

COLLECTIVE ACTION CLAUSES: THE WAY FORWARD

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Abstract

This paper restates the case for a market-based contractual approach to sovereign debt restructuring. It details the efforts in the private sector to build a consensus in favour of Collective Action Clauses, and the response from leading OECD and emerging market issuers. It explores practical measures for making collective action more effective in practice, including improvements in bondholder voting procedures; the benefit of achieving greater standardisation of Collective Action Clauses; why current progress with the Collective Action Clause initiative needs to be matched by progress on a Code of Conduct; and the possibility of extending the use of CACs into the syndicated loan market. 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 and sustain capital flows to the world's developing economies.

1. Introduction

The international debate on sovereign debt restructuring has focused on two diametrically opposed approaches: a market-based contractual approach – based on the widespread inclusion of Collective Action Clauses (or CACs) in debt contracts and a Code of Conduct – and the statutory approach embodied in the International Monetary Fund's proposal for a Sovereign Debt Restructuring Mechanism (SDRM). At its meeting in April 2003 the International Monetary Financial Committee (IMFC) concluded that it was not desirable to move forward to establish the SDRM. However the IMFC recognised that work should continue on issues of general relevance to creating a more orderly and predictable framework for sovereign debt crisis resolution. But the battle between these two approaches, portrayed by some as complementary but in reality conflicting, is not over. The SDRM attracted a high degree of support from the membership of the IMF¹. The IMF continues to argue that an approach based on a combination of CACs and a Code of Conduct is not sufficiently powerful to provide what is needed to address the more complex and potentially damaging crises that may occur in the future.

The core of the private sector's disagreement with the IMF is whether sovereign debt restructurings have in the past, been characterised by collective action failure. The private sector remains convinced that the IMF exaggerates the difficulty of achieving effective collective action; retaining our confidence that a market based approach benefits both issuers, by reducing their vulnerability to the risk of rogue investors, and investors, by rendering the workout process with issuers more predictable and less protracted. There is agreement between the private sector and the IMF that CACs should be viewed within the broader context of a more stable financial system: "the case for collective action clauses is strongest if they are viewed as one of several

¹ In a speech given at the Carnegie Council on Ethics and International Affairs on April 30, 2003 Jack Boorman, Special Advisor to the IMF's Managing Director, stated that support for the SDRM within the IMF included over seventy percent of the membership.

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 the others”² The official and private sectors are also agreed on the crucial importance of effective creditor co-ordination in the orderly resolution of sovereign debt crises; and that CACs 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.

2 Private sector objections to the SDRM concept

The SDRM concept, first mooted by the International Monetary Fund in November 2001, encountered stiff and sustained opposition from private sector participants from the outset. The SDRM was premised on the amendment of the IMF charter in order to enact sovereign bankruptcy into the domestic laws of member states (see “Chapter 11 for Sovereign Debtors?” Andrew Yianni, Loan Market Association News December 2002). The original proposal was modified in early 2002 to lessen the IMF’s role in connection with the proposed regime. The G-7 finance ministers and central bank governors’ April 2002 Action Plan expressed the hope that the official sector would work with emerging market countries and their creditors to implement a market-oriented approach “in which new contingency clauses would be incorporated into debt contracts”. It also suggested that the G-7 work with the IMF on incentives for countries with IMF programmes to adopt these clauses. However, the G-7 also implied that it was willing to support the statutory approach if the market-based approach proved ineffective. It expressed support for further work by the IMF on additional statutory approaches to sovereign debt-restructuring, which may require international treaties, changes in national legislation or amendments of the Articles of Agreement of the IMF. In the G-7’s words, “this work is complementary”.

The U.S. Treasury called for a more voluntary, decentralised approach to the general challenge of making the resolution of sovereign financial crisis more orderly. Under a proposal made by John Taylor, Under Secretary for International Affairs at the U.S. Treasury, the private sector was strongly encouraged to develop Collective Action Clauses for inclusion in sovereign contracts.³ Bonds subject to English law had included CACs going back to the late 19th century. But sovereign bonds subject to New York law had typically not included CACs, or certainly not qualified majority voting clauses. This is why to a large degree the core of the debate on CACs was focused on convincing the US investor community that the use of CACs did not represent a threat to their interests.⁴ The International Primary Market Association (IPMA) together with five other trade associations (the “gang of six”) took the lead in developing marketable CACs suitable for inclusion in bond contracts governed by

² IMF Working Paper WP/03/196 (October 2003)

³ Remarks at the Conference “Sovereign Debt Workouts: Hopes and Hazards”, Institute for International Economics April 2, 2002

⁴ There is some irony in the fact that it should be the investor community that had to be persuaded that CACs were 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 had 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.

both New York and English law. The gang of six's marketable CAC package provided specific language covering majority action, engagement, initiation and transparency (visit the IPMA website - www.ipma.org.uk – for a more detailed discussion). The core of the gang of six position was well summarised by Rieffel (2003)⁵, based on the discussion paper issued on December 17, 2002, by the Bond Market Association, the Emerging Markets Creditors Association, EMTA, the International Primary Market Association, the Institute of International Finance and the Securities Industry Association:

“The goal is to develop and implement a marketable approach to collective action clauses that would operate in the context of an international code of conduct for crisis prevention and resolution to be applied on a case-by-case basis. New bond clauses that would help facilitate effective restructurings where unavoidable while protecting essential creditor rights are part of the approach. The model clauses would provide for:

1. **Majority action** To permit the amendment and waiver of key bond terms by a supermajority (of at least 85 per cent.) of bonds outstanding (and not opposed by more than 10 per cent). Key terms would include due dates for payments, the amount of principal or interest payable on any date, the currency to be used, and other substantive covenants as appropriate. Amendment and waiver could be approved by written resolution as well as at a bondholder meeting. Bonds held or controlled, directly or indirectly, by the issuer would be excluded from voting.
2. **Engagement** To provide for the appointment by bondholders of a committee to represent bondholder interests after an event of default has occurred or the issuer has initiated restructuring discussions. The committee could adopt such internal rules as it saw fit, and engage legal and financial advisors, subject to reimbursement by the issuer.
2. **Initiation** To require a vote of at least 25 per cent. of the bonds outstanding to accelerate principal following an event of default, and to provide for a supermajority vote (of at least 75 per cent. of bonds outstanding) to rescind acceleration.
4. **Transparency** To require the issuer to comply fully with the IMF's Special Data Dissemination Standard, to provide rolling forecasts of inflation and of key budget components, and to disclose proposed treatment of other creditors such as domestic and Paris Club creditors. This information could be published on the websites of relevant industry associations”.

A parallel initiative was undertaken by the official sector with the formation of a G-10 working group to draft its own a set of model clauses, which proved to be broadly in line with those developed by the gang of six. The IMF responded to these initiatives by reaffirming the argument that although the SDRM proposal went further than the CAC approach it “could complement it nicely”⁶. The IMF belief in the merit of a “two track” approach was based on the logic that a sovereign debtor would only

⁵ Lex Rieffel, *Restructuring Sovereign Debt: the case for ad hoc machinery*, 2003 p267

⁶ “Sovereign Debt Restructuring Mechanism – One Year Later”; speech by Anne O Krueger, IMF First Deputy Managing Director at European Commission December 10, 2002.

invoke the SDRM if it had been unable to achieve a voluntary restructuring with its creditors. There was no lack of enthusiasm for the principle of collective action at the IMF. In fact the IMF argued that the essence of the SDRM approach was to provide a legal framework under which a debtor and its creditors could act as if common collective action clauses were included in all relevant debt instruments. At the core of private sector opposition was the conviction that progress with the SDRM would be viewed by investors and issuers as overriding CACs thus rendering any parallel initiative to implement CACs ineffective.

Responding to these concerns, the IMF sought to further modify its proposal by strengthening the provisions for collective representation and providing greater transparency in relation to the proposed terms of any restructuring of official or domestic debt outside of, but in parallel with, the restructuring taking place under the SDRM⁷. However the SDRM retained two key factors that remained contentious with the private sector. First the SDRM would apply to debt instruments issued before its creation. Second the SDRM represented an interference with existing contractual rights by providing for the aggregation of voting rights across different debt instruments, including bank loans, on a retroactive basis.

Why did such an apparently emasculated SDRM concept continue to attract such a high degree of opposition from the private sector? The core of the market's objection was that the SDRM would be both unnecessary and counterproductive. In particular, the gang of six argued that the SDRM rested on the false premise, for which indeed the IMF had produced no empirical evidence, that there is an inherent collective action problem among private sector creditors in sovereign debt restructuring that precludes agreement between them. The case that any restructuring had been prevented from moving ahead by the actions of recalcitrant or rogue creditors still remains unproven. The gang of six also argued that the IMF's attempt to draw an analogy between an SDRM and private sector bankruptcy legislation was fundamentally flawed because private companies are subject to the jurisdiction of a bankruptcy tribunal. Finally the selective coverage of the debt covered by the SDRM effectively was deemed to potentially create subordinated classes of debt thereby increasing funding costs for borrowers and jeopardising their access to private capital markets.

3 Mexico's bold initiative

Prior to the IMFC meetings in April 2003, the level of discomfort among emerging market issuers with the implications of the SDRM for their access to capital markets became increasingly apparent. The alternative of a market based contractual approach, based on the general use of CACs, started to appear distinctly attractive by comparison. However a degree of uncertainty remained over whether U.S. investors would demand a higher spread for a CAC bond since they would be sacrificing the freedom of individual creditor action traditionally incorporated in New York law bonds. In this environment which sovereign issuer would be the "first mover"? Mexico answered the question by launching the first New York-law, SEC- registered bond to include CACs in February 2003 (U.S.\$1 billion 6.625% global notes due 2015). Mexico's initiative took the market by surprise because it had previously expressed its scepticism about the possibility of adopting CACs: this suggested to the

⁷ "Proposed features of a Sovereign Debt Restructuring Mechanism" prepared by IMF's legal and Policy Development and Review Departments, February 12, 2003.

market that its move was indeed a measure of its concern with the threat of the SDRM alternative to its access to capital; and perhaps also a measure of Mexico's concern that another less well regarded issuer would launch a bond with CAC language that it would not itself regard as acceptable, thereby establishing an unattractive market norm. Although Mexico did not adopt CACs in the form proposed by either the gang of six or the G-10 working group, it did adopt the key majority action and initiation clauses. Particular attention was focused on the selection of the threshold for amendment of key terms, also known as reserved matters. Although the voting level (75%) selected by Mexico was lower than that recommended by the gang of six, Mexico introduced three key changes favourable to creditors by comparison with more traditional majority action clauses:

- (i) the threshold would apply to aggregate principal amounts outstanding. By comparison, English law bonds have traditionally counted votes cast at a meeting, where typically 75% of a quorum as low as 25% may amend key terms;
- (ii) bonds directly or indirectly controlled by the government and its instrumentalities would not be considered "outstanding" for voting purposes; and
- (iii) governing law, jurisdiction and waiver of immunity were added as reserved matters.

The favourable reaction to Mexico's bond reflected in large part the market judgement that Mexico and its advisers had achieved an equitable balance between its interests and those of the bondholder community. Mexico's initiative was followed in rapid order with CAC bonds from Brazil, South Africa, Korea and, of greatest interest, Uruguay. Uruguay's U.S.\$3.7 billion SEC-registered exchange offer was notable for a number of reasons:

- (i) Uruguay adopted Mexico's approach to majority action, but added additional safeguards for its bondholders: a limit on future exit consents (a technique adopted in Ecuador's 1998 Brady restructuring) to amend reserved matters, limitations on the issuance of new debt to dilute a restructuring vote and tighter non-reserved matter amendment rules;
- (ii) Uruguay issued its new bonds order under a trust indenture (IPMA is a supporter of the use of trustees since trustees can provide a useful channel of communication between a debtor and its bondholders, and also act as the focus of litigation on behalf of all the bondholders thereby rendering sharing, a standard feature of the loan market, feasible); and
- (iii) perhaps of greatest interest, Uruguay incorporated provisions allowing for the aggregation of voting rights across different bonds. In essence, several bonds can be amended by one vote with the support of 85% of the aggregate principal amount of the relevant bonds and 66 2/3 % of each relevant bond.

Other sovereign borrowers to have also included CACs in their bond issues include Chile, Panama, Colombia, Costa Rica, Venezuela, Turkey, Belize, Guatemala, Italy, Peru, Poland and the Philippines. Most recently the Republic of Hungary has become the first sovereign issuer to include an engagement clause in a global bond governed by New York law.

These recent examples provide further evidence of the private sector's capacity to provide innovative solutions in the sphere of sovereign debt restructuring. Although only a few months have passed since Mexico's bold initiative, it is safe to assume that any emerging market issuer that does not adopt CACs will be the exception rather than the norm. It is also safe to assume that the market will question the motivation of any issuer that does not adopt CACs. And yet this is not a time for complacency in respect of crisis prevention and resolution. The CAC initiative should be reinforced by a process for early consultations to strengthen crisis prevention and sustained by the framework of a broader Code of Conduct. A Code of Conduct would outline the respective roles that all parties including bank lenders could be expected to play in emerging markets finance, particularly during times of crisis. The Code should be developed as a joint initiative of the private and official sectors, including the IMF.

4 Making collective action more effective in practice

The private sector is aware that the problem of creditor co-ordination has become more acute since the 1980s. In the loan restructurings that were characteristic of that era, it was typical for a steering committee to be formed that would co-ordinate the formulation of the restructuring proposal with the sovereign debtor. The process followed an established framework of practice about which there was a reasonably high degree of consensus among the banks. In most cases a combination of moral suasion and sharing provisions discouraged individual banks from resorting to any individual remedies available to it.

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 places an imperative on transparency: if bondholders feel that they are being treated fairly in relation to other creditors, they are more likely to co-operate. Bondholders are increasingly aware that their interests are best secured by collective action, even if that means accepting limits on their ability to act individually. The key issue for the market is how to bring bondholders to the negotiating table, and engage them in the voting process⁸. It is particularly difficult to identify and mobilise holders of bearer bonds which are still a feature of the international bond 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

⁸ A report by Paul Myners to the U.K. Shareholder Voting Working Group in January 2004 identified similar concerns, namely that the system for voting the shares of U.K. issuers was not as effective and efficient as it should be. This report concluded that "the problems are largely the product of a process that is still quite manually intensive, where the chain of accountability is complex, where there is a lack of transparency and where there is a large number of different participants, each of which may give a different priority of voting." IPMA would fully expect that a review of the impediments to the voting of international bonds would reach a similar conclusion to that of the Myners report: that "it is like old pipework which could have been more effectively maintained over the years, and is now leaking at various points. It does not need to be ripped out and replaced, but instead the points of weakness need to be overhauled and upgraded". As in the case of the Myners report, IPMA would anticipate that the main remedy in the case of the international bond market would also be a combination of the increased use of electronic voting and a stronger role for proxy voting agencies. However given the different incentives at work in each market it is less immediately obvious how the investment required to make changes in international bond voting procedures would be funded.

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. A further complication is that if an issuer is in default, it is typical for the defaulted bonds to be withdrawn from the clearing systems and held by the beneficial owner directly.

Another shortcoming in the bondholder engagement process is the difficulty of gaining access to the relevant documentation. In 2000 IPMA carried out an analysis of the documentation provisions in a broad range of emerging market and OECD sovereign bonds. Our particular interest was to examine the qualified majority voting provisions under different governing laws, notably the range of percentages that applied to securing bondholder approval for a restructuring. We were aware of the differences that existed between bonds documented under different governing laws in the matter of how to secure bondholder support for a restructuring. Under New York and German law, bond contracts typically required unanimous agreement among bondholders before an agreement with the debtor could be reached. This contrasted with English law contracts, according to which 75 per cent., two thirds and even as few as 18.75 per cent (a 75% majority vote based on a 25% quorum) of the bondholders could agree to a restructuring. The IPMA study also established that for a large number of issues, it was impossible to determine the relevant percentage because it was incorporated in fiscal agency agreements that were not available to the public.

5 Exchange offers are not the perfect solution

The lack of transparency in bond documentation and the challenge of securing attendance at bondholder meetings have contributed to the paucity of cases where a sovereign debtor has attempted to achieve a restructuring through the amendment of existing bond 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 any voluntary 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 exit consent mechanism, under which 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 bonds⁹. 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.

⁹ Although the exchange does provide the debtor the opportunity to incorporate CACs in its new bonds, as in the case of the Uruguay exchange offer.

The exchange offers for Ukraine and Ecuador certainly attracted high levels of bondholder support, well over 95 per cent. 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.

6 Inclusion of CACs has not been a key decision variable

As far as bond documentation was concerned, it was also clear from the IPMA study in 2000 that borrowers had simply adopted the market conventions for the market in which they are issuing at any particular time; the same borrower was including a unanimity provision in its New York law contracts while including qualified majority voting provisions in its English law contracts. The precise form of clauses did not figure in pre-mandate negotiations between issuer and underwriter; or even in that period between when a bond issue is mandated and launched. It was assumed that such matters would be left to each party's legal counsel. Richards and Gugiatti (2004) have made a useful examination of market practices that prevailed in the market for sovereign bonds in the period 1997-2002.¹⁰ I share their key conclusions as to market practice during this period: first, that there was a “degree of indifference to the use or non-use of CACs” among legal advisers (and I would add issuers, investors and underwriters); second, that governing law is closely related to the market of issuance, except in the case of the euromarket; and third, that law firms generally draw upon or copy the contractual terms from earlier issues “either by that country or another country in the same region”. Richards and Gugiatti highlight examples where English-style contractual forms were modified to make New York law the governing law for contracts; and the extent to which, despite conventional wisdom to the contrary, a number of New York law sovereign bonds launched in the euromarket did include CACs, including Egypt, Lebanon and Qatar. Richards and Gugiatti's research would suggest that the majority of issues of New York law bonds in the euromarket that did not include CACs were from South and Central America: in the normal course of events issues from these regions would be more dependent upon investor interest from the United States, and a possible explanation of the absence of CACs in bonds from such issuers would be a concern at that time about the acceptability of CACs to U.S. investors. Equally, longer dated U.S. dollar bonds would typically be more dependent upon U.S. investor demand, but in the case of Qatar and Egypt, both issuers were successful in placing longer dated issues despite the inclusion of CACs. It is probably most relevant that both Qatar and Egypt were first time issuers in the international market: as a result there was a lack of specific precedent for these issues upon which the law firms might seek to draw. The popularity of the Qatar and Egypt issues with US investors also supports the other key conclusion of Richards and Gugiatti that “the inclusion of CACs has simply not been an important decision variable for borrowers or investors”.

¹⁰ Do collective action clauses influence bond yields? New evidence from Emerging Markets”, Anthony Richards and Mark Guigiatti February 2004.

7 Debt Issuance Programmes have specific advantages

The historical absence of dialogue between issuers and underwriters on documentation matters should come as no great surprise. There was no strong conviction on either side that contractual provisions would have a significant impact on the outcome of a bond restructuring. The absence of trading discrepancies between bonds governed under different governing laws may also have encouraged a sense of complacency. The current focus on contractual provisions has changed all that. Issuers will have to be proactive in deciding whether or not to include qualified majority and other collective action provisions in their bond documentation, and the form of such provisions. Debt issuance programmes provide them with a particular opportunity to standardise their bond documentation. Under a debt issuance programme, individual bond tranches are issued on the basis of common terms set out in an offering circular which is typically updated annually. The bulk of issuance in the euromarket already takes place under such debt issuance programmes. This trend is likely to continue under the new regime for prospectuses that will be transposed into national law in individual European Union member states in the middle of 2005. The use of debt issuance programmes could also provide emerging market sovereign issuers with the opportunity to test the concept of aggregating voting rights across different bond tranches issued under such a programme, whether by currency of issue or by maturity, following the example of Uruguay.

IPMA will follow its normal practice of including standardised Collective Action Clauses in its handbook. Where an underwriter deviates from IPMA's standard clauses, it is required to disclose the same to prospective underwriters at the time the issue is launched. Since Mexico's initiative in February 2003 there has been much discussion about the pros and cons of standardised collective action clauses. The arguments in favour of uniform clauses are overwhelming. In the time frame in which bond issues are launched and sold, there is little time for investors to judge the fine points of different contractual provisions. Investors' priority is on judging whether the bond in question represents good value relative to other investment opportunities. IPMA is not aware of any investor enthusiasm for a world in which an issuer yield curve would be based on the relative strengths and weaknesses of levels of CAC protection for investors. An even less desirable outcome would be if the form of a particular issuer's collective action clauses became a source of competition between underwriters: 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 was a stronger credit than other issuers. Underwriters should remain resolute in their encouragement of issuers to maintain standards of documentation and disclosure.

8 The use of trustees remains a valid option

The competitive enthusiasm of underwriters was one reason why the use of trustees has virtually disappeared from market practice. To save the issuer a small amount of expense, underwriters failed to stress to issuers the value of appointing trustees. The degree of consensus on CACs provides a platform for renewing the debate on the role of trustees.

The benefit of a trustee is twofold. 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 payments or recoveries through litigation are shared on a pro rata basis among all the bondholders¹¹.

The second benefit of a trustee is that it provides a useful channel for communication between the issuer and the bondholders. Bearing in mind that, legally at least, neither the lead manager nor a fiscal and paying agent has any responsibility to do so. There is clearly some antipathy among many US investors to the use of trustees for sovereign bond issues. This appears to be grounded in the belief that US trustees have been very passive. Trustees will certainly stick closely to the text of the indenture in deciding what they are authorised to do. This does not strike me as valid criticism of the trustee concept, more one of how trustees have been allowed to behave in practice. Trustee timidity need not be a fact of life. In the international market, we have seen trustees take unilateral action in putting a debtor into default without prior consultation with bondholders because it believed that the circumstances justified such action.

9 The Role of Creditor Committees

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 G-20. 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 would engage with their creditors in resolving any crisis that may arise during the life of the bonds. The

¹¹ Sharing is generally regarded as providing a disincentive to any creditor to take unilateral action: if it is required to share the fruits of litigation with fellow creditors it will be less motivated to incur the trouble and expense of unilateral legal action. The concept of sharing is simple: that any creditor receiving a disproportionate payment from a debtor, whether through recovery or otherwise, should share any such excess with the other creditors on a pro rata basis in proportion to their respective claims. Without a trustee at the centre of the process, it would be difficult to induce a creditor that had made a disproportionate recovery to disgorge the excess. Also in the absence of a trustee, which party will determine which bondholders would be entitled to share: would it be those holding the bonds when the issuer agreed to pay, those holders when the issuer actually paid or those holding the bond when collecting bondholder actually disgorged his excess share? Expressions of private sector hostility to the official support for incorporating sharing clauses in bond contracts (viz. G-22 Report of the Working Group on International Financial Crises (1998)) may have been dictated as much by practical as philosophical objectives. By comparison, UK banks successfully invoked sharing provisions in Argentine syndicated loan agreements; at the time of the Falkland Islands invasion when the debtor sought to withhold payments from UK banks.

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; bondholders, discouraged by recent events in Argentina 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. IMF Working Paper WP/03/196 suggested that a “code of conduct leading to common procedures and a bondholders committee where information can be pooled may then limit opportunistic behaviour” (p.30).

The private and official sectors are on the same page as far as the value of creditor committees are concerned, but it may be worth elaborating 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; leaving aside the matter of any outstanding loans. There is no easy answer to this concern. And this is where it may be distinctly preferable for the creditor committee concept to be qualified in a Code. For example, the borrower could limit its liability to pay professional expenses to the reasonable expenses of a single committee. The Code could also provide explicit support for the idea of 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 also 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.

10 The case for including CACs in syndicated loan contracts

With very few exceptions, syndicated bank loan agreements have traditionally been drafted on the basis that any amendment to the key terms, including the payment of principal and interest, should require unanimous approval of the lending banks. The case for unanimity in the case of syndicated loans is based on two main arguments:

- (i) that the greater homogeneity of banks as a creditor class, by comparison at least with bondholders, facilitates the process of gaining a consensus for a particular restructuring proposal; and
- (ii) the existence of sharing clauses in syndicated loan agreements acts as a disincentive for any individual bank to seek an individual settlement with the debtor.

In other respects bank loan documentation incorporates CAC-like features, notably the initiation clause (more typically referred to as a “no action” clause in the loan market) whereby acceleration of the loan requires the agreement of a specified percentage of lenders.

It is undeniable that there has been a shift in the creditor landscape since the 1980s Latin American debt crisis. The 1980s sovereign debt equation was characterized, superficially at least, a homogeneous group of syndicated bank lenders. The banks had a broader range of remedies available to them than did bond investors. But in practice it was the bondholders that were repaid in full and the banks that suffered considerable losses. By the mid 1990s the Mexican crisis showed that the matrix had shifted: a public sector debtor was confronted by a heterogeneous group of bondholders. In the Asian and Russian financial crisis, another shift: a complex of private and public sector debtors facing up against a similar diverse mix of creditors, with a quantum leap in the proposition of debt in bonded form; and a dramatically different outcome than in the case of the Latin American debt crisis, with the bondholders suffering a significant impairment of value whereas the banks did not suffer losses in their public sector loans.

More recent events in Ukraine, Pakistan and Ecuador made it clear that in a work-out situation bank lenders face a number of advantages in comparison with bondholders.

- (i) In the absence of a trustee, no particular party is necessarily representing the interests of bondholders or keeping them informed of developments. Lending banks have direct access to their borrowers and much greater information about the borrower’s willingness and ability to repay its debt. They benefit from the data gathered by industry bodies such as the Institute of International Finance. By comparison bondholders have significant information gap;
- (ii) Banks have multiple and frequently long term relationships with their borrowers. A bank may take the view that it will always retain a presence in a particular country come hell or high water; as a result it may not be too concerned to extend the maturity of loans in the context of a work-out. Bondholders do not operate within this kind of open-ended time frame. A bondholder’s relationship with an issuer is usually limited to holding an issuer’s bonds. Their only options are twofold; to hold an issuer’s bond to maturity or to sell (provided a buyer can be found). They expect a bond to be repaid at its stated maturity and move on to other investment opportunities. By the same token, they are less open to the menu of alternatives (such as debt for equity swaps) that might be found very attractive by a bank creditor; and

- (iii) Bank credits are much larger than the average bondholding. This means that it is usually more economic for a bank lender to entertain the option of enforcing its rights directly.

The diversity of banks' relationships with sovereign debtors has underpinned their willingness to enter into voluntary standstills which notably in the cases of Korea and Brazil, have pre-empted the need for more broad restructurings.

The case for encouraging the inclusion of qualified majority voting provisions in syndicated loan agreements is based on two arguments.

First, that lenders are not as homogeneous a credit class as appearances might suggest. In the 1980s crisis, a number of banks engaged in "hold out" tactics in a manner now associated with rogue bondholders. As a direct result of such tactics, a number of post-restructuring syndicated loan agreements were drafted to include qualified majority provisions in order to discourage similar behaviour. Examples include Romania (1983), Poland (1983, 1984, 1988) and Vneschombank (1997) which included 95% qualified majority voting provisions. Another factor may be at work which could weaken the assumed homogeneity of bank syndicates: namely the increasingly dynamic approach of banks to credit risk management. Historically banks have reduced individual loan exposures through the use of sub-participations to other lenders, which have not required the approval of, and are not typically disclosed to, the borrower. More recently the credit default swap market has been a more efficient risk management tool due to the liquidity that has accompanied the growth in the market. To the extent that a lending bank has reduced or eliminated its credit exposure through selling a sub-participation or buying a credit default swap, its interest may no longer be fully aligned with the other banks in the syndicate. The credit default swap contract will specify the fixed income security that the buyer is required to deliver in the event that the credit default swap is triggered. It is not inconceivable that the buyer of such credit insurance will be motivated to depress the price of the underlying fixed income security; something that might be achieved by threatening to withhold its approval to a restructuring that extends to the borrower's loan indebtedness¹². Although the writer is not aware of such a scenario having taken place, his purpose is to stress that the development of new risk management tools is a factor that can bear upon the sovereign debt restructuring process¹³.

Second, that as a matter of inter-creditor equity in the context of an overall restructuring bank lenders and bondholders should not have an asymmetric system of incentives; particularly bearing in mind the increasing overlap of the creditor classes where banks are increasingly important as bondholders and institutional investors are purchasing bank loans. In the absence of qualified majority provisions across all relevant debt instruments there is a heightened risk of a consensus-based restructuring falling at the last hurdle.

¹² A similar dynamic could of course, occur in a bond restructuring where a bondholder may have bought credit insurance through the credit derivative market

¹³ "You can have a creditor with £100m at stake who is relaxed about what happens because he has laid off all his debt exposure through credit derivatives while a £10m creditor who has not laid off any risk wants to put money in" Ian Powell of Pricewaterhouse Coopers quoted in Financial Times February 11 2004.

However some concession should be made to the fact that bank syndicates are more homogeneous than bondholders, if only because of the existence of sharing provisions. As a result a qualified majority voting level of 95 per cent. (versus the 75 per cent now typically associated with bonds) is appropriate for syndicated loans¹⁴; a level that has been endorsed by the London-based Loan Market Association.

10 Conclusion

“.... there remains the question of how much can be expected of these improvements in procedures for sovereign debt restructuring” (IMF Working Paper WP/03/96).

The private sector has been consistent in its view that sovereign debt restructurings have not been characterised by collective action failures. The evidence is that creditors do not typically pursue legal remedies while debtors are negotiating in good faith. Sovereign restructurings based on exchange offers can leave residual securities outstanding that can fall into the hands of opportunistic investors. CACs should provide issuers and investors, with the assistance of financial intermediaries, with the opportunity to achieve restructurings that are more soundly based. Undoubtedly there will be transitional issues to be addressed due to the lack of standardised provisions in the existing debt stock, the so-called transition problem. The private sector is confident that problems of creditor co-ordination – the aggregation problem - can be addressed through transparency and communication. This paper suggests a number of building blocks all or some of which could contribute to more orderly and predictable sovereign debt restructuring processes.

¹⁴ If it can be assumed that sharing clauses do act as a disincentive to hold out behaviour, an interesting theoretical discussion could take place as to whether a higher qualified majority voting percentage would be justified for bonds incorporating sharing provisions (through the use of a trustee). Logically bond issuers that included explicit sharing provisions (through the use of a trustee) should be prepared to raise the qualified majority level to 85 --90 per cent. if they had confidence that hold out creditors would be suitably disincentivised. Unfortunately the debate is likely to remain a theoretical one because of the practical obstacles to including sharing clauses in a bond contract. For the time being it remains more realistic to control the risk of hold out behaviour through a clause that restricts the right to bring legal proceedings to a trustee.