INTERNATIONAL MONETARY FUND

Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use

Prepared by the Policy Development and Review, International Capital Markets
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(In Consultation with other Departments)

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I. INTRODUCTION

1. **There is a general consensus that the current process for restructuring sovereign debts needs to be improved**. The Board is considering two approaches to improving the legal framework for sovereign debt restructuring: the creation of a new statutory regime and the use of collective action clauses and new contractual provisions to facilitate restructurings. These two approaches are complementary. The development of a new statutory regime will take time. In the interim, the use of contractual provisions could facilitate collective action by creditors during the restructuring process and thereby reduce the risk that holdout creditors pose to the sovereign bond restructuring process. The design and effectiveness of contractual provisions is discussed in a companion paper "The Design and Effectiveness of Collective Action Clauses" (to be issued). This paper focuses on possible ways to promote the broader use of such provisions in international sovereign bonds.

2. **The paper is organized as follows.** Section II discusses current market practice for international sovereign bond documentation. Section III discusses the incentives that the Fund could provide to promote the use of collective action clauses. Section IV discusses the steps the private sector and others in the official community could take to supplement the Fund's efforts in promoting the use of these clauses. Finally, Section V suggests issues for discussion.

II. CURRENT MARKET PRACTICE

A. The Outstanding Stock and Issuance since 1995

3. **Market practice for international sovereign bond documentation is not uniform.** Bonds governed by English and Japanese law typically contain majority restructuring provisions which enable a qualified majority of bondholders to modify key financial terms, and to make that decision binding on all holders of a given bond issue. Majority restructuring provisions are not included in bonds that are issued in Germany and governed by German law, nor are they generally found in bonds governed by New York law. Majority enforcement provisions enable a qualified majority of bondholders to limit the ability of a minority to enforce their claims following a default, providing the debtor and the qualified majority more time to seek a cooperative solution. They are commonly found in bonds governed by New York and English law. In addition, some bonds governed by English law are issued under trust deeds where the right to initiate legal proceedings on behalf of all bondholders is conferred upon the trustee. These provisions, along with proposals for additional provisions to facilitate sovereign debt restructuring, are discussed in depth in the companion paper. In this paper, the term collective action clauses will be used to refer to clauses that include both majority restructuring and majority enforcement provisions. This paper also uses the definition for the term "international sovereign bond" set forth in the companion paper. Accordingly, an "international bond" is a bond governed by a foreign law and subject to the jurisdiction of a foreign court.

4. **Majority restructuring provisions were introduced into corporate bonds governed by English law in the nineteenth century when it became apparent that a minority of bondholders could take action that reduced the value of the bonds held by the majority.** English law traditionally has lacked a bankruptcy process comparable to Chapter 11 in the United States, which allows a firm in bankruptcy to reorganize its debts to avoid liquidation. While many debts were reorganized outside of the courts to avoid liquidation, unanimity provisions allowed an uncooperative minority to force the debtor to liquidate even when the majority preferred a debt reorganization. To reduce such a minority's leverage, holders of bonds governed by English law demanded the introduction of provisions allowing a qualified majority to amend key financial terms and to bind a minority to accept these new terms. Such amendment provisions became the market standard in England, and were adopted in sovereign bond issues.[1]

5. **Collective action provisions can also help to facilitate a sovereign restructuring**, for the following reasons:

- The ability to amend key financial terms by the vote of a qualified majority limits the ability of a minority to hold out from a restructuring agreement, and then litigate for full payment.

- The risk of holdouts creates a potential collective action problem. A majority may be unwilling to accept an agreement if they believe that the minority who holds out will be treated better than the cooperative majority. Even if the risk of holdouts does not inhibit reaching a deal, holdouts can also seek to litigate to stop payments on the new bond that emerges from the restructuring. This complicates the sovereign debtors' ability to quickly normalize its relationship with its creditors.

- The ability to bind an agreement on a minority can have a significant financial impact. Even a small number of holdouts can have significant cash flow consequences if the debtor must pay the full face value of the bond to avoid litigation. To date, sovereigns have often been able to minimize the cash costs of settling with holdouts. Ecuador, for example, reversed the acceleration of its long-term bonds and was able to cure the default and eliminate the risk of litigation by paying interest arrears on its old bonds. However, it may be more costly to avoid litigation in future restructurings.

- These provisions can be used to restructure a bond before as well as after a default.

6. **The official sector has, since 1996, encouraged the use of collective action clauses in international sovereign bond issues**. The G-10 Deputies endorsed collective action

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[1] Lee Buchheit and G. Mitu Gulati, "Sovereign Bonds and the Collective Will", Working Paper No. 34, Georgetown University Law Center (March 2002)

clauses in their 1996 report on Sovereign Liquidity Crises, and a broader group of countries endorsed collective action clauses in the 1998 report of the G-22 on International Financial Crises. Communiqués of the IMFC and the G-7 have consistently endorsed their use by emerging market economies, and called on the World Bank and other development banks to consider the use of clauses in bonds that they back with partial guarantees.

7. **There is little evidence to suggest that official calls for the broader use of collective action clauses have had an impact on market practice**. Provisions to facilitate collective action have continued to be used where they are already the market standard, and have not been adopted for use in bonds issued in other jurisdictions. Countries seeking to tap investors who typically purchase bonds governed by English, New York, German or Japanese law generally either follow the market norm in that jurisdiction or make use of the governing law that the country traditionally has used in its international bonds.

8. **The data confirm that the vast majority of international sovereign bonds that are currently outstanding do not contain collective action clauses (Table 1)**.[2] Roughly 69 percent of the $354 billion in outstanding bonds was issued under U.S. or German law, while only 30 percent was issued under English or Japanese law or in other jurisdictions. Because there is a strong correlation between governing law and the use of collective action clauses—particularly majority restructuring clauses—in international sovereign bonds, data on governing laws can be used as a proxy for the use of collective action clauses in sovereign bonds. An important part of the total stock (21 percent) consists of Brady bonds which typically are governed by New York law and do not include majority restructuring provisions.[3]

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[2] Data from the Bondware database; Brady bond data from JP Morgan.

[3] The end-2001 stock data was compiled using Bondware (flow) data on sovereign debt issuance since 1985 and eliminating pre-2001 maturities and post-2001 issuance. JP Morgan data on Brady bond stocks and amortization was used to augment this data. A few bonds were issued under the governing law of multiple jurisdictions. These have been categorized according to the first jurisdiction listed. However, given that this involves only a handful of bonds this is not material to the results. For Argentina data from JP Morgan's EMBI global was used to replace the dollar denominated portion of the Bondware data, in order to adjust for the June 2001 megaswap. The results were cross-checked with the annual Merrill Lynch publication "The Size and Structure of the World Bond Market" (see table 2). The data are roughly comparable after taking into account that the Bondware data excludes certain Brady-Eurobond swaps (roughly $45 bn) and issuance by quasi-sovereigns such as the Korean Development Bank (would add $12 bn to the stock). The Bondware data is somewhat more comprehensive in its coverage of emerging market countries.

Table 1: Stock of Outstanding Bonds by Jurisdiction
(End-2001)

Jurisdiction	Amount in percent of total	Amount in millions of U.S. dollars	Number of bonds (excluding Bradies for US) 1/
Austria	0.02	67	1
UK	24.05	85,182	156
France	0.30	1,060	4
Germany	10.13	35,864	89
Italy	0.03	105	1
Japan	5.85	20,716	59
Luxembourg	0.22	763	4
US	59.07	209,199	233
of which Bradies		73,837	
Spain	0.04	138	1
Switzerland	0.29	1,034	10
Total 2/	100.00	**354,129**	**558**

Stock of Outstanding Bonds by Currency
(End-2001)

Currency	Amount in millions of US$	Amount in percent of total	Number of bonds (excluding Bradies for U.S. dollar) 1/
Argentine peso	1,000	0.28	2
Canadian dollar	361	0.10	1
Chilean peso	285	0.08	2
Dutch guilder	450	0.13	2
Deutsche mark	21,123	5.95	51
Euro	53,567	15.08	142
French franc	708	0.20	3
Italian lira	5,683	1.60	17
Lithuanian litas	25	0.01	1
Spanish peseta	138	0.04	1
Austrian schilling	317	0.09	3
Swiss franc	1,034	0.29	10
UK Sterling	2,194	0.62	12
US dollar	245,120	69.00	242
Japanese yen	23,225	6.54	71
Total 2/	**355,229**	100.00	**560**

Source: Bondware Database and Fund Estimates

1/ Data include the aggregate amount of Bradies, but not the number of separate bonds.
2/ Data on jurisdiction were not available for two bonds accounting for the differences in the totals.

9. **Nonetheless, bonds with collective action clauses constitute an important part of the bonds in major indexes.** Sovereign bonds governed by English law constitute roughly 17 percent of the face value of the bonds in the EMBI global index, and a slightly higher fraction of the sovereign bonds in the index (the EMBI includes some quasi-sovereign issuers such as Mexico's Pemex and Malaysia's Petronas). This is largely because Russia makes use of English law in its dollar-denominated international sovereign bonds. Sovereign bonds governed by English law make up a higher share—roughly 50 percent—of various indexes that have been developed for Euro-denominated bonds.

10. **Seventy percent of the international sovereign bonds in the current stock were issued after 1995.** If collective action clauses had been adopted as a market standard following the publication of the G-10 in 1996, a substantial share of the existing debt stock would already contain collective action clauses (Charts 1 and 2). The G-10 report did not change the pattern of issuance, and the majority of bonds issued after 1996 was issued without collective action provisions.

11. **If collective action clauses were introduced into all new issues, it would probably take roughly a decade before the bulk of the international sovereign bond stock would contain these provisions.** Barring voluntary debt exchanges to replace the existing stock of international sovereign bonds that do not contain collective action clauses, the speed with which non-collective action clauses bonds will be replaced is a function of their maturity profile and assumptions about the growth in net new issuance of bonds. About half of all outstanding bonds have a residual maturity of less than five years, but there is also a long tail of long maturity bonds (Chart 3).[4] Rough projections indicate that the share of bonds with collective action clauses would increase quite rapidly initially if collective action clauses were used in all new bond issues, but that the pace of progress would slow over time and it would take some time before all bonds contained these provisions. Assuming that all bond issuance from now on will include collective action clauses and that net new bond issuance grows at a rate of roughly 3 percent per annum, approximately 80 percent of the bond stock would contain collective action clauses by 2010 and approximately 90 percent by 2019 (Chart 4). In practice, the stock is likely to turn over slightly more rapidly than this since voluntary debt swaps, such as Brady bonds exchanged for Eurobonds, and distressed bond exchanges could accelerate the rate. For countries having debt with a short average maturity, the stock will also turn over more rapidly. Nonetheless, the existing stock of bonds without collective action clauses is likely to constrain the extent to which such clauses can address many of the collective action problems that arise in sovereign debt crises for years to come.

[4] There are two bonds with a remaining maturity of 94 and 95 years respectively.

Chart 1: Stock of Outstanding Bonds by Jurisdiction (end-2001)

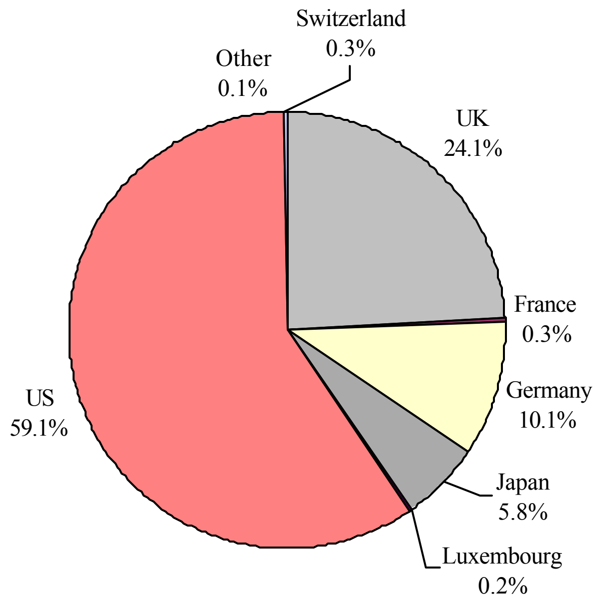
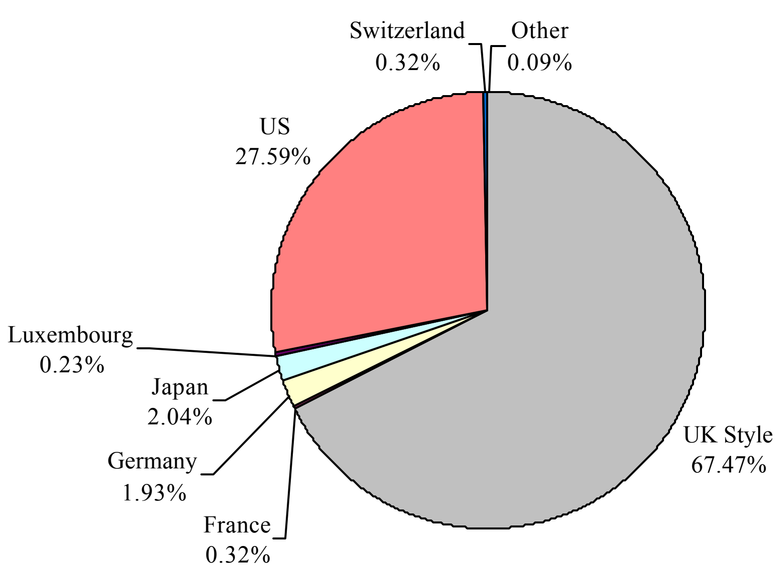


Chart 2: Stock of Bonds if all Bonds Issued in Major Jurisdictions had Included CAC's Post May 1996 (Publication Date G10 Report)



Source: Bondware Data, JP Morgan and Fund Staff Estimates.

Chart 3: How Long Does it Take for the Entire Stock of Outstanding Bonds to Roll Over? (Including Bradies)

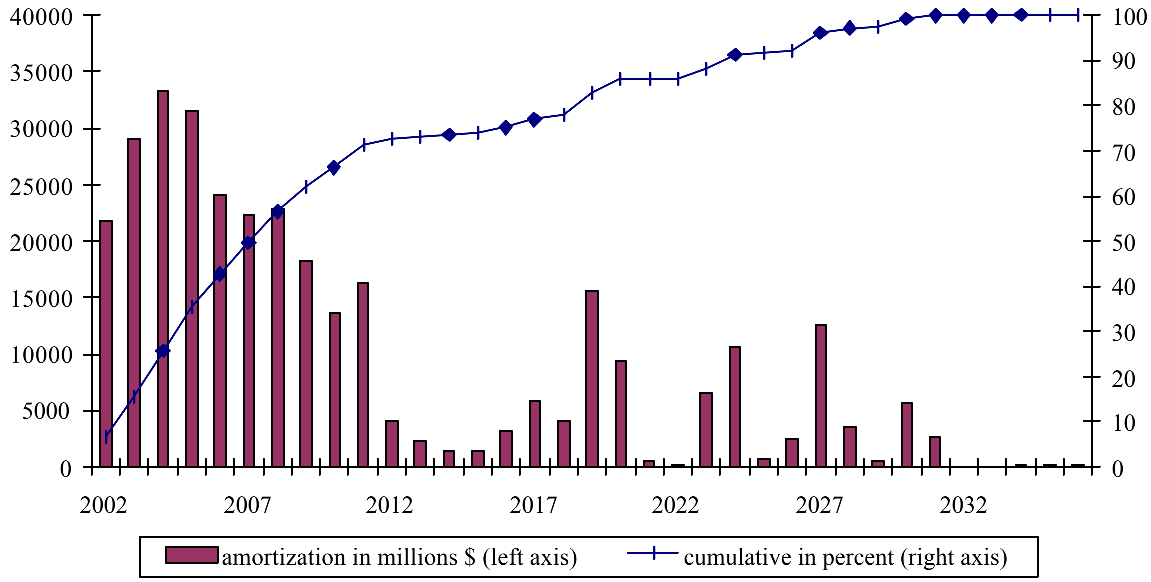
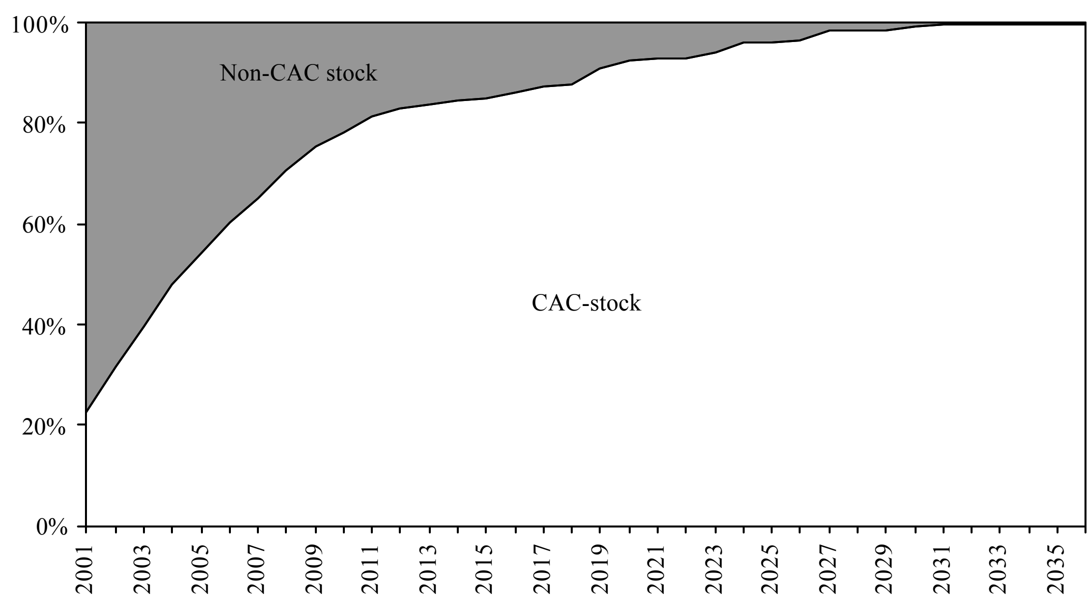


Chart 4: Projected Growth of Collective Action Clauses in Bond Stocks if All Future Issuance Included CAC's. 1/



Source: Bondware Data, JP Morgan and Fund Staff Estimates.
1/ Assuming 3 Percent Annual Growth in Net Bond Issuance.

12. **More than half of all sovereign international bonds between 1995-2002 were issued by members while a Fund arrangement was in place.** Between January 1995 and April 2002, 635 international bonds were issued by 48 sovereigns for an amount of $286.2 billion.[5] Fifty-two percent of these bonds (by amount) were issued under New York law, 25 percent under English law, 14 percent under German law and 7 percent under Japanese law (the residual of roughly 2 percent relates to a few other infrequently used jurisdictions). During this period, 27 countries with Fund arrangements issued a total of 336 bonds in the amount of $167.5 billion.[6]

13. **Out of the total of 336 international bonds issued during Fund arrangements, 215 bonds (in the amount of $117.3 billion)** did not include collective action clauses. Put differently, if all members with Fund arrangements had issued their debt with collective action clauses, this would have had an impact on the contractual terms used in 41 percent of total issuance during this time period. The largest issuers of bonds (by number) under Fund arrangements were: Argentina (128), Turkey (31), Mexico (27), Brazil (24), Philippines (24), Colombia (18) and Uruguay (16). Almost all countries issued in multiple jurisdictions during Fund arrangements.

B. Reasons for Resistance to Change

14. **The variation in the use of collective action clauses in outstanding international sovereign bonds is largely, but not exclusively, due to market practice rather than the requirements of national laws.** There is no legal or regulatory reason why international sovereign bonds governed by New York law could not make use of the contractual provisions common in bonds governed by the laws of England and Japan. International sovereign bonds governed by German law have not included collective action clauses. This issue is covered in more depth in the companion paper.

15. **Why have efforts to promote collective action clauses achieved limited results in jurisdictions such as the U.S. where such provisions are not the market standard, given the advantages of their use?** Among the possible reasons, two seem most compelling: concerns about short-run costs associated with the introduction of any change in documentation (inertia); and concerns that issuers might face a permanent increase in

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[5] Note that the sample is restricted to the central government only. The sample is thus smaller than that used in some other studies on CAC's (e.g. Eichengreen and Mody,"Would Collective Action Clauses Raise Borrowing Costs: An Update and Additional Results", Policy Research Working Paper no. 2363, World Bank, May, 2000) and may show a somewhat different distribution of bond issuance jurisdictions.

[6] A Fund arrangement was considered to be in place until the arrangement formally expired or was terminated. These data therefore include issuances by members with Fund arrangements that were off-track or precautionary.

borrowing costs if they were to introduce such provisions in their New York and German law bonds.

Short run costs and inertia

16. Resistance to change from established market practice on the part of issuers and sell-side and buy-side investors appear to have been a key impediment to the use of clauses in the U.S. market.

- **There is a general perception that the costs of change are likely to be borne most heavily by the first issuers to include collective action clauses in their New York and German law bonds.** The first issuer would have to market the merits of the new contractual provisions as well as its credit. It might take time for the market to fully accept the new provisions, and the first issuer might be charged a higher spread. There also might be a higher financial cost associated with drafting and marketing new provisions. This creates a “first mover" problem: all issuers would rather have another issuer bear the costs associated with innovation.

- **There is a potential signaling problem.** Introducing provisions in jurisdictions where they are not already the norm could be interpreted as a signal that the issuer envisions circumstances when it might need to seek a restructuring.[7] However, where the use of clauses is already the market standard, the use of clauses by any one issuer does not seem to signal future credit difficulties.

- **Sovereign debtors generally do not alter the standard documentation used in a given jurisdiction.** A sovereign bond’s documentation typically is not negotiated on a case-by-case basis. Rather, most issuers and their investment banks tend to make use of the existing, standard documentation. Off-the-shelf language costs less, is clearly acceptable to market participants and minimizes any execution risk. Investors prefer to trade on the basis of the sovereign’s underlying credit quality, not on the basis of specific legal provisions in the documentation.

- **First mover costs are compounded by the long time horizon required to obtain the full benefit of the introduction of collective action clauses.** The costs to issuers of changing the market standard are likely to be front loaded, and will be felt

[7] In a very small number of cases, sovereign borrowers may have deliberately deleted the conventional restructuring provisions—including provisions allowing the amendment of non-financial terms that are typical in bonds governed by New York law—to send a clear signal of their commitment to meet their payment obligations. However, in most cases, countries have not changed their issuance pattern even as their financial situation has deteriorated. For example, Russia typically used English law for its dollar denominated Eurobonds, and it used English law in the bonds offered in its June 1998 GKO for Eurobond swap.

immediately. The benefits of such a change, however, are likely to be realized only slowly. The presence of clauses in even a limited number of bonds can help to facilitate a multi-instrument restructuring, but the full potential benefits only accrue if clauses are included in all international debt instruments.

17. **If inertia and short run costs are the major hindrance, then once the market accepts the new standard, there may not be systematically higher borrowing costs for countries that make use of collective action clauses, even in jurisdictions like New York.** Strong incentives might be needed to overcome the first mover problem. But if the use of collective action clauses emerged as a market standard, there should be market incentives for subsequent issuers to continue to make use of such clauses.

Permanent costs

18. **The second possible reason for reluctance by issuers to include collective action clauses in all sovereign bonds is the fear of a permanent increase in borrowing costs.** It is possible that U.S. and other investors who generally now purchase bonds without collective action clauses in the new issuance market may have a strong intrinsic preference for such bonds. Investors may therefore demand a premium to hold sovereign bonds with collective action provisions, particularly if there are not strong provisions protecting against potential abuses. If this is indeed the case, market pressure will tend to pull debtors away from the use of clauses. Debtors would have to determine whether the benefits they would receive in the long run by including collective action clauses in their bonds outweigh the costs.

19. **Groups representing dedicated emerging market portfolio managers in the United States, along with other private sector groups representing a broad spectrum of the "buy" and "sell" sides of the market, have expressed willingness to consider the adoption of majority restructuring provisions in bonds governed by New York law.** However, they have also requested substantially higher voting threshholds than typically in the majority restructuring provisions now found in bonds governed by English law, and other contractual changes that would make it more difficult to amend non-financial terms to encourage participation in a restructuring (so called exit consents). Informal contacts with dedicated emerging market portfolio managers in the United States highlight the likely resistance to a comprehensive exchange to retire bonds that lack collective action clauses in return for new bonds with clauses.

20. **Dedicated portfolio managers have raised two concerns associated with the broader use of the majority restructuring provisions now found in bonds governed by English law.** First, investors doubt that the inclusion of collective action clauses in some, but not all, debt instruments will significantly reduce the difficulty of reaching agreement on a comprehensive debt restructuring. Second, investors believe collective action clauses need to be carefully designed to protect "creditor rights" and to limit the potential for abuse. = Specifically, domestic investors may hold a large portion of the principal of a specific issue with collective action provisions, either as a result of secondary market trading or heavy

domestic participation in the primary market. Such investors, while not under the legal control of the debtor, may nevertheless be subject to moral suasion. This creates a risk that debtors may be able to engineer support for a restructuring which is not supported by a majority of non-resident investors. Some investors believe that the voting threshholds in the majority restructuring provisions now found in bonds governed by English law fail to provide sufficient protection against the risk that the sovereign would gain de facto control of the majority of a bond, and that this risk outweighs the potential benefits associated with a greater capacity to resolve collective action problems.

Available evidence

21. **Existing evidence does not suggest that the use of collective action clauses would systematically raise borrowing costs.** A comparison of the price of two liquid bonds issued in the same jurisdiction with identical financial terms but with different restructuring provisions would offer the best test of the impact of clauses on pricing. Such a comparison is impossible; issuers do not typically issue bonds in the same jurisdiction with clauses that contain different restructuring provisions. A number of studies have attempted to compare the effect of issuing in a particular jurisdiction—a close proxy for the use of collective action clauses. All seek to control for a host of characteristics of the bond (liquidity, currency, etc.) and of issuer, including variables that affect credit quality, in order to try to isolate the impact of jurisdiction on pricing. This is difficult: the average size of new issues governed by English law is smaller than that of new issues governed by New York law; and low credit quality and high credit quality borrowers are more likely to issue bonds with collective action clauses than borrowers in the middle of the credit spectrum. One study (Eichengreen and Mody[8]) suggests that high quality issuers who used English-style documentation paid lower spreads, while lower quality borrowers paid a premium. However, most such studies have found little evidence that issuers who issue bonds governed by English law systematically pay a premium relative to issuers who issue bonds governed by New York law, and some even found a small discount for the use of English law.[9] These studies also indicate that the

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[8] Eichengreen and Mody, "Bail-ins, Bailouts and Borrowing Costs," IMF Staff Papers, Volume 47, pp. 155-188 (2001). See also Eichengreen and Mody, "Would Collective Action Clauses Raise Borrowing Costs: An Update and Additional Results", Policy Research Working Paper No. 2363, World Bank, May 2000.

[9] See Petas and Rahman, "Sovereign Bonds – Legal Aspects that affect Default and Recovery", *Global Emerging Markets – Debt Strategy*, Deutsche Bank (May 1999), Tsatsanoris K., "The Effect of Collective Action Clauses on Sovereign Bond Yields", in Bank for International Settlements, *International Banking and Financial Market Developments*, Third Quarter, pp.22-23 (1999), Dixon and Wall, "Collective Action Problems and Collective Action Clauses, Bank of England Financial Stability Review (June 2000), and Becker, Richards and Thaicharoen, "Bond Restructuring and Moral Hazard: Are Collective Action Clauses Costly?", IMF Working Paper WP/01/92 (July 2001).

findings are highly sensitive to the econometric technique used, the type of corrections to data quality problems and whether or not one corrects for the possibility of endogeneity.

22. **The absence of clear econometric evidence of any impact on borrowing costs is consistent with other evidence that the market accepts sovereign bonds governed by English law.** [10] Many institutional investors, including U.S. based institutional investors, already hold Russia's U.S. dollar denominated bonds, which are governed by English law. These bonds make up a substantial share of the EMBI Global index. [11] Staff did not find examples in sell-side research of investment banks that refer to collective action clauses in explaining why yields on particular bonds deviate from fair-value yield curves. The rating agencies have not cited the governing law of a bond issue as a risk factor affecting bond ratings. A majority of emerging market sovereigns have already issued bonds in jurisdictions where collective action clauses are the market norm. Some sovereigns use the same governing law for all their external issuance, while others make use of different governing laws for bonds issued in different currencies. A number of issuers routinely use New York law for the dollar-denominated international sovereign bonds and English law for their Euro-denominated international sovereign bonds. This suggests that there is not a systematic pricing advantage associated with the use of a given governing law across all market segments. Issuers, for example, do not appear to believe that New York offers a price advantage for Euro-denominated issues. However, none of this evidence is conclusive. The ultimate impact of the broader use of collective action clauses on borrowing costs cannot be determined with certainty on the basis of the available evidence.

23. **Official exhortation alone has not been sufficient to overcome existing impediments to changing the documentation to include collective action clauses for new bond issuance.** Previous calls by the official community for the broader use of such provisions have had limited effect. The use of collective action clauses in the foreign-currency denominated bonds issued by some industrial economies—notably Canada and the U.K.—has been insufficient to convince emerging market economies to alter the documentation they use in their New York law and German law governed bond issues. This has prompted interest in exploring the creation of stronger incentives for the use of contractual provisions that could contribute to an improved sovereign debt restructuring process.

[10] This evidence is only germane to the use of clauses typical in English law bonds; the market acceptability of more innovative provisions is discussed in the companion paper.

[11] Ukraine and Pakistan's dollar-denominated international sovereign bonds are also in the EMBI global index and are governed by English law. The index also includes one dollar denominated international bond issued by the Philippines' Central Bank that is governed by English law.

III. Considerations in Promoting the Broader Use of Clauses

24. **Any attempt to promote the broader use of collective action clauses would have to address a series of important questions.**

- First, what types of clauses should the Fund actively promote? Would the clauses be limited to majority restructuring and majority enforcement provisions that are found in existing bonds or would the adoption of new types of clauses be promoted? What voting threshold would be required for a majority restructuring provision? Would a 95 percent voting threshold be sufficient?[12]

- Second, would the focus be on new debt issued after a defined date, or would it there be an effort to change the contractual terms in the *existing* debt stock?

- Third, would the clauses need to be used in international bonds only or would they also need to be included in other types of debt, including syndicated loans and debt governed by local law (whether denominated in foreign or local currency)?

25. **The companion paper discusses in depth the type of clauses that the Fund might actively promote.** It concludes that the most critical components of existing collective action clauses are:

- **Majority restructuring provisions**, which enable a qualified majority to bind all bondholders within the same issuance to the financial terms of a restructuring both before and after a default, and

- **Majority enforcement provisions**, which enable: (a) a qualified majority of bondholders to limit the ability of minority of bondholders to accelerate their claims after a default and (b) a simple or qualified majority to reverse an acceleration that has already occurred. An even more effective type of enforcement provision is one found in trust deeds governed by English law, where, in addition, the right to initiate legal proceedings on behalf of all bondholders is conferred upon the trustee, who is only required to act if requested to do so by the requisite percentage of bondholders. Moreover, the terms of the trust deed will ensure that the proceeds of litigation are distributed by the trustee among all bondholders

There may be scope for variation in the voting thresholds used in these provisions. However, requiring the support of 95 percent of bondholders, as suggested by some dedicated emerging market portfolio managers, may effectively defeat the purpose of the majority restructuring provision.

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[12] The Emerging Markets Creditors Associated recently suggested a 95 percent voting threshold in their model provisions for sovereign bonds.

26. ***Regarding the feasibility of developing new types of clauses***, the companion paper assesses these clauses in terms of both their contribution to the restructuring process and their acceptability in the market. Since a number of the design features of these clauses are still unclear and feedback from the market has been rather limited, it is too early to draw any firm conclusions regarding them. With that important caveat, preliminary analysis suggests that the most promising of these provisions is a ***representation clause*** (or "engagement" clause), which would authorize the trustee of a bondholder syndicate (or its delegate) to act as a channel of communication between a debtor and the bondholders as early as possible during the restructuring. While such a provision could play a helpful—but perhaps not a critical—role in the restructuring process, market reaction to date has been mixed. With respect to the ***initiation clause***, although there is still some uncertainty as to how such a provision would be designed, the market has not responded positively to this proposal. Finally, while it would be extremely helpful to introduce ***clauses that aggregate claims across instruments***, designing and implementing such a clause would be difficult and, to date, market reaction to this proposal has been negative.

27. **The choice of whether to seek the inclusion of clauses in new issues alone, or to cover the entire stock through an exchange that would replace existing bonds that lack collective action clauses has important implications for any policy designed to promote the use of clauses.** Requiring the inclusion of collective action clauses only in new issues limits the pace with which bonds with collective action clauses will diffuse through the entire stock of emerging market international sovereign bonds. The benefits to the specific member country also will be limited until bonds with collective action clauses constitute a significant share of the country's outstanding debt stock. While clauses have helped to facilitate restructurings in cases where not all bonds issues had clauses (Ukraine), obtaining the full impact of clauses requires that clauses be present in all bonds. Consequently, it may be difficult to demonstrate that requiring the use of clauses in new issues alone would make a significant impact on the member's ability to adopt policies to help resolve its balance of payments difficulties or meaningfully to safeguard Fund resources.

28. **Efforts to change the outstanding stock would have a greater impact.** Retiring all bonds that lack collective action clauses would immediately increase the member's capacity to restructure its debt should that prove necessary. Moreover, such an exchange offers an opportunity to consolidate a number of outstanding bond issues into a single new bond, and thus obtain a measure of aggregation. Such consolidation, however, may also result in a single large bullet payment or otherwise create a lumpier debt service profile that complicates the members' efforts to manage its debt prudently.

29. **Even exchanges conducted in favorable market conditions are likely to have a significant cost, as bondholders will need to have an incentive to trade in their old bonds for the new bonds.** Bondholders may also demand a premium to hold the new bonds with collective action clauses, as was discussed in the preceding section. The premium bondholders demand to participate in an exchange is likely to be particularly large if the member waits until it encounters distress to initiate such an exchange, as there is a higher risk that the effort to introduce collective action clauses will be interpreted as a signal of a greater

risk of future restructurings. Conditioning access to Fund resources on an exchange also gives bond holders additional leverage over a member-country. To the extent that they can coordinate and act collectively, bondholders would have the capacity to slow access to Fund resources to a member that has outstanding bonds that lack collective action clauses.

30. **As discussed in the companion paper, including collective action clauses in instruments other than bonds and in domestic debt raises a number of difficult issues that also relate to the design and scope of the Sovereign Debt Restructuring Mechanism (SDRM).** These issues will be discussed in depth in a future paper.

31. Clarity on these issues is more important in the discussion of policies that condition access to Fund resources on the inclusion of collective action clauses than in the discussion of the merits of a general effort to persuade issuers to broaden their use of collective action clauses.

IV. THE SCOPE FOR THE FUND TO PROMOTE THE USE OF CLAUSES

32. This section considers how the Fund could promote the use of clauses; the next chapter considers the actions that others could take.

A. Fund Surveillance

33. **The Fund could encourage more strongly the use of collective action clauses through its surveillance process.** The Fund already has a policy of encouraging its members to make use of collective action clauses.[13] There are a number of possible ways that the Fund could more actively encourage the use of collective action clauses in new issues. The Fund could also consider steps to encourage exchanges to retire existing debt and replace it with new debt that contains collective action clauses. Possible ways of strengthening the Fund's surveillance include:

- **More active surveillance of contractual provisions employed in new sovereign debt issues.** The provisions that a country has used in its recent bond issues could be a topic covered in Article IV consultations. Members could routinely provide the Fund with copies of the documentation they use in their international sovereign bond issuance to facilitate such surveillance. The Fund could also track the overall use of collective action provisions by emerging market issuers, and Fund staff could periodically report to the Board on the provisions used in international sovereign bonds issued by its members—CAC-tracking.

- **The Fund could also keep track of the total portion of the country's stock of sovereign external debt that contains collective action clauses.** Countries with

[13] Acting Managing Director's Report to the IMFC, (4/12/00); IMFC Communiqué, (4/29/01).

substantial stock of debt that lacked clauses could be encouraged to consider voluntary exchanges to retire existing bonds that do not contain collective action clauses.

- **Making the use of clauses known to the public.** The results of the Fund's multilateral "CAC-tracking" could be disclosed. A country's use of collective action clauses could also be reported in Article IV staff reports and referred to in Board summing ups.

- **IMF/ World Bank guidelines on public debt management could be amended to endorse explicitly the use of collective action clauses as best practice.**

34. **These efforts could be supported by concurrent efforts to encourage the development of a new market standard for the documentation of emerging market bonds, and to provide technical assistance to support the use of collective action clauses.** Fund staff could actively work with issuers and the major sell-side firms active in the sovereign debt market to encourage change in the market standard in key jurisdictions. Most sovereign bonds are brought to market by a relatively limited number of investment houses, and their documentation generally follows the existing market standard. Major sell-side firms, major buy-side investors, major issuers, and the official community could work together to develop a new documentation template, and the official sector could monitor the use of this new template.

35. **More active surveillance of the use of clauses is clearly desirable.** It is worth trying to help catalyze the development of a new market standard, and tracking of trends in bond issuance has the obvious advantage of increasing the Fund's understanding of the contractual provisions used in international debt issues and of the debt structure of its members. However, past experience suggests that such efforts are unlikely to be sufficient to induce a change in the behavior of major issuers.

B. Financial Incentives: Conditions for Access to Fund Financing

Conditions for access to Fund facilities

36. **This section discusses making the use of clauses a condition for access to Fund resources, and/or special facilities, such as the CCL, and providing augmented level access to countries seeking to retire existing bonds that lack collective action clauses in an exchange.** As noted previously, under any of these options it would be necessary to outline precisely what specific steps a member would need to do to in order to be able to draw on Fund resources. This would include specifying whether it would suffice to include collective action clauses in new issues or whether the member would need to conduct an exchange to retire existing bonds that lack collective action clauses.

37. **More generally, all of the options discussed below assume that there is a strong relationship between the introduction of collective action clauses and the objectives of the policies that govern the use of the Fund's resources.** This relationship will not always

be entirely obvious**.** In many cases no debt restructuring will be needed and the issuance of bonds without collective action clauses will not have any impact on the member's balance of payments adjustment. The failure to include collective action clauses in new issues or to pursue an exchange to retire bonds without collective action clauses may not, therefore, justify interrupting Fund support. Conversely, in the event that a member does have a balance of payments crisis that requires the restructuring of debt, the inclusion of collective action clauses does not necessarily mean that they will eventually be activated. Their ability to contribute to a prompt and orderly restructuring will be reduced in restructurings that require coordinating the actions of many different bond issues. As noted in the companion paper, the fact that collective action clauses only operate within a single issuance represents an important limitation of the contractual approach.

Requiring collective action clauses in new bonds issued during Fund arrangements

38. **The inclusion of collective action clauses in debt issued during a Fund program could be made a requirement for purchase of Fund resources**. All countries drawing on the Fund could be required to use clauses in new debt issued during the program. This could be justified on the grounds that the use of clauses in new debt would, in extremis, help to safeguard Fund resources. Over time, such a requirement would progressively increase the number of bonds outstanding that include collective action clauses. The use of such provisions by countries with Fund- supported programs might help to further acclimate the market to holding bonds with such provisions, and therefore pave the way for their broader acceptance.

39. There are several potential objections to such a requirement.

- **First, emerging market members tend to draw on Fund resources when they are experiencing difficulties accessing private financial markets on sustainable terms.** To the extent that the adoption of clauses reduces the quantity or increases the price of available private finance, it may complicate a member's difficulties with financial markets. This is particularly true if the member in question typically issues in markets where the adoption of collective action provisions is not already the market standard.

- **Second, there is a risk that making program countries adopt clauses will stigmatize the use of clauses**, and make countries that are not drawing on the Fund less willing to make use of such provisions. It is impossible to tell whether the use of clauses by program countries will break down resistance to change in markets where the use of such provisions is not already the norm, or solidify opposition to the voluntary use of clauses.

- **Third, such a requirement might reduce demand for Fund arrangements.** Countries would have to assess whether the advantages of a policy framework agreed with the Fund outweigh the difficulties associated with introducing new documentation into their sovereign bonds.

Requiring that all outstanding bonds have collective action clauses as a condition for disbursement

40. **A much broader requirement would be to condition any use of Fund resources on a swap of all outstanding debt into debt with collective action clauses.** Countries that already make use of collective action clauses in all their international bonds or that arranged a swap in advance would avoid the difficulty of trying to arrange a major debt exchange at the same time that they are seeking to negotiate an agreement with the Fund. But countries that had not already sought a swap could draw on the Fund only if they had changed the restructuring terms in their debt. A major swap would be a prior action for disbursement.

41. **As noted previously, one major difficulty is that the start of a Fund-supported program is a poor time to seek to alter the legal terms of the debt stock given the potential signaling problem.** Countries would likely have to pay a substantial premium just to change the legal terms. However, it is not obvious that the gains associated with inserting collective action clauses alone would justify the costs. On the other hand, if countries sought to alter both the maturity profile and legal terms in a major swap in a market-based operation, the financial costs would increase substantially. In either case, the cost of the exchange would worsen the prospects for debt sustainability.

42. **It may also be inherently difficult to obtain high rates of participation in an exchange to retire existing debt during the unfavorable market conditions likely to prompt a member to seek access to Fund resources.** Particularly in times of stress, investors may prefer to retain bonds that lack collective action clauses to maximize their individual leverage should there be a restructuring. There are offsetting factors that may encourage participation if the issuer can obtain the support of a critical mass of bondholders for the exchange. Holding debt that lacks collective action clauses does not obviously increase an investor's leverage in a restructuring negotiation. Similarly situated bonds with and without collective action clauses are likely to be offered similar terms. Moreover, investors value liquidity. If a large portion of a given bond is retired and a new bond with collective action clauses is issued, trading will migrate to the new bond. Nonetheless, it is possible that some investors may prefer to hold less liquid bonds that provide a stronger basis for litigation.

43. **Exit consents could be used to amend the non-financial terms of bonds governed by New York law in order to make holding out less attractive.** However, the aggressive use of exit consents might complicate the restoration of confidence and efforts to establish a sustainable debt profile. In addition, as discussed in an earlier paper, the use of exit consents

in Ecuador's recent debt restructuring has generated considerable unease within the creditor community.[14]

Eligibility for access to special facilities

44. **One alternative would be to make CCL approval contingent on the use of collective action clauses, either in all new bonds issued after a defined date or in all outstanding bonds.** This would require a simple majority of the Fund's Executive Board. The use of collective action clauses is at present a consideration for CCL eligibility, though not a requirement.[15] More broadly, the CCL is intended for those members that have adopted practices in debt and reserve management to limit their vulnerability to financial crises as they integrate into global financial markets. The use of collective action clauses—which would facilitate the cooperative and orderly resolution of a deep crisis in the event that an unanticipated deep shock left a country with no alternative but to seek a debt restructuring—is clearly one such practice. The obvious drawback of this option is that tightening eligibility requirements for a facility that has not been used may not prove to be a particularly powerful incentive. A review of the CCL will take place in the fall of 2002.

Eligibility for exceptional access

45. **A presumption could be introduced that exceptional levels of access to Fund resources would be provided only to those members that make use of collective action clauses**. The provision could apply to the CCL, the SRF or across facilities more broadly on the grounds that efforts to maintain a flexible debt stock that is resilient in the face of external shocks could help limit the need to resort to a more comprehensive and disruptive default and restructuring in a crisis. Such a presumption could, in theory, be justified by the need to safeguard Fund resources when access exceeds normal limits: the use of collective action clauses would facilitate crisis resolution and reduce the risk of its being prolonged. In the event of greater than anticipated difficulties, the use of collective action clauses could facilitate the restoration of a sustainable debt profile that enhanced the member's capacity to pay the Fund. Of course, the use of collective action clauses alone would not be sufficient to justify exceptional access. Such access would be provided only to those members facing exceptional financing needs whose debt was judged sustainable in the context of a strong program of policy adjustment.

46. **Such a policy might be difficult to implement consistently.** The incentive effect would hinge on the credibility of the commitment of the Fund to deny exceptional levels of support to a member solely because that member had failed to make use of collective action

[14] See Seminar on Involving Private Sector in the Resolution of Financial Crises—The Restructuring of International Sovereign Bonds—Further Considerations, EBS/02/15 (1/31/02).

[15] Summing Up by the Acting Chairman, Contingent Credit Lines, EBM/00/113, (11/17/00).

clauses. This could be a difficult commitment to justify and sustain, given the relative importance of many other factors in determining the capacity of a member to return to financial viability with a given mix of policy measures and financing.

Eligibility for lending into arrears

47. **The Fund's willingness to lend into arrears could be conditioned on a commitment to use of collective action clauses in the new debt issued in a comprehensive debt restructuring**. This avoids the difficulty of requiring a country that is not in default to seek a comprehensive change in the legal terms of its outstanding debt stock. Countries already in arrears will need to seek a restructuring to clear arrears and lay the basis for a return to sustainability in any case. This requirement risks making the use of clauses a mark of a previous default, and thus potentially stigmatizing their use. However, it also would increase the share of outstanding bonds with collective action clauses, and thereby contribute to making the use of collective action clauses the market standard. This would be analogous to the role the Brady plan played in the creation of the market for new sovereign bond issues. English law bonds already constitute roughly 17 percent of the face value of bonds in the EMBI Global, and future debt restructurings could well increase that share rapidly.

Higher levels of access to encourage the use of clauses

48. In order to avoid the perception that existing policy is being changed to penalize those countries that fail to make use of collective action clauses, consideration could be given to options that clearly provide additional access to those who make use of such provisions.

49. **One option would to be to increase access limits under existing facilities for members that make use of collective action clauses in their sovereign debt.** For example, a higher access norm under the CCL could be created for countries that have made use of collective action clauses. This could make it more attractive for countries with clauses to seek a CCL. Of course, access must be related to need. The use of clauses by itself would not necessarily create a larger potential balance of payments need. But the Fund could adopt a policy that would provide higher level of access to those members who included clauses in their international bonds when they experienced a need for access to Fund resources that justified Fund financing.

50. **The Fund could provide additional access to meet the additional balance of payments needs that arise in the context of a swap to retire existing debt that lacks collective action clauses.** Such additional financing might be provided in the form of a "set aside" that would be committed when the arrangement was approved and disbursed if and when the member undertook an exchange to retire existing debt that lacks collective action clauses. In all probability, this set aside would provide funds that would be passed on to existing holders of the debt, and thus used to provide an incentive for them to exchange their existing debt for new debt that includes collective action clauses. This would be in some ways analogous to the supplemental financing provided to support debt and debt-service

reduction.[16] In such cases the extra financing was linked to a clearly defined need—the need to finance the purchase of collateral to catalyze a deal that would lower external payments and thus pave the way for the restoration of sustainability. A swap to retire existing debt would also give rise to balance of payments need, given the likely costs of any exchange.

51. **To the extent that the "set asides" made available in the context of the debt swap are used to finance an up-front payment made by the debtor to bondholders to facilitate an exchange, this set-aside amount could be made available under existing policies or a special facility established to meet this special balance of payments need.** As discussed in more detail below, the amounts set aside for this special purpose could benefit from a lower charge and a longer repurchase period if made available under a special facility, but only if they were actually used to meet this special need. The lower charge and longer repurchase period could *not* be applied to resources that are used to finance other balance of payments needs of members that happen to use collective action clauses.

52. **Such an approach has the advantage of rewarding a member for seeking to retire bonds that do not include collective action clauses, but also raises a number of additional policy issues.** First, it links access to a single, specific policy—an effort to retire existing debt that lacks collective action clauses—rather than the overall strength of the program. Second, it may be difficult to justify the provision of Fund financing solely to encourage a swap to retire debt without collective action clauses and to replace it with debt that includes collective action clauses but carries identical financial terms. Previous efforts to support debt exchanges have been linked to efforts to improve the sustainability of the debt stock by changing its financial profile. Third, it will be complicated to determine the precise level of balance of payments need associated with a transaction to retire debt that lacks collective action clauses. Fourth, such a policy would not reward member countries that already include collective action clauses in a substantial fraction of their sovereign debt.

Changes of the financial terms of Fund facilities

A special rate of charge

53. **The inclusion of collective action clauses could not, in and of itself, provide a legal basis for the Fund to offer lower charges or longer repurchase periods.** However, to the extent that the inclusion of collective action clauses gives rise to a special balance of payments need, lower charges could be offered on those purchases that are made to meet this special need.

54. **Under the Articles, charges must be uniform for all members.** Pursuant to Article V, Section 8(d) of the Fund's Articles, the periodic charges that the Fund levies on members' use of its resources beyond the reserve tranche must be "uniform for all members."

[16] The DDSR policy was adopted in May, 1989, phased out in March, 2000.

The concept of uniformity set forth in Article V, Section 8(d) permits the Fund to adopt a different rate of charge for a special facility. It allows a special facility to be established to address "special balance of payments problems" under Article V, Section 3(a). For example, the Fund is permitted to levy a higher rate of charge on SRF purchases because the SRF facility is a special policy established to address a particular balance of payments problem within the meaning of Article V, Section 3(a). The higher rate applies uniformly to all purchases by members under the facility. ***It would not be possible to differentiate the rates levied on purchases made under the same facility since these purchases would be made available to address the same balance of payments problem***. The relevant criteria for determining whether a member is encountering a balance of payments problem that is "special" within the meaning of the Article V. Section 3(a) is the cause of the balance of payments problem. Thus, for example, the SRF was established to address balance of payments problems caused by a "sudden and disruptive loss in market confidence reflected in pressure on the capital account and the members' reserves."[17]

55. **The existence of collective action clauses would not normally, by themselves, give rise to a special balance of payments need.** The inclusion of a collective action clause may be relevant for purposes of determining whether a member is implementing policies that will enable it to address a general balance of payments problem, and thus may be relevant for the design of Fund conditionality. However, while these clauses may help a country *resolve* a balance of payment problem, they would not normally be the *cause* of these problems.

56. **One exception could be where a member is facing additional financing costs associated with an upfront cash payment as an inducement for investors to swap existing bonds for new bonds with collective action clauses.** The special need arising from this payment could conceivably provide a basis for the establishment of a special policy with lower charges. Such a special facility would only provide financing at a lower rate of charge for the special need arising from the cost of the debt exchange. It could not be applied to resources used to meet other balance of payments needs.

57. **It would also be possible to make the inclusion of collective action clauses an eligibility criterion for one of the existing special facilities**, such as the Contingent Credit Lines (CCL), and then lower the rate of charge on that facility. However, it would not be possible to have a "CCL-1" with higher charges and a "CCL- 2" with lower charges since both would be meeting the same balance of payments problem.

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[17] Similarly, the Extended Fund Facility—another special policy—was established to finance balance of payments problems that arise, inter alia, from "structural maladjustments in production and trade."

A special repurchase period

58. **Under Article V, Section 7(d), the Fund, by an eighty-five percent majority, may adopt special repurchase periods** for resources that are made available pursuant to special policies that have been established pursuant to Article V, Section 3(a); i.e., for special balance of payments needs. Accordingly, and consistent with the above analysis, a longer repurchase period could only be made available with respect to those purchases that are made available to meet the special need arising from the upfront costs associated with a debt exchange that was undertaken to include collective action clauses.[18]

59. **In any case, it is not obvious that the prospect of lower charges on future Fund financing or a special repurchase period would prompt major changes in patterns of issuance.** The magnitude of such incentives is unlikely to be sufficient to induce such changes.

C. Obligations of Membership

60. **The Fund's Articles could be amended to require that members of the Fund make use of collective action clauses, whether in new bonds or for their entire existing stock.** Members would be required to bear the financial costs, if any, associated with using clauses in their new debt or conducting a swap to change the legal terms of their outstanding debt.

61. **There are also important practical problems if the use of clauses were to be made a requirement for membership**. It is not clear how the Fund would react if a member issued debt without clauses (or issued a complicated financial instrument that was judged to be debt). The remedies for such a breach of obligation by any member would presumably be those now specified in Article XXVI Section 2, and range from a declaration of ineligibility to use the general resources of the Fund through suspension of voting rights to compelling withdrawal from membership.

V. The Scope Outside the Fund to Promote the Use of Clauses

Efforts by the Fund would be most effective if they were supported by intensified efforts by others to encourage a broad change in the standard documentation employed in markets where collective action clauses are not now the norm. There are a number of steps that actors other than the Fund could take that would be helpful.

[18] The only other basis for establishing a special repurchase period would be Article V, Section 4, which permits the Fund to establish conditions when enabling a member to make purchases that would result in the Fund's holdings of the member's currency exceeding 200 percent of quota. However, given its purposes—to safeguard the Fund's resources, this provision could only be used to shorten—not lengthen the repurchase period.

A. Persuasion

62. **Major issuing houses and institutional investors could lead by example.** Leading institutional investors and investment banks active in the emerging market debt could —in conjunction with representatives of major issuers—develop new model clauses and encourage major emerging market issuers to make use of such provisions in new issuance.[19]

63. **The G-10 and other industrial economies could also include collective action clauses in their sovereign debt.** Several members of the G-10 already make use of collective action clauses in their foreign currency denominated sovereign bond issuance without any apparent impact on market practice in New York and Germany. The consistent use of such provisions by industrial countries might alter the market standard for emerging markets issuing in New York, though the market reaction to date does not provide a strong basis for confidence. As bond markets are segmented, it is not clear that changing the documentation standard for industrial country bonds would translate into changes in the documentation used by more risky emerging market borrowers. However, wider use of such provisions by G-10 countries could help to establish that the use of such provisions are not a signal of poor credit quality, and thus could contribute to an overall environment that would make it easier to change market practice in jurisdictions and markets where such provisions are not now the norm.

64. **Similarly, investment grade emerging markets could use these collective action clauses in their bonds**. The introduction of such provisions in bonds issued by high quality emerging market issuers—those who have achieved an investment grade rating and are currently issuing at moderate spreads—would help to establish a new market norm in those jurisdictions that have not already embraced the use of collective action provisions. This would help to limit the risk that the use of clauses would be interpreted as a negative signal by the markets, and help to avoid stigmatizing their use. If a "cartel of major issuers" agreed to only issue bonds with collective action clauses, it could prompt the development of a new market standard.

65. **The advanced industrial countries could provide financial enhancements to promote the use of collective action clauses.** To encourage a swap to retire the outstanding debt stock without collective action clauses, the G-10 or other relatively wealthy countries could offer to help defray some of the costs of a new issue that sets the "market standard" for bonds with such clauses in certain jurisdictions or, more ambitiously, for a swap that reprofiles the restructuring provisions of existing bonds. To help overcome the first mover problem, for example, the international community could offer a one time 50 basis point subsidy to the first $5 billion of sovereign debt issued with collective action clauses in

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[19] The Emerging Markets Creditors Association recently proposed a number of model provisions for sovereign bonds. See a detailed discussion of these proposed provisions in the companion paper.

jurisdictions where clauses are not the norm (at a cost of $250 million).[20] Similar incentives could be imagined for an exchange to alter the legal terms of existing bond contracts. A small cash payment could be made to a country that exchanges existing emerging market sovereign bonds that lack majority amendment provisions for new bonds with identical financial terms and majority amendment provisions. In all likelihood, this cash payment would effectively flow to investors as an extra inducement to purchase the issue.

B. Regulatory Requirements

66. **U.S. securities registration requirements and European listing requirements might be changed.** In the U.S., institutional investors are the primary buyers of emerging market debt. Emerging market issuers typically market their bonds governed by New York law to U.S. investors either by filing registration statements with the Securities and Exchange Commission under the U.S. Securities Act of 1933 ("Securities Act") or by private placements under certain exemptions from registration requirements under the Securities Act (including Rule 144A).[21] Changing U.S. securities registration requirements and exemption rules could be part of a concerted effort to make the use of collective action clauses a market standard for emerging market bonds. Given the possibility that tighter registration requirements alone would reduce the number of SEC-registered bonds, and that tighter exemption requirements would reduce the investment of U.S. institutional investors in sovereign bonds, rather than increase the number of bonds with collective action clauses, such a policy would be most effective if comparable regulatory or listing requirements were introduced in other major financial centers. A concerted effort to make the use of clauses a requirement for access to the financial markets of all major financial centers would limit the risk that issuers would find other forms of regulatory arbitrage to avoid using collective action clauses in their future bond issuances.

67. **A concerted effort to change securities registration requirements, exemption rules and listing requirements in all G-10 countries and Luxembourg could potentially be effective and may merit further exploration, but the difficulties associated with such an approach should not be underestimated.** Regulators generally see their role as protecting investors from fraud, enforcing disclosure standards and assuring the integrity of markets, not as encouraging the use of contractual provisions that could facilitate restructurings. Consequently, changing registration and listing requirements so that it was necessary to use collective action clauses would require a change in regulatory and listing philosophy of most regulators and exchanges. For example, the SEC emphasizes that the

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[20] Because of the principal of uniformity of treatment, the Fund could not provide financing for an enhancement that was targeted only at "first movers."

[21] Rule 144A under the Securities Act provides a safe harbor against the registration requirements of the Act for secondary sales of unregistered securities to Qualified Institutional Buyers.

securities laws and rules aim at investor protection through disclosure requirements, not at the regulation of the provisions used in capital market instruments. Since making collective action clauses a requirement for either registration under the Securities Act or an exemption from such registration are not believed to be consistent with the SEC's current legislative mandate, legislation likely would be needed to make the use of collective action clauses a requirement for such registration and exemptions.

VI. CONCLUSION

68. **Contractual provisions to facilitate collective action by creditors during the restructuring process could contribute to the development of an improved process for restructuring sovereign debts.** They cannot replicate a statutory regime, but they could grant a supermajority of holders of a single debt instrument the capacity to bind in a minority. In conjunction with exchange offers, contractual provisions could be employed to facilitate a multi-instrument restructuring, though they offer no protection against a determined group of holdouts that gains operational control of a single instrument. Existing efforts to encourage the use of clauses have failed to alter market practice; provisions that require unanimity to amend key financial terms are the norm in several key markets. Issuers have been reluctant to deviate from the market standard.

69. **There is scope for intensifying the Fund's efforts to promote the broader use of contractual provisions.** As part of the Fund's intensified focus on debt dynamics, debt sustainability and its members' interaction with capital markets, there are clear merits in intensified surveillance that tracks the use of contractual provisions that facilitate collective action in international sovereign debt contracts. Article IV reports could examine the provisions used in the member's existing debt stock. The Fund's multilateral surveillance of capital markets could track trends in new issuance in various markets. These efforts could be supplemented by outreach efforts to participate in the development of new documentation norms in key jurisdictions, particularly New York. This would be most effective if matched by work outside the Fund to support a change in market practice. Eliminating any potential legal impediments to the use of collective action clauses in certain jurisdictions, leading by example, and regulation to make the use of clauses a listing or registration requirement in all major financial centers would be important, although members have been reluctant to take these steps to date.

70. **The Fund should expect that countries that need to seek a comprehensive debt-reducing restructuring will make use of contractual provisions that facilitate collective action in their restructured debt.** Comprehensive restructurings offer an opportunity to introduce such provisions into a country's entire debt stock. Consequently, the use of collective action clauses could be a condition for programs that are designed to support a comprehensive restructuring in the context of the Fund's lending into arrears policy. Making the use of clauses a condition for access under all Fund–supported programs or for exceptional access raises more difficult questions. Many countries seeking Fund support are trying to regain market access and rebuild confidence. Until the use of clauses is an established market standard, there is a risk that the required use of clauses could signal a risk

of future restructuring and thus be an impediment to market access. Introducing clauses into new issuance alone would fail to alter the contractual terms of the outstanding debt; this may limits the gains expected from such a requirement. Moreover, it would be hard to implement consistently a policy of denying access to Fund resources to members that fail to make use of clauses.

71. **In general, there are advantages to a coordinated effort that focuses on changing the overall market standard for international sovereign bond issues in jurisdictions where the inclusion of collective action clauses is not now the norm.** Such an effort is likely to be more effective than putting pressure on individual borrowers, as it avoids potential signaling problems. Coordinated change in the market standard would help to minimize the cost of change. Short of amending the Articles, there are limits to the extent to which the Fund can assure coordinated change in market practice rather than put pressure on individual countries. All options other than helping to meet the balance of payments costs associated with an exchange inherently put more pressure on those countries who need to turn to the Fund for financing.

VII. Issues for Discussion

72. Directors may wish to address the following issues drawn from this paper and the companion paper.

- What types of collective action clauses should the Fund actively promote?

  (a) Do Directors agree that, with respect to existing clauses, majority restructuring and majority enforcement provisions are critical to the workout process? Do Directors have a view as to what the voting threshold should be for majority restructuring provisions? Do Directors believe that the Fund should actively promote the type of trust deeds that currently confer upon the trustee certain authority regarding the initiation of litigation and which ensure that the proceeds of any litigation are distributed among all bondholders?

  (b) Regarding new types of clauses, do Directors have a view as to the desirability of promoting the clauses discussed in the companion paper; namely, representation provisions, initiation provisions and aggregation provisions?

- Should the Fund actively promote, through its conditionality or otherwise, the inclusion of collective action clauses in new debt or also seek to promote a change in the existing stock through debt exchanges?

- Should the use of collective action clauses in international sovereign bond documentation be systematically tracked as part of the Fund's surveillance of its members and of capital markets?

- Should the use of collective action clauses be a condition for access for special facilities, such as the CCL?

- Should the use of collective action clauses be a condition for exceptional access to Fund resources?

- Should the use of collective action clauses be a condition under all Fund-supported programs?

- Should the Fund's willingness to lend into arrears be conditional on a commitment to include of collective action clauses in the new debt issued in a comprehensive debt restructuring?

- Should the Fund provide additional financing to meet the balance of payments needs that would arise in the context of an exchange to retire existing debt that lacks collective action clauses? Should a special facility be created to provide such financing on favorable terms?

- Should the use of collective action clauses be made a requirement for Fund membership through amendment of the Articles?

- What steps can those outside of the Fund take to encourage the use of collective action clauses?