likely to be more scope for comprehensive bondholder representation.

As regards transparency clauses, the Mexican issue would appear to demonstrate that such provisions need not be necessary for a successful issue, although they would appear sensible and may evolve over time. The Industry Association draft appears clearly excessive, and as the paper points out, impractical in terms of information requirements. Nevertheless, Subscription to the SDDS is one condition that could be agreed between debtors and creditors that would provide a simple indication of the availability of a range of data.

Finally, the work on CACs should proceed in conjunction with work on a voluntary code. However, this is an area that has to evolve between debtors and creditors. The Fund cannot drive the process, but it can encourage and help educate both parties.

Mr. Bennett submitted the following statement:

We believe that the Fund should continue to endorse broad principles for CACs rather than a particular set of clauses. We would be interested in seeing analysis undertaken to ascertain if the "collective action spread" is positively related to the amount of a particular issue held by domestic financial institutions. While the recent Mexican issue may be a useful example of how to apply majority restructuring provisions in jurisdictions that put a high value on individual bondholder rights, we are concerned about "bondholder inertia". We wonder what the additional value of the trustee structure is, given acceleration/de-acceleration provisions? Without presumptive limits on Fund lending, which are well-known ex ante, CACs may not provide sufficient incentives to expediting restructurings. It is important to think of ways to address the aggregation issue.

This was a very useful paper. As the market evolves, we would appreciate follow-up analyses of the costs and benefits of particular contractual provisions as well as updates on the market's acceptance of bonds with CACs. We also support continued outreach.

As alluded to in the paper, there is a certain tension between setting a market standard and engendering market acceptance. We believe that too much emphasis on the former could imperil the latter. While the standardization of market practice through the establishment of a standard may be desirable, we would want to ensure that contracting parties have the flexibility to arrange their affairs in a manner that responds to their particular circumstances. Moreover, financial markets are in constant evolution and the endorsement of particular clauses runs the risk of becoming obsolete.

The Fund can play an important role in advising borrowing countries on how particular clauses either contribute to or detract from an orderly and rapid restructuring process. However, we believe that the Fund should continue to endorse broad principles rather than a particular set of clauses, at least until we have more experience with CACs, in practice.

Empirical work by Eichengreen and Mody suggests that CACs reduce the cost of borrowing for the more creditworthy issuers. However, they lead to higher spreads for less creditworthy issuers. The authors conjecture that, for the latter group, the provisions facilitating an orderly restructuring are offset by moral hazard and the additional risk associated with the presence of renegotiation-friendly provisions.

Eichengreen and Mody's conclusions have not been supported by further research. This is perhaps a function of differing methodologies.┐ However, we believe that the credit- worthiness of the issuer should have less of an effect on spreads than the composition of the creditors. After all, if protracted renegotiations are costly for creditors, and less credit-worthy issuers are more likely to renegotiate, CACs should be relatively more beneficial for their securities. Thus, we would expect that the bonds of low-grade issuers that contained CACs would sell at a premium (lower yield) to those that did not.

Regardless of the quality of the issuer, bonds containing CACs ought to sell at a discount (higher yield) where a sizable portion is held by the private domestic financial institutions. These institutions would not be disenfranchised because they are not under direct control of the issuer. However, they are susceptible to suasion and could be persuaded to vote in a manner that is inconsistent with the interests of external creditors.

We would be interested in seeing analysis undertaken to ascertain if the collective action spread is positively related to the amount of an issue held by domestic financial institutions.

More generally, disenfranchisement of bonds controlled by the issuer and public sector instrumentalities is a welcome provision. However, it may not address investors' concerns that domestic financial institutions may be subject to considerable suasion from the sovereign. What scope is there for these concerns to be addressed through contract law?

The staff notes that Egypt, Qatar, and Lebanon have all issued bonds under New York law that contained CACs. Apparently, the market accepted these bonds "at issue". We understand that these bonds are relatively illiquid. Nevertheless, we would see merit in tracking their evolution in the secondary market to determine if they sell at a premium or a discount with respect to bonds that do not contain CACs. Even though there may not be a specific issue with which these bonds can be compared directly, are there econometric techniques sufficiently powerful to delineate theoretical yield curves for comparative purposes?

As the staff points out, the recent Mexican issue is a type of hybrid in that it applies the 75 percent voting threshold to the outstanding amount of the issue, rather than the quorum of a bondholders' meeting. While the Mexican approach may be a useful example of how to apply majority restructuring provisions in jurisdictions that put a high value on individual bondholder rights, it raises a concern with respect to "bondholder inertia". In particular, bondholders that, for one or another reason, fail to vote will be counted as having voted against restructuring, in effect becoming holdouts. As the Mexican issue is innovative, it is difficult to gauge the extent to which bondholder inertia will be a problem. Nevertheless, we wonder if there are any lessons that we can draw from the corporate context. Is there anything in the "voter turnout" of corporate bondholders or shareholders that might lead us to believe that bondholder inertia would be an obstacle to restructuring?

One way to address bondholder inertia in the design of CACs, while recognizing individual bondholders' rights, is to apply the voting threshold to actual votes rather than the outstanding amount. Abstentions would simply be deducted from the denominator. This would put the onus on those who oppose the restructuring to make sure their voices are heard. Could the staff ascertain whether or not such a proposal would be acceptable in jurisdictions where individual bondholders' rights are highly valued?

The staff argues that trust deeds—or an equivalent legal structure—can play a very important role in the restructuring process and that the potential benefits justify the limited financial costs of using them. Indeed, vesting the power of litigation in a trustee and requiring that the proceeds of litigation be shared on a pro-rata basis would effectively minimize the prospect of disruptive litigation. Moreover, it appears that the cost of engaging a trustee only runs to the tens of thousands of dollars, a small amount when compared to the potential costs of disruption.

However, it appears to us that in jurisdictions where individual bondholder rights are highly valued, there is an additional (psychic) cost involved in delegating the right to litigate. This cost cannot be quantified, but it could pose an obstacle to market acceptance of the trustee structure.

Recognizing that some bondholders are loath to relinquish their rights to litigate, we wonder what the marginal contribution of the trustee structure is, given acceleration/de-acceleration provisions?

As a minority of bondholders is sufficient to accelerate the bond, it is possible that litigation could be undertaken before the sovereign could organize sufficient bondholders to de-accelerate. However, litigation is extremely time consuming. If the sovereign is unable to organize bondholders to de-accelerate before judgment is reached, it is likely that the litigation is not simply "disruptive" but that bondholders have serious concerns about the restructuring process.

If the de-acceleration threshold is to be calculated with respect to the outstanding principal, it is important, for the reasons noted above, that it not be too high. Thus, it appears that an effective threshold would, therefore, be closer to 50 percent than 66.6 percent.

It is one thing to design clauses that lead to the rapid and orderly restructuring of sovereign debt. It is another to ensure that there are incentives to activate these clauses. When a country runs into trouble, its creditors will probably not agree to reduce their claims if they have reason to believe that the Fund will eventually come through with a large assistance package. Thus, the development of CACs alone may be insufficient to provide debtors and creditors with the incentive for early resolution of their problems. Presumptive limits on Fund lending, which are well-known ex ante, would go a long way in this regard.

CACs are issue-specific and, in instances where there are a large number of issues outstanding, it is possible that a "holdout class" could undermine a restructuring. While there are provisions in bonds, like cross-default clauses that speak across issues, there is, at present, no way to aggregate voting and bind in all issues. Moreover, given the concerns noted above with respect to domestic financial institutions, there is likely to be stiff resistance to aggregation.

Uruguay is proposing to include an "aggregation clause" in its debt-swap that would aggregate voting across issues. While the EMCA's reaction has been negative, this could be because much of Uruguay's external debt is held by local investors. Would aggregation be more acceptable if creditors were classified as domestic or foreign, according to their residence, as opposed to the jurisdiction under which the bond is sold?

We understand that the "class action" procedure used under U.S. law may offer a way to deal with the aggregation issue. Could the staff provide more information?

Ms. Jacklin and Mr. Ralyea submitted the following statement:

The staff paper provides a clear and very useful explanation of the G-10 and "Gang-of-Six" suggestions for collective action clauses for sovereign bonds, as well as the collective action clauses in the recently issued Mexican bonds. It is important to bear in mind that the G-10 clauses (drafted by a group of industrial country issuers and drawn to a large extent from existing market practice under English law) and the Gang-of-Six clauses (drafted by trade associations of investors and underwriters with no issuer input) are not the product of a negotiation between parties to an actual transaction. Each thus represents the views of the particular sponsors and not necessarily the outcome of negotiation, which is how a "market-accepted" documentation standard emerges. The only examples we have today of market-accepted clauses are the current English law CACs used in Eurobonds in the London market, the bonds issued by Lebanon, Egypt and Qatar, and the Mexican bonds most recently issued in the New York market. In short, the staff review of the content and effect of different clauses has an important educational value in informing future decisions, but collective action clauses acceptable to particular issuers and their investors need to be developed in practice.

One should also bear in mind that current bond documentation for sovereign or corporate issuers is not standard across jurisdictions nor even within jurisdictions. For example, English law sovereign bonds often do not have express de-acceleration provisions, bonds differ as to which items are "reserve matters," and the percentages required for special majorities vary. Moreover, the current bond documentation did not develop instantly. It developed as credit and legal issues were considered by market participants and as risk concerns and market practices (such as securities settlement systems) changed over time.

Therefore, the staff correctly notes that any decision as to the use and features of CACs will ultimately be made by an issuer and its creditors. Those parties stand to gain the most from inclusion of CACs in bond documentation. With that in mind, we believe the staff largely gets the Fund's approach to CACs right. The Fund should encourage the use of CACs through surveillance and educational outreach, but the Fund should not be prescriptive or formally endorse a specific set of clauses at this time.

A prescriptive approach can "chill" the current environment where a number of issuers, their investors, underwriters, and counsel are actively reviewing and discussing specific bond issuances with CACs. We need to be encouraging ownership of this process by the parties, not seeking to impose standards in what is now a fairly early stage in our experience. It is likely that over the next several months, the Mexican precedent and a few others that will also be helpful to enhancing international financial stability, will emerge and something close to a flexible market standard will naturally arise. This we should encourage.

In response to the staff's questions:

We agree that the Fund should promote the widespread use of those types of CACs that exist in many international sovereign bonds and promote an orderly and rapid restructuring process, subject to the caveat about being prescriptive, and as further detailed in paragraph 6 below.

We also generally agree that the majority restructuring provision relied on by Mexico strikes a balance between resolving collective action problems and protecting creditor rights. The approach adopted by Mexico reflected both what the authorities thought was achievable in the market at this time and the relevant existing bond document being amended (that is, a SEC-registered medium-term note program using a fiscal agency structure).

With respect to enforcement provisions, acceleration and de-acceleration provisions are broadly acceptable in the market, and therefore they seem to be easily included in new bond documentation. Market practice is likely to evolve on what are the desired percentage thresholds.

As to trust structures, a trust structure can be a helpful feature in fostering early communication and deterring disruptive litigation. As the staff notes, under a trust deed litigation can only be initiated by the trustee and recovery proceeds must be shared pro rata. This clearly hampers rogue/vulture creditor litigation. A trust structure also confers a further benefit in terms of managing litigation, as illustrated by the Elliot v. Peru case. In that case, Peru's assets, which were held by its fiscal agent in Euroclear, were attached in execution of Elliott's New York judgment. If a trustee had held the assets, they could not have been attached in Euroclear, as the assets would be those of the bondholders (a trustee is the bondholder's agent) rather than assets of Peru (the fiscal agent is agent of the issuer). The third litigation management benefit of a trustee structure is that a "class action" suit cannot easily be brought. Finally, a trustee also provides some helpful administrative services. However, trustees charge fees, and, it is possible that issuing bonds with trustees in the New York market might initially carry a pricing premium.

We would leave it to the issuers to decide if the costs of a trust structure are outweighed by potential benefits. Of course, if trustees are not used, then issuers need to consider the potential costs in terms of dealing with the "vulture" or "free rider" problem in the courts or by settling outside litigation should a restructuring be necessary.

Likewise, we would leave it to market participants to decide on the best approach to debtor/creditor engagement. We noted above that neither the G-10 nor the Gang-of-Six clauses are market-accepted presently. Moreover, the Gang-of-Six does not preclude the representative(s) appointed through their clauses from serving on a broader bondholders/creditors committee. As long as bond documents permit bondholders to organize or to appoint a representative, if they desire, the organization of a creditors' committee or committees can be addressed easily enough. This was the view of Mexico in its recent bond issuance.

We have some concrete suggestions on how the Fund can best encourage the use of CACs. Going forward, the Fund's outreach should focus on educating members on the benefits of including CACs in bond documentation. Surveillance provides an important opportunity for such outreach. We recommend that during a surveillance mission the staff engage in a dialogue with members about CACs. In that regard, the following questions may prove helpful: Has the country considered issuing bonds with CACs, including in refinancings or bond exchanges to amend the existing stock of debt? Who specifically in the government has looked at the question? Are the funding experts and their lawyers engaged directly in discussions on CACs? Can the Fund help in informing these key officials of the importance of CACs? Do these or other government officials need to talk to some market experts? Have they received the Fund staff memorandum describing CACs? Do they need to speak to other issuers who have successfully issued bonds with CACs at no pricing premium? Can the Fund help to arrange such discussions? Have they spoken to their underwriters and investors about their interest?

The Article IV staff report would tell the Board what kind of answers the staff received, and the Board may wish to comment on whether the member is contributing to orderly crisis management.

In addition, educational seminars presented by the Fund staff on the content and effect of collective action clauses and on the steps involved in issuance could be held at Fund Headquarters and regionally. (We do not believe conferences involving investors or underwriters are needed under Fund sponsorship. Issuers need to take ownership of this dialogue.) The International Capital Markets Department should continue to monitor market practices and would be key in the effective design and implementation of the foregoing educational and promotional efforts.

Naturally, we favor improved data collection and dissemination, particularly by those members accessing capital markets. Separate and apart from contract issues, the Fund should be working with members to improve investor relations programs, data standards, and transparency. This should be part of the Fund’s work agenda for this year. The issue of appropriate covenants related to financial data is one for the issuers and investors to consider. Should a breach of this information covenant lead to a declared event of default and potential cross-defaults, it would have potentially serious consequences, which makes this a provision to be considered most carefully by the parties.

Finally, as market practices evolve over time, “price” will become less of a concern. The Fund’s goal should simply be to encourage the membership to increase the use of documentation that reduces the likelihood of disorderly debt restructuring processes. There are now some very thoughtful templates for CACs representing various points of view and varying degrees of market acceptance. It is likely and highly desirable that market participants build on these while we have some market momentum, supported by Fund outreach efforts. This should result in the development of CACs that garner the widest acceptance and use by issuers and investors, and thereby reduce the costs associated with sovereign debt restructurings.

Mr. Yagi and Mr. Miyoshi submitted the following statement:

We welcome today's discussion on collective action clauses (CACs) before the IMFC meeting next weekend, in light of developments since the previous Board meeting last June, including the report by the Group of Ten (G-10) Working Group and, more recently, a concrete proposal by market participants for model clauses and Mexico's successful introduction of CACs in bonds issued in the New York market. We thank the staff for the useful paper, which presents a comparative analysis of model clauses proposed by the G-10 Working Group and the private sector.

We believe that CACs should be considered in the context of the strengthening of the overall framework for crisis resolution, and that CACs would complement measures such as the SDRM and access policy. From this standpoint, we look forward to a comprehensive discussion on the crisis resolution framework at the IMFC meeting next week and to further other opportunities for discussion in the future.

On one hand, the contractual approach based on CACs can be easily implemented based solely on agreement between bond issuers and bond purchasers/bondholders, and can be introduced step by step, thereby contributing to the gradual achievement of the objective of rapid and orderly sovereign debt restructuring. This is one of the features of CACs that the statutory approach does not have, and the Fund is expected to continue to encourage the widespread use of CACs in sovereign debt contracts. On the other hand, the introduction of CACs is still at an early stage in a number of markets and we should therefore wait and see whether many other countries will follow Mexico's lead. Moreover, some theoretical issues remain with regard to CACs, including the issue of aggregation, and we need to wait for empirical research of actual cases before making a judgment about the validity of CACs in sovereign debt restructuring.

On the design of CACs, it is most important that the provisions are formulated to serve the goal of facilitating orderly restructuring of sovereign debt. At the same time, it is also essential that they are acceptable to the market, as CACs are market-based. From this standpoint, it is appropriate that, as described in paragraphs 63 to 69, the Fund should continue to promote more widespread use of types of CACs that already exist in many international sovereign bonds. However, in considering what kinds of provisions should be promoted, it is also necessary for the Fund to monitor developments in market practices concerning CACs and market reactions to the introduction of such clauses. It is also important for the Fund to take into consideration differences between the legal systems and institutions of jurisdictions.

Because of the early stage of development, we wonder whether it is constructive at this time to recommend the introduction of a single type of model clauses in all markets, or to aim at detailed standardization of CACs. Moreover, the existing debt contracts that include CACs should be respected in principle, even if they deviate from, say, model clauses proposed by the G-10 Working Group. Priority should be given to the introduction of CACs in debt contracts in markets where their use is not widespread.

On majority restructuring clauses, the staff rightly stresses the importance of striking the right balance between the objective of resolving collective action clauses and the need for protecting creditors' rights. In this regard, we welcome Mexico's successful issuance of bonds with CACs in the New York market because this indicates that the qualified majority that the G-10 Working Group Report suggests, namely, 75 percent of total outstanding principal, has been recognized in the market as the threshold that is adequate to reconcile the two possibly conflicting needs mentioned above. On the other hand, like Mr. Kremers, we have the impression that the voting threshold proposed by the Industry Associations Draft, that is, 85 percent combined with a 10 percent blocking minority, might allow minority creditors to disrupt the debt process too easily, making orderly restructuring difficult.

Taking into account recent cases of sovereign debt restructuring, in which enforcement by holdout creditors has not been a major problem, we do not feel a strong need for putting in place majority enforcement provisions, as we do for majority restructuring provisions. That said, majority enforcement provisions would still be useful in light of the potentially adverse effects of enforcement proceedings on the debt restructuring process. In this connection, we think that the voting thresholds for acceleration and de-acceleration reflect the prevailing practices of a particular market. Whether they are acceptable in other markets should be judged with due regard to the markets' practices and the composition of participants.

Establishing trust deeds following the practice in the London market may be an ideal way to prevent the frequent occurrence of disruptive legal actions and ensure inter-creditor equity, but consideration should be given to the costs involved in introducing such schemes because of differing legal systems and practices. The same can be said of what is known as the engagement provision, and flexibility is required to accommodate equivalent measures that can bring about similar effects.

We recognize that the introduction of clauses with regard to the provision of information and the improvement of transparency in the debt restructuring process is an issue that needs to be addressed in the future. The lack of concrete proposals for such clauses in the G-10 Working Group Report and the lack of such clauses in the recent Mexican bond contracts in New York, indicate that this issue has not been discussed thoroughly. Further dialogue is therefore needed among debtor countries and market participants. The costs of providing information should also be taken into account. In this respect, the Industry Associations Draft is not only too demanding, but also it could also be inappropriate if it gave rise to problems under securities regulation on financial disclosure.

On the role of the Fund in encouraging members to use CACs, we support continued monitoring through multilateral and bilateral surveillance and outreach activities. The use of CACs could also serve as an indicator of the degree of self-help efforts by a member when the Board makes a judgment on Fund assistance, even though it would not be appropriate to make the introduction of CACs a strict conditionality.

Furthermore, if the markets' reluctance indicates the expectation that the Fund would eventually provide assistance when a member's debt becomes unsustainable, it is essential that such moral hazard is wiped out in order to promote the introduction of CACs. Specifically, the Fund should bear in mind that clearer and more transparent access and lending into arrears policies would facilitate the widespread use of CACs, and thereby contribute to the strengthening of the crisis resolution framework as a whole.

Finally, consideration of possible aggregation clauses is something that needs to be tackled in the future. While we expect difficult and complex issues to emerge, such consideration is meaningful from the standpoint of enhancing the effectiveness of CACs and ensuring inter-creditor equity among different types of bond issues and debt instruments.

Mr. Beauregard submitted the following statement:

We would like to thank the staff for a comprehensive paper on recent developments and issues related to Collective Action Clauses (CACs).

At the outset, I would like to say that my authorities concur in full with the observations made by the staff regarding the CACs used by Mexico for its last issuance of bonds in the New York market.

As noted by Mexico when the use of CACs was announced, increased acceptance by the private sector to the idea of incorporating this type of clauses in the bond instruments made us reconsider our views, even after have being publicly opposed to use those clauses. As a debtor country, the least thing we want to do is to take a step that Mexican investors do not support. There might still be different views with regard to some of the characteristics of the clauses used by Mexico, but the results of the issuance—where no premium was paid neither initially nor later in the secondary market—show that we were able to strike a balance between protecting creditor's rights and the design of clauses that would be an effective instrument for resolving rare restructuring processes—what I would call the "the twin objectives" of CACs.

Having said this, the characteristics of clauses is an issue that we think will evolve in the future, and eventually converge to a set of standard clauses that would be perceived as best practices. However, this will take time. As the staff notes, legal jurisdiction issues, as well as differing characteristics of the markets used to issue sovereign bonds play a role in determining the set of clauses to be used by sovereigns. Needless to say, country circumstances should be also taken into account. At the end, the objective is to design CACs that would achieve "the twin objectives". This is important because only in those cases it will be possible to minimize the potential premium debtor countries would have to pay for including CACs in their debt contracts or, being more positive, to maximize a potential discount.

Finding the optimal clauses for all countries and all markets and circumstances might be a utopia in the short run. As noted by the staff, while Egypt, Lebanon, Qatar, and Mexico used different set of clauses with no additional premium paid, all of them perhaps achieved "the twin objectives", given the circumstances of each debtor country. So, in our view, some degree of flexibility should be accepted at this time—which I would characterize as a development stage—where investors, the Fund, and especially debtor countries currently issuing debt with CACs, are learning by doing. Therefore, we ought to remain cautious on the steps to be taken in the future.

We strongly agree with the staff's proposal to strengthen outreach efforts to promote the use of CACs, as outlined in paragraph 77. We believe this is the right decision given the scarce budgetary resources of the Institution. It would imply using these resources on a project that promises a high return. We have to build on the current momentum.

We remain strongly opposed on the need to include covenants that would require the provision of information. We strongly believe that economies with market access should be committed to transparency as a matter of principle and not obliged by some clauses. As an example, I would like to draw Executive Director's attention to the Investor's Relations Office that Mexico has developed in order to have an efficient communication channel with the market, both in good as well as in bad times. We all know that the market rewards countries that are committed to transparency through lower funding costs and more stable capital flows, thus this should be the main incentive for countries to become more transparent.

With regard to majority restructuring and enforcement provisions, we tend to agree with the G-10 proposal. In relation to the engagement provision, even though we see some merit in the objectives, we also think it is an issue that requires more discussion. On the one hand, I can reaffirm the view of my Mexican authorities that it would not be appropriate to dictate today the process for restructuring that might occur in the future. However, this is a subject that the staff could include in the outreach effort it is planning to conduct. At this stage, the same comments can be made with regard to the use of Trust Deeds.

The most difficult question is the last one; what would be our advice to member countries if there were a clear premium for using CACs? In this regard, maintaining flexibility in the design of CACs according to country circumstances should help to avoid this problem.

Mr. Portugal and Mr. Tombini submitted the following statement:

We thank the staff for presenting a concise and useful report on recent progress made in promoting the wider use of Collective Action Clauses, including developments within the official community and the private sector. It is also very useful to learn about the details of recent use of CACs in new international sovereign issues, in particular, the successful placement made by Mexico under New York law.

As we pointed out in previous discussions, we believe a promising route to foster greater use of CACs would be for governments of industrial countries to include collective action clauses in their own international bond issues, and also to dispel lingering uncertainties regarding the use of these clauses in their jurisdictions. In this respect, we welcome the EU Finance Ministers' intentions to include CACs in future sovereign bonds issued under foreign jurisdiction. This is a symbolic step toward a more universal use of such clauses. Also, the recent use of CACs in the New York market helps dispel some of the uncertainties regarding the use of these clauses in such jurisdiction, while some adjustments and clarifications are still needed in the cases of Japan and Germany.

As the staff points out in the report, Collective Action Clauses are contractual in nature, which means that any decision on the form and use of them will ultimately be made by the parts to the contract, that is, the sovereign debtor and its creditors. In this context, we see a limited role for the Fund to play in fostering their use. The Fund could continue to cover the use of CACs during bilateral and multilateral surveillance with the purpose of raising awareness to the issue. It is also important that the Fund continues to research the topic, following the evolution of market practices and future discussions amongst market participants and within the official community. In this respect, we support the organization by the Fund of an international seminar with the participation of a broad spectrum of relevant parties to discuss ways to promote CACs.

In principle, we support the Fund's effort to broaden the use of those clauses that have already been accepted in the market and that the issuers consider as relevant to facilitate an orderly and rapid restructuring process. However, any role for the Fund in pressing member countries into using CACs will be inappropriate and counterproductive. Likewise, the objective of fostering greater use of CACs should take into account specific circumstances, such as market conditions and credit ratings.

While the Mexican sovereign issue under New York law was a meaningful first test for the use of CACs and also a successful financial operation, we have no reasons to believe that the introduction of such clauses should be cost-free. Indeed, the staff recognizes this issue and there is also some evidence that there might be costs involved. We believe that the issue is not whether there is or there is not a cost associated to the use of CACs, but rather how high this cost will be and how long it will take before the instrument becomes widely accepted. We also share the view that the first-mover problem remains for sub-investment issuers.

We are of the view that to foster greater use of CACs in jurisdictions where they are not an established market practice, such clauses should be limited to the existing majority restructuring and enforcement provisions. Other clauses, in addition of being of less importance for the ultimate purpose of improving the process of restructuring sovereign debt, would increase documentation requirements and would likely and unduly impose higher costs for borrowers.

Before returning to majority restructuring and enforcement provisions, we will briefly examine the other clauses. We are not convinced with the idea that using a trust deed would facilitate the restructuring process. To the contrary, trustees tend to be highly risk averse and are unlikely to act quickly or to act without broad bondholder support. A trustee is also likely to require the advice of an investment house before acting, thus increasing costs further. Likewise, we are not enthusiastic with the proposed engagement provision. Contacting bondholders has not proven to be difficult in early restructurings, and a representative bondholder committee is not likely to make a difference. We also do not agree that all fees and expenses of such committees, in case they are formed, should be paid totally by the issuers. As the staff points out, given the potential for multiplicity of committees, there could be excessive costs to be borne by debtors. There is also the compelling argument of the Mexican authorities against the establishment of a bondholders committee namely, "that it would be inappropriate to determine ex ante the type of restructuring process that may occur many years in the future, by which time best practices may have evolved."

Regarding the disenfranchisement provision, we disagree with the proposals of the G-10 Working Group and of the Industry Association to exclude bonds controlled indirectly by the issuer or of any of its public sector instrumentalities. While it is an improvement upon early suggestions from the industry, it is still too encompassing and not clear regarding the precise definition of "its instrumentalities". We would prefer to limit the exclusion only to bonds held by or on behalf of the issuer.

On information provision we find the suggestions by both groups redundant and representing an unjustified burden on the issuer. First, such a provision is not directly related to the resolution of collective action problems. Second, as the Mexican authorities correctly pointed out, continuous access to international capital markets is conditioned on transparency, hence adding such a covenant should not affect the access to relevant information by bondholders. Third, regardless of its irrelevance, as the staff points out, such information provision can create a number of difficulties. Some of the information required under the Industry Association Draft proposal would either be confidential or would be under the control of third parties, and hence its release would be subject to their consent. There is also the risk alluded in paragraph 38 of noncompliance with such redundant provision triggering an event of default; and finally, as explained in paragraph 39, there is the risk of falling into the situation of "conditioning the market" under the U.S. "Securities Act".

We agree that the most important feature of any CAC is the provision that enables a qualified majority of bondholders to bind the terms of the restructuring upon other bondholders within the same issue. While we agree with the staff that is perhaps too early to endorse any model clause, we believe that in the case of the majority restructuring provision, the terms applied in the Mexican case are broadly appropriate and reflect a balanced compromise between improving the resolution of collective action problems and offering protection for creditors' rights. Likewise, we are broadly in agreement with a majority enforcement provision along the lines of the Mexican case, that is, a 25 percent voting threshold for acceleration and over 50 percent voting threshold for de-acceleration.

Mr. Egilsson and Mr. Farelius submitted the following statement:

We welcome the progress made in the design and development of collective action clauses (CACs) in sovereign bond issues, not least the important work done by the G-10. The recent bond issue of Mexico, which proved to be highly successful, will hopefully encourage others to follow. In parallel with our continued work on SDRM and other elements in our crisis resolution toolkit, the Fund should play an important role in promoting CACs, including through the surveillance activities. Indeed, it is clear that our discussions of other aspects of crisis resolution, notably on the SDRM, not only have brought about a better understanding of these issues, but also have helped to bring about real progress on implementing CACs. It is now time to consolidate our efforts to bring about more predominant use of such clauses.

First, a best practice is needed in order for us to be able to move forward. In this regard, agreement between the official sector, market participants, and emerging markets should be reached on a set of provisions built on existing market practice. We believe the G-10 report should form the basis for such agreement. While we should try to standardize clauses, it is also important to recognize that differences in legal systems may necessitate some flexibility as the Mexican experience has demonstrated.

Second, more emphasis should be put on encouraging and facilitating more sovereign issuers to follow in the steps of Mexico. It will be important that all member countries, both advanced and developing ones, play their part in helping to promote the establishment of appropriate tools to facilitate the inclusion of CACs in international bonds. In this respect, the EU-member states intend to use contractual provisions based on the framework developed by the G-10 when issuing bonds in a foreign jurisdiction and/or governed by foreign law. The Fund clearly has a role to play in promoting CACs and, as Mr. Kremers, we think that we could be more ambitious on this front. We fully support the outreach program. An international seminar to explain the benefits of and promote the use of CACs is appropriate and well timed at this juncture.

Third, we concur with Mr. Kremers's emphasis on the limitations of CACs compared to an efficient SDRM. The problem of the outstanding stock of bonds that do not include CACs remains unsolved. Further efforts by the international community, including on an SDRM, must continue to be made to address this issue. As mentioned earlier, it is clear that we need to continue to discuss issues related to the SDRM in order for us to make further progress on real implementation. Moreover, the success of the Mexican bond issue as well as empirical research indicate that there is no negative price effect of including CACs. Indeed, the Mexican bond issue was oversubscribed and trading on the secondary market has been fine so far. The first mover problem appears to be solved and now we have to encourage countries to follow. The price effect might be different for below investment grade issuers. But even if that would become the case the remedy is not to exclude CACs from bond contracts rather to solve the problems leading to below investment grade ratings as borrowing cost should only reflect the risk taken by the investor.

Finally, regarding the recent decision taken by Mexico to issue bonds with CACs on the U.S. market in conformity with the G-10 framework, we believe that basing voting thresholds on the outstanding principal serves to balance collective action problems and protect creditor rights, given that the majority threshold is not set higher than 75 percent. The majority enforcement provisions that are in use seem adequate and more widespread use should be promoted as a standard part of all CACs. To promote dialogue between sovereigns and bondholders we support the more widespread promotion of trust deed (or equivalent structures). We believe the benefits of such structures outweigh the costs. We support that the rules prescribe appointment of a trust deed and/or a bondholder representative as suggested by the G-10. Fund surveillance and program reviews alongside other economic analysis that is readily available for most sovereigns form a basis to provide a true and fair picture of the economic situation of most sovereign issuers. However, we see merit in including provisions to promote communication and early consultation between creditors and debtors. This should be in line with the recommendations of the G-10, as we believe that the information requirements suggested by the private sector place an unduly large administrative burden on sovereigns and could be costly.

Mr. Usman submitted the following statement:

We thank the staff for its ongoing work to strengthen the Fund's ability in dealing with issues of crisis prevention and resolution. Their work in the area of designing a sovereign debt restructuring mechanism has contributed to increasing the public's awareness of Collective Action Clauses (CACs). The use of CACs in future bond contracts would certainly contribute toward more certainty regarding the restructuring of claims, at the time when debtor countries and creditors actually have to go that route.

We encourage the staff to promote the use of CACs during bilateral and multilateral surveillance exercises, as its inclusion in bond contracts would only gain momentum if more countries include them. We support also the outreach program proposed in paragraph 77. As the inclusion of CACs in bond contracts would remain very much a contract between the debtor and its creditors, the jurisdiction in which the bond would be issued would determine the nature of provisions to be included in such contracts. Therefore, we would prefer that the relevant parties negotiate such details.

The inclusion of CACs in the recent Mexican bond issue provided an important test case of the willingness of investors under New York Law to buy bonds, which include these provisions. While the terms of the agreement are in line with recommendations of the G-10 working group, it ultimately remains a contract between the contracting parties and the extent to which the agreement could become a benchmark for similar future contracts remains to be seen. The negligible impact that the inclusion of the CACs had on the country's interest spread, could spearhead the inclusion of them in similar future contracts. In our view, the provisions included in the CACs in the Mexican bond contract strike an appropriate balance between minority and majority creditor rights, and could be a useful platform for addressing possible future collective action problems.

The Mexican bond contract does not however provide for engagement provisions in the case of a restructuring, and rightly so. In this connection, we support the view that best practice in the future, which might be many years from now, should determine the rules of communication between the debtor and creditors in the restructuring of claims.

The staff suggested that a premium may be payable for including CACs in bond contracts. This may be so, but whether or not a country has an investment grade would also be an important determining factor in this regard. In the Mexican case, such a premium was at best minimal. We believe if and when the inclusion of CACs in future bond contracts becomes more widespread, the premium for including them would become even less burdensome.

Mr. Le Fort and Mr. Pereyra submitted the following statement:

We thank the staff for a very useful paper. The work regarding the design of Collective Action Clauses (CACs), developed in particular by the G-10 Working Group, constitutes a significant progress toward a set of provisions that can accommodate the interests of both investors and issuers. At the same time, we can agree at the outset that practices that already exist in many international sovereign bonds, as well as the promising prospects opened by some recent market developments, can be taken as a basis for the Fund's strategy to promote a more widespread use of CACs.

Given its characteristics, the case of Mexico's bond floating provides an obvious starting point toward the definition of an "optimal" set of clauses, in the sense that they would pragmatically address both potential collective actions problems and creditors' concerns, especially in the institutional investor-dominated New York market. Two crucial aspects highlighted by the staff are that Mexico's bond issuance provided a successful test of market acceptance, thus diminishing the "first mover" problem, and that there were no indications as to the need of a premium for incorporating CACs.

However, caution is called for, in generalizing this zero-premium result to all debtors, and to a possible expansion of the debt coverage of CACs. It is likely that sub-investment grade debtors with a more significant perceived probability of having to restructure in the future may have to face some CAC premium. Even investment-grade debtors may have to pay a premium as the coverage of CACs is extended to other issues, covering a proportion of total debt meaningful enough to allow for their eventual use in case the country faces difficulties in the future. In any case, the issue of premia on the use of CACs would become less significant to the extent that developed economies also incorporate them in bond contracts. In this regard, we welcome the initiatives taken by the European Union and Canada in this respect and urge a broader proactive stance to facilitate market acceptability in jurisdictions where such clauses are novel.

Obviously, the most important feature of the Mexican operation was the adoption of majority restructuring provisions subject to a 75 percent voting threshold based on the outstanding principal amount—rather than on the basis of the claims of bondholders present at a duly convened meeting—consistent with the recommendations by the G-10 Working Group. Indeed, the "quorum" approach can generate the perceived risk that a minority of bondholders can decide a restructuring if a small percentage attends a convened meeting. Therefore, we agree that the majority of structuring provisions used by Mexico would effectively contribute to greater acceptance, notably by institutional investors operating in the New York market. We also concur that going above a 75 percent threshold —as proposed by the Industry Associations Draft— could make it overly difficult to gather the necessary number of bondholders.

At the same time, we note the staff's remark in paragraph 71 that differing features of the market could originate variations across jurisdictions. Even though, according to the staff, recent evidence suggests a shift to reliance on the outstanding principal amount approach, the "quorum" approach characteristic of English law may be more practical when bonds are held primarily by retail investors —as seems to be the case frequently in the London market. Thus, particularly in cases of significantly disperse tenure, coordination problems could be envisaged in attempting to bring together enough investors to account, for instance, for 75 percent of the outstanding principal amount.

Regarding majority enforcement provisions, we support the thresholds currently used in the market—namely a vote by 25 percent of outstanding principal to accelerate claims and a vote of more than 50 percent to de-accelerate them—which are in line with the recommendations by the G-10 Working Group, and were used in the Mexican bond. We can support the inclusion of trust deeds, noting at the same time that their ability to litigate on behalf of bondholders would be activated only if requested by the requisite percentage of votes, and there is flexibility in their adoption, depending on their compatibility with a given legal system.

The engagement provision by extension implies costs associated with the formation of representative bondholder committees, which in the past have often proven substantial. The prospects of multiple committees, together with substantial fees and other reimbursable expenses borne by the debtor, poses a potentially contentious question that warrants operationalizing adequate incentives and a fair burden sharing of these costs as part of the overall CAC framework. More generally, the ex-ante establishment of representative bondholder committees may detract from the intended efficient functioning of these clauses should these need to be activated in the future.

Probably the least clear aspect of the otherwise sound G-10 Working Group proposal regards transparency covenants. As the disclosure of relevant information can be expected to be a main condition in these kinds of contracts, publication of country reports or observance of certain standards, both endorsed by the Fund and the World Bank, can be encouraged. However, we note that in the Mexican case it was not necessary to include any such covenant, suggesting that enough information was available to investors. This leads us to the Fund's key role in increasing market transparency by further improving its ability to provide complete information to investors—thereby facilitating bond operations—as emphasized by us during the last discussions on the World Economic Outlook and the Global Financial Stability Report.

As CACs involving thresholds based on the "quorum" approach seem to be well-positioned in the London market, the main goal should be to introduce a set of clauses that can be acceptable in the New York market—not least in consideration of its critical importance for emerging economies seeking to consolidate their international standing and meet their financing needs. In this regard, the Fund should favor the use of a set of model clauses based on the G-10 Working Group guidelines. Even though it might be necessary to refine certain elements in order to generate a standard than can be accepted by all participants, and to allow for a certain degree of flexibility on a case-by-case basis, in our view, there are sufficient grounds to assert that the key features of the G-10 Working Group proposal have been validated by recent market experiences.

In establishing the pricing of bonds, the desirability of CACs for both issuers and investors will have to be considered carefully, and therefore adequate education and information are essential. In this regard, while welcoming the Fund's outreach efforts in this field, dialogue with market participants could be expanded to include prospective sub-investment grade issuers. Finally, we support publication of the document.

Mr. Reddy submitted the following statement:

We welcome this staff paper on Collective Action Clauses (CACs) as a useful addition in moving forward the discussion on developing congenial systems and market practices that would promote orderly sovereign debt workouts. A positive recognition of CACs by countries and their incorporation in new bond issues will strengthen the contractual approach toward a SDRM. We must at the outset recognize the fact that the extensive debate generated by the SDRM proposal, had contributed to the added interest in CACs.

We also welcome the Fund encouraging greater use of CACs and following the September 2002 communiqué of IMFC, the developments in both official and private sectors are encouraging. In the official sector, the G-10 has developed a set of draft CACs, consistent with the approach endorsed by the Executive Board and the EU Finance Ministers, to lead by example, have announced that sovereign bonds issued by them would henceforth include CACs. In the private sector, the Institute of International Finance and six other financial and trade associations has come out with another set of draft CACs. In addition, more recently, the Mexican government has successfully issued an international bond incorporating CACs, governed by the New York law.

We would like to offer a few comments on the specific issues raised in the staff paper. We appreciate the staff's effort in suggesting a consistent move toward CACs in all jurisdictions balancing between resolving collective action problems and protecting creditor rights. However, in our view, while bonds are actually issued with incorporations of CACs by individual countries, consistency with domestic laws of issuing country as also the investing country is important. Secondly, there could be differences in the bond terms and types and ratings. While there could be some convergence over a period, with further work by both official and private sectors, on various elements of CACs, the experience thus far shows clearly that any rigid approach to standardize CACs now, may be counterproductive. Furthermore, as of now, the bond issuances without CACs continue to remain very dominant.

In the above backdrop and given the difference of views and differences in law, it will be a desirable and effective strategy for the Fund to promote use of CACs as found appropriate and acceptable to issuing authorities and investor country, rather than promoting any rigid format or model. The new issues could be based on past issuances, G-10 draft or IIF draft, or Mexican draft or a combination of these. In the immediate context what is more important is adoption of CACs as a principle, with a set of common basic features, and details have to be as acceptable to concerned parties from time to time.

We agree that the most important basic feature of CACs is the majority restructuring provision. Here, the Mexican bond provision based on 75 percent voting threshold in terms of outstanding principal amount strikes a good balance and will avoid a minority of bond holders attending a shareholders meeting deciding restructuring. However, we agree with Mr. Portugal on the issue of expanded disenfranchisement provision relating to public sector instrumentalities. As we have stressed on several occasions earlier, it will be very difficult to establish indirect control of sovereign issuer.

We support the use of range of voting thresholds, for acceleration and de-acceleration, to avoid a minority of bondholders disrupting the restructuring process.

We support the use of trust deeds or equivalent structures and engagement provisions consistent with creation of creditor committees in a transparent manner for ensuring speedy restructuring process.

We feel that the covenants to information provisions should be directly related to the material information and data relating to the bond and should not cause undue strain or additional costs to the issuers.

We support the Fund in organizing a seminar on the subject, representing all interests.

Last, but not the least, while we appreciate Fund incorporating this element as part of multilateral and bilateral surveillance process, there should be no 'prescriptive' approach either advocating the approach or getting into micro details. Taking into account country specific legal and institutional circumstances and also the program status, the element of CACs could be analyzed in the broader context of assessing external sector sustainability, only if so desired by the member.

The Director of the International Capital Markets Department (Mr. Häusler) made the following statement:

The purpose of the paper prepared jointly by the International Capital Markets, Legal, and Policy Development and Review Departments is threefold. First, to provide an update on the use of CACs in sovereign bond contracts expanding on the information we provided to you in other documents about efforts in both the official and private sectors to develop model CACs. Second, to assess the proposals of the working group of the G-10 and leading industry associations. Third, to draw some preliminary conclusions from recent developments on what could be considered the best way forward in promoting the more widespread use of CACs, in particular in the New York market, for sovereign debt and to outline possible implications for the Fund and its policy advice.

The staff paper comes a little later than originally scheduled and we apologize for this delay. However, the staff felt that it was necessary in order to capture the most recent developments, such as the successful issuance of a $1 billion dollar bond with CACs in New York by Mexico and a number of discussions that took place on this subject recently in Europe with members of the G-10, representatives of issuing countries, and market participants.

Going forward, we have reason to believe that the recent Mexican bond issue did in fact help remove, at least to some degree, the first-mover barrier that we had spoken about in the past. Thus, the period ahead could see the emergence of a market standard that meets both the public policy objective of making the process of bond restructuring more orderly and predictable and strengthens the efficiency and integrity of the market for sovereign debt.

We believe that the Fund has an important role to play in supporting this process. However, as we have outlined in the paper, CACs are contractual in nature and thus any decision as to their use and features will ultimately be one made by the debtor and its creditors. Neither the official sector nor the relevant industry associations will be able to mandate their incorporation or determine their design.

The International Capital Markets, Legal, and Policy Development and Review Departments have discussed amongst ourselves the question of whether the Fund should give a pronounced endorsement of certain types of CACs. We believe there is a fine line between endorsing an acceptable range for the features of the clauses and pushing model clauses. We concluded that the development of a market standard is desirable. However, from the perspective of allowing a reasonable market standard to develop over time it would be counterproductive, at this moment in time, for the Fund to be viewed as pushing for model clauses.

We already have the strong impression over the last days and weeks that the necessary process of education is going forward, and we have spoken about this at length with less sophisticated investors and with underwriters that are not familiar with CACs. We feel that this process of education will contribute to gaining acceptance by this target audience from crying out for standardization along the lines of the proven and tested models. It is probably also quite likely that the trade association's clauses may be shelved by then.

In our view, the Fund should contribute to a strengthened educational effort both inside and outside the institution—as the statements have underlined—and help member countries assess better the merits of various features in CACs and facilitate better informed decision making by members when faced with potential trade-offs between the inclusion of certain CAC features and the pricing of a bond issue. I think all the statements, as much as I could see, support this approach.

Let me by way of concluding say that we have not been sitting on our hands. The staff will be monitoring the use of CACs. Together with the Legal Department, we have acquired a database that allows us to assess all bond prospectuses, and on this basis we are currently establishing a more comprehensive database going forward and have also begun to set up workshops on collective action clauses with colleagues from area departments. Finally, the staff from the International Capital Markets, Legal, and Policy Development and Review Departments have been and will continue to be in touch with legal advisors, issuers, underwriters, investors, and investor groups to discuss constructive ways to increase the acceptance of CACs.

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The Deputy General Counsel (Mr. Hagan), in response to questions and comments from Executive Directors, made the following statement:

> Directors raised a number of concerns and some questions on some of the specific design features, and I would like to address some of them at this point.
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> There has been considerable focus on what we call the expanded disenfranchisement provision that has been proposed by the G-10 Working Group. Specifically, while traditionally bonds that were owned directly or indirectly by the issuer have been excluded for voting and quorum purposes, the expanded definition would also include public sector instrumentalities. In this context, Mr. Bennett asked whether commercial banks that are fully private but are subject to the regulatory jurisdiction of the central bank would be covered. The answer is, having participated in the G-10 Working Group and Mr. Beauregard can correct me, that the expanded definition was not intended to cover those institutions. It was also not intended to cover resident institutions that are not publicly owned. In one of the original model clauses drafted by the EMCA—this is not the Industry Association's proposal but an earlier one—they wanted to capture that, and to do so they wanted to include any institution under the jurisdiction of the central bank. However, the EMCA concluded that disenfranchising all resident institutions would be a step too far.
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> Several Directors have raised the question of the trust deed structure or an equivalent legal structure, and have asked the question: given the fact that there are some carrying costs and that there is some resistance at least from some quarters in the United States as to introducing such a structure, is it really worth it? It is helpful to make a distinction between two different purposes of a trust deed or an equivalent legal structure. One is to provide bondholders with an interlocutor with the issuer. I think it is fair to say that traditionally in performing this role—it is true especially in the United States in the corporate context—trustees have been relatively shy and are particularly concerned about liability, and therefore have been relatively passive. Thus, there is a question as to whether or not they would be willing to play a more proactive role in that context. However, where the staff was coming from in the paper, and I think this has also been highlighted by Ms. Jacklin in her statement, was from the perspective of the second purpose of the trust deed, which is that it creates a legal structure that actually can have important benefits. These benefits exist even if acceleration and de-acceleration

provisions are included in bonds. They are especially important in circumstances where the issuer has a number of different bond issuances, because in those circumstances there will be situations where a vulture has been able to obtain a controlling interest in one of those bond issuances and thereby can not only force an acceleration, but also prevent the de-acceleration. In those circumstances, if there is litigation under that bond issuance, of course it will disrupt the negotiations of the sovereign issuer with other bond issuances. However, a trust deed feature reduces the incentive for litigation by the vulture, because, among other things, the vulture will have to share the proceeds of any litigation with all other holders in that issuance, which is an important disincentive.

On information, Mr. Kremers expressed concern about one of the paragraphs that discusses possible U.S. securities law concerns to the extent that the information covenants proposed by the Industry Associations would require a rolling 12-month forecast on projections. I can assure the Board that the staff did not go out looking for this problem; it was brought to our attention by practitioners that do have considerable U.S. securities law experience. At that point, with the cooperation of Ms. Jacklin, we did contact the U.S. Securities and Exchange Commission and had discussions with the staff, and this language was discussed with them in some depth. The point here is to simply identify the issue that may arise under U.S. securities law in certain cases. If these provisions are introduced, the issuer and its counsel will need to look at this matter very carefully.

While a number of Directors have focused on the issue of aggregation, Mr. Bennett asked a couple of specific questions. This is an issue that, as Directors know, we will be looking at going forward in the context of the work program, both in terms of what can be achieved under the contractual approach and what can be achieved under the statutory approach. However, without prejudging that, it is clear that there are several issues that will need to be addressed. First, what are the benefits of aggregation and are there any costs? How much does aggregation actually help in terms of facilitating an orderly and prompt restructuring process? Second, under the contractual approach, is it feasible to aggregate claims of very different types of instruments, specifically commercial debt and trade credit, with bonds, or is it only feasible to aggregate the claims of different bond issues? In the latter case, there are important legal issues. For example, is a master agreement needed to establish the inter-creditor relationship that enables voting to take place? Is it necessary to ensure that all of the bonds are issued in the same jurisdiction? If a dispute arises, can the dispute occur in different countries? Finally, and this is the most difficult issue, what happens in cases where a qualified majority of bondholders with long maturities gang up on a minority that has a shorter maturity and simply vote to stretch out the maturity of the bonds? How is the discrimination issue to be addressed? Does each bond issuance need to be classified? If so, is the purpose of aggregation not being defeated? Thus, there are many difficult issues that we will need to address.

Finally, Mr. Bennett asked about class action. What he is referring to is a relatively well known law review article that came out recently discussing the possibility of using the Federal Rules of Civil Procedure in the United States as a means of essentially having a mandatory class established whereby a settlement that is approved by a court could be binding on all holders in that class. This is also referred to in a couple of recent speeches by the First Deputy Managing Director. As pointed out in her speeches, while it is an intriguing idea, there are many issues that need to be resolved. First, a class action is normally used for tort victims, and it is not clear whether a class action could be entertained in the context of sovereign debt restructuring. Second, it would only address claims that are governed by U.S. law. Thus, how would foreign claims be addressed? Finally, a class action cannot achieve aggregation because the settlement is based on court approval rather than a vote by creditors; that is, a settlement could be approved by a court even if in fact the majority of creditors do not approve because there is no vote.

Mr. Nyambal made the following statement:

I would like to thank the staff for giving us the opportunity to discuss the recent developments related to the promotion of collective action clauses in the context of our ongoing work on the SDRM. By bringing more certainty to debt restructuring claims a broader use of collective action clauses can help strengthen the Fund's effectiveness in crisis prevention and resolution. As I agree with the thrust of the staff paper, I will focus my comments on the following points.

First, on Fund promotion of the use of CACs, it is important to keep in mind that collective action clauses are contractual in nature. Thus, as Mr. Portugal and Mr. Callaghan, I am of the view that the Fund's involvement in this matter during bilateral and multilateral surveillance should be limited to the sole purpose of educating its membership. In this regard, it is not for the Fund to try to design, promote, or endorse any particular model over another. I see a greater role for governments of industrial countries in the promotion of CACs, and I commend the European Union authorities for their intent to lead by example in this area.

Second, on the restructuring provisions in the recent Mexican issue, while the terms of the agreement are consistent with the recommendations of the G-10, they also provide enough room for maneuver to the issuer to adopt or exclude certain provisions without incurring a higher interest spread. Such a flexible approach strikes the right balance between resolving collective problems and protecting creditor rights.

Third, as regards the majority restructuring provisions, I believe that the ability of a bondholder holding 10 percent of outstanding principle to block a restructuring supported by those holding 85 percent could jeopardize the ability of achieving workouts. For bonds involving smaller outstanding amounts, I would rather support further restrictions on the ability of vulture creditors to block agreements between creditors and debtors.

Fourth, on the majority enforcement provisions, I am in broad agreement with the New York provisions used by Mexico. As regards engagement provisions, I agree with the staff that given the cost involved for the issuer, it is important to avoid the establishment of a multiplicity of bondholder committees. I would rather prefer a more direct channel of communication between the issuer and its creditors.

Finally, on information provision, I cannot go along with the suggestions of both groups, which can add an unjustified burden to the issuer. I believe that it is not necessary to add such a covenant because continuous access to capital markets is already based on transparency. Furthermore, releasing confidential information could create more difficulties for market participants.

Mr. Al-Turki made the following statement:

I thank the staff for a useful update on developments regarding collective action clauses. I am encouraged that the move toward the inclusion of collective action clauses (CACs) in new bond contracts is gaining momentum, as evidenced by the inclusion of CACs in bonds issued by Lebanon, Qatar, Egypt, and most recently Mexico. However, it is clear from the paper that there are still disagreements among the various concerned groups on some of the details. Here, I will make a few comments.

I fully agree that the most important provision of CACs is the majority restructuring provision. Indeed, enabling a qualified majority to bind all bondholders within the same issue to the financial terms of a restructuring is essential for facilitating an orderly restructuring. We should however be mindful here of the fact that while it is important to safeguard the rights of creditors, setting the percentage of votes needed to achieve the qualified majority too high, will undermine the contribution of CACs to an orderly workout. Accordingly, I remain of the view that standardizing and promoting existing practices with respect to CACs would be the preferred option, especially as markets are familiar with these practices. However, in view of the importance of bringing the U.S. institutional investors on board, and the different legal structures among jurisdictions, I can go along with some differentiation in the terms of CACs. In this connection, I agree with the G-10 Working Group that in circumstances where the outstanding principal approach is used, going above the 75 percent threshold could jeopardize the ability to achieve workouts.

I endorse the inclusion of majority enforcement provisions and agree that the voting threshold should follow current market practices. My preference is that a vote by more than 50 percent should be sufficient to reverse an acceleration. I can, however, go along with the range suggested by the G-10 Working Group.

On the bonds to be excluded from voting, I agree that bonds owned or controlled by the issuer or any of its public sector instrumentalities should be excluded. However, the reference to indirect ownership or control is not clear and could create contentious disputes in the future.

I thank the staff for its elaboration on this issue and I think it would be useful if the staff can further elaborate on the issue of indirect ownership or control.

On the initiation of proceedings, I agree with the staff that a trust deed or similar legal structure would help facilitate an orderly workout. However, there are also costs to establishing the trust deeds. Here, it would be useful if the staff could elaborate on these costs and whether they would be incurred even if a restructuring did not take place. I would also like the staff to elaborate on the costs of the proposed engagement provisions.

We have always advocated more frequent and open consultations as well as greater flow of information between countries and their creditors as a means to help in crisis prevention. Therefore, I can go along with the G-10 Working Group recommendations regarding the provision of information. Indeed, in view of the sensitivity of the issue, the specifics should be dealt with on a case-by-case basis.

Finally, I agree that the Fund should focus on encouraging the use of CACs through its multilateral and bilateral surveillance as well as the several forms of outreach detailed in paragraph 77.

After recessing at 1:00 p.m., the Executive Board reconvened at 2:30 p.m.

Mr. Bischofberger made the following statement:

I thank the staff for preparing this very useful paper on CACs. Today's discussion is well timed, given the recent proposals on CACs put forward by the G-10 working group under the chairmanship of Mr. Quarles as well as by the six Financial Industry Associations.

I agree with those speakers who expect a clear step forward from today's meeting in the Fund's efforts to promote the use of CACs. Recent steps in this regard are most welcome. Nevertheless, there is probably further scope for the staff to become more vocal on this subject in terms of surveillance work and outreach efforts. The Fund has an important role to play in advising members—or "educating" them, as some Directors have put it - on the advantages of CACs. In this respect, we think the G-10 report provides a very good point of reference. At the same time, however, it is important that the Fund takes the evolving market practices into due account. Therefore, the degree of flexibility provided by the G-10 report is indeed helpful. For example, the report allows for different voting calculation procedures. This is, in our view, important as the outstanding principal approach might hamper the restructuring process, if the bond issuance is largely held by retail investors.

As regards the recent bond issue by Mexico, we agree that the design of its majority restructuring provision is appropriate and well balanced. That said, we would point out that the Mexican bond lacks sharing clauses, providing for pro rata distribution of proceeds recovered in litigation. We generally find such clauses useful and desirable. However, we concede that there is probably less of a need for them, if there are satisfactory acceleration and de-acceleration clauses in place, as is the case with the Mexican bond.

In addition, sharing clauses mostly come in conjunction with trust deed structures. We generally support trust deed or equivalent structures and consider them to be helpful, though not absolutely essential elements of bond contracts. I welcome Mr. Hagan's clarifying remarks at the beginning of today's meeting.

As regards information provisions, we share some of the staff's reservations on the far-reaching proposals in the Industry Associations Draft. While we consider some information provisions along the lines suggested by the G 10 to be very useful, we do not believe that very extensive data provisions should become standard requirements under CACs. Member countries already have transparency obligations under the Articles of Agreement and there is an array of instruments in place, such as the GDDS, the SDDS as well as the ROSC and the FSAP, to encourage increased transparency. Moreover, as the recent reviews of these instruments have shown, ROSCs and FSAPs are increasingly being monitored by markets. This in turn means that markets should provide increasing incentives for borrowers to improve their transparency practices, irrespective of whether very comprehensive information requirements are included in CACs.

As regards other forms of contributions the Fund can make, we support the proposals to organize several forms of outreach meetings. Furthermore, I agree with Ms. Jacklin and Mr. Ralyea that ICM should continue to monitor market practices and should be key in carrying out the various educational and promotional efforts.

On the question of possible interest premia for the use of CACs, we do not regard this to be a high risk. The staff mentions a number of studies supporting this position, and there have even been some recent additions to this rather convincing list of empirical work, as noted by Mr. Callaghan. Clearly, less creditworthy borrowers may have to reckon with higher interest spreads, but this should mainly be the result of a welcome increase in risk differentiation by markets, rather than of a more widespread use of CACs.

Finally, I agree with Mr. Bennett that the promotion of CACs must be accompanied by a more rigorous implementation of access policies and that it is important to continue our work on ways to address the aggregation problem.

Mr. Padoan made the following statement:

I would like to thank the staff for its comprehensive picture on where we stand on the design of CACs and on how far the global economy has been moving with their implementation. I would also like to thank the Director of the International Capital Markets Department and the Deputy General Counsel for the clarifications earlier.

We have always supported work on CACs as a part of a two-track strategy aiming at exploiting the complementarities between the contractual and statutory approaches to sovereign debt restructuring. Since the early Board discussion on this issue, and as Mr. Egilsson and Mr. Farelius, we consider that the limitations of a purely contractual approach could be overcome if the approach were adopted in the context of an integrated PSI sequence that included the SDRM as a second last step before all out default. We should also recall the strong interconnections between instruments for debt restructuring and the features of the Fund's access policy, a point raised by Mr. Bennett and Mr. Bischofberger. In the end, our efforts will be successful if we have contributed to put in place the right set of incentives for the appropriate combination of debt restructuring, adjustment, and official support.

As Mr. Yagi and Mr. Miyoshi, we continue to believe that the two approaches, if integrated together, reinforce each other. As we argued repeatedly, the very existence of a strong costly statutory mechanism would encourage creditors and the debtor to coordinate their actions early in the process, well before the situation gets to the point where the option to activate the mechanism becomes compelling. In that context, CACs would be useful in making coordination possible prior to default. At the same time, the SDRM would still provide a good chance for the parties to reach an agreement if

CACs fail to resolve the coordination problem, as aggregation and enhanced coordination problems remain issues to be resolved, which was made clear in the discussion earlier this morning.

We welcome the recent initiative by Mexico. In Europe, work is under way to issue bonds with CACs within the current year. On the other hand, the picture we receive from the staff report is one where the response from emerging market countries, while moving in the right direction, is still slow. If it is true that the discussion on the SDRM has contributed to a move forward on CACs, the situation will hardly improve if the prospects of the SDRM fade out. If we add to this the fact that, once introduced, CACs will take possibly several years before they can cover all the existing debt stock, we feel that our strategy risks being weakened.

In line with earlier findings, the evidence from Mexico tells us that markets do not seem very much concerned by the adoption of CACs. What seems to matter most to them is the fundamentals of a debtless economy as well as its policy implementation. This is consistent with what we have been thinking all along on the impact of CACs and the SDRM on market access. If both have an impact at all, it is going to be one of making investors discriminate better between good and less good borrowers, which is not a bad feature after all. If anything, both types of instruments would induce investors to screen borrowers more effectively. As further evidence hopefully accumulates on the impact of CACs on the cost of capital, we will know more about market reaction, and we thank Mr. Callaghan for the new evidence he signals to us. For instance, it would be important to assess if there is any difference between investment decisions taken by dedicated or by crossover investors respectively in response to the inclusion of CACs in debt contracts.

This leads me to the issue of surveillance. As others, I agree that the Fund should encourage the use of CACs. However, this principle should be better clarified. First, I think we can hardly disagree that CACs are not a substitute for good policy. In fact, good policies and CACs can mutually reinforce each other if it is true that CACs help markets discriminate better between issuing countries. This message should be reinforced through surveillance. In addition, we were asked to what extent should the Fund aim at recommending specific best practices. Here, I agree with Mr. Bennett that the Fund should endorse the basic principle of CACs rather than specific features. I also agree with Mr. Beauregard that what he aptly calls the "twin objectives" of CACs will be best served by an evolutionary approach that could take into account different country cases, and Ms. Jacklin and Mr. Ralyea offer useful practical suggestions for the coverage of CACs on surveillance missions.

We welcome the G-10 recommendations. Of course, they still need to pass the test of markets, and we encourage the staff to monitor this aspect in the future keeping in mind some additional issues. For instance, should additional clauses be considered? Could markets be willing to accept even more bearing clauses. What should the role of trust deeds or equivalent structures be with regard to which type of entities work best as a coordination device, a point raised by Mr. Al-Turki earlier. The Director of the International Capital Markets Department and the Deputy General Counsel have already provided some initial responses. As others, we feel that it would be important to have periodic reports on the introduction of CACs and market reaction, and we encourage the International Capital Markets Department to keep the Board updated.

Let me finally note that the response of the industry associations in indicating best practices is disappointing, as it falls short of even recommending the clauses that are already included in international bond issues. In addition, as Mr. Kremers points out, some of the industry recommendations on voting thresholds might run contrary to the strategy's very purpose of facilitating debtor-creditor coordination. Indeed, one could argue that if adopted, such voting thresholds could generate problems for collective action rather than help to solve them.

Mr. Brooke made the following statement:

As other Directors, I would like to thank the staff for this paper, which we broadly agreed with. I have only a few points to make.

First, we agree with the staff's suggestions for increased advocacy efforts and support their ideas for outreach that are mentioned in paragraph 77. Here, we very much agree with Mr. Callaghan that such efforts need to educate both investors and issuers that CACs are already widely used, that they have not hitherto been used to undermine creditors' rights, and that there is no evidence that they add to borrowing costs. Going beyond the proposed advocacy, we agree with those Directors who have pressed for more active measures, including in Article IV surveillance. Here, we think this work should focus primarily on educating authorities on the benefits of CACs and on the types of clauses they might consider including. We thought Ms. Jacklin's suggested questions to raise in an Article IV surveillance context were appropriate and deserve further consideration. We think this approach could be supplemented by mission chiefs handing over relevant background material, perhaps the soon to be edited version of this report, and that after a mission was completed, perhaps a follow-up should come in the form of a phone call from relevant experts from the International Capital Markets, Legal, or Policy Development and Review Departments to see if there are any more technical issues to follow-up on in areas where the mission chief was not the best qualified to provide answers on.

Second, we strongly welcome Mexico's recent bond issue that included CACs. We think this sets a very good precedent and should help to dispel fears of other issuers on costs associated with CACs. We also feel the design of Mexico's collective action clauses reflected a sensible balance between the recommendations of the G-10 experts group and the concerns of private sector investors.

Third, while we see the attraction of having a standard set of clauses that could be included in all bond contracts, we agree with the Director of the International Capital Markets Department and other Executive Directors that it would not be advisable at this stage for the Fund to advocate strongly a specific set of clauses. Rather, we think it would be sensible for the Fund to discuss the appropriate range for these clauses and the advantages and disadvantages of the various aspects of them. In addition, this advice should be guided in terms of the already existing collective action clauses being used, particularly by Mexico and those being used commonly in London. Ultimately, however, as a number of Directors have pointed out, it would be up to each issuer to decide for itself which clauses to include.

Picking up briefly on some of the individual clauses that countries might include, we feel that the trust deed structure works well in the U.K. context or London issuing law context, and we feel consequently that the Fund should continue to advocate this approach. In contrast, while we think the issues raised by the proposed engagement and transparency clauses are very important, we are less convinced that it would be appropriate to include these provisions in bond contracts. Rather, we think these elements should form an important part of any code of conduct between debtors and creditors.

Finally, we agree with Mr. Kremers that collective action clauses will not provide a comprehensive solution to sovereign debt restructuring issues, and as such we support those Directors who have called for further work on aggregation issues. In this regard, I very much welcome the comments made by the Deputy General Counsel at the start of the meeting.

Mr. Wei made the following statement:

At the outset, let me thank the staff for the very helpful paper. The G -10's research of CACs marks important progress. Meanwhile, the recent cases of emerging market economies issuing sovereign bonds with CACs provide empirical evidence for deepening our understanding. However, the limited sample size does not give us sufficient experience and further study is needed before generalized conclusions can be drawn. Like others, we also believe that the Fund does not need to promote a particular set of model clauses. That said, we have the following comments.

As indicated in the G-10 report, the most important element of the CAC is the majority restructuring provision. To protect the interests of both debtors and creditors, we share the view that the threshold at 75 percent is appropriate. A higher threshold will probably jeopardize the restructuring agreement. With regard to the duly convened meeting, we share the concern that a situation could arise in which a minority of creditors finally determines the restructuring terms. We support solving this problem with the approaches suggested by the staff in paragraph 11.

Regarding the majority enforcement provision, we believe that the thresholds set by the G-10 report , that is, a minimum of 25 percent to accelerate a bond and 50-66 2/3 percent to reverse the acceleration, are appropriate and in line with present market practices.

The trust structure is conducive to the coordination between creditors and debtors, and will probably facilitate early discussion of the necessary debt restructurings. However, it also incurs certain costs that will be translated into premiums. Hence, this issue needs to be further addressed in order to promote the use of CACs.

On the issue of data provision, we believe the agreements should be reached between creditors and borrowers on this issue based on the realities of the borrowing country. We share the view that so far the information provided by debtors through the information disclosure framework established by the Fund is sufficient. To require bond issuers to meet the SDDS requirements seems to be too stringent as what investors care most about are the economic fundamentals of bond issuers.

A number of emerging market economies have pioneered the use of CACs in their recent bond issuance. They deserve commendation for their skillful management of the related issues. Nevertheless, their successful experience has yet to be generalized for other developing countries given the difference in economic situations at the time of bond issuance. Hence, to determine whether and when to incorporate CACs in bond issuance probably remains state of the art and needs great caution. In this regard, we support the Fund's educational role in the promotion of CACs taking careful account of the potential bond issuers' concrete economic situation.

Lastly, to expand the use of CACs, we would like to encourage the industrial countries to include them in their own international bond issues.

Mrs. Farid made the following statement:

We thank the staff for a well-written and lucid paper which provides us with a comprehensive overview of the work done by the Group of 10 as well as by the private sector in designing collective action clauses, and which also covers recent developments in market practice. We also thank the Director of the International Capital Markets Department and the Deputy General Counsel for their further clarifications this morning.

We join other Directors in encouraging the Fund to continue to raise awareness of the benefits of the inclusion of CACs through multilateral and bilateral surveillance. However, we do not believe the Fund should endorse any set of model collective action clauses, nor should it exert pressure on member countries to include CACs in their bond contracts. Sovereign debtors will need to decide on whether to include such clauses and, if they do, which particular clauses to use, based on their own particular circumstances. The Fund should, nonetheless, stand ready, when asked, to advise its members on the implications of the different clauses.

Turning to the issues raised in the staff paper, in view of the elaborate statements already made by other Directors, we would like to make only a few brief remarks.

We agree that to foster a more widespread use of collective action clauses it may be most effective to promote those types of provisions that already exist in many international sovereign bonds, the most important being the provision that enables a qualified majority to bind all bondholders with the same issue to the financial terms of a restructuring.

We welcome the recent Mexican issue and agree that the design of the majority restructuring and enforcement provisions recently relied on by Mexico strike an appropriate balance between the objective of resolving collective action problems and of protecting creditor rights.

With regard to the provisions on the use of a trust deed, or the engagement and information provisions referred to in the G-10 and the Industry Association proposals, we would like to associate ourselves with the views of Mr. Portugal and Mr. Tombini. We also join Mr. Portugal and other Directors in their concern with regard to the need for greater clarity in the wider disenfranchisement provisions.

Finally, we welcome the intention of the EU countries to include CACs in sovereign bonds issued under foreign jurisdiction. By the example it provides, this step should help in facilitating a more widespread incorporation of such clauses in bonds issued by emerging market countries.

Mr. Rouai made the following statement:

I thank the staff for the concise and informative report on recent developments and issues related to Collective Action Clauses (CACs). I also welcome the work achieved in this respect by the Group of Ten and the private sector, as well as Mexico’s recent use of CACs. We continue to regard the CACs as a useful component of the toolkit for crisis resolution and supports Fund’s further efforts in promoting their use by industrial and emerging market economies and in educating market participants.

At this stage of the CACs' development and in order to increase chances for a broader acceptance and voluntary use, it is important to allow a sovereign debtor and its creditors to opt for flexibility in selecting the type of clauses that best suits their conditions. Consequently, I believe that it is premature for the Fund to endorse a specific set of clauses and that it should rather promote broad principles based on the CACs' experience.

As indicated in the Board meeting last June, I continue to consider most of the majority restructuring provision and the majority enforcement provision as the most relevant clauses, and I consider the terms applied by Mexico appropriate and a foundation for best market practices, as they strike a sensible balance between the need to safeguarding creditors' rights on the one hand, and improving the resolution of collective action problems on the other. As for the other CACs' clauses, at this stage, I have an open mind and I prefer to gather enough experience from the evolution of market practices.

As regards the transparency covenant, I join Directors who consider the Industry Association proposal excessive and unnecessary, as demonstrated by the Mexican example. Transparency is more relevant as a component of the crisis prevention efforts and should be part of the incentive structure, in order to improve a country's financing terms and conditions of access to international capital markets.

Finally, I support outreach exercises by the Fund, including an international seminar, to explain the benefits of CACs and to promote their use by the membership. I also support efforts by the ICM Department to track the use of CACs under Fund bilateral and multilateral surveillance, to help countries better assess the merit of CACs' features, and to assess the cost premium of issuing bonds incorporating CACs.

Mr. Szczuka made the following statement:

Although collective action clauses have many important limitations and fall short of the SDRM proposal, their widespread application would be an important improvement over the present situation. We have endorsed collective action clauses since the beginning of this discussion and we believe that Fund should actively promote them even regardless of the future course of our SDRM debate.

I believe that this recent progress in promoting the CACs can, to a large extent, be seen as a welcome by-product of advancing the SDRM proposal. I particularly welcome and broadly support the model clauses proposed by the G-10 Working Group, which provide good guidance to issuers of bond contracts. Institutional and legal differences in member countries can justify some deviations from these model clauses, as long as such deviations do not water down the proposal and defeat its objectives. The recent Mexican bond issue is a good example as it incorporates many, but not all elements of the G-10 proposal. I also welcome last year's EU declaration to start applying CACs in bonds issued under foreign jurisdiction. However, as far as I know at least three EU countries have issued such bonds since making this announcement and I wonder whether they include any CACs.

In our view, the G-10 recommendations are clearly preferable to the proposal made by the Industry Associations. This is particularly true with regard to the majority restructuring provision, where the Industry Associations' draft seems to be far too restrictive while the G-10 provisions strike a much better balance between resolving collective action problems and protecting creditor rights.

The staff has decided not to endorse, at least not at this stage, any particular set of clauses. I believe it is a right approach even though my first reaction after reading the staff paper was that it may be difficult for the Fund to support something that is not well defined. However, it is clear that any decision on the formulation and application of CACs will ultimately have to be made by market participants, and the clauses will certainly continue to evolve with experience. Nevertheless, the Fund should have a rather clear view as to some general features of the CACs it would be willing to promote as the emerging best practice. One of such general rules should be, for example, that the application of the new CACs should not lead to any significant backtracking with regard to the current practice on markets with a well-established tradition of using such clauses. The same holds true for the useful precedent created by the recent Mexican issue. The Fund should also closely monitor the progress in CACs implementation and report on their use as part of the Fund's bilateral and multilateral surveillance. I can also support the proposed outreach effort as an appropriate form of Fund's involvement.

Let me now make a few comments on some of the proposed clauses:

Regarding the majority restructuring provision, I support the G-10 compromise solution providing for a 75 percent outstanding principal majority for bonds issued under the New York law. However, to the extent possible, I would prefer to stick to the current thresholds and methods of calculating the quorum in case of bonds issued under the English law.

I also support the G-10 formulation of majority enforcement provisions (voting thresholds of 25 percent for acceleration and a range of 50 percent to 66 2/3 percent for a reversal of acceleration). The 75 threshold for de-acceleration proposed by the Industry Associations is clearly too high and I would rather see merit in the Mexican-like solution of staying close to 50 percent.

I recognize the positive impact trust deed structures could have on deterring disruptive litigation. However, I also realize that the trust dead is a rather cumbersome legal structure not well- known in most legal systems. While I support further efforts to promote the trust deed structures, I also agree with the staff that some alternative solutions should be explored. I would welcome the staff's clarification, why the possibility of introducing sharing clauses seems to have been completely taken off the table. Such clauses could, to a large extent, replicate the very welcome pro-rata distribution feature usually contained in a trust dead. I would also encourage the staff to analyze the main obstacles to a wider application of the trustee structures and the possible ways of overcoming such barriers.

At this stage, I do not have a very strong view on the use of engagement or representation provisions. While it is clear that such clauses could facilitate the dialogue between the issuer and bondholders, I also see merit in Mexico's claim that it may be better not to create structures that could prove redundant, or would remain inactive. At the very least, however, the bond documentation should clearly stipulate, how such bondholder representatives and/or bondholder committees should be appointed in case of a real need. I also continue having some doubts whether the issuer should cover all costs of the operation of creditor committees.

While I certainly agree that it is very important to provide the bondholders with adequate information I would also advise against imposing on issuers new obligations that may largely be redundant in today's era of transparency and broad availability of all types of data. I am not quite sure what kind of non-public, but also non-confidential, information could be provided on a regular basis. The Industry Associations' requests are certainly going much too far, and in particular the implication that a failure to satisfy a demand for information submitted by 5 percent of bondholders could give rise to an event of default can hardly be deemed acceptable. At the same time, I agree with Mr. Beauregard that, at least in case of countries with well-established market presence and proven record of transparency, the establishment of open and effective channels of communication, including through creation of investor relations offices, can go a long way toward satisfying the creditors' demand for information.

On the issue of the disenfranchisement provision, I agree that at least in some cases it may be appropriate to expand the coverage of this clause. However, care should be taken to define very precisely the meaning of direct and indirect ownership and control.

The issue of the possible negative impact of CACs on bond pricing may have a decisive impact on the scope of the future use of such clauses. I am rather reassured by the apparent success of the recent Mexican transaction and by the results of various research studies suggesting the absence of any significant negative effects. I am afraid, however, that the jury on this issue may still be out and that this question should be studied further. This concerns in particular the impact of CACs on the pricing of any bonds to be placed in the future by sub-investment grade borrowers. Of course, this whole problem would disappear should the CACs become a truly common standards and that is why we should encourage their broadest possible use, also by the industrial countries.

Ms. Indrawati made the following statement:

We also welcome the discussion of the well-written paper on the recent developments and issues regarding collective action clauses. We believe it will help our participation in the effort to build orderly and timely sovereign debt workouts.

On the role of the Fund in promoting the more widespread use of CACs, the inclusion of CACs in bonds issued by countries should be voluntary. Although we support the principle of including CACs, the design of CACs should be left flexible. We concur with Mr. Bennett and Mr. Reddy that financial markets are in constant evolution, hence promoting standards will potentially run the risk of them becoming obsolete or becoming counterproductive, possibly even creating constraints for restructuring.

On Mexico's recent issue with CACs, in our opinion, the appropriate balance between the objective of resolving collective action problems and protecting creditor rights would depend on the specific voting threshold. The provision for a 75 percent voting threshold is a good compromise between the lower threshold of 66 2/3 percent recommended under English law and the higher threshold of 90 percent as proposed by some market participants. The provision that the 75 percent threshold be based on the outstanding principle amount rather than the claims of bondholders present at a duly convened meeting is more equitable as it will prevent a minority of bondholders from agreeing on a restructuring if only a small percentage attend the meeting. As also stated by Mr. Callaghan, the fact that the demand for the Mexico issue was strong and the paper was well priced is evidence that the two concerns were appropriately balanced.

On the provision designed to limit the ability of minority bondholders to disrupt the restructuring process by enforcing their claims after a default and prior to a restructuring agreement as is practice in New York law and English law, our opinion is that enforcement of majority enforcement provisions would enable parties involved in the restructuring to negotiate without intransigent holdouts from dissident minority creditors.

The range of voting thresholds for acceleration and de-acceleration in the event of default appears workable, and the widespread use of such thresholds should be encouraged. While acceleration triggered by default would protect the debtor's interests, the de-acceleration would aid in halting adverse consequences stemming from the acceleration endured by debtors.

On the different types of engagement provisions, an engagement provision would expedite the restructuring process by establishing a channel of communication between bondholders and sovereign debtors upon default. We support the G-10 Working Group proposal for the appointment of a bondholder representative for the life of the bonds and a special bondholder representative in the event of restructuring, as this arrangement can be more efficiently implemented to achieve the objective of facilitating restructuring.

On a call for provision of information, the scope of information to be provided in the event of default should be specified prior to the issuance of a bond. This would prevent any abuse of information provided while expediting the restructuring process when restructuring becomes necessary. This would also avoid a delay that could be caused by a restriction on the issuance resulting from statutory obligations of confidentiality, as the issuer can set the scope of information to be disclosed with reference to such obligation.

On the use of CACs as a market-driven process, both in terms of the precise CACs and in terms of the pricing of bonds containing CACs, emerging market economies, particularly those with below investment grade rating, may have reservations regarding the use of CACs owing to uncertainty and the benefits of CACs. This is in line with studies by Eichengreen and Mody, as stated in Mr. Bennett's statement, that less creditworthy issuers will have to pay a higher spread. If there is a clear premium for using CACs, specifically a lower cost of borrowing, issuers could be more inclined to use CACs.

Finally, we recognize the fact that a significant stock of current outstanding debt does not include CACs. Therefore, we encourage further work to solve this issue, either by using a market-based mechanism or by using the statutory approach of a SDRM.

Mr. Mozhin made the following statement:

We welcome the two recent important developments related to the promotion of the use of CACs. The G-10 recommendations and the Industry Associations Draft provided much needed substance to the discussion on the modalities of CACs. The recent placement of Mexican bonds with CACs under the New York law demonstrated that CACs may be successfully placed in this important jurisdiction.

At this stage, we continue to believe that CACs could be helpful for orderly restructuring of certain segments of sovereign debt. At the same time, we also know that they have limitations in terms of debt coverage and that they do not resolve the aggregation problem.

One may hope that in the near future the development of CACs will gain momentum. Should such expectations fail to materialize, this would certainly strengthen the case for the SDRM approach.

We see the CACs process as a market driven one reflecting interactions between sovereign borrowers and private investors. Therefore, the Fund should refrain from endorsing any set of standard formulations. Instead, there should be a set of broad principles with a clear recognition that actual terms of placements may vary significantly.

Regarding the modalities, we believe that the G-10 recommendations on CACs are quite balanced and reasonable.

Finally, we agree with the approach to promoting the use of CACs as proposed in the staff report.

Mr. Boitreaud made the following statement:

As previous speakers, I would like to commend the staff for a concise and focused report. At this stage of the discussion, my intervention will be very short and supportive of previous speakers' comments, in particular, Mr. Kremers's statement and Messrs. Bischofberger's and Padoan's interventions. I would like to associate myself with Mr. Padoan's argumentation on the interaction between the SDRM and CACs. Let me insist on three points.

First, as Mr. Yagi and Mr. Miyoshi, and many other Directors, I believe that CACs should be considered in the context of the strengthening of our overall framework for crisis resolution, as a complement to other pillars such as the SDRM and the code of good conduct. As CACs provide solutions to some of the problems addressed by the SDRM— but not to all, as mentioned by Mr. Mozhin, this caveat is very important—and the Fund should promote their use across the membership.

That leads to my second point: promoting the use of CACs. I must admit that I share Mr. Kremers's disappointment on this issue. I acknowledge that there is no support at this stage for the inclusion of CACs in the Fund's program conditionality but we need, at least, to promote CACs through our surveillance more strongly. Another venue could lay in the inclusion of CACs in debt stock swap implemented within the framework of a Fund-supported program.

One more point, the existing Public Debt Management Guidelines do not include any specific recommendation as to the inclusion of CACs in international bonds. In their recent joint "Accompanying Document to Guidelines for Public Debt Management" (IMF, WB), dated 21 November 2002, IMF and World Bank refer to the experience of some countries with CACs (pp. 45-46, § 111) but refrain from promoting such clauses to the extent that "these clauses are not attached to securities issued in some other markets, such as Germany and the State of New York". It seems to me that this statement should at least be updated. Moreover, we could go a step further and consider the inclusion of CACs in international bonds as a "best practice" to be inserted in the Guidelines themselves.

Finally, and related to the previous point, I believe we need to be clear on the CACs we support. Like the staff, and for the reasons mentioned in the report, we think the G-10 clauses are preferable to the Industry Associations Draft. We therefore favor the use of G-10 clauses in bond issues and would favor the Fund actively promoting these clauses them across the membership, while of course keeping sufficient flexibility to adapt to new developments in capital markets.

Mr. Kiekens made the following statement:

The Fund should help establish a best practice standard on how to resolve collective action problems that arise among holders of international sovereign bonds. This standard should outline the public policy objectives to be achieved by a statutory SDRM and by contractual clauses dealing with collective action by creditors.

The Fund should endorse the G-10's model clauses aimed at achieving these public policy objectives. These G-10 clauses are only illustrative. Issuers and investors are free to adapt them to particular cases. This can be done without jeopardizing the public policy objectives described in the standard on collective action by bondholders.

I expect that after a time a standard acceptable to the markets will emerge, whose form may vary somewhat from one financial center to another.

The Fund, too, should gradually modify its standard on collective action by creditors, and particularly the "illustrative section" about model clauses, to keep it consistent with a market practice consistent with the public policy objectives that are the core of the standard. I strongly agree with the wise counsel provided by Ms. Jacklin about trust structures. Such structures could be very helpful for deterring disruptive litigation and organizing a better protection against attachment. However, as the staff notes and Ms. Jacklin seems to admit, trust services do not come free of charge, especially in the

United States where the litigation of liability sometimes seems to inhibit economic activities instead of stimulating them.

The Fund should promote collective action clauses through its bilateral and multilateral surveillance, and by organizing outreach meetings, as proposed in the staff paper. Ms. Jacklin has suggested a useful set of questions that would help organize the bilateral surveillance in this area. The Fund and World Bank guidelines on public debt management do not recommend the inclusion of CACs in external bond issues. These guidelines should be changed to include such a recommendation.

The International Capital Markets should continue to monitor market practices. The establishment of a database about the documentation of sovereign bonds by the International Capital Markets and Legal Departments is very useful.

I would like to stress that while they are useful, CACs do not represent a comprehensive solution for collective action problems. They cannot aggregate the holders of different types of debt instruments, or even the holders of different issues of a bond; nor do they apply to the existing stock of debt that lack CACs. The Fund should therefore continue to operate on a statutory SDRM.

I hope we will see emerge more and more creditors that consider CACs not as an infringement on their rights, but as a protection of their interests and the value of their claims. Such a change in attitude would positively influence the pricing of bonds containing CACs.

I agree with the publication of the staff report.

Mr. Szczuka asked whether the idea of swapping already existing bonds for bonds with CACs as proposed by Stern and Bartholomew was a practical way to prevent disruptive legal action by a small minority of creditors.

Was there any truth to the claim that the recent bond issue by Mexico included a premium of up to 25 basis points? Mr. Szczuka inquired. In addition, was the demand for the issue significantly lower than usual for transactions of this type by Mexico?

The Director of the International Capital Markets Department (Mr. Häusler), in response to questions and comments from Executive Directors, made the following statement:

First, my apologies to Mr. Callaghan that our paper did not capture the very recent paper by two colleagues from the Reserve Bank of Australia, and we will make sure that the final version will make due reference to that very good work that has been done.

Mr. Al-Turki asked about the carrying costs and the costs of engagement with regard to trust structures. Our analysis has shown that the costs are fairly small. The carrying costs, the yearly costs, and the ongoing costs would vary a bit, but would be about $10,000 per year, and given that in some financial centers there is a sprawling trustee industry not related to CACs, but that in others—I know this from London and from Amsterdam—this could spring up very quickly and there might even be competition such that this might be less expensive going forward. On the engagement costs, it has to be understood that this would be a one-time cost only, so this is not a revolving cost every year and would certainly depend on the circumstances.

Mr. Bennett asked how can we potentially extrapolate whether or not CACs might carry an additional cost if there were no well-established yield curves in some countries. He wondered whether there was any econometric model or anything like a synthetic yield curve that we could use in this regard. I think this would be very difficult. In the case of countries that do not have a well-defined yield curve against which to compare yields on bonds issued with CACs, one could assume that certain econometric techniques could be used to isolate the effects of CACs on the bond spread. However, this is rather difficult mostly because country-specific factors have a far greater effect on spreads than any conceivable premium or discount arising from the use or absence of CACs. Therefore, it is almost impossible to identify the secondary effects when we cannot properly control for the first order factors.

Mr. Szczuka asked the question of how to compare the costs of investment grade versus noninvestment grade borrowers, and whether we should be perhaps a bit more patient before drawing conclusions in this regard. I think in my mind at least—I can only speak personally here—we would just have to wait a little until the market has become more familiar and more used to CACs as a standard best practice feature, and is less nervous than it is today and takes CACs as a routine matter going forward. In time, maybe not in a long time, there might even be a recognition that CACs do not only restrain individual creditor rights—and sometimes this is how it is seen still today—but also will be of benefit to creditors by taking away some of the potential impediments to a smooth and speedy debt restructuring. I am not pessimistic at all on this matter. As I said earlier this morning, I think there are quite a few investors meanwhile who have resigned themselves to CACs being a fact of life, and they would like to see a standard set that they can adhere to.

With regard to all the comments made in the statements and oral comments this afternoon as to the outreach, we will be glad to do that, and I think the questions that were mentioned in Ms. Jacklin's statement can provide some good guidance in that respect.

> One last point, on the Stern-Bartholomew paper. It was meant to be a contribution to the debate on how to resolve the first mover problem, and I think it proposed providing significant incentives in this regard. However, the Board decided already some time ago that it is better not to use such incentives.

Mr. Padoan asked for the views of the Director of the International Capital Markets Department on whether the differences between dedicated and crossover investors would play any role with respect to the success of CACs in the future.

Mr. Beauregard noted, in response to Mr. Szczuka's question, that the vast majority of studies on Mexico's recent bond issue indicated that there had been no premium included in the price of the bond. Nonetheless, premium calculations ultimately depended on the model that a particular investment house used to construct the Mexican yield curve.

With regard to the demand for the issue, it was true that the demand for that particular issue had been lower than the previous issue, Mr. Beauregard explained. However, the bond was nonetheless oversubscribed, and there had been more than $1 billion demand for it.

Mr. Abbing asked whether the staff had inquired as to why the World Bank had not used CACs in the bonds it issued in the United States.

The Director of the International Capital Markets Department (Mr. Häusler) remarked, in response to Mr. Padoan's question, that it would be difficult to speculate whether the investment decisions of crossover or dedicated investors varied as a result of the introduction of CACs in bonds. However, in the case of Mexico it was clear that the crossover investor was less sophisticated than the so-called dedicated investor was and depended more on advisors. However, that issue would become less relevant as more bonds were issued with CACs.

The staff would look into whether the World Bank was including CACs in its U.S. bond issues, the Director commented.

It was unclear at the present time whether the bond exchange idea Mr. Szczuka noted would actually work, the Director remarked. That idea had been considered during the course of some recent debt restructuring negotiations. However, more experience needed to be gained in that area before any conclusions could be drawn on the viability of the proposal.

Ms. Jacklin noted that emerging market countries considering including CACs should take advantage of the decline in interest rates to refinance any existing issues and introduce CACs in the new bonds, which should reduce their costs. In this regard, dealing with the outstanding stock of sovereign debt that did not include CACs should not be an enormous long-term problem if market forces were favorable.

Mr. Szczuka asked why the three recent bonds issues that took place prior to Mexico's and also included CACs received significantly less attention from market participants than Mexico's did. Was it because the Fund had not highlighted the other three? The Fund also had to consider whether it was important for the institution to make investors sensitive to bond documentation.

The staff representative from the Policy Development and Review Department (Mr. Fisher), in response to questions and comments from Executive Directors, made the following statement:

> First, let me say another word if I may on the J.P. Morgan proposal. The First Managing Director gave a speech at Harvard University about ten days ago on this topic. The proposal is that there would be a global swap for all of a country's debt, not just bonds but also syndicated bank loans and whatever other instruments may be out there. This would not be done by a country in a period of stability, but rather in the context of a recognition that there is a need to restructure the debt. The first stage would be to swap all of the existing instruments for new instruments that would have collective action clauses and would be linked together. What is interesting about that is that there is a market recognition of two issues. First, that there is a collective action problem, and second that there is a need for aggregation, both of which are more difficult in the bond-by-bond treatment. What would happen is that, over time, as policies fell into place, as the medium term became clear, and as agreement was reached on the debt, creditors—who would by then be in a collective framework—would be able to vote up or down on a comprehensive package.
>
> The proposal is clearly intriguing, but the First Deputy Managing Director in her speech identified a number of areas where she doubted its feasibility. One of them was that in a period of great uncertainty, when appropriate polices are not in place and the medium-term outlook is unclear, there is a question as to whether investors would be willing to give up their legal rights, to which they are extremely attached, and enter into a collective framework. After all, investors, in addition to the attachment they have to their rights, have fiduciary responsibilities, and they will be very conscious as to whether they are doing the right thing. Another concern was that once investors agree to a collective framework with aggregation, will they believe there are sufficient safeguards against fraud. It is one thing to go into aggregation in a court supervised process where there are protections against fraud, but it is much less clear in the J.P. Morgan proposal whether or not this could be made to work. It is intriguing but I think it warrants further work.
>
> Directors raised a question about the treatment of collective action clauses in the debt management guidelines, and they noted correctly that the current draft is, if I may say so, agnostic on the question of CACs and certainly does not give specific recommendations. I think that in light of recent developments it would be appropriate for us to take another look at this.

These are of course joint Fund-Bank guidelines so we will need to work with our colleagues in the Bank on this.

The Deputy General Counsel (Mr. Hagan), in response to further questions and comments from Executive Directors, made the following statement:

> Several Directors asked about the scope of the disenfranchisement provision. As I had indicated earlier, it is relatively clear that public sector instruments would not include privately owned commercial banks, for example. There is a question, of course, however, in defining whether an entity is controlled or indirectly controlled by the sovereign. For example, is indirect control focusing primarily on legal relationships that are established through subsidiaries or is it a more subjective concept? I should tell Directors that this was an issue discussed at length during the G-10 Working Group deliberations, and there was a possibility of actually trying to come up with a definition of control. However, and to become very specific, there was a concern that if that were done it would be inviting circumvention. Thus, the decision was to keep this as a general concept, and that it would be resolved if and when disputes arose. However, there is clearly no specificity as to what the meaning of control is.
>
> Second, responding to Mr. Szczuka, sharing as a modality was not dismissed as such under the G-10 Working Group's discussions. The starting principle was that we should build on provisions that achieve pro rata distribution of proceeds that exist in bonds already. It was recognized that trust deeds effectively do that, because essentially the trustee is given a limited monopoly over litigation and therefore as it represents all the bondholders it would have to distribute to all the bondholders. Introducing a sharing provision would represent a more fundamental change because it would introduce inter-creditor obligations into bond documentation that does not currently exist. However, and this is the point that I think is relevant for a number of civil law jurisdictions, it did recognize that in those jurisdictions where a trust deed was not feasible because the concept of divided ownership is not recognized, perhaps alternative structures would need to be introduced to achieve the same pro rata distribution, and so it leaves that possibility open.

Mr. Szczuka asked again whether the bonds recently issued by three European Union countries had included CACs.

The Acting Chair (Ms. Krueger) responded that the staff would address that matter bilaterally with Mr. Szczuka.

The Acting Chair (Ms. Krueger) made the following summing up:

> Executive Directors welcomed the opportunity to review progress toward the inclusion of collective action clauses (CACs) in sovereign debt

instruments. They were encouraged by developments over the past year with respect to both the design of majority restructuring and majority enforcement clauses, and the incorporation of such clauses into bonds governed by New York law. In this regard, Directors lauded Mexico's recent successful issuance as well as efforts by other countries, including Egypt, Lebanon, and Qatar to include such collective action clauses in their bonds. They noted that the Mexico issuance has gone a long way toward resolving the "first mover" problem. There was broad agreement that the wider use of such clauses could contribute to more orderly and rapid agreement on debt restructurings, although a few Directors observed that without well-known ex ante presumptive limits on Fund lending CACs may not provide sufficient incentives to the sovereign and its creditors to expedite restructurings. Directors saw CACs as a useful element in the Fund's overall work to strengthen the framework for crisis resolution. A number of them considered that given the limitations of CACs, work in this area should proceed in parallel with the ongoing work on a possible statutory framework.

Given the outstanding stock of bonds that do not yet include CACs, Directors acknowledged that it will take some time before CACs are included in most international bonds. Moreover, given the contractual nature of CACs, they noted that any decision as to the inclusion and design of CACs will ultimately be made by the debtor and its creditors. Against this background, Directors reiterated that the Fund's most effective strategy is to promote the more widespread use of those types of provisions that already exist in many international sovereign bond contracts. They emphasized that the Fund should more proactively promote the use of CACs through its multilateral and bilateral surveillance. Directors also stressed that all member countries, both advanced and developing, should play their part in encouraging the use of CACs, and, in this regard, welcomed the intention of European Union member states to use contractual provisions based on the framework developed by the G-10 Working Group when issuing bonds under a foreign jurisdiction.

Most Directors noted that it is too early to reach a definitive view on the degree of standardization that should be sought in terms of the design of CACs, within and across jurisdictions. Several Directors agreed that it would not be advisable for the Fund at this early stage to promote or endorse a single set of model clauses as the exclusive benchmark. Several other Directors went further, noting that the Fund should refrain from endorsing any particular model of CACs as the exclusive benchmark, even at a later stage, and leave it up to the relevant parties to negotiate the details. Nonetheless, most Directors noted that, based on recent developments, a number of observations could be made regarding those features of CACs that would both facilitate a rapid and orderly restructuring process and have a reasonable probability of being acceptable to the market. Some Directors, however, were of the view that without a clearer endorsement of a set of model clauses by the Fund, efforts to promote them would be constrained. These Directors suggested that the G-10 Working Group proposal could serve as reflecting best practices.

Majority Restructuring Provisions

Directors noted that perhaps the most important feature of any CAC is the provision that enables a qualified majority to bind all bondholders within the same issue to the financial terms of a restructuring. This provision is found in bonds governed by English law, where the required majority is normally set at 75 percent, which Directors viewed as being a reasonable threshold. As regards the method used to calculate whether the 75 percent voting threshold has been met, Directors generally agreed that a 75 percent voting threshold based on the outstanding principal of the bond, rather than on the claims of bondholders present at a duly convened meeting, would be a reasonable approach. It was noted that such an approach was utilized by Mexico, and would also be consistent with the recommendations of the G-10 Working Group Report.

Directors also noted that Mexico's recent issuance had complemented such a provision with an expanded disenfranchisement provision that precludes bonds being voted where they are directly or indirectly owned or controlled by the sovereign issuer or its public sector instrumentalities. This provision was also consistent with the recommendations made by the G-10 Working Group. Most Directors were of the view that, taken together with the voting thresholds described above, this clause assisted in striking an appropriate balance between the objective of resolving collective action problems and protecting creditors' rights. A few Directors, however, preferred to limit the disenfranchisement exclusion only to bonds held by, or on behalf, of the issuer.

Majority Enforcement Provisions

Most Directors supported the use of clauses that are designed to limit the ability of a minority of bondholders to disrupt the restructuring process by enforcing their claims after a default and prior to a restructuring agreement. They noted that 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. Directors generally viewed as reasonable the thresholds for these provisions that have already been generally accepted in bonds governed by New York law: a vote by 25 percent of outstanding principal is needed to accelerate the claims and a vote of more than 50 percent is needed to de-accelerate these claims.

Directors noted that a more difficult question relates to the use of provisions that confer the right to initiate litigation on behalf of all bondholders upon a bondholder representative who is only required to act if requested by the requisite percentage of bondholders. Moreover, these provisions ensure that the proceeds of any litigation are distributed by the representative on a pro rata basis among all bondholders. Many Directors were of the view that the use of trust deeds—or an equivalent legal structure—that can implement these provisions can play an important role in the restructuring process, and that the potential benefits may justify the limited financial cost of using them. Some Directors, however, felt that the financial costs of trusts may outweigh their benefits. Nevertheless, it was noted that this is an issue for issuers and investors to decide.

Directors agreed that, while it might be desirable for CACs to possess the features described above, differences in legal systems, market features, or country circumstances may necessitate some variation. For example, not all jurisdictions will be able to limit disruptive litigation through reliance on trust deeds and may need to implement other structures to achieve the same results. Similarly, reliance on the outstanding principal amount for purposes of calculating whether the voting threshold has been met may be appropriate in the New York market, which is dominated by institutional investors. However, continued reliance on the "quorum" approach–where the calculation is based on the vote of bondholders attending a meeting—may be a more practical method for the London market, where bonds are more widely held in the retail sector.

Engagement Provisions

A number of Directors expressed the view that a representation or "engagement" provision could play a useful role in the restructuring process by giving a bondholder representative the authority to act as a channel of communication between bondholders and the sovereign debtor in the context of a crisis. They noted that, although such clauses would be novel, both the G-10 Working Group Report and the Industry Associations Draft have proposed variants of such a provision. Although it is too early to form a judgment as to its specific design features, most Directors were of the view that the provision should clearly avoid the establishment of a multiplicity of bondholder committees where a number of bond issues are being restructured. However, some Directors were not enthusiastic about engagement provisions, as it has not proven difficult so far to contact bondholders, and it would be inappropriate to determine beforehand the type of restructuring process that could take place years into the future, given the evolving nature of the practice. In any event, Directors agreed that market participants should be left to decide themselves the best approach to debtor/creditor engagement.

Information Requirements

Directors supported improved data collection and dissemination, and emphasized that the Fund should be working with members to improve investor relations programs, data standards, and transparency. They considered that Fund country reports as well as other sources provide important information for creditors to make decisions about the economic situation of sovereign issuers, and that members' subscription to the Special Data Dissemination Standard (SDDS) would also be useful. Some Directors also supported the use of contractual covenants that require the provision of certain information. A number of others, however, were not in favor of such covenants as they are not directly related to the resolution of collective action problems, and because borrowers should be committed to transparency as a matter of principle. It was also felt that the issue of appropriate covenants related to financial data is one for the issuer and its creditors to consider. Directors also noted that some of the information identified by the Industry Associations Draft would either be confidential or would be owned or controlled by parties other than the sovereign.

Directors agreed that there are few reasons to expect that bonds containing CACs should trade at higher spreads than those that do not. They noted that there has been no systematic historical difference in pricing between bonds issued in London and those issued in New York; and that Mexico—as well as Egypt, Lebanon, and Qatar earlier—was able to issue a bond in New York containing clauses without paying a noticeable premium. A few Directors cautioned, however, that at least in the period before CACs become standard practice, it remains to be seen whether the same treatment will be accorded to other borrowers for incorporating CACs into their bond contracts.

Directors welcomed the proposals to continue several forms of outreach to encourage the use of CACs. First, they strongly 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 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 international bond issuance would further strengthen these efforts. Second, as part of a more concerted effort to encourage the use of CACs, they encouraged the staff to hold an international seminar or workshops with key issuers and legal practitioners later this year on ways to promote CACs.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/03/32 (4/4/03) and EBM/03/33 (4/7/03).

2. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 03/12 is approved.

APPROVAL: June 24, 2003

SHAILENDRA J. ANJARIA
Secretary