INTERNATIONAL MONETARY FUND

Progress Report to the International Monetary and Financial Committee on Crisis Resolution

April 12, 2005

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Boxes

I. INTRODUCTION

1. **In its recent Communiqué, the International Monetary and Financial Committee (IMFC) considered progress on crisis resolution initiatives.**[1] The IMFC welcomed the increased adoption of collective action clauses (CACs)[2] in international sovereign bonds, and called on the Fund to continue to promote progress in this area. It noted recent initiatives aimed at achieving a broad consensus between sovereign issuers and their creditors on voluntary principles for emerging markets' crisis management and debt restructuring, and looked forward to reviewing further work on general issues of relevance to the orderly resolution of financial crises.

2. **Over the last six months, there have been further developments in crisis resolution mechanisms under the existing legal framework.** CACs have by now clearly become the market standard for sovereign bonds governed by New York law. Since the last Progress Report, the number of countries issuing bonds with CACs has increased, along with the share of issues with CACs in the total outstanding stock of emerging market sovereign bond issues. Efforts to improve engagement between creditors and debtors have been continuing in the context of the draft Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets (henceforth, the “draft Principles”). The draft Principles are a welcome contribution to efforts aimed at improving the current international financial architecture. Going forward, the process will need to focus on fostering further consensus among the various stakeholders.

3. **Over the past several months, a number of countries have restructured their sovereign debt.** In particular, some countries have undertaken further steps to restructure their sovereign debt owed to private creditors, while there have been further reschedulings under the Evian Approach. Sovereign debt litigation has taken several new directions since the last Progress Report, with uncertain implications for future sovereign debt restructurings.

4. **This report focuses on these crisis resolution issues.** Section II describes progress in the use and design of CACs in international sovereign bonds. Section III provides background and staff commentary on the draft Principles. Section IV gives an overview of recent sovereign debt restructuring cases. Section V reports on progress in the Paris Club’s Evian Approach and other issues in the treatment of official bilateral debt, and Section VI provides a brief update of issues relating to litigation against sovereign debtors.

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[1] *Communiqué of the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund*, Washington, October 2, 2004.

[2] In this paper, the term "collective action clauses" (CACs) is used to refer to clauses that include both majority restructuring and majority enforcement provisions. The term "international sovereign bonds" refers to bonds issued or guaranteed by the government or central bank that are governed by a foreign law or subject to the jurisdiction of a foreign court.

II. Collective Action Clauses

A. Developments in Market Practice

5. **CACs have become the market standard in New York law-governed sovereign bonds, with over 90 percent of all sovereign issues, in value terms, having included CACs in the recent six-month period.** The inclusion of CACs has not had any observable impact on pricing.

6. **Since the last Progress Report in September 2004, the number of countries including CACs in their sovereign bonds issued under New York law has increased.** In particular, thirteen countries, including two more emerging market countries—Hungary and El Salvador— issued twenty-three sovereign bonds with CACs. The share of issues with CACs in the total value of the outstanding stock of sovereign bond issues from emerging market countries grew from 39 percent at the beginning of 2004 to 47 percent at the end of February 2005 (Tables 1 and 2).

- Ten emerging market countries—Brazil, Colombia, Guatemala, Lebanon,[3] Mexico, Panama, Peru, Philippines, Turkey and Venezuela—continued to include CACs in their sovereign bonds issued under New York law. Among mature market countries, Italy remained the only country that recently issued under New York law. Its new bonds continued to include CACs. In contrast, China and Israel did not include CACs in their recent New York law issues.[4]

- All sovereign issues under English law included CACs, as is customary in that jurisdiction: emerging market countries included Brazil, Hungary, Lithuania, Jordan, Poland and Turkey, while mature market countries included Austria, Finland and Sweden. There were no issues under Japanese law.

- Jamaica was the only country issuing under German law and its bond did not include CACs, in line with the practice under German law. Legislative efforts to eliminate perceived legal risk in the usage of CACs in this jurisdiction are well underway. These efforts, consisting of repeal of the Bond Act of 1899 and introduction of a new Bond Act of 2005, will give full discretion to both domestic and foreign issuers to use any type of CACs and will ensure their legal enforceability.[5]

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[3]The Lebanese bond includes only majority restructuring provisions.

[4]The Israeli bond is fully guaranteed by the United States with respect to principal and interest.

[5]See *Progress Report on Crisis Resolution* (SM/04/316, 9/08/04).

Table 1. Emerging Markets Sovereign Bond Issuance by Jurisdiction

	2003				2004				2005
	Q1	Q2 3/	Q3	Q4	Q1	Q2	Q3	Q4	Q1 4/
With CACs 1/									
Number of issues	9	31	10	5	25	19	21	14	14
Of which : New York law	1	22	5	4	14	12	14	12	9
	(In billions of U.S. dollars)								
Value of issues	5.6	18.0	6.4	4.3	18.5	15.9	12.2	9.1	16.7
Of which : New York law	1.0	12.8	3.6	4.0	10.6	9.5	7.7	7.7	8.8
Without CACs 2/									
Number of issues	14	4	7	7	2	2	1	4	0
	(In billions of U.S. dollars)								
Value of issues	8.1	2.5	3.5	4.2	1.5	0.4	0.3	2.7	0.0

Source: Capital Data.

1/ English and Japanese laws, and New York law where relevant.
2/ German and New York laws.
3/ Includes issues of restructured bonds by Uruguay.
4/ Data as of February 28, 2005.

Table 2. Emerging Market Sovereign Bonds Outstanding Stock by Governing Law

	Number of Issues		Value of Issues	
		(In percent)	(In billions of U.S. dollars)	(In percent)
New York	416	62	248	65
English	168	25	105	27
German	45	7	20	5
Japan	37	6	11	3
Total	666	100	385	100
Of which with CACs	292	44	183	47

Sources: Capital Data; and IMF staff estimates (as of February 28, 2005).

B. Design of CACs in Recent Issues

7. **Since mid-2002, the Executive Board has encouraged the inclusion of CACs in international sovereign bonds.** While recognizing that it was too early to reach a definitive view on the degree of standardization in the design of CACs across jurisdictions, Directors considered it appropriate to continue existing practice in English law-governed bonds and for bonds governed by New York law, encouraged the use of CACs that are broadly in line with the provisions recommended by the G-10 Working Group (see Table 3).[6] They noted, however, that given the contractual nature of CACs, any decision concerning the inclusion and design of CACs will ultimately be made by issuers and their creditors. Table 3 contains a summary of CACs contained in New York law bonds issued since September 2004 and a comparison of these provisions with the G-10 recommendations.

- With respect to majority restructuring provisions, all recent New York law bonds utilized a 75 percent voting threshold.[7] Market practice for bonds issued under New York law has rapidly converged to a 75 percent voting threshold (based on outstanding principal) consistent with the G-10 recommendations. In particular, following Brazil, both Guatemala and Venezuela lowered the voting threshold in their recent sovereign bond issues to 75 percent from 85 percent of outstanding principal.

- Almost all of these recent bond issues contain an expanded disenfranchisement provision that excludes bonds that are held by public sector instrumentalities, in addition to those held by the sovereign issuer, for quorum and voting purposes, which is in line with the G-10 recommendations.

- Regarding majority enforcement provisions, all recent bond issues governed by New York law, except those of Lebanon, included a 25 percent threshold for acceleration.[8]

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[6] *Review of G-10 Working Group on Contractual Clauses,* 9/26/01, www.bis.org/publ/gten08.htm. In particular, Directors expressed the view that it would be reasonable to set the voting threshold at 75 percent of outstanding principal with respect to majority restructuring provisions contained in bonds governed by New York law. Directors generally considered as reasonable the thresholds for majority enforcement provisions that have already been accepted in New York law bonds, namely a vote of 25 percent of outstanding principal to accelerate the claims following a default and a vote of 50 percent and up to 66⅔ percent of outstanding principal to rescind an acceleration of these claims. See *Acting Chair's Summing Up: Collective Action Clauses – Recent Developments and Issues* (BUFF/03/52, 4/10/03).

[7] While the voting threshold in the Lebanese bond is calculated on the basis of the claims of bondholders present at a duly convened meeting that meets the specified quorum requirements, the threshold in the other bond issues is based on the outstanding principal of the bond.

[8] The Lebanese bond allows individual bondholders to accelerate their claims upon default.

They differ, however, on the threshold for de-acceleration.[9] The Lebanese bonds do not contain any majority enforcement provisions. Finally, all the recent New York law bond issues utilized a fiscal agency structure, while the G-10 recommendations encourage the use of a trust or an equivalent legal structure.[10]

- Hungary's New York law bonds contain an engagement clause that allows bondholders with at least 50 percent of outstanding principal to "appoint any persons as a committee to represent the interests" of bondholders in the event of a default or acceleration or following any public announcement by the issuer of a restructuring.[11] This clause is consistent with the G-10 recommendations, and has been welcomed by market participants.[12]

C. Encouraging the Use of CACs

8. **Staff has continued to take an active role in promoting the inclusion of CACs in international sovereign bonds.** In particular, it maintains an active dialogue with private market participants and debt managers from a number of emerging market countries, including through the Forum for Public Debt Managers.

9. **The G-10 Deputies Group has continued its efforts to promote and monitor developments in the use of CACs.** In September 2004, the G-10 Deputies considered the extent to which the CACs included in sovereign bonds issued in New York compared with the main objectives set out in the G-10 recommendations.

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[9]While Brazil, El Salvador, Guatemala, Italy, Panama and Turkey adopted a 66⅔ percent threshold for de-acceleration, the others relied upon a threshold of 50 percent of outstanding principal.

[10]Trust structures are not common in New York law bonds as some investors view them as being excessively intrusive on creditor rights. Under a trust structure, the right of individual bondholders to initiate litigation is effectively delegated to the trustee, who is required to act only if, among other things, it is requested to do so by bondholders holding a requisite percentage of outstanding principal. Significantly, the terms of the trust deed will also ensure that the proceeds of any litigation are distributed by the trustee on a pro rata basis among all bondholders. By contrast, under a fiscal agency structure, individual bondholders have the right to initiate legal proceedings against the debtor following a default for the amount that is due and payable and can keep any recoveries from such proceedings. While several issuers have included trust structures in New York law bonds, they represent the exception rather than the rule. See *Collective Action Clauses - Recent Developments and Issues* (SM/03/102, 03/25/03) and *The Design and Effectiveness of Collective Action Clauses* (SM/02/173, 6/7/02) for a detailed discussion of the differences between a fiscal agency structure and a trust structure.

[11]An engagement clause seeks to provide for the appointment of a bondholder representative for the life of the bond (to act as interlocutor with the sovereign during this time) and for the election of a bondholder representative that could represent bondholders in connection with any restructuring. See *Report of G-10 Working Group on Contractual Clauses*, 9/26/2002, www.bis.org/publ/gten08.pdf .

[12]Hungary included a similar engagement clause in its English law bonds issued in 2004. See *Progress Report on Crisis Resolution* (SM/04/108, 3/31/04).

- The G-10 Deputies noted the widespread adoption of majority restructuring provisions, disenfranchisement provisions, acceleration and de-acceleration provisions, and rules for voting on "non-reserved matters" (i.e., non-key terms).

- They observed, however, that limited progress had been made on including provisions that would foster early dialogue, coordination, and communication among creditors and sovereigns when a sovereign debt problem arises; effectively block litigation by individual bondholders; and enable the aggregation of different sovereign bonds.

10. **In January 2005, the Bank of England held a workshop on "Sovereign Bond Contracts" with both private and official sector participation.** The workshop took stock of developments in contractual techniques designed to strengthen the legal framework for debt restructurings. In particular, the legal advantages of trust structures were highlighted. The workshop also considered the appropriate pace of further innovations in bond contracts beyond the clauses endorsed by the G-10. The workshop did not seek to reach conclusions on these points, but rather presented a forum for discussion that would inform market practice. A report on the workshop is expected to be published in June by the Bank of England.

11. **The International Primary Market Association (IPMA), a group representing underwriting securities houses, together with six other trade associations,**[13] published in October 2004 a standard form of CACs for use in sovereign bond issues that are governed by English law and use a fiscal agency structure. IPMA indicated that it would also be preparing similar model CACs for sovereign bonds issued under New York law, as well as for bonds using a trust structure issued under either English or New York law. The IPMA clauses are largely consistent with the G-10 recommendations and expand upon them, particularly with regard to their information and engagement provisions (see Table 4).

12. **Recent discussion on enhancing the contractual framework for the orderly resolution of sovereign debt crises revolves around debtor/creditor engagement.** This is reflected both in private sector attempts to include engagement clauses in bond documentation and in the draft "Principles" (see Section III). Issuers and bondholders appear to agree on the usefulness of a common understanding on best practices for such engagement, including when debt restructuring becomes inevitable. While some in the private sector prefer to see such rules of engagement included as legally binding clauses, most issuers prefer such rules to be non-legally binding, such as in the voluntary framework envisaged in the draft "Principles."

[13]The six trade associations are the Bond Market Association, the Emerging Markets Creditors Association, the Emerging Markets Traders Association, the Institute of International Finance, the International Securities Market Association, and the Securities Industry Association.

Table 3. Collective Action Clauses: G-10 Recommendations and Bonds Governed by New York Law Issued Since September 2004

Provisions	G-10 Recommendations	Brazil, Colombia, El Salvador, Guatemala, Hungary, Italy, Lebanon, Mexico, Panama, Peru, Philippines, Turkey and Venezuela
Amendment of Key Terms	75 percent based on either outstanding principal or a duly convened meeting	75 percent based on outstanding principal (except the Lebanon bond, where the threshold is based on duly convened meeting)
Disenfranchisement	Bonds owned or controlled directly or indirectly by the issuer or its public sector instrumentalities	Generally bonds owned directly or indirectly by the issuer or its public sector instrumentalities
Acceleration	25 percent of outstanding principal	25 percent of outstanding principal (except the Lebanon bond, where each bondholder has the right to accelerate upon default)
De-acceleration	Between 50 and 66⅔ percent of outstanding principal	• Colombia, Hungary, Mexico, Peru, Philippines and Venezuela: 50 percent of outstanding principal • Brazil, El Salvador, Guatemala, Italy, Panama and Turkey: 66⅔ percent of outstanding principal • Lebanon: none
Initiation of Proceedings	• Mandate the use of a trust or an equivalent legal structure where the trustee can be instructed by 25 percent to initiate lawsuits • Pro rata distribution of recovered proceeds under trust structure	Any bondholder
Engagement Provision	• A bondholder representative be appointed for the life of the bond • 66⅔ percent to appoint at any time any person to represent all holders in negotiation with the issuer or other creditors	The Hungary bond allows 50 percent of outstanding principal to “appoint any persons as a committee to represent the interests” of holders in the event of a default or acceleration or following any public announcement by the issuer of a restructuring
Information Provision	A covenant requiring the issuer to provide certain types of information over the life of the bond and following a default	None
Documentation	Trust or an equivalent legal structure	Fiscal agency agreement

Table 4. G-10 Recommendations and IPMA Standard Collective Action Clauses for Bonds Using Fiscal Agency Structure Governed by English Law

PROVISIONS	G-10 RECOMMENDATIONS	IPMA STANDARD CACS
Amendment of Key Terms	75 percent based on either outstanding principal or a duly convened meeting	75 percent based on outstanding principal
Disenfranchisement	Bonds owned or controlled directly or indirectly by the issuer or its public sector instrumentalities	Bonds held by or on behalf of the issuer, or by or on behalf of any person which is owned or controlled directly or indirectly by the issuer or its public sector instrumentalities
Acceleration	25 percent of outstanding principal	25 percent of outstanding principal
De-acceleration	Between 50 percent and 66⅔ percent of outstanding principal	At least 50 percent of outstanding principal
Initiation of Proceedings	• Mandate the use of a trust or an equivalent legal structure where the trustee can be instructed by 25 percent to initiate lawsuits • Pro rata distribution of recovered proceeds under trust structure	Any bondholder
Engagement Provision	• A bondholder representative be appointed for the life of the bond • 66⅔ percent to appoint at any time any person to represent all holders in negotiation with the issuer or other creditors	• 50% of outstanding principal to appoint any person or persons as a committee to “represent the interests” of the bondholders in the event of a default or acceleration or following any public announcement by the issuer of a restructuring • Such an appointment will not be effective if bondholders of more than 25 percent object • Issuer will pay any fees and expenses of the committee and its legal and financial advisors
Information Provision	A covenant requiring the issuer to provide certain types of information over the life of the bond and following a default	• Requiring the issuer to subscribe to the SDDS, publish rolling 12-month forecasts, and provide other information over the life of the bond • Requiring the issuer to provide information reasonably requested by bondholders of 5 percent of outstanding principal

III. PRINCIPLES FOR STABLE CAPITAL FLOWS AND FAIR DEBT RESTRUCTURING IN EMERGING MARKETS

A. Background and Main Elements of the Draft Principles[14]

13. **The draft Principles are aimed at developing a market-based, voluntary, and flexible framework for enhanced creditor-debtor cooperation both at times of relative tranquility and in the context of crisis resolution.** They outline actions that private sector creditors and emerging market sovereign debtors should take to promote and maintain stable private capital flows to emerging market economies. Because individual cases will invariably involve different circumstances, the Principles are to be applied flexibly on a case-by-case basis, and are strictly voluntary. Accordingly, no party is legally bound by any of the provisions of the Principles.[15]

14. **In early 2004, the IIF took the lead in developing a broad set of Principles—rather than a detailed Code.[16]** In November 2004, the G-20 Finance Ministers and Governors welcomed the draft Principles "as a good basis for strengthening crisis prevention and enhancing the predictability of crisis management."[17] The draft Principles have received support from a number of emerging market issuers and private creditor associations, although market views are varied. While supporting the drafting of such Principles, the Fund has left their specification to sovereign debtors and their creditors, since the effectiveness of voluntary rules hinges critically on their acceptability to the affected parties.

15. **The draft Principles are based on the following four pillars**: (i) transparency and timely flow of information; (ii) close debtor-creditor dialogue and cooperation to avoid restructuring; (iii) good faith actions during debt restructuring; and (iv) fair treatment of all parties (see Box 1).

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[14]The current version of the draft Principles, dated March 11, 2005, can be viewed at http://www.iif.com/data/public/Principles.pdf

[15]The draft Principles—whose origins can be traced to earlier proposals for a Code of Conduct (the "Code") put forward by the Council on Foreign Relations (2000), the Bank of France (Fall 2002), and the IIF (January 2003)—are the result of extensive consultations since early 2003 between several emerging market countries and a number of private sector groups, notably the Institute of International Finance (IIF).

[16]Previous progress reports highlighted challenges that have emerged in efforts to elaborate a Code. See *"Progress Report on Crisis Resolution"* (SM/03/31, 8/26/03), "*Progress Report on Crisis Resolution"* (SM/04/108, 3/31/04); "*Progress Report on Crisis Resolution" (*SM/04/316, 9/8/04).

[17]*Communiqué of G-20 Finance Ministers and Central Bank Governors*, Berlin, November 20-21, 2004. G-20 members are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Korea, Mexico, Russia, Saudi-Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union, represented by the Council presidency and the President of the European Central Bank. Argentina did not participate in the November 2004 meeting.

B. Relation to Fund Policies and Practices

16. **The draft Principles are broadly consistent with many of the expectations arising from Fund policies aimed at the prevention and resolution of financial crises.** However, there are some differences. These areas of similarity and divergence are discussed below.

Crisis Prevention and Steps to Avoid Default

17. **In the area of crisis prevention, the draft Principles are in line with the general approaches supported by the Fund.** In particular, the draft Principles underscore the importance of sovereign debtors' adopting appropriate policy frameworks, the role of Investor Relations Programs ("IRPs") in improving debtor-creditor communication, and transparency initiatives aimed at improving information sharing.

- The Fund works with its members to formulate appropriate policy frameworks in the context of its bilateral surveillance and in the use of Fund resources (UFR); supports the use of IRPs;[18] monitors progress in their implementation in the context of Article IV discussions with members; and encourages its members to take part in transparency initiatives, including through publication of staff reports and letters of intent as well as through adherence to standards and codes such as the Special Data Dissemination Standard (SDDS) and General Data Dissemination System (GDDS).

18. **In situations where a member faces debt-servicing difficulties, the draft Principles' view that debtors should consult with creditors on market-based approaches to avoid default is consistent with Fund policies.** When there are debt-servicing problems, the Fund urges members to pursue a collaborative approach with creditors to reach a preemptive agreement aimed at avoiding default. Notwithstanding the broad consistency of approaches, the draft Principles differ from Fund analysis related to measures aimed at avoiding default in one notable area:

- The draft Principles note that the creditor community should consider appropriate requests for voluntary and temporary maintenance of trade lines and inter-bank lines to support a borrowing country's efforts to avoid a broad debt restructuring. The Fund supports this practice.

[18] See "*Investor Relations Programs—Report of the Capital Markets Consultative Group—Working Group on Creditor-Debtor Relations*," (SM/01/174, 6/19/01), "*Investor Relations Program—Recent Developments and Issues*," (SM/04/364, 10/27/04).

Box 1. The IIF's Draft Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets

The following is a summary of the main elements included in the draft Principles, which are based on four pillars:

- *Transparency and timely flow of information*—The draft Principles recommend general disclosure practice to ensure that sovereign issuers share relevant information so that creditors are in a position to make informed assessments of the issuers' economic position, including their overall levels of indebtedness. They call for more specific information to be disclosed to creditors in the context of a debt restructuring.

- *Close debtor-creditor dialogue and cooperation to avoid restructuring*—(IRPs) are highlighted as a proven vehicle for debtors to disseminate data and information on a timely basis and secure feedback from investors. The draft Principles urge creditors to consider appropriate requests for the voluntary, temporary maintenance of trade lines and inter-bank advances, and/or the rollover of short-term maturities on public and private sector obligations.

- *Good faith actions during debt restructuring*—When a debt restructuring becomes inevitable, the draft Principles recommend that debtors and creditors engage in a restructuring process that is voluntary and based on good faith. They note that such a process is based on sound policies that seek to establish conditions for renewed market access, viable macroeconomic growth, and medium-term balance of payments sustainability. Many key provisions underlying the Principles are embodied in this pillar, which also includes calls on the Fund. In particular, during the debt restructuring process, the draft Principles suggest the following:

    - Timely, good faith negotiations are the preferred course of action for creditors and issuers, limiting potential litigation risk.

    - The Fund is strongly encouraged to implement fully its policies for lending into arrears to private creditors (LIA), including the good faith criterion.

    - The appropriate format and role of negotiation vehicles such as creditor committees should be determined flexibly and on a case-by-case basis.

    - In the context of a default, early negotiations with a creditor committee should take place. It is also noted that past experience has shown that the debtor has borne the reasonable costs of a single creditor committee.

    - Debtors are urged to resume, to the extent feasible, partial debt service payments as a sign of good faith and resume full payment of principal and interest as conditions allow.

- *Fair treatment of all parties*—The draft Principles note that debtors should avoid unfair discrimination among affected creditors, which would include seeking rescheduling from all official bilateral creditors. In line with general practice, trade credits and inter-bank advances are to be excluded from a restructuring and treated separately if needed. The draft Principles underscore that instruments owned or controlled by the sovereign should not influence the outcome of a vote among creditors in the context of restructuring.[1]

[1] In the above context, the draft Principles are silent on the use of exit consents in a debt restructuring.

- The draft Principles, however, link such requests to continued debt service by the sovereign debtor, noting that the prospects of a favorable response will depend in part on continued interest payments on inter-bank advances and continued service of other debt. This could, however, prove problematic. In cases where the debtors faces problems making payments on other debt obligations, a withdrawal of inter-bank credit lines by private creditors would exacerbate pressures faced by the debtor country, and risk leading to a wider default.

Post-Default Crisis Resolution and Restructurings

19. **The draft Principles encourage the Fund to implement fully its lending into arrears ("LIA") policy.** While the draft Principles can be applied in a manner consistent with the Fund's expectations under the LIA policy, in practice differences may arise in a few areas.

- *The draft Principles note that early negotiations with a creditor committee should take place when a default has occurred.* The LIA policy, however, provides for formal negotiations with a creditor committee only if the case is complex; the creditor committee is representative; and it has been established on a timely basis. In other circumstances, the member could engage with a creditor committee, but under the Fund's LIA policy a less structured dialogue is possible.[19] [20]

- *The draft Principles do not cover voluntary standstills on litigation by creditors represented on the committee.* By contrast, under the Fund's LIA policy, a formal negotiating framework, should one be warranted, would include a voluntary standstill on litigation by creditors represented on the committee.

- *The draft Principles call for a resumption of partial debt service, to the extent feasible, as a sign of good faith to facilitate a restructuring.* Such payments are not a feature of the Fund's good faith criterion under the LIA policy. The resumption of partial debt-service payments would need to be considered on a case-by-case basis by the debtor and its advisors reflecting, *inter alia*, upon the availability of, and alternative needs for, resources, the nature of the restructuring being sought, and inter-creditor equity concerns. Payments by the debtor on selective claims may in

[19] "*The Acting Chair's Summing Up on Fund Policy on Lending into Arrears to Private Creditors—Further Considerations of the Good Faith Criterion,*" (BUFF/02/142, 9/05/02).

[20] The draft Principles also note that in previous restructuring cases, when a creditor committee has been formed, debtors have borne the reasonable costs of a single creditor committee.

some circumstances be necessary to minimize economic dislocation, including to preserve the banking system, and could be acceptable to other creditors.[21]

20. **Furthermore, the draft Principles suggest that when a sovereign debtor is engaged in a restructuring with private creditors, a restructuring should also be sought from all official bilateral creditors.**[22] This could prove controversial with Paris Club creditors because some economic circumstances may warrant the exclusion of these creditors' claims and those of other official bilateral creditors. In practice, debt restructurings have not always involved official bilateral claims, particularly when the latter are relatively small.[23]

21. **In summary, the draft Principles are a welcome contribution to efforts aimed at improving the international financial architecture.** Despite the differences that have been identified, the Principles are, in most respects, consistent with Fund policies. Modifications of Fund policies, including those on surveillance, transparency, and lending into arrears, are not warranted at this stage on account of the draft Principles themselves. Looking ahead, while there is uncertainty on how the process of further broadening the consensus among issuers and the investor community would evolve (see below), efforts to integrate the Principles into policies adopted by debtors and creditors would be welcome.

C. Reactions of the Official and Private Sectors

22. **Nearly all G-20 members welcomed the results achieved between issuing countries and private-sector participants on the draft Principles.**[24] They noted that the draft Principles provide a good basis for strengthening crisis prevention and enhancing predictability of crisis management, and invited borrowing countries and the private sector to adhere to them now and as they further develop in the future. Official sector representatives have noted that the Principles constitute an important complement to CACs and that their implementation would fill an important gap in the international financial architecture, but

[21] In some cases, selective payments could help facilitate a debt restructuring. For example, in cases where a debtor is seeking a restructuring of a number of different bond issues (either as a pre-emptive deal or following default), creditors will be differently situated depending on the original terms of the bonds. In such cases, the use of limited resources to make a cash payment to bring all creditors up to a common starting point may help resolve inter-creditor equity issues and thereby facilitate agreement.

[22] The Principles are not clear on whether this applies to pre-emptive restructurings as well as post-default situations.

[23] The case of Uruguay is an example, where in the context of a pre-emptive restructuring, debt relief was not sought from official bilateral creditors as their share in the country's debt was small.

[24] *Communiqué of G-20 Finance Ministers and Central Bank Governors*, Berlin, November 20-21, 2004.

that continued efforts are needed to broaden consensus. Argentina, on the other hand, has objected to aspects of the draft Principles.[25]

23. **Notwithstanding their broad support for the draft Principles, some G-20 members see the need for further clarification of several issues.** These include the role of payment standstills and partial debt-service payments.

- Observing that the Principles do not contain a provision that allows for an automatic standstill on payments during the debt restructuring process, some industrial country members have indicated their preference for greater clarity on the modalities for introducing payment standstills, including on duration and exit strategy.

- Some industrial country members have also expressed concern whether partial debt service payments by the sovereign during restructuring negotiations—recommended by the Principles to the extent feasible—could run the risk of exacerbating inter-creditor equity issues and adding to the complexity of the restructuring.

24. **Market participants offered their opinions of the draft Principles in response to a staff survey.**[26] **Their views were varied and ranged from mildly positive to critical, notwithstanding the strong support coming from the IIF and IPMA.** The market opinions reported below do not necessarily reflect the views of the Fund. Many participants were not aware of the draft Principles and their intended objectives, and did not view them as an important input in their daily operations. The few participants who were well informed, however, were quite explicit in their views regarding the potential contribution of the Principles to the international financial architecture. In particular, market participants focused almost exclusively on the ability of the draft Principles to deliver a framework for fair debt restructuring, and significantly less on its ability to provide an environment for stable capital flows. The strength of their views reflected their perceptions of the Argentina debt restructuring.

25. **On the positive side, the draft Principles were seen as a useful step in the right direction.** Participants welcomed the emphasis on transparency, timely flow of information, close debtor-creditor dialogue and cooperation, and "two way communication with

[25] Argentina did not participate in the November 2004 G-20 meeting. It circulated a note to G-20 ministers expressing its concerns about elements of the draft Principles. This note is not publicly available. In a recent speech, Secretary Nielsen confirmed that Argentina "objected to subscribing to such a Code of Conduct...." See "*Speech by Secretary of Finance Guillermo Nielsen,*" Argentina Seminar 2005 – Macroeconomic Focus, Deutsche Bank Latin American Corporates Global Markets Research, March 4, 2005.

[26] Staff conducted a survey of a wide range of market players. The survey was conducted via telephone conferences. Market participants interviewed included fund managers, advisors to fund managers, traders in hedge funds and securities firms, market analysts and analysts from rating agencies. Generally, these participants had not been involved in the drafting of the Principles.

investors," particularly in the context of IRPs.[27] They also recognized that this is the first time that issuing countries and the private sector have come together in an attempt to agree on actions and behaviors to promote stable private capital flows.

26. **Many market participants, however, were skeptical and agreed that, while the step was indeed in the right direction, it was too small to be effective.** Their main concerns were that the draft Principles were too loosely defined, not enforceable, and did not specify the rules of engagement between the debtor and its creditors following a default. Some participants wanted the draft Principles to encourage the future use of engagement clauses.[28] They also noted that there is no mention of the potentially coercive use of exit consents. In the view of these participants, the use of exit consents could complicate future debt restructurings, and they considered that this omission in the draft Principles could be seen as an implicit endorsement of such an approach. Rating agencies predicted that endorsing the draft Principles would have no impact on a country's credit rating. Almost all participants stressed that without greater clarity in defining how this voluntary framework would be applied, including indications that the Fund would take into account members' adherence in its lending decisions, the draft Principles may not prove to be effective as a framework for orderly debt restructuring. Finally, they underscored that the draft Principles would only be put to test when a country that had endorsed them was close to default.

27. **A number of market participants offered suggestions to make the draft Principles more credible:**

- They emphasized the need for a fuller embrace from the private sector, reaching beyond the senior management level to include practitioners directly involved in emerging market debt businesses.

- Some also thought that credibility would be enhanced if a large majority of countries inside and outside the G-20 endorsed the draft Principles, so as to influence their investment decisions by taking into account whether or not sovereign issuers were endorsing the draft Principles.

- Some were of the view that greater credibility might also stem from a positive endorsement from the Fund, involving the requirement of adherence to the draft Principles as a condition for the use of Fund resources.

As noted previously, these suggestions do not necessarily represent the views of the Fund.

[27]It was noted, however, that enhanced dialogue with the private sector poses the risk that investors use the confidential information for making profits, violating insider-trading rules.

[28]In particular, participants referred to Hungary's recent New York law bonds, which are discussed above.

IV. Update on Sovereign Debt Restructuring Cases

28. **Over the past several months, a number of countries have engaged in a restructuring of their sovereign debt with private creditors.** In some of these cases, the debt operation has been undertaken preemptively, with a view to avoiding default, while in other cases restructuring has followed a default. This section reports on the recent experience with sovereign debt restructurings.

Argentina

29. **Three years after defaulting, Argentina launched its global debt exchange offer on January 14, 2005.**[29] [30] The debt offer involved the exchange of defaulted bonds for three new types of securities, including a par, discount, and quasi-par bond.[31] Each new bond has a GDP warrant that pays when growth and the level of GDP are above a specified threshold. To encourage participation in the debt exchange, the offer included a most favored creditor clause, which gives participating bondholders the right to participate in *future* exchange offers. The clause does not cover future private or judicial settlements with non-participating creditors. This prompted skepticism by many analysts concerning the value of the clause. To reinforce the authorities' position that this was the final offer, the authorities introduced new legislation to preclude the executive branch of the Argentine government from re-opening the debt exchange.[32] The offer closed on February 25.

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[29]The total eligible claims amount to US$81.8 billion, of which US$79.7 billion is principal and US$2.1 billion is accrued but unpaid interest through December 31, 2001, the date of default. According to the authorities, including past due interest since December 31, 2001 raises the total defaulted claims to about $103 billion. Bilateral debt to the Paris Club, amounting to an estimated US$2.6 billion, is expected to be restructured following the completion of this debt exchange.

[30]In Japan, the concurrent offer was not launched until a week later because of delays in reaching agreement with banks on the mechanics of the exchange before regulatory approval could be sought. To market the deal to creditors, the authorities embarked on a roadshow, visiting cities in Italy, Japan, Germany, the Netherlands, Switzerland, the United Kingdom, and the United States. They presented the debt offer to invited groups of institutional investors and advisors of retail creditors. In their presentation, the authorities explained the mechanics of the exchange and the risks of not participating, noting in particular the rationale for the offer and the reasons why the debt burden was no longer sustainable.

[31]Each of the options was designed to have broadly similar NPV value. The relative value of the offer benefited from a general decline in emerging market spreads and at the time of the exchange was in line with secondary market prices of defaulted debt—around 32 *cents* per *dollar of principal claims*. Including past due interest, this implied an NPV haircut on total claims, on the order of 75 percent using a 10 percent discount rate, the rate most commonly used by market analysts at the time.

[32]The law was passed by Congress on February 9, 2005, and was designed to reduce the incentives for not participating in the exchange offer. As stated in Argentina's amended filing with the U.S. Securities and Exchange Commission, the new law provides that: (i) the executive branch is precluded from making any future offer to exchange any Eligible Securities that are not tendered pursuant to the Offer; (ii) Argentina is precluded from entering into any type of settlement, whether judicial, extra-judicial or private, with respect to Eligible

(continued)

30. **The offer also provided a number of special incentives to encourage *early* participation.** These included (i) preferences in the allocation of par bonds—which were thought to be preferred by retail creditors—to small claims during the first three weeks of the exchange; and (ii) the allocation of quasi par bonds—which were designed primarily for pension funds—on a first come first served basis. Participation of local institutions was facilitated by the favorable accounting treatment of quasi par bonds.

31. **On March 18, the authorities announced the final results of the debt exchange.** The estimated participation rate was 76.15 percent, which implied that about US$62.3 billion out of US$81.8 billion in eligible claims was tendered in the debt exchange.[33] Of the US$62 billion tendered, 38 percent came from bonds tendered in Argentina and 62 percent from bonds tendered abroad. It is likely that participation of bonds held in Argentina was in the order of 95-98 percent while participation of bonds held abroad was in the order of 66-70 percent. Foreign participation, however, may be effectively lower than these numbers imply when one puts to one side the holdings of non-resident Argentine citizens. Settlement of the offer was scheduled for April 1 but has been delayed by court proceedings in New York.[34].

32. **The participation of Argentine creditors, and to a lesser extent foreign institutional investors, was key in achieving the observed acceptance rate.** The bulk of participation came from local institutional investors and Argentine retail investors who held bonds both in Argentina and abroad. Foreign institutional investors entered the exchange only during the last week of the offer period, which is typical of debt exchanges. Analysts attributed the lack of viable options, abundant global liquidity and low interest rates as the main reasons explaining institutional participation.

Securities not tendered pursuant to the Offer; (iii) the executive branch is charged with taking all necessary steps to delist from any stock exchange all Eligible Securities that are not tendered pursuant to the Offer, subject to applicable law and the terms of the original issuance; and (iv) "all Eligible Securities pledged or otherwise deposited pursuant to the order of any Argentine tribunal of competent jurisdiction, which have not been tendered pursuant to the Offer and whose depositary... has not affirmatively expressed, prior to the Expiration Date, its decision not to tender such Eligible Securities pursuant to the Offer, shall be replaced by peso-denominated Pars."

[33]The participation rate was achieved without use of majority restructuring provisions or exit consents. Majority restructuring provisions were only available in a few of the Argentine bond issues governed by Japan or English law. A piecemeal use of majority restructuring provisions or exit consents would have complicated the debt exchange. See footnote 53 for a further explanation of exit consents and their controversial nature.

[34]Several *ex parte* court orders were issued preventing transactions by Argentina and its exchange agent, Bank of New York, in certain bonds with a face value of US$14 billion that had been tendered by bondholders participating in the debt exchange. Upon a hearing, the court decided to vacate the attachment orders, but upon request of the plaintiffs, agreed to stay the vacation of these orders pending plaintiffs' appeal. The hearing of this appeal is scheduled for the week of April 25, 2005.

33. **The level of foreign retail participation, however, was lower**. A significant percentage of European retail creditors are reported to have stayed out of the exchange. The level of non-participation was reportedly highest in Italy. Many retail creditors apparently chose not to participate in the exchange and sold their holdings to institutional investors, reportedly at very low prices, who then tendered these bonds in the exchange. The tendency for retail selling of bonds was strongest in Japan, where participation in the end reached 95 percent.

34. **With this acceptance rate, substantial arrears will remain.** Remaining arrears amount to almost US$20 billion in principal and about US$5 billion in past due interest. In contrast, previous sovereign bond restructurings have achieved participation in the range of 93-99 percent, and, as a result, residual arrears were modest in those other restructurings. The authorities report that the post-restructuring stock of federal government debt is now 72 percent of GDP. Adding the remaining arrears, however, raises the ratio to 87 percent of GDP. The arrears are most likely predominantly on claims held by foreign creditors.

35. **The authorities will issue US$35.2 billion in new securities**, comprising US$15 billion of par bonds, US$11.9 billion of discount bonds and US$8.3 billion of quasi par bonds. As a result of the restructuring, almost 40 percent of the central government debt stock, excluding unrestructured arrears, will be denominated in *pesos*. The new bonds, other than those governed by Argentine law, will be issued under trust structure and will include collective action clauses with an aggregation feature.[35]

The Dominican Republic

36. **The Dominican Republic has recently embarked on an adjustment program supported by a new stand-by arrangement (SBA).** The financing strategy in the program features both new money and rescheduling from a mix of official and private sources.[36]

37. **The authorities recently obtained financing assurances from the Paris Club for rescheduling pre-cut-off-date obligations falling due in 2005.** The Paris Club has linked negotiations of the 2005 rescheduling to comparability of treatment for private creditors which the authorities expect will be met through early restructurings of bond and bank debt.

[35]Under these provisions, modifications to payment and other key terms may be made to a single series of new securities with the consent of the holders of 75 percent of aggregate principal amount outstanding of that series, and to multiple series of new securities with the consent of the holders of 85 percent of the aggregate principal amount outstanding of all affected series and 66 2/3 percent in aggregate principal amount outstanding of each affected series.

[36]The strategy includes (i) issuance of domestic bonds to clear arrears with local suppliers and to refinance some loans from domestic banks; (ii) continued support from the IDB and World Bank at US$260 million in 2005; and (iii) oil import financing from the government of Venezuela that provides US$200 million in long-term financing for 2005, at concessional rates.

The Paris Club has not given assurances for a 2006 rescheduling, but it has indicated willingness to consider this once fiscal and financing plans for 2006 are more concrete.

38. **The authorities are well advanced in designing a bond exchange which they expect will be launched in the second quarter of this year.** The authorities hired financial advisors and conducted a roadshow through New York and Europe in late 2004 to discuss the financing plan and the need for restructuring. During the roadshow, the authorities conducted a number of meetings with investors who held around 60 percent of the outstanding debt eligible for the exchange. Details of the offer remain under discussion, however, as the authorities continue their dialogue with creditors on the terms of the exchange.

39. **Discussions with external and domestic commercial banks continue, and it is expected that negotiations with the former will be concluded in the next few months.** The authorities have been in discussions with banks to reschedule arrears accumulated during 2004 as well as amortizations due in 2005 and 2006, and have stated their intent to continue these negotiations in a manner consistent with the Fund's policy on lending into arrears.

Antigua and Barbuda

40. **While Antigua and Barbuda has remained current in respect of its payments to the Caribbean Development Bank (CDB) and some of its commercial creditors, it has accumulated arrears on external debt for a prolonged period.** The authorities acknowledge that this situation is untenable, have initiated a major tax reform to strengthen the fiscal balances, and have approached a number of key creditors to discuss restructuring options. Antigua and Barbuda's debt renegotiations are taking place outside the framework of a Fund-supported program.

Dominica

41. **Substantial progress has been made in the pre-emptive restructuring of Dominica's sovereign debt and towards achieving long-term debt sustainability.** [37] As a result of a high debt burden and following a sharp deterioration in the fiscal accounts, selective arrears increased in 2002, including to the United Kingdom and a number of commercial creditors. In December 2003, the authorities determined that the debt was unsustainable and embarked on a pre-emptive debt restructuring strategy that aimed to avoid default. This strategy, which included both official and private creditors, aimed at restoring debt sustainability and achieving high participation through a cooperative approach that emphasized inter-creditor equity.

[37] Dominica's public debt at end-2003 amounted to 115 percent of GDP, of which 39 percent was owed to multilateral creditors, the majority of which to the Caribbean Development Bank (CDB). Claims of external commercial and official bilateral creditors, including France and the United Kingdom, accounted for about 23 and 13 percent of total debt, respectively. Domestic debt accounted for 23 percent of Dominica's obligations. Following a 16-month stand-by arrangement, Dominica has had a PRGF arrangement since December 2003.

- Following the Paris Club's decision that members would deal individually with Dominica's debt, the United Kingdom, France, and some other bilateral creditors agreed to restructure their claims on Dominica. Debt held by some non-Paris Club bilateral creditors remains to be restructured. The CDB also agreed to restructure the bulk of its claims in July 2004. In April 2004, the authorities launched an offer to exchange sovereign debt held by private creditors for new bonds. The debt exchange was formally closed in June 2004, but allowed for late participation until September 2004. Subsequently, the authorities concluded that it was no longer possible to service the claims of non-participating private creditors on the original terms. Altogether, creditors holding around 72 percent of debt to be restructured have participated in the overall debt restructuring effort.

- Consistent with the Fund's lending into arrears policy, the authorities are now engaged in a collaborative process with private creditors to seek a resolution of the arrears on their claims, on terms consistent with sustainability and inter-creditor equity.[38] They also remain in discussion with those official creditors whose debt remains unrestructured.

Grenada

42. **In October 2004, following the large-scale destruction caused by Hurricane Ivan, Grenada issued a press statement announcing that, given the circumstances, its public debt was unsustainable and that it intended to seek a cooperative solution with its creditors.**[39] Payments to a large group of creditors were missed as the almost complete interruption of revenue flows and the disaster-related expenditures resulted in an immediate liquidity constraint. Relations with several creditors, including the CDB and private creditors, were regularized soon thereafter. Grenada received emergency assistance for natural disasters from the Fund in November 2004, but does not have an upper credit tranche arrangement.

43. **In December 2004, Grenada announced that it would seek a comprehensive restructuring of its debt. .** In January 2005, the authorities hired legal and financial advisors to assist in the formulation of a comprehensive debt-reduction strategy. However, before the debt-restructuring strategy could be formalized, interest payments on its two large international bonds were missed in late December, and Grenada was downgraded to 'selective default' on its sovereign long-term foreign-currency borrowing by Standard and Poor's.

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[38]The authorities are making payments accruing to non-participating creditors on the restructured terms into an escrow account.

[39]At end-2004, Grenada's public and publicly guaranteed debt amounted to US$ 566 million (130 percent of GDP). Claims of external commercial, multilateral, and official bilateral creditors amounted to about US$177 million, US$102 million, and US$51 million, respectively.

Iraq

44. **In November 2004, agreement was reached between Paris Club creditors and Iraq on a comprehensive restructuring of its public external debt (See Section V below).[40]** The authorities have initiated the process of data reconciliation with private creditors in order to determine the actual amount and composition of these obligations, and have hired legal and financial advisors for the restructuring of the public debt.

Serbia-Montenegro

45. **The restructuring of Serbia-Montenegro's debt to private creditors is based on the commitment to the Paris Club concerning comparable treatment.** Most of this debt, which is partly owed to commercial bank creditors and partly to oil suppliers, was in arrears which have been cleared or are being cleared as a result of the restructuring.[41]

- A memorandum of understanding was signed in July 2004 to restructure Serbia-Montenegro's sovereign debt to the London Club of commercial bank creditors, which amounted to US$2.7 billion (13.2 percent of GDP) at end-2003. The Republics of Serbia and Montenegro have agreed that Serbia would be the sole obligor with respect to the new instruments issued for the restructuring.

- The agreement (which was considered by the Paris Club to be on comparable terms with those of the Agreed Minute of the December 2001 debt restructuring) envisages a write-off of about 62 percent in net present value terms and conversion of remaining debt into bonds in the amount of US$1.1 billion.[42] The debt conversion process began in March 2005, and the eurobond was launched in April 2005.

V. Progress Under the Evian Approach

46. **Under the Evian Approach, Paris Club creditors agreed that they would participate in a comprehensive debt treatment for non-HIPC countries whose debt has been agreed by the Fund and the Paris Club creditor countries to be unsustainable**, who are committed to policies that will secure an exit from the Paris Club in the framework of

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[40]Iraq's total external debt as of end-2004 is estimated at some US$120 billion, or around six times estimated GDP for 2004, and is unsustainable. All of this debt is in arrears. This does not include U.N.-mandated Iraqi war reparations related to the Kuwait invasion of 1990 (which are paid annually from 5 percent of Iraq's oil revenues). Outstanding debt to private creditors is tentatively estimated at $10-20 billion as of end-2004, equivalent to 50-100 percent of estimated GDP for 2004.

[41]Serbia-Montenegro has an extended arrangement with the Fund, which is set to expire in May 2005. The fifth review of the program is ongoing.

[42]In addition, a goodwill payment of US$40 million was settled in November 2004.

their Fund arrangements, and who will seek comparable treatment from their other external creditors, including the private sector.[43] According to usual Paris Club practices, eligibility is to be decided on a case-by-case basis, taking into account the debt sustainability analyses and the need to foster greater coordination with private creditors. Thus, debt relief provided by Paris Club creditors under this approach is likely to have a bearing on the restructuring of claims held by the private sector and on crisis resolution, more generally. Since September 2004, the Paris Club restructured the official bilateral debt of two non-HIPC countries — Iraq and the Kyrgyz Republic — under this approach (see below).[44]

47. **In addition, Paris Club creditors decided in January 2005 to offer a temporary deferral of debt payments to countries affected by the December 2004 earthquake and tsunami.** In light of the exceptional scale and the devastating effects of this catastrophe, and in order to allow the affected countries to dedicate all available resources to address humanitarian and reconstruction needs, Paris Club creditors have offered a temporary deferral of debt service payments due in 2005, that may be rescheduled, at the country's request, over 5 years with one year of grace.[45] Creditors emphasized that they expect the resources freed by this deferral to benefit directly the populations affected by the tsunami. Indonesia and Sri Lanka have expressed potential interest in this offer. Given the exceptional circumstances, traditional Paris Club principles will not apply to the deferral. Namely, there is no requirement of an accompanying Fund arrangement, nor is there an expectation of comparable treatment from other creditors.

Iraq

48. **In November 2004, Paris Club creditors agreed with Iraq on a comprehensive restructuring of its public external debt.** The Paris Club underlined that this debt restructuring was an exceptional response to a unique situation.[46] The debt operation was

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[43] The Evian Approach is described in *Progress Report to the International Monetary and Financial Committee on Crisis Resolution* (IMFC/Doc/9/04/7, 4/21/2004). Additional information on the Evian Approach is available on the Paris Club's website: http://www.clubdeparis.org/en/presentation/presentation.php?BATCH=B06WP14.

[44]Over that same period, the official bilateral debt of three HIPC countries (the Republic of Congo, Ethiopia and Madagascar) was reduced and restructured following HIPC procedures.

[45]Creditors may charge moratorium interest on a bilateral basis. However, since no payment is expected in 2005, moratorium interest accrued in 2005 will be capitalized and also rescheduled over 5 years, in line with other deferred payments

[46]Paris Club press release, November 21, 2004. Eighteen Paris Club creditors (Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, the Republic of Korea, the Russian Federation, Spain, Sweden, Switzerland, the United Kingdom and the United States of America) participated in the restructuring of Iraq's debt.

aimed at reducing Iraq's total debt owed to the Paris Club members by 80 percent (from US$38.9 billion to US$7.8 billion) in three phases:[47]

- The first phase entails the immediate cancellation of the part of the late interest that accumulated during the period of U.N. Security Council sanctions (US$11.6 billion, or 30 percent of Paris Club claims on Iraq), and is linked to the Fund program supported by Emergency Post-Conflict Assistance (EPCA).
- The second phase will apply if Iraq and the Fund have agreed, by December 31, 2005, an upper credit tranche arrangement. It envisages a reduction of 30 percent of the debt stock, and a rescheduling of the remaining debt over a period of 23 years with a grace period of 6 years.
- The third phase will apply provided that the Fund has concluded, not later than December 31, 2008, the last review of a three-year upper credit tranche arrangement. In this phase, Paris Club Creditors will grant an additional tranche of debt reduction representing 20 percent of the initial stock.[48]

49. **Following standard Paris Club procedures, Iraq has committed itself to seeking comparable treatment from its other external creditors.** The authorities have hired financial advisors for the restructuring of its official debt, and have selected an accounting firm to assist in the process of reconciliation of claims. As described in the previous section, contacts are underway with non-Paris Club official bilateral and private creditors with a view to initiating negotiations. The authorities have further committed themselves to inform the Paris Club regularly of progress made in negotiations with all of Iraq's external creditors.[49]

Kyrgyz Republic

50. **The Kyrgyz Republic received a comprehensive debt treatment from the Paris Club on March 10, 2005.** This followed a flow rescheduling provided under Houston terms in March 2002. The staff debt sustainability analyses (DSA) suggested that a stock operation under London terms was necessary to achieve a lasting reduction in debt ratios over the medium term and provide a sufficient cushion against external vulnerabilities. Under the agreed debt stock treatment, Official Development Assistance (ODA) claims will be rescheduled to 40 years of maturity with 13 years grace. As for non-ODA claims, creditors can opt to provide relief either through a 50 percent nominal debt cancellation and the

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[47]Iraq's external public debt was estimated at about US$120 billion as of end-2004, of which about 33 percent was owed to Paris Club creditors, 57 percent to other official bilateral creditors, and 10 percent to private creditors.

[48]Following the Paris Club agreement, the United States went beyond the 80 percent debt reduction under the Paris Club agreement and wrote off 100 percent of its claims on Iraq.

[49]In addition, the authorities have committed not to impose additional restrictions not agreed with the IMF which could prevent prompt repayment by private debtors in Iraq of obligations that are overdue or falling due.

rescheduling of the balance over a period of 23 years with 7 years grace; or by granting an equivalent reduction in debt service. In addition, most of the moratorium interest due for the period 2005 to 2008 will be capitalized.

VI. Developments in Sovereign Debt Litigation

51. **Sovereign debt litigation has taken several new directions since the last Progress Report.** This includes the passage of legislation in Belgium to forestall attempts to interrupt payments through Euroclear based on certain pari passu arguments; class action litigation seeking to block debt exchanges; retail bondholders seeking legal redress against the advisors associated with the sovereign issuer or the entities that sold the securities to them; and threatened initiation of investment arbitration by members of the Global Committee of Argentine Bondholders ("GCAB") as an alterative to court litigation.

"Pari Passu"

52. **Litigating creditors are now less likely to obtain court orders in Belgium interrupting payments through the Euroclear system** on the basis that the pari passu clause provides a right to proportionate payment from a sovereign debtor. The Belgian parliament amended existing legislation in order to avert further court orders preventing Euroclear from receiving and channeling payments on account of bondholders.[50] The amendment was motivated by the rulings in the Elliott vs. Peru and the LNC vs. Nicaragua cases.[51]

53. **Although the New York courts have still not ruled on the merits of the pari passu clause theory, the recent withdrawal of a pari passu claim in New York litigation may indicate that confidence in this theory is weakening.** Notwithstanding the wealth of commentary against the argument that the pari passu clause provides a contractual right to proportionate payment,[52] this theory was recently invoked in the unsuccessful attempts by

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[50]The previous legislation was contained in Article 9 of the law of April 28, 1999, which had been adopted in implementing the European Directive (98/26/EC) on settlement finality in payments and securities settlements systems. The recent amendment extends the scope of Article 9 to provide: "Any cash settlement account maintained with the operator of a system or with a cash settlement agent, **as well as any cash transfer, through a Belgian or foreign credit institution, to be credited to such cash settlement account,** cannot be attached, put under sequestration or otherwise blocked by any means by a participant (other than the operator or the settlement agent), a counterpart or a third party." (new text in bold).

[51]See *Recent Developments in Sovereign Debt Litigation and Implications for Debt Restructurings and Debt Relief Processes* (SM/04/98, 3/24/04). LNC's appeal to the Belgium Supreme Court (Cour de Cassation) is still pending against the Court of Appeal ruling that the pari passu clause could not be invoked against Euroclear, as a third party to the contractual obligations between Nicaragua and LNC. See *Progress Report to the International Monetary and Financial Committee on Crisis Resolution,* (IMFC/DOC/10/04/6, Rev. 1, 9/30/04).

[52]See discussion in *Recent Developments in Sovereign Debt Litigation and Implications for Debt Restructuring and Debt Relief Processes,* (SM/04/98, 3/24/04).

litigating creditors to block the debt exchange launched by the Argentine Province of Mendoza in the fall of 2004. The plaintiffs subsequently withdrew the pari passu allegations and have instead focused on attempts to assail the use of exit consents in the exchange.[53] [54] Both in terms of the pari passu clause arguments and the challenge to exit consents, the litigation proceedings arising from the Mendoza exchange have been closely watched as possibly predicting outcomes of ongoing court actions in New York against the Republic of Argentina.[55]

Class Actions

54. **Attempts through class action procedures to block the conduct of exchange offers have thus far not succeeded.**[56] In the so-called "*Urban*" class action of bondholders brought against Argentina, the plaintiffs sought to prevent launch of the exchange offer on the theory that the class action procedural rules required any offer to class members to be made through the class representative's attorney. Although the court refused to block the exchange offer, it required Argentina to provide class members with "fair communication" of the class action proceedings to enable bondholders to consider participation in the litigation as an alternative to accepting the exchange offer. In a separate *"Seijas"* class action, the plaintiffs unsuccessfully sought to halt the exchange offer on grounds that Argentina had failed to disclose the use of exit consents with the alleged assured participation of Argentine banks and pension funds. These allegations were undercut by the undertakings made by Argentina's counsel to the court that exit consents would not feature in the debt exchange.[57]

55. **Notwithstanding the rejection of these attempts to block the exchange, the conduct of sovereign debt class actions present uncertainties for the debt-restructuring**

[53]Exit consents entail amendments to non-payment terms of New York law governed bonds through the vote of a majority of bondholders (typically 50 percent or 66 ⅔ percent of outstanding principle) as they exit the bonds in an exchange for new bonds. For a discussion of the legal controversy surrounding the use of exit consents, see *Seminar on Involving the Private Sector in the Resolution of Financial Crises—The Restructuring of International Sovereign Bonds—Further Considerations*, (EBS/02/15, 1/31/02).

[54]The New York court upheld the use of exit consents in the Mendoza exchange aimed at limiting the waiver of sovereign immunity, but at the same time ruled that there was an independent basis to attach commercial property of Mendoza, as an "agent or instrumentality" of a foreign state under the U.S. Foreign Sovereign Immunities Act.

[55]Around 40 law suits are being maintained in New York courts against Argentina and over 100 further actions in Italy and Germany.

[56]To date, nine bondholder class actions have been certified to proceed by the New York court, with certification of eight of these taking place after the offer period for the exchange had closed. The "*Lavaggi*" class action against Argentina—noted in the September 2004 Progress Report for the US$100 billion punitive damages claim against Argentina— has not progressed beyond the initial filing stage.

[57]Also, the unsuccessful attempt to block the Province of Mendoza debt exchange on the grounds that it entailed an unlawful use of exit consents is noted in paragraph 53 above.

process. The New York court in the *Urban* class action did not completely resolve the tension between, on the one hand, the nature of a debt exchange as a voluntary process between the debtor and its creditors and, on the other, the requirements of the class action litigation procedures that provide for some supervision by the court and the attorney representing a plaintiff class. The court indicated, however, that the acceptance of the exchange offer by a bondholder would effectively remove the bondholder's claim from the class action. That approach avoids the complexity in the conduct of debt exchanges suggested by the requirement in the US class action procedural rules that the judge affirm that a proposed settlement of a class member's claim is "fair, adequate and reasonable."[58]

56. **If class actions become a more common feature of the debt restructuring process, further scrutiny of the understanding of "negotiation" and "litigation" in a debt restructuring may be warranted.** Hitherto, the practice in debt restructurings—as also reflected in the Fund's LIA Policy—has reflected the understanding that negotiation is an alternative (moreover, the preferred alternative) to litigation.[59] "Good faith negotiation" has thus been understood in a non-litigation context. However, GCAB's support of the *Urban* class action—which it characterized as a vehicle for negotiation[60]—blurs these categories, and signals the potential invocation by creditors of class action litigation in parallel to negotiation.[61]

Retail Investors Seek Other Avenues for Compensation

57. **Claims by retail investors against financial advisors presents another angle of litigation in the context of sovereign debt restructurings.** A few retail investors in Europe have pursued legal claims against the banks and brokers that on-sold Argentine bonds, alleging they did not provide adequate advice on the risks involved with such investments. Courts in Italy and Germany in some of these cases have ruled in favor of the retail investors and required the financial institution to compensate the retail investors for their losses. Although these rulings have been highly fact-specific, it is more generally notable that the

[58]Strict application of such a rule would have subjected the terms of an exchange offer to judicial review. This issue is discussed in *Recent Developments in Sovereign Debt Litigation and Implications for Debt Restructuring and Debt Relief Processes,* (SM/04/98, 3/24/04).

[59]Specifically, with regard to creditor committees where a formal negotiation framework is warranted, the expectation of the LIA policy is that creditors represented on the committee would adhere to a standstill on litigation.

[60]See GCAB's November 12, 2004 Press Release: G*CAB Files Brief in Support of Motion to Prevent Argentina's Exchange Offer*, available on GCAB's website: http://www.gcab.org/images/GCAB_-_Press_Release_-_Support_of_Motion_to_Enjoin_-_Final_Version_-_11-12-042.pdf .

[61]At around the time of GCAB's involvement in the *Urban* class action as an *amicus curiae* (friend of the court), it amended its by-laws to remove the condition restricting membership to creditors that were not pursuing litigation against Argentina.

cases illustrate the relative propensity of retail investors to seek legal redress when faced with a sovereign debt default. The initiation of legal proceedings seeking compensation from these banks and brokers presents a route of legal redress that may be available to retail investors that is separate from any cause of action against Argentina.[62]

58. **A second type of "non-issuer" claim has been brought by retail investors against financial advisors associated with the sovereign issuer (as opposed to the retail investor's direct financial advisor)**. In the litigation challenging the Province of Mendoza debt exchange, claims have been initiated against Bank of New York, as the trustee and paying and transfer agent under the defaulted bonds, alleging that it breached its fiduciary duties by not "protesting" the exchange offer.[63] Furthermore, claims have been initiated against JPMorgan Chase, on the grounds that as the paying and transfer agent of the new bonds, through facilitating the exchange, it had tortiously interfered with the contractual rights of bondholders not participating in the exchange. The court dismissed these claims as "futile" in light of its conclusion that the underlying legal challenge to the Mendoza debt exchange was unfounded. Consequently, it remains to be seen whether any of the types of "non-issuer" claims by retail investor would reach a level that they would affect the dynamic of sovereign debt restructurings (or of issues).

International Investment Arbitration

59. **The announcement by GCAB considering the initiation of international investment arbitration could potentially pose a largely unprecedented step in sovereign debt restructurings.**[64] [65] This announcement followed the introduction of the Argentine law prohibiting the government from reopening the debt exchange or engaging in private or judicial settlements with creditors that did not accept the current global offer.[66] GCAB has argued that bondholders could rely on bilateral investment treaties (BITs) between Argentina

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[62]Some of the peculiar policy challenges raised by retail investor law suits against a sovereign issuer are discussed in *Recent Developments in Sovereign Debt Litigation and Implications for Debt Restructuring and Debt Relief Processes (*SM/04/98, 3/ 24/04).

[63]Although appointed by the issuer, the trustee is an agent of the bondholders and owes fiduciary duties to the bondholders as a class. Paying and transfer agents are agents of the issuer and these roles do not imply any fiduciary duties. For a discussion of the legal elements of trust structures, see T*he Design and Effectiveness of Collective Action Clauses*, (SM/02/173, 6/07/02).

[64]The announcement was reported to be made by representatives of GCAB in its February 2005 "Roadshow Presentation" and was followed by the release of the GCAB—ICSID Position Paper, available on GCAB's website: http://www.gcab.org/images/GCAB_-_ICSID_Position_Paper_2-15-05.pdf

[65]Some bondholders are known to have considered international arbitration in relation to Russia's restructuring of GKO bonds in the late 1990s. Those claims are reported to have been settled.

[66]The features of the law are described in footnote 33, above.

and a number of G-20 countries, on the basis that the implementation of the new Argentine law would constitute an expropriation of bondholders' claims and that investment arbitrations, brought under the rules of the International Center for the Settlement of Investment Disputes ("ICSID," a part of the World Bank group), would provide bondholders with legal redress.[67] In particular, GCAB has asserted that ICSID arbitration would provide for rapid and effective enforcement of bondholder claims.[68] However, given the absence of legal precedents in international investment arbitration of bondholder claims in the context of a sovereign default, the resolution of these proceedings is somewhat uncertain. Staff is unaware of any such bondholder-initiated arbitrations against Argentina having materialized.

[67]Argentina is already a defendant in over 30 investments arbitrations before ICSID tribunals mainly brought by foreign investors in the utility sector.

[68]In practice, states have complied with ICSID tribunal awards without requiring the claimant to initiate enforcement proceedings. The provisions in the ICSID convention on the enforcement of awards, however, are somewhat qualified. Article 54(3) of the ICSID Convention provides that: "Execution of the award shall be governed by the laws concerning the execution of judgments in force in the State in whose territories such execution is sought." This implies that where execution of an ICSID award is sought, the same legal defenses that arise with court judgments may be applied. In that same vein, Article 55 expressly states that "[N]othing in Article 54 shall be construed as derogating from the law in force in any Contracting State relating to immunity of that State or any foreign State from execution."