COLLECTIVE ACTION CLAUSES

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Cliff Dammers and I would like to thank UNCTAD for the invitation to speak at this 4th Debt Management Conference. We appreciate the opportunity to address such a broadly based gathering of government debt officials on the topic of Collective Action Clauses, which I will immediately abbreviate as CACs. As you are aware, I represent the International Primary Market Association, which is also easily abbreviated to IPMA.

IMPA was established nineteen years ago as the London based trade association for banks active in the underwriting of international debt and equity securities. Our main focus is on encouraging a set of market practices that will maintain the attractiveness of the international bond market for issuers, investors and the underwriting firms that are our members. The underwriting community relies for its existence on its ability to balance the reasonable expectations of issuers and investors in the interest of maintaining an efficient market for all participants. We estimate that US$1.6 trillion was raised in our market in 2002 on a public syndicated basis and a further US$600-800 billion on a private non-syndicated basis. So our market is highly successful. And our market practices have had to evolve with it. Much of the success of our market results from IPMA's success in the harmonisation and standardisation of market practices on the basis of consensus. IPMA has long been of the view that a standardisation of market practice in the use of Collective Action Clauses would contribute to a more orderly and efficient market for emerging market finance. IPMA is pleased by the degree of consensus in the private and official sectors in favour of CACs. The official sector view was well expressed in an IMF paper released just last week under the title "Crisis Resolution: Next Steps".

I recommend this paper to you, particularly in the way that it places the issue of CACs within the broader context of a more stable financial system. I quote: “the case for collective action clauses is strongest if they are viewed as one of several interdependent changes in the international financial system, which together promise to make the world a safer financial place but none of which is feasible in the absence of other others”. Even though we have our differences with the IMF on the concept of a statutory sovereign bankruptcy regime, both sides agree on the crucial importance of effective creditor co-ordination in the orderly resolution of sovereign debt crises. CACs are intended to provide a reasonable basis upon which a debtor and its creditors can agree to modify a bond or loan contract, while still respecting the contract’s sanctity. At the end of the day the acid test with CACs is whether their wholesale introduction into bond and loan contracts can and will contribute to a more robust international financial architecture.

First, I will provide a historical perspective on CACs, focussing in particular on different market practices in the London and New York bond markets. I will look at the difference in the creditor dynamic in the bond and loan markets. I will refer to the differences between a market based approach to restructuring based on CACs and a Code of Conduct and the statutory approach based on the concept of a sovereign bankruptcy regime. I will explain why the bond market has relied on exchange offers to achieve sovereign debt restructuring.

Cliff will outline our work in the so-called Gang of Six trade associations in drafting model Collective Action Clauses and a Code of Conduct. He will explain what we mean by Collective Action Clauses, the specific contractual provisions. He will also detail the differences between our model CACs and those actually adopted by the Government of Mexico, explaining why Mexico did not choose to adopt all our clauses. He will update you on how other sovereign issuers have followed in Mexico’s wake, both from the emerging markets and the European Union.

Finally, since CACs are very much work in progress, I will discuss some of the remaining issues with CACs. In particular the benefit of standardising CAC language, the issue of aggregation and the challenge of improving bondholder voting procedures to make CACs more effective in practice.

Let me start with a brief definition of Collective Action Clauses, of which there are essentially three types. First qualified majority voting which specifies the percentage of creditors whose vote is sufficient to amend key terms such as the payment of principal and interest in a manner binding on all the creditors. Second, enforcement which requires that the decision to sue the borrower be made by a suitable percentage of the creditors, typically 25%. Third, engagement which details the basis on which creditors select a representative, typically a creditor committee, which is tasked with representing the creditors interests in negotiations with the debtor.

Bonds subject to English law have included CACs going back to the late 19th century. But sovereign bonds subject to New York law have not included CACs, or certainly not qualified majority voting clauses. This is why to a large degree the core of the recent debate on CACs has been on convincing the US investor community that the use of CACs does not represent a threat to their interests. There is some irony in the fact that it should be the investors that have had to be persuaded that CACs are not a threat to their position. When CACs were introduced in England in the 1870s, it was because of the perceived benefit in achieving effective co-ordination among investors: CACs were designed to protect the majority of investors from the actions of the minority of investors. As a result of the 1939 Trust Indenture Act the US market went in the opposite direction: this Act prohibited reductions in amounts due under a publicly issued corporate bond without the consent of each bondholder. Although the Act was limited to corporate bonds, no separate body of practice developed for sovereign bonds for the simple reason that there was virtually no foreign sovereign bond issuance in the US market between the 1930s and the 1990s.

When we talk about collective action the key issue is indeed effective creditor co-ordination. The IMF proposal for a sovereign debt restructuring mechanism in late 2001 reflected the Fund's scepticism that, as a strictly practical matter, creditor co-ordination could be made to work without a strong statutory underpinning. The IMF argued that it required a statutory approach to achieve effective co-ordination across "a diffuse and diverse creditor base, with different creditors able to seek enforcement of their rights in different legal jurisdictions". The problem was identified by Anne Krueger of the IMF:

"(Collective action clauses) typically only bind holders of the bond issue in question ………… a country with an unsustainable debt burden will require a comprehensive restructuring across a broad range of indebtedness, potentially including different bonds issued under different jurisdictions, bank loans, trade credits and some official claims".

In sum, the IMF supports the use of Collective Action Clauses but they believe them to be necessary but not sufficient: their belief is that the effort to achieve collective action among private sector creditors should be reinforced by a sovereign bankruptcy mechanism. They draw the analogy with the corporate sector where debts can be restructured in the shadow of a court administered bankruptcy procedure. The IMF could not conceive that a broad range of loan and debt instruments could be restructured if each had to be restructured individually, within the four corners of each instrument. So it proposed that there be an aggregation of claims across instruments for voting purposes. Since aggregation would effectively amend contract terms retroactively, the IMF recognised that its SDRM would require approval by its member countries and a change in the IMF's own Articles of Agreement. The unanswered question remains whether market based restructuring can work without aggregating voting claims.

The G-7 has left the door open to the SDRM by supporting further work by the IMF on “proposed approaches to sovereign debt restructuring that may require new international treaties, changes in national legislation, or amendments of the Articles of Agreement of the IMF”. But the G-7 has stressed that this should not delay the “expeditious implementation” of a market-oriented approach to the sovereign debt restructuring process in which Collective Action Clauses would be incorporated into individual debt contracts. The private sector response has also endorsed the use of Collective Action Clauses in sovereign debt contracts.

So the choice really boils down to whether the market based approach using CACs favoured by IPMA or a statutory approach premised on aggregation is the best way to restructure sovereign debts. Our voluntary approach is clearly preferred by the issuers. Understandably they have been concerned that a statutory approach would weaken investors’ appetite for their bonds.

We do recognise that the problem of creditor co-ordination has become more acute since the 1980s. There is some nostalgia for how easy sovereign debts were to restructure in the 1980s. The challenge then was to restructure long term syndicated loans. This was achieved by voluntary standstills and the provision of new money, leading finally to absolute debt reduction through the Brady Plan. Brady-style debt exchanges were the ultimate market-oriented form of sovereign debt workout. Starting with Mexico, over 20 countries carried out Brady debt exchanges, with over $170 billion of Brady bonds put in issue. In the 1980s, burden sharing fell on the banks rather than bondholders because bonds were such a small percentage of the outstanding claims on emerging markets debtors. How things had changed by the late 1990s. The Rey report after the 1994 Mexican financial crisis stressed that bonds had become such an important part of finance for emerging markets that they could no longer expect privileged treatment. Now in Argentina we are seeing virtually the entire burden falling on private bondholders.

Cases like Argentina have emphasised to bondholders the weakness of their negotiating position, and the need for IPMA and the other trade associations to fight their corner. Bondholders depend on their power, individually or collectively, to sue defaulting issuers. The threat of litigation is the key bargaining level available to bondholders, and is the only real card that they have to play. Bondholders value such contractual rights as they have, such as their ability to freeze assets of the sovereign debtor in foreign jurisdictions. But they are very aware of how difficult it is to enforce claims against sovereign governments. Bondholders have been awarded a number of judgements against Argentina but have not been able to enforce those judgements.

Let me turn to the question of how bondholders organise themselves. In a loan restructuring it is typical for a steering committee to be formed that will co-ordinate the formulation of the restructuring proposals with the sovereign debtor. The process will follow an established framework of practice about which there is a high degree of consensus among the banks. It is rare to find a bank resorting to any individual remedies available to it. In the absence of a creditor committee, the same degree of consensus is harder to achieve in the case of a bond restructuring. There is a greater likelihood of creditors failing to vote at a bondholders' meeting. Bondholders who might otherwise accept a restructuring proposal will be less willing to do so if they see other creditors being paid off. This inter-creditor dynamic can have a much stronger influence over the outcome of a bond restructuring than over a loan restructuring. Despite the challenge IPMA is more optimistic than the IMF that Collective Action Clauses can be made to work across a broad range of individual bond issues without the need to resort to a statutory regime. The key is transparency: if bank lenders or holders of an individual bond issue feel that they are being treated fairly in relation to other creditors, they are very likely to co-operate. And if the necessary majority cannot be achieved for whatever reason exchange offers are an alternative market based remedy. More on exchange offers later.

It is argued that debt restructurings based on the use of Collective Action Clauses or exchange offers are prone to disruption by “rogue” creditors. This view has it that rogue creditors are able to obstruct a restructuring by taking control of one or more bond issues and holding out for better terms. This would support the argument for aggregation of multiple bond issues for voting purposes, so as to dilute the ability of any rogue creditor to hijack the process. IPMA does not doubt that aggregation could be effective in eroding the power of the rogue creditor, but we question the desirability of imposing a statutory aggregation scheme on outstanding bond claims, asking:

- At a philosophical level, do the benefits of aggregation outweigh the demerit of direct interference in contractual rights?

- At a more practical level, is the need for aggregation proven?

The evidence is that major bond restucturings have taken place in Russia, Ecuador, Pakistan and Ukraine without the process being obstructed by rogue creditors. Even in the most widely cited example of “rogue-ish” behaviour, the 1997 restructuring by Peru was threatened but not disrupted. Suits are not brought during the period in which a sovereign is genuinely acting in good faith with its creditors and openly engaged in a constructive dialogue. The use of Collective Action Clauses (and judicious decisions by the Courts) could further reduce the risk of rogue creditor problems that may exist, without the need to create an SDRM.

The debate on how to achieve effective creditor co-ordination that followed the SDRM proposal started from a low level of market awareness. There was a general anxiety to avoid changing contracts in a way that could frighten investors from purchasing emerging market bonds because changing the contract would be too easy for borrowers. If bonds are too easy to restructure, debtor countries may be tempted to treat debt restructuring as an acceptable alternative to debt payment rather than as a final resort when all else has failed. CACs had not been the subject of much attention despite the emphasis that was placed on Collective Action Clauses in the Rey report published following the Mexican tequila crisis. As Chairman of a trade association that represents underwriters, I would be the first to admit that the subject of CACs had not been figuring in negotiations before bond issues were mandated or even in the pre-launch negotiations. The inclusion or not of CACs was left to the issuer's and the underwriter's legal teams to negotiate on an ex post basis.

IPMA first focussed its attention on CACs four years ago when we carried out a study of current market practice for a broad range of emerging market and OECD bond issues. Our study looked at as many different sovereign issuers as possible and also examined contracts from the same issuer under different governing laws. Our research confirmed that borrowers tended to follow the market practice that was typical for each market: as a result they accepted 100% bondholder approval in their New York contracts while including qualified majority voting provisions in their English law contracts. What was discouraging was the lack of transparency in the case of many bond issues: with important creditor co-ordination provisions such as bondholder meeting provisions often buried in fiscal and paying agency agreements, to which an investor would have difficulty gaining access. One of the points that we took away was the need to rethink how bondholders are enfranchised: it suggested to us the merit of a broader use of written resolutions for voting purposes, rather than the use of bondholder meetings. I will return to this subject later.

I believe that bondholders are increasingly aware that their interests are best served by collective action, even if that means accepting limits on their ability to act individually. It is helpful that there is no apparent difference in the trading performance of bonds under English law compared to those under New York or German law. In no case has a rating agency made a rating distinction between bonds issued under different governing laws. To the best of my knowledge no restructuring has favoured one group of bondholders over another due to differences in creditor protection within contracts.

There is a greater understanding that unbridled freedom of individual action for one creditor can negatively affect other creditors holding the same instrument. Qualified majority voting is also good for the debtor: it reduces both the incentives for any bondholder to seek an individual settlement and the ability of a rogue creditor to hold to ransom the prospect of a reasonable debt settlement. The key issue is how we can institutionalise the principle of collective action to make creditor co-ordination more efficient and more effective. The challenge in our market and perhaps to a lesser degree in the United States, is how to bring bondholders to the negotiating table. It is particularly difficult to identify and mobilise holders of bearer bonds, which are still a feature of our market. Where bondholders need to be lobbied, it has to be done through the international clearing systems, Euroclear and Clearstream, and through advertisements in the financial press. The international clearing systems will not disclose to an issuer or its advisers the identity of those who have positions in the bonds. Notices or requests for proxies are given to the clearing systems which pass them on to their participants. These participants are typically custodians, who in turn are expected to pass all communications on to the beneficial owners. But the issuer or its advisers have no way to know whether that has actually happened. Should the beneficial owner wish to vote its bonds, the chain operates in reverse. If an issuer is in default, the clearing systems will seek to have defaulted bonds withdrawn from their system to be held by the beneficial owner directly.

In practice there are few recent cases where a sovereign debtor has attempted to achieve a restructuring through the amendment of existing bond or loan terms. The exchange offer has been more usual. Exchange offers have been used in a variety of countries including Ecuador, Ukraine, Pakistan and Uruguay. Exchange offers will be the basis of the Argentine restructuring. New bonds, providing the borrower with a measure of debt relief, are offered in exchange for the outstanding bonds. Recently most exchange offers have used the so-called exit consent mechanism, under which the exit consent mechanism, a creditor accepting new bonds under the exchange offer also votes to amend the terms of the old bonds in a manner that disadvantages any residual holder of the old bonds. As a result bondholders are strongly motivated to accept an exchange offer in order to avoid being left holding existing bonds which have been tainted by amendments to their terms instigated by the exiting holders. The use of exchange offers is a pragmatic response to the difficulty of getting bondholders to a meeting to vote to amend their bonds. But exchange offers have their disadvantages. Inevitably with an exchange some of the original bondholders, either because they are hostile to the idea or merely passive, will not tender their bonds. The part of the original bond issue that remains outstanding can fall into the hands of rogue creditors, who may then become a thorn in the side of the debtor. Far better that the original bond should be amended so as to bind all creditors.

The exchange offers for Ukraine and Ecuador certainly attracted high levels of bondholder support, well over 95 percent. The high response level was due to a combination of factors – including the energetic efforts of the banks executing the exchange offers and the effectiveness of the exit consent mechanism – but equally important was the flexibility that allowed the bondholders to vote their bonds through written proxies and even through the internet. There is no reason why the same techniques should not be used to encourage bondholders to vote when asked to approve amendments to bond contracts.

The United Mexican States pioneered the use of Collective Action Clauses in a global bond governed by New York law. The Mexico bond is a good example of how CACs can be structured to balance the interests of both issuer and bondholder. The majority action level at 75% was lower than some investors might have liked, but Mexico gave something back to investors by broadening the range of reserve matters where any amendments would require approval, thereby making the use of exit consents more difficult.

In the debate on CACs, most attention has been paid to the majority action clause. It is now accepted that a supermajority rather than unanimity should be required for amending core provisions, such as modifying scheduled principal or interest payment dates or amounts, the so-called reserved matters.

How should the supermajority be defined? It should reflect the market experience to date with hold-out creditors, those who may withhold their vote in the hope of getting a better deal, but it should also recognise that an apparent hold-out creditor may merely be a passive creditor, which may value its anonymity. Nor can we ignore the potential for sovereigns to influence the process by acquiring or controlling creditor positions. However, the majority is defined, the denominator should exclude debt held or controlled by the sovereign debtor.

Issuers are now proactive in deciding whether or not to include any CACs in their bond documentation. Debt issuance programmes give them a particular opportunity to standardise their bond documentation. The market would welcome standardisation; it is important that these clauses be as uniform as possible.

In the period during which bond issues are launched and sold, there is little time for investors to gauge the pros and cons of different provisions. Their main concern is whether a given bond represents good value relative to other investment opportunities. The least desirable outcome would be for a particular issuer's CACs to become a source of competition: for example, if an underwriter marketed itself to an issuer as being able to launch an issue with a lower qualified majority level than its competitors, or if an issuer argued that a lower percentage of bondholders should be allowed to amend its bond terms because it had stronger credit than other issuers. What we need is for emerging-market and OECD issuers from a broad credit spectrum to follow Mexico's example. European Union issuers have stated their willingness to include CACs in their foreign currency bonds, as has Canada. I am not convinced that issuers should be given financial incentives by the official sector, including the IMF itself, to introduce them. If issuers need incentives to adopt these clauses, that sends a strong signal that they may be undertaking something that is not in their interest. From their side, investors would view a system of incentives as official interference in the workings of the market. Far better that CACs should be adopted because they represent a win-win situation for issuers and investors – for issuers because they will be less vulnerable to the risk of rogue investors, and for investors because workouts should be more predictable and less protracted.

IPMA believes that trustees could play an important role in improving creditor co-ordination. First, a bondholder trustee offers the best opportunity for effective creditor co-ordination. For a start, no bondholder can take unilateral action without involving the trustee. Litigation must be carried out by the trustee, and any recoveries through litigation are shared pro-rata among al the bondholders.

With a trustee, too, sharing becomes a practical reality. The concept of sharing is that if one creditor makes a recovery from the debtor, it should share it on a pro rata basis with the other creditors. Without a trustee at the centre of the process, it would be difficult to either induce a creditor that had made a disproportionate recovery to disgorge the excess or to determine which bondholders would be entitled to share.

The second benefit of a trustee is that it provides a useful channel for communication between issuer and bondholders, given that legally at least, neither the lead manager nor a fiscal and paying agent has any responsibility to communicate. Many US investors seem to have some antipathy to the use of trustees, apparently grounded in the belief that US trustees have been very passive. Trustees do stick closely to the text of the indenture in deciding what they are authorised to do. But trustees timidity need not be a fact of life. In the international market, we have seen trustees take unilateral action to put a debtor into default without consulting with bondholders because it believed that the circumstances justified such action.

The Gang of Six trade associations twinned the release of its model collective action clauses with a proposal for a Code of Conduct for both debtors and creditors. We proposed that the Code be developed as a joint initiative of the private and official sectors, with an important role for the G20. The Code concept recognised that there were some matters that could not be dealt with on a contractual basis. From IPMA's view point the manner in which a debtor engages with its creditors post-default is a major issue. A good example is the issue of creditor committees.

Why are creditor committees important and why should the Code provide for them? You will recall that the private sector's original model Collective Action Clauses included an engagement clause. The engagement clause anticipated that, post-default and subject to a positive bondholder vote, a representative bondholder committee would be formed with which the debtor would engage in good faith and whose reasonable expenses would be borne by the debtor. The idea of an engagement clause was supported by both the official sector and the private sector, because they would better define, as a procedural matter, the process of how issuers will engage with their creditors in resolving any crisis that may arise during the life of the bonds. The absence of engagement provisions unfortunately puts at risk the perceived benefits of CACs and their potential effectiveness because without effective engagement there is simply no mechanism to ensure that bondholder interests will be adequately protected. The engagement clause has proved unpopular with issuers, starting with Mexico. One reason may be a concern that a separate creditor committee would be established for each of its bond issuers (leaving aside the matter of loans), and that the issuer could be drawn into a plethora of bilateral negotiations and an unimaginable level of expenses. If that is the only objection, I believe that is something that we can fix in the Code.

I am certainly convinced that bondholders, discouraged by recent events, will expect the Code to include a framework for negotiation between the debtor and its creditors. Why do bondholders believe that creditor committees are so important post-default? For a start because in the absence of a trustee, no particular party is necessarily representing their interests or keeping them informed of developments. Investors that do not feel well informed and satisfied that a deal is fair between different classes of creditors will be tempted to shun or even vote against an exchange. Outright hostility, including litigation against the debtor, increases. A well functioning creditor committee can reduce that risk.

Last month the IMF produced a paper on the process for sovereign debt restructuring within the existing legal framework which also argued strongly for creditor committees:

“In circumstances in which creditors have organised a representative committee on a timely basis, the debtor’s interests would normally be well served by elaborating a restructuring proposal in close co-operation with this committee”. The private and official sectors are on the same page as far as the value of creditor committees are concerned.

Let me elaborate on why creditor committees are also of benefit to the debtor:

First, a debtor should wish to consult with its creditors on the design and process of a restructuring strategy. But it may wish to limit discussions to a narrow group due to confidentiality concerns. To quote the IMF again, “creditor committees have generally provided an effective vehicle to achieve confidential exchanges of information”.

Second, the existence of a creditor committee will assist the process of identifying bondholders. Once a creditor committee has been established bondholders will be motivated to make contact with it. This will give the debtor a clearer picture of its bondholders and could even help identify potential holdouts earlier in the restructuring process.

A legitimate borrower concern with including engagement clauses in a broad range of its bond contracts could be the risk of a proliferation of creditor committees bond issue by bond issue. There is no easy answer to this concern. And this is where it may be distinctly preferable for the creditor committee concept to be included in a Code rather than in individual bond contracts. For example, the borrower could limit its liability to pay professional expenses to the reasonable expenses of a single committee. This would encourage the consolidation of individual creditor committee initiatives at an early stage after a default has occurred.

After a default consultation should be replaced by negotiation and a creditor committee should be an integral part of that process. We could use the framework of a Code of Conduct to set out precise rules as to how the creditor committee should operate, perhaps looking at best practice in the corporate sector.

Both issuers and investors can benefit from bringing sovereign debt crises to a quick resolution. Bondholders typically are not a homogeneous group; as a crisis develops, they tend to become even less homogeneous. The introduction of CACs into loan and bond contracts is an essential step forward. Protracted restructurings are not in the interest of either investors or issuers. From the creditors’ viewpoint, the evidence is that the longer a bond is in default, the lower the recovery rate. From the borrowers’ viewpoint, unresolved debt claims can help deny them further access to capital markets. CACs can help expedite the restructuring process.

We may take some comfort from knowing that sovereign debt restucturings were even more difficult in the past. Some nineteenth century reschedulings dragged on for sixty years. In the 1920s and 1930s Thomas Lamont of J P Morgan negotiated with the Mexican Government on behalf of the International Committee of Bankers, which acted at that time for no less than 200,000 foreign bondholders. In the 1930 rescheduling, all accrued but unpaid interest was fully forgiven and the principal was rescheduled into a forty-five year sinking-fund bond. Lamont had some battles with the official sector over the importance of protecting bondholder interests; ironically, perhaps, his main opponent was the US Government in the form of Secretary of State Dwight Morrow. It is gratifying that the level of cooperation between the official and private sector has moved to a different plane since those distant days, not least in the consensus in favour of Collective Action Clauses.