INTERNATIONAL MONETARY FUND

March 2019

FOURTH PROGRESS REPORT ON INCLUSION OF ENHANCED CONTRACTUAL PROVISIONS IN INTERNATIONAL SOVEREIGN BOND CONTRACTS

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International Monetary Fund
Washington, D.C.

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FOURTH PROGRESS REPORT ON INCLUSION OF ENHANCED CONTRACTUAL PROVISIONS IN INTERNATIONAL SOVEREIGN BOND CONTRACTS

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ANNEX

INTRODUCTION

1. **The IMF Executive Board endorsed in October 2014 the inclusion of key features of enhanced *pari passu* provisions and collective action clauses (CACs) in new international sovereign bonds.**[1] [2] Specifically, the Executive Board endorsed the use of (i) a modified *pari passu* provision that explicitly excludes the obligation to effect ratable payments, and (ii) an enhanced CAC with a menu of voting procedures, including a "single-limb" aggregated voting procedure that enables bonds to be restructured on the basis of a single vote across all affected instruments, a two-limb aggregated voting procedure, and a series-by-series voting procedure.[3] Directors supported an active role for the IMF in promoting the inclusion of these clauses in international sovereign bonds. The IMFC and the G20 further called on the IMF to promote the use of such clauses and report on their inclusion.[4]

2. **Since that time, the IMF has published periodic progress reports on inclusion of the enhanced clauses.**[5] These reports found that since the Executive Board's endorsement, substantial progress had been made in incorporating the enhanced clauses, with approximately 87 percent of new international sovereign bond issuances between October 2014 and September 2017 (in nominal principal amount) including such clauses.[6] The reports also found that there was no observable market impact on inclusion of the enhanced clauses. However, the reports noted that the

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[1] International sovereign bonds are defined as bonds issued or guaranteed by a government or central bank under a law other than the law of the issuer (or where a foreign court has jurisdiction over claims arising under the bond), in freely traded form with fixed maturities, normally in excess of one year. Consistent with the approach taken in past papers, staff has not focused on the incorporation of the enhanced clauses in international sovereign guaranteed bonds.

[2] See http://www.imf.org/external/np/pp/eng/2014/090214.pdf (the "2014 paper") and http://www.imf.org/external/np/sec/pr/2014/pr14459.htm.

[3] For descriptions of "series by series" and "two-limb" aggregated voting procedures, see paragraphs 24 and 28 of the 2014 paper, respectively. Note that with respect to a "single-limb" aggregated voting procedure, to safeguard the interests of creditors, the enhanced CAC requires all affected bondholders to be offered the same instrument or an identical menu of instruments (the "uniformly applicable" condition, see paragraphs 33-34 of the 2014 paper) and include a voting threshold of 75 percent of the aggregated outstanding principal of all affected bond series. The enhanced CAC also provides the issuer the flexibility to use the single-limb voting procedure to conduct separate votes for different groups of bond issuances ("subaggregation", see paragraph 37 of the 2014 paper). It also includes a disenfranchisement provision, which, in line with the G-10 approach, excludes for voting purposes all bonds owned or controlled directly or indirectly by the issuer and its public sector instrumentalies (see paragraph 46 of the 2014 paper) and an information covenant consistent with Fund policy (see paragraph 44 of the 2014 paper).

[4] See Communiqué of the Thirtieth Meeting of IMFC, Washington, October 11, 2014; G20 Leaders' Communiqué, Brisbane, November 16, 2014; Communiqué of the G20 Finance Ministers and Central Bank Governors Meeting, Istanbul, February 9-10, 2015; and G20 Leaders' Communiqué, Istanbul, September 5, 2015.

[5] See http://www.imf.org/external/np/pp/eng/2015/091715.pdf (the "2015 paper"), Second Progress Report On Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts ("the 2016 paper"), and Third Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts ("the 2017 paper").

[6] See the 2017 paper.

outstanding stock without the enhanced clauses remained significant, with issuers of those bonds showing little appetite for liability management exercises to accelerate the turnover.

3. This paper provides an update on the inclusion of the enhanced clauses in international sovereign bonds, and suggests that regular periodic updates can now be discontinued. The results are very similar to those in the previous progress report (the 2017 paper). Section II reports on the inclusion of these provisions, finding that the vast majority of issuances include them, with only a few countries continuing to stand out against the market trend. The section also provides an update on the outstanding stock of international sovereign bonds, showing that the percentage of the outstanding stock with enhanced clauses is increasing, but a significant percentage of the stock still does not include these clauses and little action has been taken by sovereign issuers to increase the rate of turnover. Section III reports on the use of different bond structures. Section IV describes other developments and proposes that future updates be prepared as needed rather than periodically given that the inclusion of enhanced clauses has become the norm for international sovereign bond issuances.

ENHANCED CONTRACTUAL PROVISIONS

A. Collective Action Clauses

Uptake of Enhanced Clauses

4. Almost all new international sovereign bond issuances include enhanced CACs (see Annex). Based on information available as of October 31, 2018, there have been around 510 international sovereign bond issuances since October 1, 2014, for a total nominal principal amount of approximately US$ 620 billion.[7] Of these, approximately 88 percent of new issuances have included the enhanced CACs, as compared with 87 percent as of end-September 2017.[8] From end-September 2017 to end-October 2018, only 8 percent of issuances did not include enhanced CACs.

5. Only a few issuers are not following the market trend. From end-September 2017 to end-October 2018, these issuers were The Bahamas and Lebanon under New York law, and Azerbaijan, Macedonia and Poland under English law. Uptake of enhanced clauses under New York

[7] The figures presented in this paper are based on information available to staff through the Perfect Information database. The sample includes international sovereign bonds issued between October 1, 2014 and October 31, 2018, except: euro area sovereign issuances (as they are required by law to include euro area-specific CACs), China's domestic issuances under Hong Kong law, and GDP warrants. There may also be international sovereign bond issuances (e.g., private placements) that have not been captured by the database relied upon by staff.

[8] For purposes of this paper, "new issuances" exclude reopenings of previous issuances or take-downs under programs established prior to October 1, 2014. All shares are calculated in terms of total nominal principal amount.

and English law is almost the same at 89 and 90 percent respectively.[9] [10] Issuances under Chinese and Japanese law do not include enhanced CACs.[11] [12]

Table 1. Enhanced CACs and Governing Law

(In percent of total issuances since October 2014)

	No enhanced CACs	Enhanced CACs	Total
English	5.2	45.1	50.3
New York	5.2	43.0	48.2
Chinese and Japanese	1.5	0.0	1.5
Total	11.9	88.1	100.0

Source. *Perfect Information* database and staff calculations.

B. Pari Passu Provision

6. The modified *pari passu* provision continues to be largely incorporated as a package with the enhanced CACs, with some exceptions. In 2014, the Executive Board endorsed a modified *pari passu* provision that explicitly states that the clause does not require the issuer to pay external indebtedness on an equal or ratable basis.[13] Since end-September 2017, all issuances that have included the enhanced CACs also included modified *pari passu* provisions, with the exception of those issued by Bahrain, Indonesia (both sukuk), and Pakistan[14] and Russia under English law (Table 2). According to English-law attorneys that advise sovereign issuers, the non-inclusion of

[9] As a share of the nominal principal amount (rather than as a share of total issuances as in Table 1), about 45 percent of the total stock outstanding of international sovereign bonds are governed by English law and about 52 percent by New York law.

[10] Formulation of the clauses under English law and New York law governed bonds generally track the language of their respective model clauses published by the International Capital Market Association (ICMA): http://www.icmagroup.org/assets/documents/Resources/ICMA-Standard-CACs-Pari-Passu-and-Creditor-Engagement-Provisions---May-2015.pdf.

[11] Issuances by the Philippines and Korea under Chinese law did not include enhanced CACs. Issuances by Hungary and Poland under Chinese law included two-limb aggregation clauses in line with euro area CACs. Over the last year, there were issuances by Hungary, Indonesia, Mexico, the Philippines and Turkey under Japanese law. While documentation for these issuances is not available, staff understand issuances under Japanese law do not include enhanced CACs.

[12] As noted in the 2017 paper, most issuers of sukuk now include enhanced CACs (e.g., Bahrain, Hong Kong, Indonesia, Oman, Pakistan, Saudi Arabia and Turkey); Malaysia is the exception.

[13] As reported in past papers, the formulation of the modified *pari passu* clause is designed to significantly mitigating the risk that a court would interpret the clause similarly to the interpretation that had been given by the New York courts in the Argentine litigation. In litigation against Argentina in late 2016 and 2017 by holdout creditors, the Southern District of New York clarified that a sovereign's decision to pay some creditors but not others *in and of itself* did not give rise to a breach of the *pari passu* clause, and some other acts by the sovereign are necessary. See *White Hawthorn, LLC et al. v. the Republic of Argentina* and *Ajdler v. Province of Mendoza*.

[14] Sukuk issued by Pakistan in December 2017 do, however, include the modified *pari passu* clause.

these clauses issued under English law appears to reflect the view that English courts are unlikely to interpret the *pari passu* clause as requiring that the issuer make ratable payments to creditors.[15] Several issuers—Azerbaijan and Macedonia (under English law), and Lebanon (under New York law)—which did not include the enhanced CACs—have included modified *pari passu* clauses in their recent issuances. Euro area sovereigns have generally not included modified *pari passu* clauses.[16] While there have been variations in the formulation of the modified clauses, they all specifically disavow the obligation to make ratable payments.[17]

Table 2. Enhanced CACs and Modified Pari Passu

(In percent of total issuances since October 2014)

	No enhanced CACs	Enhanced CACs	Total
No Modified Pari Passu	7.3	5.7	13.1
Modified Pari Passu	4.6	82.3	86.9
Total	11.9	88.1	100.0

Source. *Perfect Information* database and staff calculations.

C. Market Impact

7. In line with previous findings, the inclusion of enhanced CACs does not seem to have an observable pricing effect, according to either primary or secondary market data. As mentioned in the previous papers, empirical analyses have shown little impact from the inclusion of CACs.[18] Over the last twelve months, the yields at issuance of bonds with enhanced CACs are well aligned with the relevant points on their sovereign yield curves for both investment grade and noninvestment grade countries (Figure 1). In the secondary market, two countries with significant

[15] The Financial Markets Law Committee (FMLC), an independent body of legal experts established by the Bank of England to examine issues of legal uncertainty in financial markets, has taken the view that the interpretation of the *pari passu* clause by the New York courts is unlikely to be followed by the English courts (see paragraph 18 of the 2014 paper).

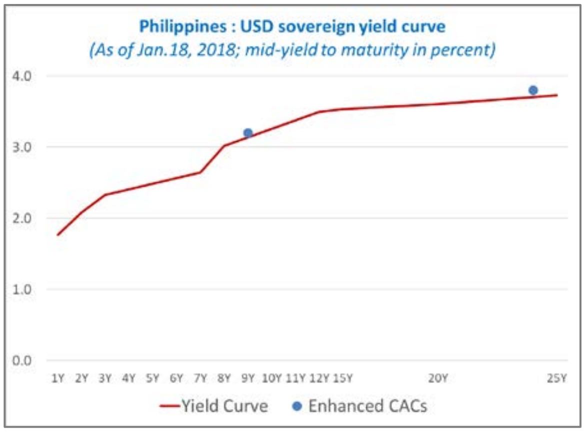
[16] For example, as reported in the 2017 paper, Finland and Lithuania have included modified *pari passu* provisions in their new international sovereign bond issuances, while Ireland and Luxembourg have not. Greece included a modified *pari passu* provision in its pre-October 2014 issuance. As noted in footnote 7, euro area sovereign issuances are currently required by law to include euro area-specific CACs.

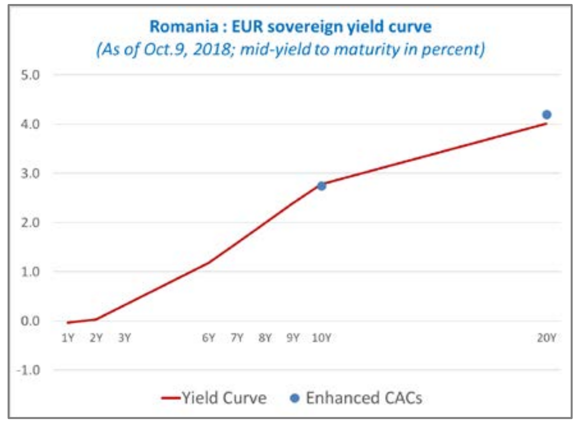
[17] ICMA published in May 2015 two different versions of the model *pari passu* clause—one for English law and another for New York law bonds: http://www.icmagroup.org/assets/documents/Resources/ICMA-Standard-CACs-Pari-Passu-and-Creditor-Engagement-Provisions---May-2015.pdf.

[18] See Eichengreen, Barry, Kletzer, Kenneth, Mody, Ashoka, "Crisis Resolution: Next Steps", National Bureau of Economic Research Working Paper No. 10095, November 2003; Bardozzetti, Alfredo, Dottori, Davide, "Collective action clauses: how do they weigh on sovereigns?" Banca d'Italia, Working Paper No. 897, January 2013. Bradley, Michael, Gulati, Mitu, "Collective Action Clauses for the Eurozone", *Review of Finance*, 2013, pp. 1-58.

issuance (Brazil and Mexico) were examined at recent market lows and highs.[19] Bonds with enhanced CACs did not exhibit noticeably higher yields, including during periods of market stress (Figure 2).[20] Recent empirical studies suggest that these findings are more broadly generalizable (Box 1).

Figure 1. Examples of Primary Market Pricing Impact of Enhanced CACs: Yields at Issuance





D. Outstanding Stock

8. The total outstanding stock of sovereign debt without enhanced CACs continues to decline slowly through attrition. The share of international sovereign bonds that include enhanced CACs grew from 27 percent of the total outstanding stock as of end-September 2017 to 39 percent as of end-October 2018. However, it will take some years for all existing bonds without enhanced clauses to mature. About 31 percent of those bonds will mature in more than 10 years (about 50 percent of these are below investment grade). Also, close to 70 percent of the bonds maturing in more than 10 years are governed by New York law, and may pose risk of holdout behavior.[21]

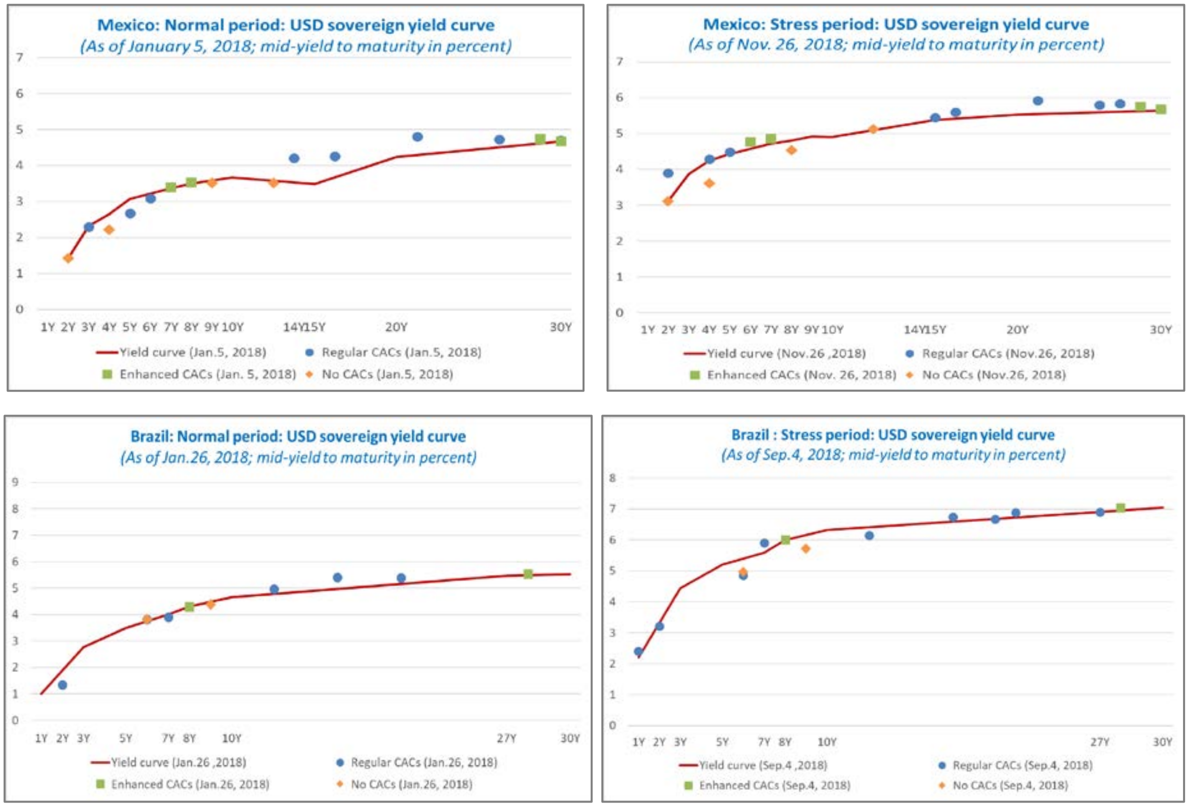
9. Sovereign interest in conducting liability management operations to accelerate the incorporation of enhanced CACs remains very limited. As mentioned in past papers, this reluctance seems largely attributable to the associated transaction costs.

[19] Dates were chosen when 5 year CDS spreads for the countries analyzed were at a minimum and maximum in the period of 2014-2018.

[20] If investors expect higher recoveries on bonds without CACs, those bonds may be priced higher when the probability of default rises. However, the presence of an (enhanced) CAC may increase net recoveries for most investors, so the direction of the effect is not determinable a priori.

[21] As discussed in the 2014, 2015 and 2016 papers, some past New York court decisions interpreting the *pari passu* provision in Argentine bonds may strengthen a holdout creditor position in a restructuring. However, the extent to which these decisions will apply to future sovereign bonds is not clear. See footnote 13.

Figure 2. Examples of Secondary Market Pricing Comparison of Enhanced CACs: Normal and Stress Periods



Source. Bloomberg LP.

Box 1. Recent Studies on the Impact of Enhanced CACs on Sovereign Borrowing Cost

Recent studies have looked at the pricing impact of the inclusion of CACs in bond contracts. The results from these studies consistently show that market participants value the additional investor protection provided by CACs, particularly in cases where borrowers are more likely to default.

Chung and Papaioannou (2019)[1] look at the pricing impact of both regular CACs and enhanced CACs. Their findings show that inclusion of regular CACs generally contributes to lower bond yields, and the cost-reducing impact is pronounced for the lowly-rated countries during episodes of market stress. Enhanced CACs also contribute to lower yields of noninvestment-grade issuers but there is no statistical significance. These results may reflect that market participants associate inclusion of CACs with the implied benefits of an orderly and efficient debt resolution process during a potential sovereign debt restructuring, rather than with debtors' moral hazard.

Other recent analyses of European issuance shows that two-limb Euro CACs bonds trade at lower yields when the sovereign is more likely to be in distress and in countries with better legal systems.[2] However, the cost-reduction differs across European countries.[3]

[1] IMF Working Paper to be published in 2019, available upon request.

[2] Carletti, Colla, Gulati, and Ongena, *The Price of Law: The Case of the Eurozone Collective Action Clauses* (October 19, 2018). Available at SSRN: https://ssrn.com/abstract=2817041

[3] Erce, Picarelli, and Jiang, *The Benefits of Reducing Hold-Out Risk: Evidence from the Euro CAC Experiment*, 2013-2018 (December 4, 2018). Forthcoming at Capital Markets Law Journal. Available at SSRN: https://ssrn.com/abstract=3288645

BOND GOVERNANCE STRUCTURES

10. Past progress reports discussed the use of trust structures in New York law-governed bonds. International sovereign bonds are typically issued under either fiscal agency agreements (FAAs) or trust structures. Under an FAA, the fiscal agent serves as an agent of the issuer, and its main responsibility is making principal and interest payments to the bondholders. Under trust structures, a bond trustee acts on behalf of, and has a number of responsibilities to, bondholders as a group. Trust structures provide additional protection against holdout creditors, including limitations on individual creditor enforcement actions and the pro rata distribution of the proceeds of litigation among all bondholders, which disincentivize minority holders to take enforcement actions to disrupt an orderly restructuring.[22] Past reports noted that, in light of this additional

[22] See paragraphs 23-25 of the 2015 paper.

protection, a number of large emerging market issuers under New York law, such as Mexico and Chile, had switched to trust structures from FAAs.

11. While trust structures continue to be prominent in international sovereign bonds issued under New York law, issuances under English law almost exclusively use FAAs. Data show that the total percentage of new international sovereign bond issuances since October 1, 2014 using trust structures is approximately 36 percent (in nominal principal terms), of which over 93 percent are issued under New York law.[23] In fact, while 68 percent of new New York law issuances since October 1, 2014 have used trust structures, Ukraine is the only issuer to use a trust structure under English law since then. The preference for FAAs may reflect that many lower income countries that issue under English law may be more sensitive to the higher costs associated with trust structures.

OTHER DEVELOPMENTS AND NEXT STEPS

12. The Eurogroup recently announced broad support amongst euro area finance ministers to amend the ESM treaty to require single-limb CACs in all euro area issuances by 2022.[24] Currently, the ESM treaty requires the inclusion of two-limb and series-by-series CACs in all issuances by euro area members.[25] The inclusion of single-limb CACs would be a significant development in harmonizing market practice around the world.

13. Staff will continue to promote the inclusion of enhanced clauses in international sovereign bonds. In particular, staff will continue to (i) collect information on the stock of existing international sovereign bonds, including the use of CACs and *pari passu* provisions, residual maturities, and authorities' intentions regarding future issuances, and (ii) engage on related issues with the membership through various fora.

14. In light of the fact that the inclusion of enhanced collective action clauses and modified *pari passu* provisions has become the market standard, staff proposes to discontinue annual progress reports on this topic. Staff will continue to inform the Board of any significant developments in this area in the context of future papers on sovereign debt related issues.

[23] The number reported in the 2017 paper (based on end-September 2017 data) was 42 percent. This number did not exclude sukuk, whereas the 2018 number does. All numbers reported in this section exclude sukuk.

[24] See https://www.consilium.europa.eu/en/meetings/eurogroup/2018/11/19/# and https://www.consilium.europa.eu/media/37267/esm-term-sheet-041218_final_clean.pdf

[25] For a discussion of euro area CACs, see the 2014 paper. During the October 2014 Board discussion, Directors noted that bonds issued by euro area sovereigns are required to include a CAC that allows for either a series-by-series or a two-limb aggregated voting procedure. Taking into account the fact that bond issuances by euro area sovereigns are, in most cases, governed by domestic law, and that this type of CAC has been positively received by market participants over recent years, Directors considered that this approach is appropriate for such bonds.

Annex I. Incorporation of Enhanced Sovereign Bond Clauses

International Sovereign Bond Issuance Since October 2014

(In billions of USD)

	Not included enhanced CACs	Included enhanced CACs
Albania		1.1
Angola		5.1
Argentina		43.5
Armenia		0.5
Azerbaijan	**3.3**	
Bahamas	**0.8**	
Bahrain		8.8
Belarus		2.0
Bermuda		0.7
Bolivia		1.0
Brazil		8.5
Bulgaria		6.5
Cameroon		0.8
Chile		11.6
China		5.5
Colombia		15.8
Costa Rica		1.0
Côte d'Ivoire	**1.0**	4.0
Croatia		5.3
Dominican Rep		9.8
Ecuador		14.8
Egypt		19.2
El Salvador		0.6
Ethiopia		1.0
Fiji		0.2
Gabon		0.7
Ghana		3.8
Grenada		0.2
Guatemala		1.2
Honduras		0.7
Hong Kong	**1.0**	1.0
Hungary	**1.8**	1.2
Indonesia	**6.5**	31.4
Iraq	**1.0**	1.0
Israel		5.4
Jamaica		2.9
Jordan		3.0
Kazakhstan		6.5

	Not included enhanced CACs	Included enhanced CACs
Kenya		2.0
Korea	**1.5**	1.0
Kuwait		8.0
Lebanon	**15.0**	
Macedonia	**1.4**	
Malaysia	**3.0**	
Maldives		0.4
Mexico	**2.5**	33.2
Mongolia	**0.7**	1.4
Montenegro		1.4
Mozambique		0.7
Namibia		0.8
Nigeria		7.3
Oman		19.1
Pakistan	**1.0**	4.0
Panama		5.6
Papua New Guinea		0.5
Paraguay		1.6
Peru		3.6
Philippines	**7.6**	2.0
Poland	**14.4**	
Qatar		21.0
Romania		14.7
Russia		13.9
Saudi Arabia		52.0
Senegal		3.3
South Africa		8.8
Sri Lanka	**3.7**	4.1
Suriname		0.6
Sweden		15.8
Tajikistan		0.5
Trinidad and Tobago		1.0
Tunisia		3.5
Turkey	**2.5**	18.5
UAE	**0.5**	10.0
Ukraine		18.2
Uruguay		4.4
Vietnam		1.0
Zambia		1.3

Sources. Perfect Information database and staff calculations.

1/ As noted in the paper, *pari passu* clauses are largely incorporated as a package with enhanced CACs, with some exceptions.