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REPORT OF THE WORKING GROUP ON INTERNATIONAL FINANCIAL CRISES

October 1998

2nd October 1998

In response to the crisis in Asia, Finance Ministers and Central Bank Governors from 22 systematically significant economies met in Washington, D.C. in April 1998 to examine issues related to strengthening the international financial architecture. This initiative was intended to complement ongoing efforts in the IMF, the World Bank and other international institutions and fora, and to help develop a broad international consensus on these important issues.

Ministers and Governors identified three key areas where action is needed: enhancing transparency and accountability; strengthening national financial systems; and managing international financial crises. Recognising the complexity of the issues at hand, working parties were formed to study these issues further with the aim of developing concrete proposals to strengthen the architecture of the international financial system. These groups, of which we are the co-chairs, benefited from the diversity of their participation and the openness of the consultation process. In addition to representatives from finance ministries and central banks with a breadth of experience in systemic issues, each working party included observers from international organisations. The working groups also sought and received the views and contributions of countries not represented in the working groups, private sector representatives and other international groups.

The working groups have prepared reports on their deliberations recommending actions in a number of areas. The international community is invited to consider these recommendations and to take actions to implement them.

These reports are being sent to the Managing Director of the IMF and the President of the World Bank with the request that they be forwarded through Executive Directors to Finance Ministers and Central Bank Governors in anticipation of meetings held at the time of the annual meetings of the Bretton Woods institutions. The reports will be discussed at a meeting of Finance Ministers and Central Bank Governors on 5th October.

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PREFACE

The international financial crisis that began in Asia and has now spread to other continents lends urgency to efforts to strengthen the architecture of the international financial system. The importance of these efforts was first given prominence in 1995 at the Halifax summit of heads of state and government of G-7 countries, and progress since has benefited from the involvement of finance ministries and central banks from both developed and emerging market economies.

In response to the crisis in Asia, Finance Ministers and Central Bank Governors from a number of systemically significant economies met in Washington, D.C. in April 1998 to examine issues related to the stability of the international financial system and the effective functioning of global capital markets.[1] In their discussions, Ministers and Governors stressed the importance of strengthening the international financial system through action in three key areas: enhancing transparency and accountability; strengthening domestic financial systems; and managing international financial crises.

Three working groups were formed to contribute to the international dialogue on how to proceed in these key areas. A strength of these working groups was the diversity of their participants and the openness of their consultation process. Each working group comprised representatives from finance ministries and central banks of developed and emerging market economies; international organisations were invited to participate in the discussions; and contributions and views from other international groups, countries not represented in the working groups, and private sector representatives were sought.

The three working groups have prepared reports on the outcome of their discussions and recommended a range of actions to strengthen the international financial system.

ENHANCING TRANSPARENCY AND ACCOUNTABILITY

The Working Group on Transparency and Accountability considered the contributions that transparency and accountability can make to improvements in economic performance, as well as the nature of information needed for effective transparency and

[1] The April meeting was attended by Finance Ministers and Central Bank Governors from Argentina, Australia, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Thailand, the United Kingdom and the United States. The heads of the BIS, IMF, OECD and the World Bank, as well as the Chair of the Interim Committee, attended as observers.

accountability.[2] Members attached particular importance to enhancing the relevance, reliability, comparability and understandability of information disclosed by the private sector. They recommended that priority be given to compliance with and enforcement of high-quality accounting standards.

There was consensus on the need to improve the coverage, frequency and timeliness with which data on foreign exchange reserves, external debt and financial sector soundness are published. Furthermore, members recommended that consideration be given to compiling and publishing data on the international exposures of investment banks, hedge funds and other institutional investors.

Transparency is an important means of enhancing the performance and public accountability of international financial institutions. Members recommended that international financial institutions adopt a presumption in favour of the release of information, except where release might compromise a well-defined need for confidentiality.

Members emphasised the importance of there being transparency about transparency. Members recommended that the IMF prepare a Transparency Report summarising the extent to which an economy meets internationally recognised disclosure standards.

STRENGTHENING FINANCIAL SYSTEMS

The Working Group on Strengthening Financial Systems sought consensus on principles and policies that foster the development of a stable, efficient financial system.[3] Members identified several areas – corporate governance, risk management (including liquidity management) and safety net arrangements – where standards for sound practices need to be enhanced or developed. The report outlines elements that such standards might contain and suggests ways forward.

Members emphasised that the implementation of sound practices is best fostered through market-based incentives backed by official sector actions. The report sets out a number of concrete actions to promote implementation.

Members recognised that cooperation and coordination among national supervisors and regulators and international groups and organisations are crucial to the strengthening

[2] Representatives of the following economies contributed to the Working Group on Transparency and Accountability: Argentina, Australia, Brazil, Canada, France, Germany, Hong Kong SAR (co-chair), Japan, Malaysia, Thailand, the United Kingdom (co-chair) and the United States.

[3] Representatives of the following economies contributed to the Working Group on Strengthening Financial Systems: Argentina (co-chair), Brazil, Canada, China, France, Germany, India, Italy (co-chair), Japan, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Sweden, Thailand, the United Kingdom and the United States.

of domestic financial systems. The report sets out several options for enhancing international cooperation: for example, the establishment of a Financial Sector Policy Forum that would meet periodically to discuss financial sector issues.

MANAGING INTERNATIONAL FINANCIAL CRISES

The Working Group on International Financial Crises examined policies that could help to prevent international financial crises and facilitate the orderly and cooperative resolution of crises that may occur in the future.[4] The report should not be considered an agenda for addressing the problems currently being experienced in many emerging markets.

Members stressed the need to encourage better management of risk by the private and public sectors, and recommended that governments limit the scope and clarify the design of guarantees that they offer.

Effective insolvency and debtor-creditor regimes were identified as important means of limiting financial crises and facilitating rapid and orderly workouts from excessive indebtedness. The report outlines the key principles and features of such regimes.

Countries should make the strongest possible efforts to meet the terms and conditions of all debt contracts in full and on time. Unilateral suspensions of debt payments are inherently disruptive. The report sets out a framework to promote the collective interest of debtors and creditors in cooperative and orderly debt workouts, and principles that could guide the resolution of future international financial crises.

CONSULTATION

The three Working Groups have sought to develop recommendations in areas where consensus could be achieved and have set out options for consideration in other areas. They recognise the importance of the views of others and welcome their advice and counsel. Interested parties in the private and official sector are invited to convey their comments to the secretariat (fax +41-61 280 9100) by end October, 1998.

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[4] Representatives of the following economies contributed to the Working Group on International Financial Crises: Argentina, Australia, Belgium, Brazil, Canada, France, Germany, Hong Kong SAR, Italy, Japan, Korea, Mexico (co-chair), the Netherlands, Singapore, South Africa, Thailand, the United Kingdom and the United States (co-chair).

Report of the Working Group on International Financial Crises

EXECUTIVE SUMMARY

The larger scale and greater diversity apparent in recent capital flows to emerging markets have been of immense benefit both to emerging market countries and the world as a whole. However, they also allow crises to erupt and spread more quickly and with greater force than in the past. These new risks make it more essential than ever that countries pursue sound domestic policies to minimise their vulnerability to contagion.

Over the past year, many investors have suffered significant losses on certain emerging market debt instruments. As a result, there has been a general withdrawal of funds from emerging markets without respect for the diversity of prospects facing those countries. This report does not aim to address the critical current issues arising from this contagion. Rather, it focuses on the architecture required for the future. The international community has an interest in encouraging credit and investment decisions based on careful analysis that is focused on the long-term strengths and fundamentals of the economies involved. *Moreover, it is critical that the international financial system strengthen its ability to limit and better manage international financial crises, including appropriate roles for the official community and private sector.*

This report identifies a range of policies and institutional innovations that could help prevent international financial crises and facilitate the orderly resolution of the crises that may occur in the future. It highlights questions that would have to be addressed in the context of a particular crisis, given the circumstances at the time and the types of instruments that are contributing to the crisis. It seeks to identify for further consideration principles that could help guide debtors, their private creditors and the official community in answering these often difficult questions. In particular, this report identifies for consideration policies that could help reduce the frequency and limit the scope of future crises, improve creditor coordination, and promote the orderly, cooperative and equitable resolution of the international financial crises that occur in the future. Some of the recommendations will require further examination and will take time to implement. The report should not be considered an agenda for addressing the problems currently being experienced in many emerging markets.

POLICIES THAT COULD HELP REDUCE THE FREQUENCY AND LIMIT THE SEVERITY OF INTERNATIONAL FINANCIAL CRISES

The number and depth of recent payments crises have highlighted the critical importance of adopting policies to reduce their frequency and limit their severity. A range of policies can contribute to crisis prevention and help limit the scope of the crises which do occur. A number of these are examined in the reports of the other two Working Groups. This report highlights four issues in particular: limiting the scope of government guarantees; expanding the use of innovative financing arrangements that provide emerging markets with greater insurance against periods of market volatility; maintaining appropriate exchange rate regimes; and implementing effective insolvency and debtor-creditor regimes.

Implicit or explicit access to government resources on subsidised terms distorts market incentives and may encourage private debtors and creditors to take excessive risks.

> **Limiting, to the extent possible, the range of economic and financial activity that is covered, implicitly or explicitly, by government guarantees and ensuring that those guarantees which are offered are as explicit as possible and are "priced" appropriately, so as to reflect the risks being insured by the government, would contribute critically to crisis prevention.**

The Working Group recognises the role of the government in protecting smaller depositors in the banking system and the overall integrity of the payments and financial system. However, preserving the stability of the financial and payments system does not require protecting individual banks, their managers or their equity owners from the risk of failure. (See the report of the Working Group on Strengthening Financial Systems for more detailed recommendations on the management of the financial safety net.)

Recent events have highlighted the continued vulnerability of many emerging markets to external shocks and the consequent need for the prudent management of their external liabilities.

> **The Working Group encourages the development and greater use of innovative financing techniques that could provide, depending on the nature of the arrangements, either greater payments flexibility or the assurance of new financing in the event of adverse market developments.**

Arrangements that could provide more flexibility in payments and greater risksharing among debtors and creditors include: pre-negotiated options that would allow the debtor to extend automatically the maturity of certain obligations, debt instruments under which repayments would be reduced in certain precise, contractually defined circumstances, or other insurance-type products. Contractual arrangements that would provide assured new financing or guaranteed liquidity in the event of market volatility include the contingent credit and liquidity facilities that several countries have recently negotiated. Such contingent credit and liquidity lines may provide additional liquidity at a lower cost than holding a comparable quantity of reserves and may also exert useful ex ante policy discipline. Governments should use such lines prudently, just as they should use their reserves prudently, and, in particular, should not use them as a means of postponing adjustment.

The choice of an exchange rate regime is one of the most critical policy choices any country can make. This report does not seek to resolve the complex issues associated with the choice of an exchange rate regime; it seeks only to identify certain issues so as to help policy-makers avoid policy mistakes which can contribute to an international financial crisis. It should be emphasised that the policy mistakes which can contribute to an international financial crisis can occur in the context of any exchange rate regime.

Recent events in Asia have highlighted the critical importance of strong insolvency and debtor-creditor regimes to crisis prevention, crisis mitigation and crisis resolution. Effective national insolvency regimes contribute to crisis prevention by providing the predictable legal framework needed to address the financial difficulties of troubled firms before the accumulated financial difficulties of the corporate sector spill over into an economy-wide payments crisis. Such a predictable framework is also essential to the orderly resolution of corporate financial difficulties, and thus is an essential element of any regime for orderly and cooperative crisis management. Among the most important basic objectives of an insolvency regime are: to maximise the ex post value of the firm, whether it is liquidated or reorganised; to provide a fair and predictable regime for the distribution of assets recovered from debtors; and to facilitate the provision of credit for commercial transactions by providing an orderly regime for the distribution of the proceeds of debtors' assets.

The Working Group endorses the key principles and features of effective insolvency and debtor-creditor regimes outlined in Annexes A and B of this report and encourages further efforts in countries and in the relevant fora to strengthen existing insolvency and debtor-creditor regimes.

POLICIES TO ENCOURAGE CREDITOR COORDINATION

Difficulties associated with creditor coordination can preclude the orderly and cooperative resolution of international financial crises, as actions taken by an individual creditor in pursuit of its own self-interest, narrowly defined, can reduce the potential resources available for all creditors, in part, by failing to create a framework that provides the debtor with the time and incentives needed to adopt and implement the policy adjustments required for orderly crisis resolution. Certain contractual clauses – the collective representation clause, the majority action clause and the sharing clause – could be incorporated into the legal documentation of sovereign bonds issued in foreign offerings in order to encourage more effective creditor coordination should difficulties occur.

To encourage the adoption of such "collective action clauses", the Working Group recommends that their governments give consideration to: (i) engaging in educational efforts with identified constituencies in major financial centres to promote the use of collective action clauses in sovereign and quasi-sovereign bonds issued in foreign offerings; (ii) identifying sovereign and quasi-sovereign issuers likely to come to their markets soon and encouraging such issuers to use the collective action clauses; and (iii) examining the use of such clauses in their own sovereign and quasi-sovereign bonds issued in foreign offerings.

The Working Group discussed the possible merits and potential difficulties associated with the creation of new channels to enhance communication between the IMF, other international financial institutions and private market participants and emphasised the need for any arrangement to be fair and transparent.

PROMOTING THE ORDERLY, COOPERATIVE AND EQUITABLE RESOLUTION OF INTERNATIONAL FINANCIAL CRISES

Recent events have highlighted how the larger scale and greater diversity of recent capital flows to emerging markets generate the risk that payments crises can erupt more quickly and can be larger in scope than in the past. The assistance and support of the IMF and other international financial institutions for their members in the event of a crisis, in the context of a strong programme of policy adjustments, remain critically important.

The IMF must have sufficient resources to remain capable of catalysing policy reform and the restoration of market confidence. Therefore, it is essential to implement rapidly the agreed IMF quota increase and to put into place the New Arrangements to Borrow (NAB).

Countries that anticipate possible difficulties should seek early assistance from the IMF, in order to reduce the risk that they will be placed in a position where they lack sufficient resources to meet their debt obligations in full. The combination of adjustment and

financing typically associated with IMF assistance should be sufficient to resolve most payments difficulties and should continue to constitute the normal framework for managing and resolving international financial crises.

The size, sophistication and heterogeneity characteristic of recent international capital flows have reduced the relevance of the procedures used in the past to ensure an appropriate private sector role in resolving severe international financial crises. In particular, many such procedures were developed and proved effective during the 1980s, in an era when a small number of large international banks provided most capital flows to emerging markets.

The same capacity for innovation that enabled the private sector to help create markets for a range of new emerging market debt instruments should be applied to modernise existing procedures and institutions or to develop new practices that will contribute to the orderly and cooperative resolution of future crises.

Such innovation is required because the scale of private capital flows significantly exceeds the resources that can reasonably be provided by the official community, even with the needed quota increase to bolster IMF resources and other measures to supplement the ability of international financial institutions to provide emergency liquidity during severe financial crises. Moreover, the perception that sufficient official financial assistance may be made available to allow a country to meet all contractual obligations without some form of appropriate private sector involvement may distort the incentives of both creditors and debtors, encouraging some creditors to take unwarranted financial risk and some debtor countries to follow inappropriate policies.

A country that anticipates possible difficulties meeting the terms of debt contracts, public or private, should immediately undertake appropriate policy adjustments to enhance its capacity to meet those obligations. The international community has a clear interest in assuring that no country suspends debt payments as an alternative to policy reform and adjustment, given the costs associated with even a temporary suspension of payments.

Countries should make the strongest possible efforts to meet the terms and conditions of all debt contracts in full and on time.

Nonetheless, it is unlikely that temporary interruptions in payments on some debt obligations would never occur, particularly if there were to be unanticipated adverse market developments. In cases where an interruption in debt payments is unavoidable, a voluntary, cooperative and orderly debt restructuring, combined with the adoption of a strong programme of policy reform to enhance the debtor's payments capacity, constitutes the most efficient means of crisis resolution.

> **When the government of a crisis country faces the possibility that either it or a significant portion of the country's private sector may be unable to meet their obligations on time and in full, the government should initiate discussions with private creditors aimed at achieving a voluntary agreement on a strategy for addressing the country's debt problems.**

In some circumstances, a purely voluntary approach may be impractical. In particular, it might consume so much time that it would lead to an erosion of confidence that would be contrary to the collective interest of creditors and debtors in a cooperative and equitable workout.

Recent experience has underscored the fact that unilateral actions, especially if they substitute for reform and adjustment, are highly disruptive.

> **In those extreme cases where a temporary suspension of payments cannot be avoided, experience indicates that a disorderly workout is against the interests of debtors, creditors and the international community.**

A disorderly workout fails to promote the common interests of all parties in prompt and equitable crisis resolution in two ways: first, it fails to maintain incentives for the debtor to pursue a programme of strong and sustained policy adjustments that will allow the rapid restoration of market access and help maintain the value of outstanding creditor claims, and second, the absence of a rapid and cooperative restructuring of payments can itself contribute to poor economic performance, leading to a reduction in the total resources available for debt service. In extreme cases, it is particularly important for the government of the crisis country to maintain an open and transparent approach to the country's private creditors and work with them to achieve a cooperative, orderly restructuring of contractual obligations.

> **In such extreme cases, the interests of all parties in orderly and cooperative restructuring of contractual obligations can be furthered by devising an enhanced framework for future crisis management that would allow the international community to signal its willingness to provide conditional financial support, where appropriate, in the context of a temporary payments suspension, in certain limited circumstances.**

Such an informal signal should be provided only if, in the judgment of the international community, a government's decision to suspend debt payments reflects the absence of reasonable alternatives, if the government is undertaking strong policy adjustments and if the government is engaged in good faith efforts with creditors to find a cooperative solution to the country's financial difficulties. Such a signal has been provided in certain exceptional cases during previous crises, so as to support a comprehensive and credible programme of policy reform and to encourage the negotiation of a cooperative agreement with creditors that places the country on a sustainable payments path, thus promoting the collective interests of both debtors and creditors.

> **The Working Group supports an IMF policy decision to indicate its willingness to consider providing financial support for policy adjustment, despite the presence of actual and/or impending arrears on the country's obligations to private creditors, including arrears on marketable debt instruments. Such a signal should be provided only if: the government of the crisis country is not interrupting debt payments as an alternative to reform and adjustment; it is implementing a strong programme of policy reform; it is making a good faith effort to work with creditors in finding a cooperative solution to the country's financial difficulties; and international support is critical to the success of a strong adjustment programme.**

In some cases governments facing the need for a comprehensive restructuring of debt payments arising from an extreme international financial crisis have imposed temporary capital and exchange controls in order to buttress a temporary suspension of payments. The use of such controls should be considered only in exceptional circumstances and in conjunction with IMF-supported programmes of policy adjustments to create the conditions required for the restoration of financial and macroeconomic stability and the ultimate restoration of currency convertibility. Even in such circumstances, it may be determined that the large costs associated with the suspension of convertibility, given the extensive ties created by modern financial markets, exceeds the possible contribution such measures could make to limiting balance of payments pressures.

Several factors are likely to determine the speed with which a country regains market access, including: the policy measures adopted by the government; the stance of the IMF and the official community more broadly towards the government's policy decisions; and the approach the government adopts towards its private creditors. Recent events have demonstrated that a financial crisis in one country can augment greatly market pressure on other countries. In such circumstances, the official sector may want to provide additional financing to countries which are pursuing appropriate policies but who nevertheless face increased pressure.

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Chapter 1

INTRODUCTION

The Finance Ministers and Central Bank Governors of twenty-two economies met in Washington on 16th April, 1998 to examine how to increase the stability of the international financial system and to encourage the effective functioning of global capital markets. In their discussion, the Ministers and Governors emphasised that sound domestic policies are fundamental to healthy and robust national economies and financial sectors and increasingly to the prospects for other countries and the world economy as a whole. They emphasised the benefits of greater integration and globalisation but also noted that this process creates new risks, making it more essential than ever that countries pursue sound domestic policies to minimise their vulnerability to contagion during international financial crises. The Ministers and Governors agreed that there was a critical need to strengthen the international financial system and announced the formation of three Working Groups to advance work in this area. The three groups were asked to focus particularly on: increasing transparency and disclosure; strengthening financial systems and market structures; and improving the management of future international financial crises.

This Working Group[5] has examined methods to help reduce the frequency and severity of international financial crises and to better manage those crises that do occur in the future, with the following three objectives in mind:

- increasing, as appropriate, the role of the private sector in the resolution of international financial crises, thereby limiting the burden on the official sector and reducing moral hazard;
- avoiding unnecessary damage to the creditworthiness of the countries directly involved and promoting their future access to international capital markets; and
- containing crises, so as to minimise contagion.

This report identifies for consideration a range of policies and institutional innovations that could help prevent international financial crises and facilitate the orderly resolution of the crises that do occur. In many cases, this report highlights questions that would have to be addressed in the context of a particular crisis, given the circumstances at

[5] Senior officials from 17 economies, the International Monetary Fund, the World Bank, the Bank for International Settlements, and the Organisation for Economic Cooperation and Development participated in the Group's deliberations. See the list of participants.

the time and the types of instruments that are contributing to the crisis. It seeks to identify for further consideration principles that could help guide debtors, their private creditors and the official community in answering these often difficult questions.

While the objectives of this Working Group are similar to those of the Working Group that, under the auspices of the G-10 Deputies, drafted the "Resolution of Sovereign Liquidity Crises" in May 1996 – commonly referred to as the G-10 Report or the Rey Report, the scope of this report is broader. The G-10 Report focused primarily on sovereign bonds. It recommended that financial systems in emerging markets be strengthened, that the private sector take the lead in incorporating collective action clauses in bond contracts to facilitate orderly workouts in the event of a sovereign liquidity crisis, and that the IMF give serious consideration to lending into arrears on sovereign debt owed to private creditors and specifically lending into arrears on bond obligations. Little progress has been made in implementing these suggestions, despite the additional urgency demanded by the current environment.

The scale of international capital flows into emerging markets has increased substantially in recent years and the range of financial instruments employed by emerging markets has expanded significantly. The larger scale and greater diversity apparent in recent capital flows to emerging markets have been of immense benefit both to emerging market countries and the world as a whole. However, the increased scale and greater diversity characteristic of recent flows also allow crises to erupt and spread more quickly and with greater force than in the past. The recent experience of several countries has drawn attention to the risks associated with sovereign debt, whether denominated in a foreign currency, indexed to a foreign currency, or denominated in a convertible domestic currency. The experience of other countries has focused attention on the risks associated with cross-border bank and corporate debt.

The growth and evolution of international capital markets have demanded a more critical and complex role for the official community, notably of the IMF and other international financial institutions, in the event of an international financial crisis. Large swings in capital flows have been an important feature of recent crises. The official sector has adjusted correspondingly the amount of assistance provided in some exceptional cases, the pace at which assistance is provided and the policy adjustments demanded as prerequisites for such assistance.

The assistance and support of the IMF and other international financial institutions for their members in the event of a balance of payments crisis, in the context of a strong programme of policy adjustments, remains critically important. In many cases, official assistance, combined with strong policy adjustments, will be sufficient to stabilise market expectations and produce a rapid restoration of private capital flows. In other cases, official financing will help cushion and provide more time for the required balance of payments adjustment by the affected country, while maintaining incentives to pursue strong policy adjustments. The IMF must have sufficient resources to remain capable of catalysing policy reform, the restoration of market confidence and viable payments positions. Therefore, it is essential to implement rapidly the agreed IMF quota increase and to put into place the New Arrangements to Borrow (NAB).

Countries should make the strongest possible efforts to meet the terms and conditions of all debt contracts in full and on time. A country that anticipates possible difficulties meeting the terms of debt contracts, public or private, should immediately undertake appropriate policy adjustments to enhance its capacity to meet those obligations. Countries that anticipate possible difficulties should seek early assistance from the IMF, in order to strengthen their ability to avoid being placed in a position where they lack sufficient resources to meet their debt obligations in full. In most cases when a country experiences payments difficulties, the combination of adjustment and financing of a typical IMF programme can be expected to restore market confidence and catalyse private capital flows.

A temporary suspension of debt payments should not, and normally will not, be undertaken until all other reasonable alternatives have been explored, because of the significant economic and financial costs associated with a temporary suspension of debt payments and subsequent negotiated debt restructuring.

Historical experience, however, indicates that temporary suspensions of debt payments will occur in certain unusual and exceptional circumstances, particularly in the event of unanticipated adverse market developments. In these cases, it will be important to have orderly and cooperative techniques for negotiating the restructuring of contractual obligations. Orderly and cooperative workouts have served the common interest of both debtors and their private creditors in containing some previous crises, and in achieving prompt and equitable crisis resolution. In some extreme cases, the presence of an unsustainable debt overhang has diminished incentives for the crisis country to undertake sensible policy adjustments and has prolonged poor economic performance, leading to a reduction in the total resources available for debt service.

The size, sophistication and heterogeneity characteristic of recent international capital flows have reduced the relevance of the procedures used in the past to ensure an appropriate private sector role in resolving severe international financial crises. In particular, many such procedures were developed and proved effective during the 1980s, in an era when a small number of large international banks provided most capital flows to emerging markets. The same capacity for innovation that enabled the private sector to help create markets for the wide range of new emerging market debt instruments should be applied to modernise existing procedures and institutions and to develop new practices that will facilitate an appropriate private sector role in the effective management and orderly resolution of future international financial crises. Such evolution of the role of the private sector in the resolution of future crises is needed to match the evolution of the role of the official sector that has occurred during recent crises.

Such innovation is also required because the scale of private capital flows significantly exceeds the resources that can reasonably be provided by the official community, even with the needed quota increase to bolster IMF resources and other measures to supplement the ability of international financial institutions to provide emergency liquidity during severe financial crises. Moreover, the perception that sufficient official financial assistance may be made available to allow a country to meet all contractual obligations without commensurate commitments from the private sector may distort the incentives of both creditors and debtors, encouraging some creditors to take unwarranted financial risk and some debtor countries to follow inappropriate policies.

The international community has a clear interest in ensuring that no country suspends debt payments as a means to avoid the policy reform and adjustment required to address the causes of its financial difficulties. In those extreme cases where a temporary suspension of payments cannot be avoided, the international community has an interest in encouraging the cooperative, orderly restructuring of contractual payments that will allow for the early restoration of market access. The international community and private creditors also have an interest in providing incentives for strong and sustained policy adjustments. These interests can be furthered by devising an enhanced framework for future crisis management that would allow the international community to signal its willingness to provide conditional financial support, where appropriate, even in the context of a temporary interruption of debt payments. Such a signal should be provided only if, in the judgement of the international community, a government's decision to suspend debt payments reflects the absence of reasonable alternatives and is not an attempt to use a payments suspension as a substitute for reform and adjustment; if the government is undertaking strong policy adjustments; and if the government is engaged in good faith efforts with creditors to find a cooperative solution to the country's payments difficulties. Such a signal has been provided informally in certain exceptional cases during previous crises, so as to support a comprehensive and credible programme of policy reform and to encourage the rapid negotiation of a cooperative agreement with creditors that would place the country on a sustainable payments path, thus promoting the collective interests of both debtors and creditors.

This report contains four major sections. The first examines a set of policies that could help prevent future crises and limit their scope; the second examines measures that could improve creditor coordination in the event of a crisis; the third examines methods of crisis containment and management, including methods to reduce the disruption associated with the extreme case of a temporary suspension of debt payments; and the fourth discusses measures to limit the impact of severe international financial crises on the crisis country and on the international financial system.

Chapter 2

POLICIES TO PREVENT CRISES AND TO LIMIT THEIR SCOPE

The highest priority needs to be given to measures and policies that can help prevent future crises and can help limit the scope of the crises that do occur. The design and development of preventive policies and measures have been the primary task of the first two Working Groups, which examined measures to increase transparency and improve disclosure and policies to strengthen national financial regimes.

The efforts of this Working Group complement those of the other two Working Groups. The measures to increase disclosure and transparency identified by the first Working Group will increase both the quantity and quality of information provided to the private sector. Such efforts will be enhanced by measures proposed in this report which will augment market incentives to use information efficiently. The measures to strengthen financial systems identified by the second Working Group will help prevent the build-up of unsustainable risk positions in the private sector. The effectiveness of such measures will be augmented by the measures proposed by this Working Group, which will strengthen the incentives of debtors and creditors to pursue prudent strategies.

Over the past year, many investors have suffered significant losses on certain emerging market debt instruments. As a result, capital has been flowing out indiscriminately, just as it flowed into certain emerging markets without due attention and adequate analysis of the risks involved. The international community has an interest in encouraging credit and investment decisions based on careful analysis and focused on the long-term strengths and fundamentals of the economies involved.

A range of policies can contribute to crisis prevention and help limit the scope of the crises which do occur. The policies identified in the following section – limiting the scope of government guarantees, developing insurance arrangements which protect borrowers against sudden liquidity shortages and explicitly provide for greater risksharing between debtor and creditors, maintaining appropriate exchange rate regimes and implementing effective insolvency and debtor-creditor regimes – are by no means exhaustive. Nonetheless, each of these measures can contribute to crisis prevention and limitation.

2.1 Limiting government guarantees to the private sector

Implicit or explicit access to government resources on subsidised terms distorts market incentives and may encourage private debtors and creditors to take excessive risk, in part by failing to hedge against potential adverse market developments. Consequently, limiting government guarantees, making those guarantees which are offered as explicit as possible and designing the guarantee arrangements so that they are "priced" appropriately, so as to reflect the risks being insured by the government, can contribute to crisis prevention. Limiting the scope of guarantees can also help limit the scale of the liabilities accumulated by the government during a crisis and the associated fiscal cost.

The appropriate design of the financial safety net is the subject of the second Working Group; however, the appropriate roles of government guarantees during the period immediately preceding a crisis, during the crisis and during crisis resolution are relevant to this report.

In practice, there is great variety in the extent and explicitness of the guarantees offered by various governments. Private obligations guaranteed by governments range from bank deposits and short-term financial instruments explicitly backed by government insurance schemes to financial and corporate obligations backed by implicit government guarantees. Government guarantees, both explicit and implicit, may be employed for a number of reasons: forestalling self-reinforcing runs on the financial system and on banks in particular; protecting troubled corporations from insolvency, with associated economic and social costs; and subsidising preferred forms of economic activity. In some cases, guarantees have also been provided for inappropriate reasons, such as subsidising favoured firms and concealing financial problems.

The Working Group acknowledges the proper role of the government in protecting smaller depositors in the banking system and maintaining the integrity of the payments system. However, preserving the stability of the payments and financial system does not typically require that the government protect individual banks, their management and their equity owners from the possibility of failure. Even when it is decided that the stability of the payments system requires that a government prevent individual institutions from failure, the management and equity holders of those financial institutions should not, to the extent possible, be insulated from the consequences of their prior decisions.

The systemic risks associated with the failure of a bank or other financial institution, of course, depend on the macroeconomic and financial context in which the failure occurs: the failure of an individual bank or financial institutions during a period of macroeconomic and financial stability will pose smaller systemic risks than the failure of the same institution during a period of greater volatility.

The ex ante design and operation of the financial safety net, including the government's willingness to allow private financial institutions, including banks, to fail in the absence of a crisis will have important consequences for crisis management. The willingness of a government to allow individual institutions to fail during periods of macroeconomic and financial stability is likely to help shape expectations concerning the range and type of obligations that the government will guarantee in the event of a crisis. Governments that do not allow private financial institutions, including banks, to fail during "normal times" may be expected by market participants to protect all private financial institutions during a crisis. This, in turn, can encourage the excessive accumulation of risk. Furthermore, allowing the failure of private financial institutions during periods of stability, by closing problem institutions and encouraging better credit evaluation, helps to reduce the costs incurred should the government be required to intervene in order to protect the integrity of the financial system during a crisis.

The scope of government guarantees has often expanded during crises. Several governments have guaranteed explicitly either all or most of the liabilities of the banking system, including its external liabilities, in an effort to restore confidence in the financial system when clear signs emerged that financial markets were beginning to re-evaluate the extent of their existing exposure. Once offered, such unilateral, blanket guarantees cannot easily be revoked. Consequently, they constitute a significant new public financial liability and can limit the government's options during crisis resolution. Once a government has guaranteed the financial obligations of the banking system, it cannot use guarantees to help catalyse the creditor contributions needed for equitable crisis resolution.

The cost of socialising risk through the granting of government guarantees may be worthwhile if the extension of a guarantee is linked to needed concessions from creditors in the form of maturity extension, debt reduction, or other improvement in the terms of the debt. The use of guarantees to stop a sudden withdrawal of credits or to catalyse rapid and orderly agreements with creditors on the resolution of private debt crises can help to spur the restoration of macroeconomic and financial stability. Even in this context, however, it is important to limit the scope of the guarantees so as to limit the scale of the risks assumed by the government.

The contribution of government guarantees to financial stability depends on the credibility of the government and its ability to provide or raise the resources needed to honour its financial guarantees without introducing destabilising macroeconomic policies. Questions about the credibility and capacity of the government can prevent the extension of guarantees from generating the rapid restoration of market confidence required to achieve the expected benefits. The potential costs associated with the provision of a government guarantee should be assessed carefully. Even if a guarantee fails to generate the expected short-term benefits, the government will have to assume the full long-term costs, including the fiscal costs, associated with a guarantee.

Explicit and implicit government guarantees of corporate sector obligations should normally be avoided. Corporate financial difficulties do not ordinarily constitute a threat to the payments system, and the best means of restoring corporate solvency and maximising the value of corporate assets is through the application of an effective insolvency regime. However, even a well-developed and long-established insolvency regime may not cope easily and efficiently with a crisis affecting the entire corporate sector, such as has occurred recently in some Asian countries. Large-scale insolvency in the corporate sector can generate significant or even systemic problems in the banking and financial sector and possibly require that the government intervene to provide support for the banking system at a potentially substantial fiscal cost.

When faced with large-scale insolvency in the corporate sector, private financial institutions may not have strong incentives to initiate insolvency proceedings against non-performing debtors, since those proceedings could reveal the scale of the institutions' own financial difficulties. Therefore, it may be appropriate for the government to encourage the workout of corporate difficulties while adopting policies to sustain the integrity of the banking and financial system. In extreme cases, such as those in some Asian countries, it may be appropriate for the government to devise special arrangements aimed at facilitating rapid economy-wide restructuring.

2.2 Insurance facilities

2.2.1 Self-insurance

The Working Group recognises the utility of insurance against market volatility. The most basic form of insurance is self-insurance, which, in the case of a government, takes the form of foreign currency reserves that can be used to cover temporarily a government's financing requirements during periods of market volatility, to provide resources to support the country's exchange rate regime and, in some circumstances, to provide short-term foreign currency credits to the country's banking system in the event of a sudden deterioration in the confidence of external creditors.

The prudent management of the government's own liabilities constitutes a form of self-insurance. Prudent management requires the use of long-term financing for a significant portion of the government's domestic and external debt and the spacing of the maturities of existing debt so as to avoid surges in the need for new financing. The failure to maintain such standards for prudent financial management has contributed to certain recent international financial crises.

2.2.2 Contingent credit and liquidity facilities

Several countries have sought to insure themselves against a shortage of liquidity by arranging contingent credit facilities. The participating country pays a commitment fee for the availability of the facility to a consortium of international banks and, in turn, receives the right to draw down on the facility at a predetermined interest rate up to pre-established limits. The structure and objectives of such facilities can differ in key ways. The Argentine facility is a repurchase facility for Argentine government bonds and other assets held by Argentine banks and is intended to supply liquidity to the financial sector in the event of a liquidity crisis. The Mexican facility is designed as a credit line to the government that would cover a significant portion of its financing needs during periods of market turbulence.

Given the discrepancy between local interest rates and the interest rates that can be earned on hard currency assets held as reserves, contingent credit and liquidity facilities can provide access to supplementary liquidity at a lower price than an equivalent quantity of reserves. Like reserves, contingent credit and liquidity facilities can enhance confidence that sufficient liquidity will be available in the event of unexpected volatility and thus can help prevent crises by enhancing investor confidence. They can also facilitate the management of liquidity shocks. The presence of a contingent credit or liquidity facility and the need to renew it periodically can also exert useful ex ante policy discipline, in part by providing a continuing discussion between the government and a group of committed private creditors.

Contingent credit and liquidity facilities may not provide significant net new money in the event of a crisis. The banks involved in the facility may engage in dynamic hedging: they may reduce other credit to the country in order to limit their exposure to the country when the contingent credit facility is drawn upon or take other actions to hedge their exposure. Furthermore, contingent credit and liquidity facilities may not be sufficient in the event of a severe crisis, may be difficult to renew during periods of volatility and may not be available to more than a handful of countries. Consequently, they are likely to play only a partial role in the management of future international financial crises.

Just as the international community has an interest in assuring that countries do not use their reserves in an attempt to postpone needed adjustment, the international community has a clear interest in ensuring that contingent credit and liquidity facilities, which can substitute for reserves, are used prudently and are not used to postpone adjustment. If a contingent credit or liquidity facility is used to postpone adjustment, the facility would only serve to increase the magnitude of the government’s overall foreign exchange liabilities and thus exacerbate the crisis.

Some have raised the possibility of using the multilateral development banks (MDBs) to provide credit enhancement for contingent credit and liquidity facilities. They might provide contingent credit lines of their own or guarantee a portion of the credit drawn under private contingent lines, in order to: (i) expand the number of countries that might be able to participate in such facilities (e.g. for countries that the private sector would regard as too risky in the absence of MDB involvement); or (ii) increase the quantity of resources that creditors might commit to such facilities. These suggestions raise issues that require further study. Any involvement of the MDBs would generate potential claims on their financial resources and would have implications for their country risk exposure limits and for their reserves and lending capacity. The use of public resources to guarantee the repayment of private creditors also raises issues of moral hazard. The amount of conditionality and link to the IMF required for the MDBs' involvement in such a facility would also need to be considered carefully, along with the leverage that might be exerted by MBD involvement, i.e. the size of the net increase of private finance that could be generated by the commitment of a unit of MDB funds to credit enhancements of contingent credit and liquidity facilities.

2.2.3 Other forms of insurance and risk-sharing

Recent developments in financial markets suggest that countries may be able to structure their external assets and liabilities to provide a greater degree of explicit, contractual risksharing than has been the case in the past. The development and use of such financial arrangements to provide more insurance against adverse market developments than typical in the financial arrangements currently employed could strengthen the capacity of emerging markets to avoid potential financial difficulties. In particular, the negotiation of financial arrangements to provide insurance against volatility in the prices of key exports would be useful and could be feasible, since it should be possible to assess and price the risks associated with such arrangements. While the purchase price of such insurance may seem expensive during periods of strong capital flows to emerging markets, recent events have illustrated the potential value of such insurance during future episodes of market volatility. Consequently, the Working Group encourages countries to explore the use of such innovative financing techniques as part of their strategies for prudent risk management.

Examples of possible instruments that might provide a higher degree of risk-sharing include bonds linked to the prices of key commodities as well as bonds linked to overall indices of emerging market risk. The recent development in advanced markets of bonds issued by insurance companies that cease payment in the event of a catastrophic natural disaster suggests the possibility of developing markets for innovative bonds that contain a similar form of risk-sharing. Such instruments differ fundamentally from the contingent credit and liquidity arrangements discussed previously, since they would automatically reduce payments, rather than provide new credits, in certain unfavourable circumstances.

It is also worth considering the addition of options to sovereign bonds and interbank credit lines that would allow a debtor government or debtor banks to extend the maturity of a bond or credit line for a specified period of time at a predetermined spread. Such options could be exercised to ease pressure on the government and the banking system in the event of a liquidity crisis. Such provisions could have an effect opposite to the effect of the put options that have been exercised in certain recent crises. These put options have reduced the maturity of various credits and thus exacerbated market pressure. There may be a risk, however, that adding options to extend interbank credit lines could prompt creditors to withdraw such lines more rapidly, at the earliest signs of difficulties, so as to prevent the debtor from exercising the option of extending the line.

2.3 Liquid domestic bond markets

Many countries that have recently experienced crises were characterised by their weak and underdeveloped local bond markets, which induced excessive reliance on bank credit and international borrowing. The availability of a deep local market for domestic obligations allows a government and private firms to raise long-term financing in the local currency and can help limit the risks of financial crises. Such bond markets can help permit the maintenance of uninterrupted market access during periods of volatility in the international markets. They also can augment the degree of competition in the allocation of finance within an economy by providing an alternative to bank finance, and thus encourage the efficient allocation of capital. The development of liquid and deep domestic financial markets that can channel domestic savings efficiently to finance economic activity should therefore be encouraged.

A successful bond market requires a number of mechanisms and institutional features. Key mechanisms and features include the following: an adequate supply of high quality issues and issuers, as well as demand from institutional investors; data transparency and good disclosure standards, along with transparent standards for rating bond issues, to provide a sound basis for evaluating the risks associated with particular securities; standardisation of papers and procedures to facilitate trading and market liquidity, including the emergence of a benchmark yield curve; low tax and transaction costs; financial infrastructure for payment, clearing, settlement and custody to facilitate transactions, both regionally and internationally; and a clear and fair regulatory framework. Successful local bond markets usually require sound macroeconomic policies to create the overall environment needed for such markets to flourish over an extended period of time.

2.4 Exchange rate regimes

The examination of the considerations underlying a country's choice of an appropriate exchange rate and monetary policy regime has not been the focus of this working group and this section does not seek to resolve these complex issues. It seeks only to identify certain issues of relevance to this report associated with different exchange rate regimes, including the role that different regimes can play in the prevention of international financial crises.

Exchange rate regimes vary in degree of rigidity. They range from institutional arrangements like currency boards, to conventional fixed exchange rates, to crawling exchange rates or bands, to managed or unmanaged floats. A country's exchange rate regime can influence the volume and pricing of private capital flows and has strong implications for other macroeconomic and microeconomic policies. It must be emphasised that policy mistakes which can contribute to an international financial crisis can occur in the context of any exchange rate regime. Strong financial sector regulation and monetary and fiscal policies appropriate to the exchange rate regime are essential in all exchange rate regimes.

Relatively rigid exchange rates can be an important symbol of policy commitment to achieving and maintaining low inflation, especially when countries are seeking rapid disinflation, and an integral part of a country's strategy for achieving and maintaining macroeconomic stability. A sustainable commitment to a relatively rigid exchange rate regime requires a corresponding commitment to strong monetary and fiscal policies and an appropriate framework for regulating financial institutions. In a rigid exchange rate regime, a decline in demand for domestic financial instruments can bring a country's hard currency reserves under pressure.

Relatively flexible exchange rates explicitly introduce two-way risk and, consequently, can help prevent the accumulation of excessive foreign currency liquidity mismatches and unhedged foreign currency exposure. Flexible exchange rate regimes also allow for greater macroeconomic policy flexibility than do more rigid exchange rate regimes, and thus can help facilitate a country's adjustment to external shocks, such as the swings in capital flows and the terms of trade shocks which have been factors in recent crises.

There are clear historical examples of the costs of maintaining excessive exchange rate rigidity for too long. Introducing flexibility during a crisis can be highly destabilising. On the other hand, there is often little pressure to introduce exchange rate flexibility during times of stability, even though such flexibility may assist some countries in pre-empting a future crisis by facilitating a country's adjustment to external shocks. Countries will differ in the extent to which they have made institutional commitments to a rigid exchange rate regime, but many would benefit from considering strategies for increasing flexibility during periods of macroeconomic and financial stability, when the costs of introducing increased flexibility may be quite small.

Policies to limit a country's vulnerability to external shocks, such as terms of trade shocks or large swings in capital flows, and to ensure the availability of needed liquidity in the event of market volatility are required regardless of a country's exchange rate regime. In the event of market volatility, the ability of the government to cover temporarily its own financing requirements and to ensure its own access to needed liquidity can be critical to the maintenance of financial and macroeconomic stability and its ability to avoid recourse to an expansionary monetary policy as a means to meet its own financing needs.

Market participants should recognise that changes in exchange rates and exchange rate regimes may occur, especially if the exchange rate regime is not backed by a commensurate commitment to appropriate monetary and fiscal policies. The possibility of such changes in the exchange rate should be taken into account and reflected in the financing decisions of private borrowers and lenders, as well as in the government's own financing decisions.

2.5 Insolvency and debtor-creditor regimes

Strong insolvency and debtor-creditor regimes provide the predictable legal framework that is essential for addressing the financial difficulties of troubled firms before the accumulated financial difficulties of the corporate sector spill over and contribute to an economy-wide payments crisis. Many insolvency regimes allow for private creditors to replace the management of troubled firms, and can thus create powerful market incentives for prudent corporate behaviour. Consequently, strengthening the insolvency and debtor-creditor regimes of many emerging market economies could contribute to crisis prevention.

Strong insolvency regimes also provide the necessary framework for the efficient restructuring or orderly liquidation of troubled firms. Consequently, they are essential to the orderly resolution of payments crises, particularly when corporate indebtedness, including external indebtedness, is a major source of strain on a country's macroeconomic stability. By facilitating the rapid workout of corporate debt crises and the quick restoration of a financially stable corporate sector, strong regimes help to limit contractions in economic output and to ensure the rapid return of economic growth.

Strong insolvency laws minimise creditors' aggregate losses resulting from borrower non-performance by fostering cooperation among creditors when they are confronted by borrowers in financial difficulty. Such cooperation maximises asset value, benefiting the economy as a whole. In the absence of insolvency laws, individual creditors may compete to be the first to seize collateral or to obtain a legal judgement against a debtor. Such a competition may lead to the breaking apart of the debtor's assets to repay individual creditors, undermining the overall value of the debtor's total assets when the assets of the debtor are worth more as a whole than as a number of pieces. It can also precipitate a general loss of market confidence. For this reason, it is in the collective interest of creditors that the reorganisation of a debtor or the disposition of the debtor's assets be carried out in an orderly manner. The coercive aspect of insolvency arrangements enhances social welfare by ensuring that the losses incurred by all creditors are not increased by the unilateral actions of a few creditors.

Insolvency law is meaningless unless enforced in a fair and predictable manner by competent courts or tribunals, staffed by professionals trained in commercial matters. The relevant members of the community (the legal and dispute resolution communities, and domestic debtors and creditors) must be brought into the implementation process so that they understand and utilise the regime.

Insolvency reform is often ineffective without parallel reform of other commercial laws. It is therefore important to identify and remove legal impediments to reorganisation, such as tax penalties on debt forgiveness, obstacles to debt-equity swaps, restrictions on the transfer of creditors' rights, restrictions on foreign ownership and limitations on the rights of equity owners created by poor and inadequately enforced regimes for corporate governance. A strong insolvency regime and the removal of such legal impediments create a favourable framework for private sector workouts.

Even if an insolvency regime is infrequently put to use, the regime creates incentives for negotiated resolution and provides a framework for negotiating a workout or restructuring outside of court-administered insolvency proceedings. In some cases, this may require a spirit of cooperation by creditors on a cross-border basis, outside formal insolvency or court rehabilitation processes, that facilitates attempts to preserve value when commercially viable firms face financial difficulties.

2.5.1 Key principles and features of effective insolvency regimes

Among the most important basic objectives of an insolvency regime are: to maximise the ex post value of the firm, whether it is liquidated or reorganised; to provide a fair and predictable regime for the distribution of assets recovered from debtors; and to facilitate the provision of credit for commercial transactions by providing an orderly regime for the distribution of the proceeds of debtors' assets. In practice, insolvency laws are designed to balance the rights and interests of various constituencies in apportioning the burdens of insolvency in a manner consistent with a country's policies and goals, including social objectives that may include, for example, the preservation of employment opportunities.

While there may be variations in countries' approaches, there are certain key principles and features that could be considered as important to an effective insolvency regime for commercial firms.[6]

Effective insolvency regimes should:

- seek to maximise the value of a firm's assets by providing for an option to reorganise;
- strike a careful balance between liquidation and reorganisation;
- provide for equitable treatment of similarly-situated creditors, including similarly-situated foreign and domestic creditors;
- provide for timely, efficient and impartial resolution of insolvencies;
- prevent the premature dismemberment of the debtor's assets by individual creditors seeking to obtain quick judgements against a debtor;
- provide for a procedure that is transparent and contains incentives for gathering and dispensing information;
- recognise existing creditor rights and respect the priority of claims with a predictable and pre-established process; and
- establish a framework for cross-border insolvencies, with recognition of foreign proceedings.

Annex A lists in greater detail the above key principles and features of an effective insolvency regime that are being endorsed by this Working Group. The Working Group has consulted with the International Federation of Insolvency Practitioners (INSOL International) in formulating the key principles and features of effective insolvency regimes.

The UNCITRAL Model Law on Cross-Border Insolvency, once enacted, could be useful in the following ways. Among other things, it creates a procedural mechanism that would allow for the imposition of a creditor moratorium protecting the international assets of a firm undergoing insolvency proceedings; provides a foreign representative with access

[6] The key principles and features of effective insolvency regimes set out here are intended to apply only to the insolvency of commercial firms and not to financial firms. However, an effective insolvency regime is a necessary tool for dealing with failing financial firms. Some of the key principles and features of effective insolvency regimes for non-financial firms, such as equitable treatment of similarly-situated creditors, are clearly appropriate for financial firm insolvencies as well.

to local insolvency proceedings; provides a transparent regime for foreign creditors to commence, or participate in, insolvency proceedings in a given state; and permits courts in a given state to cooperate more effectively with foreign courts. Rules on cross-border insolvency and recognition of foreign proceedings should enable better coordination in the case of multi-jurisdictional insolvencies and thus facilitate more orderly workouts as well as allow countries to be better prepared for the increased incidence of cross-border insolvencies stemming from the expansion of global trade and investment. The Working Group encourages the wider use of the UNCITRAL Model Law on Cross-Border Insolvency or the adoption of similar mechanisms to facilitate the efficient resolution of cross-border insolvencies.

2.5.2 Key features of effective debtor-creditor regimes

Debtor-creditor laws refer to a wide variety of laws covering the creation of debt contracts and the collection of debt. Of particular importance are those laws that provide the framework for the extension of credit secured by the assets of an enterprise – both its movable property (framework for secured transactions) and its real estate (framework for mortgages). These laws are integral to the operation of an effective insolvency regime. They provide a framework for collecting debts prior to borrower insolvency, mitigating the magnitude of the debts of the insolvent enterprise.

Recent experience shows that financial systems which are heavily dependent on banks can experience financial instability of a magnitude that can generate macroeconomic difficulties. Effective debtor-creditor regimes can allow a wide variety of institutions and agents to act as financial intermediaries and can therefore have positive and economically important effects on the strength and stability of the financial sector. Effective debtor-creditor laws create a legal framework that allows for loans to be extended at lower interest rates and at less risk while facilitating the diversification of credit risk and fostering non-bank financial intermediation. Reduced dependence on bank credit lessens the economic impact of a banking crisis on the real economy, and thus on overall macroeconomic performance.

This Working Group has identified certain key features of effective debtor-creditor regimes. These features are listed in Annex B.

2.5.3 Encouraging the adoption of effective regimes

The Working Group has focused on the identification of key principles and features of effective insolvency and debtor-creditor regimes. It has not tried to develop specific new means to encourage the adoption of effective insolvency and debtor-creditor regimes. It is expected that the enhanced international surveillance process under consideration in a number of fora will review national insolvency and debtor-creditor regimes as well as other elements of strong national financial systems. Also, technical assistance from both the IMF and the World Bank should help encourage and facilitate improvements in existing insolvency and debtor-creditor regimes. Capital markets should also help promote the adoption of appropriate regimes, as recent experience is expected to lead market participants to intensify their scrutiny of the quality of existing insolvency regimes. Nevertheless, consideration should be given in the appropriate fora to the development of additional means and incentives for encouraging the adoption of effective regimes.

Chapter 3

INSTITUTIONAL ARRANGEMENTS TO PROMOTE CREDITOR COORDINATION

3.1 Collective action clauses

Insolvency regimes mandate creditor coordination when an enterprise has difficulty servicing its contractual payments, facilitating the orderly workout of corporate debt crises. There is currently no analogous regime for sovereign debtors. As noted in the G-10 Report on “The Resolution of Sovereign Liquidity Crises”, the creation of an internationally agreed and binding insolvency regime for sovereign debtors is unlikely. Consequently, there is a particular need to develop institutional and legal mechanisms for facilitating the orderly workout of sovereign liquidity crises. Because a great deal of sovereign debt takes the form of securities, particularly bonds, held by numerous creditors, rather than bank loans, the need to enhance coordination among creditors is particularly acute in today’s environment.

Clauses designed to improve creditor coordination could be built into sovereign bond contracts to discourage disruptive legal action, to facilitate debtholders’ decision-making and to prevent dissident debtholders from blocking a debt restructuring acceptable to the vast majority of debtholders. Certain of these clauses have been employed in a number of sovereign and non-sovereign bonds issued under English law and traded in the Euromarkets.

The G-10 Report, often referred to as the Rey Report, recommended the use of three specific clauses in sovereign bond contracts. They provide for: (i) collective representation of creditors; (ii) majority action to alter the payment terms of the contract; and (iii) sharing of payments among creditors. These three clauses will be referred to as the “collective action clauses” in this report.

Collective representation clauses provide mechanisms for co-ordinating action among holders of a bond issue, facilitating coordination and communication between the holders of a bond issue and sovereign debtors and also facilitating communication between the holders of a bond issue and other creditors. The G-10 Report concluded that collective representation clauses could make debt restructuring advance more quickly and smoothly during a liquidity crisis.

Majority action clauses allow a qualified majority of creditors to alter the payment terms (interest, principal, maturity or other material terms) of a debt contract. Decisions made to alter these terms by the specified majority, without the unanimous consent of the debtholders, are binding on each of them.

Sharing clauses could discourage dissident creditors from engaging in disruptive action such as pursuing litigation or preferential settlements. Such actions may make the orchestration of an orderly workout more difficult. In such clauses, creditors agree to share proportionally with all other creditors payments received from the debtor, including proceeds of set-offs, litigation and other preferential payments. Sharing clauses are most effective when creditors present a credible threat to each other: one creditor must be aware that another creditor has received a disproportionate payment and must be able to locate that creditor in order to bring suit. There is little experience with the effect of these clauses when the community of creditors is large and dispersed, as is typically the case with bondholders.

Such clauses are not likely to prove a panacea. Although they could provide a framework for restructuring bond payments in an orderly way, they would not guarantee that the issuer of sovereign bonds and a qualified majority of the holders of such bonds would be able to agree to restructure contractually obligated payments rapidly enough to avert a possible crisis, nor does the adoption of such a framework guarantee a rapid workout in the event of a severe crisis. Furthermore, coordination among holders of a particular bond issue or among holders of different bond issues will not necessarily resolve coordination problems between holders of different types of instruments. Even if such clauses become standard in new sovereign bonds issued in foreign offerings, it will take some time before the outstanding stock of all such bonds incorporates these clauses.

Nevertheless, wider use of these clauses would be helpful in addressing a central aspect of the collective action problem in sovereign liquidity crises: lack of coordination among multiple creditors holding a single debt instrument. They might also provide a mechanism for designating a representative of a particular bond issue to participate in the negotiations with a sovereign over the terms of a cooperative restructuring of several bond issues or for calling a restructuring meeting. In sum, they could provide an improved mechanism for the cooperative workout of payments difficulties stemming from sovereign bond issues, should such a workout prove necessary.

The pricing implications of such clauses are ambiguous. The use of such clauses might be seen as increasing the probability of an interruption of payments, and therefore lead bondholders to increase the yields they demand. However, given that some interruptions in payments would undoubtedly occur even in the absence of collective action clauses, the presence of such clauses could be seen as reducing the uncertainty surrounding the debt workout process and therefore reduce the yields demanded by bondholders. The risk premia associated with certain emerging market debt instruments indicate that the international financial markets currently assign a high probability to the possibility of some interruption of payments. The widespread adoption of such clauses by sovereign bond issuers and their standard use by underwriters would be likely to have fewer market implications than their use by a single bond issuer.

At present, the use of collective action clauses is not sufficiently widespread to permit any definitive conclusions about the implications of such clauses on the pricing of a bond issue. Majority action clauses have been incorporated into a number of sovereign bonds issued in the Eurobond market under English law without any noticeable price penalty. However, it is possible that other clauses, notably the sharing clause, may have more noticeable price implications. Consequently, the absence of a noticeable price penalty on bonds containing one of the clauses cannot be used to predict the pricing of bonds containing all of the collective action clauses.

Some have expressed concern that the increased use of collective action clauses would create, at least during a transitional period, two different types of sovereign bonds. In the event of a payments crisis, they indicated that a country might be tempted to interrupt payments only on bonds containing the collective action clauses that facilitate restructuring, while continuing to make payments on its other sovereign debt. It should be noted that the presence of such clauses would not eliminate the protection to creditors provided by cross-default and similar clauses, nor does the presence of collective action clauses, as a legal matter, make bonds containing these clauses subordinate to bonds not containing these clauses. A specified majority of bondholders would retain the legal right to determine the terms of a restructuring, and could therefore refuse to accept a restructuring of their particular bond issue unless the holders of other bond issues accept a restructuring of their issues.

To encourage the wider use of collective action clauses, particularly in sovereign or quasi-sovereign bonds issued in foreign offerings, the participants of this Working Group recommend that their governments give consideration to: (i) engaging in educational efforts with identified constituencies in major financial centres to promote the use of collective action clauses in sovereign and quasi-sovereign bonds issued in foreign offerings; (ii) identifying sovereign and quasi-sovereign issuers likely to come to their markets soon and encouraging such issuers to use the collective action clauses; and (iii) examining the use of such clauses in their own sovereign and quasi-sovereign bonds issued in foreign offerings.

Although there may be a case for the use of collective action clauses in a wider range of debt instruments, including debt instruments issued by private entities, the Working Group believes that it is appropriate to focus first on the use of such clauses in sovereign and quasi-sovereign bonds issued in foreign offerings. The expanded use of collective action clauses in such bonds could play a critical role in creating the institutional structure needed to encourage orderly workouts.

3.2 Coordination between creditors, debtors and the international official community

A government should provide markets with timely and accurate information on the country's external position and should stay in close, constructive contact with its creditors.

Enhanced IMF transparency is the most effective means to improve communication between the IMF and private creditors. Open disclosure avoids the preferential and selective release of market-sensitive information. Measures to increase transparency and disclosure have been examined by the first Working Group. The efficient functioning of private markets requires that markets have access to the information needed to assess various risks adequately, that they use such information in an appropriate manner and that the markets themselves are as transparent as possible.

The growing importance of private capital flows increases the importance of considering how to avoid preferential or selective contact with private creditors, both during existing informal, ad hoc contacts between the official community and private creditors and in the design of any new channel for communication between the official community and private creditors.

A number of proposals have been made to create a new, institutionalised channel of communication between the IMF, and possibly other official sector institutions, and private creditors. The creation of a new channel of communication would present the following advantages and disadvantages: (i) such a channel, in theory, could help the international capital markets to gain a better understanding of the IMF and the IMF to gain a better understanding of the international capital markets; (ii) such a channel for communication would risk providing selective access to market-sensitive information; and (iii) a more formal channel may provide an institutional avenue for creditor pressure on the official sector. During its meetings with representatives of the private sector, the Fund could, at its discretion, review and highlight information, provided that such information is at the same time also made available to the public more broadly in an open and transparent manner.

The structure of a channel for communication between the IMF, other official institutions and representatives of the private sector that would be appropriate for routine purposes is unlikely to be appropriate for communication during a crisis. The creditors who participate in the channels for communication between the official sector, the government of the crisis country and private creditors organised during an international financial crisis will necessarily be determined on a case-by-case basis to assure inclusion of those creditors with a significant interest in the crisis country. When, in extraordinary and exceptional circumstances, a member of the IMF is obliged to contemplate a temporary suspension of debt payments, communication between the IMF and representatives of the private sector runs the risk of providing selective access to extremely sensitive information. Thereafter, however, in the course of a debt restructuring and workout, a debtor could ask the IMF to meet with a selected group of creditors if the debtor believes that such a meeting could help facilitate the negotiation of a cooperative and orderly debt workout.

If a new channel of communication between the IMF, other official institutions and private creditors is desired, the following questions would need to be answered during its design: (i) how to select the private sector representatives in a open and representative fashion; (ii) how to enhance the ability of the IMF to receive information from market participants in a systematic and transparent fashion; (iii) how to ensure that the IMF does not release confidential information to selected market participants; and (iv) how to avoid creating the impression among private sector representatives that the failure of the IMF to warn of an impending crisis would impose an obligation on the IMF to assist should a crisis subsequently develop.

Chapter 4

IMPROVING CRISIS MANAGEMENT

Despite the efforts of this and the other two Working Groups to identify policies that will help prevent and mitigate future crises, international payments crises will occur. This section examines the appropriate roles of the government of a country facing an external payments crisis, of the international official community and of private creditors in the resolution of future international financial crises.

4.1 The role of the government of an economy facing a payments crisis

A government must monitor and manage closely its own obligations, whether denominated in a foreign currency, indexed to a foreign currency or denominated in the domestic currency. Although the evolution of modern international capital markets has increased the scope of cross-border financial links and made the monitoring of many cross-border transactions difficult, governments should also monitor the foreign currency position of the country's financial sector and, as far as possible, of the country's corporate sector. This is particularly true if the government or the private sector has accumulated large amounts of foreign-currency-denominated debt or if there is a risk that large domestic-currency-denominated debt payments could place significant pressure on the country's exchange rate and macroeconomic stability. (See the report of the Working Group on Strengthening Financial Systems for additional details on the monitoring of foreign currency liquidity.)

When the government of a country anticipates that the country may have difficulty meeting in full the terms of its contractual obligations, public or private, or that it may face serious balance of payments problems for other reasons, it should initiate a dialogue with the IMF. It should evaluate its policy options and rapidly develop and implement a programme of policy adjustments to enhance the country's capacity to meet its obligations and to attract new private capital. If widely adopted, the innovative financing techniques identified earlier in this report could play a useful role in reducing pressure on a country's reserves and balance of payments during periods of market volatility, thus reducing the prospects of a financial crisis.

Policy adjustments by the government facing a financial crisis are central to efforts to restore financial and macroeconomic stability and the confidence of private creditors. In many cases, the possible adjustments will take place in the context of an IMF programme. The policy reforms required by the IMF and other international financial institutions as a condition for their assistance will typically include modifications to monetary, fiscal, and structural policies, depending on the circumstances of the country facing the payments crisis. The combination of the vigorous implementation of policy reforms and, when appropriate, IMF support will normally avert an acute payments crisis and permit the maintenance of uninterrupted debt service payments.

Even when the exchange rate is not firmly fixed, a government may want to avoid very large changes in the exchange rate. Large exchange rate movements can undermine macroeconomic stability, the fiscal situation of the government itself and the solvency of the private sector. Thus, judgements must be made about the exchange rate, whether or not it is fixed, and those judgements, in turn, will affect judgements about the need for – and size of – adjustments in monetary and other policies.

A government should make the strongest possible efforts to meet the terms and conditions of all debt contracts in full and on time, conforming to market discipline and avoiding the costs associated with a temporary suspension of debt payments. Given the economic and financial costs of a suspension, such a course should not, and normally will not, be undertaken until all reasonable alternatives have been explored.

The government of the crisis country is responsible for choosing among its various policy options. A government's choice, of course, will be influenced by the IMF's evaluation of the country's financing need and possible policy adjustments, as well as by preliminary indications from the IMF and other members of the official community of the amount of official support that is likely to be forthcoming if the government adopts strong policy reforms.

In extreme cases when an interruption of payments is unavoidable, a cooperative, orderly restructuring of contractual obligations, combined with the initiation of a strong programme of policy reform, could increase the collective welfare of both the debtor and its creditors by providing the debtor with the time and incentives needed to make appropriate policy adjustments necessary to enhance its payments capacity and encourage the rapid restoration of market access.

Over the past few decades, procedures for the restructuring and reduction of international bank debt have been developed and utilised when necessary. However, the heterogeneity and sophistication characteristic of recent international capital flows have increased the importance of innovation to modernise existing procedures and institutions and to develop new practices for addressing new financing techniques in an orderly and cooperative manner. Any such institutional mechanisms and procedures should create strong disincentives to help deter disruptive and non-cooperative unilateral action by debtors as an alternative to adjustment and reform, while providing incentives for debtors to undertake an orderly and cooperative restructuring of contractual obligations in the event of a truly exceptional crisis.

In such extreme cases, the interests of the debtor, its creditors and the international community in a cooperative, orderly restructuring of payments can be best served by devising an enhanced framework for future crisis management that would allow the international community to signal its limited, conditional willingness to provide financial assistance, when appropriate, even in the context of a temporary payments suspension. Such a signal should be provided only if, in the judgement of the international community, a government's decision to suspend payments reflects the absence of reasonable alternatives and not an attempt to use a debt payments suspension as a substitute for reform and adjustment, if the government undertakes strong policy adjustments and if the government engages in good faith efforts to find a cooperative solution to the country's payments difficulties with its creditors.

4.2 The role of the international community

The IMF and other international financial institutions remain committed to supporting their members in the event of a payments crisis in the context of a strong programme of policy adjustments. If a government facing a serious balance of payments problem adopts and implements appropriate policy adjustments, it should expect to qualify for financial assistance from the IMF, including, in exceptional cases, large-scale financing from the Supplemental Reserve Facility.

In most cases, assistance from the IMF and other international financial institutions, combined with strong policy adjustments, has been sufficient to restore market confidence and to catalyse a rapid restoration of private capital flows. In other cases, official financing has cushioned the required balance of payments adjustment by the affected country, provided more time for the required economic adjustment and maintained incentives to pursue strong policy adjustments. In many cases, the combination of adjustment and official financing has been sufficient to resolve payments difficulties. It will continue to constitute the normal framework for managing and resolving international financial crises. The scale of the IMF's financial assistance will be determined by the member country's quota, the strength of the policy adjustments undertaken by that country's government, and the extent of its balance of payments need.

The size, sophistication and heterogeneity characteristic of recent international capital flows have reduced the relevance of the procedures used in the past to ensure an appropriate private sector role in resolving severe international financial crises. In particular, many such procedures were developed and proved effective during the 1980s, in an era when a small number of large international banks provided most capital flows to emerging markets. The same capacity for innovation that enabled the private sector to help create markets for the wide range of new emerging market debt instruments should be applied to modernising existing procedures and institutions and to developing new practices that will facilitate an appropriate private sector role in the effective management and orderly resolution of future international financial crises.

Such innovation is also required because the scale of private capital flows significantly exceeds the resources that can reasonably be provided by the official community, even with the needed quota increase to bolster IMF resources and other measures to supplement the ability of international financial institutions to provide emergency liquidity during severe financial crises. Moreover, the perception that sufficient official financial assistance may be made available to allow a country to meet all contractual obligations without commensurate commitments from the private sector may encourage both debtor and creditor moral hazard. Moral hazard, in this context, refers to distorted incentive structures that may prompt borrowers and lenders to engage in risky financial behaviour in the expectation that official financing will insulate them from the adverse consequences of their action.

4.3 The role of the private sector

An IMF-supported programme may implicitly indicate the need for a contribution from the private sector; it is the responsibility of the government of the crisis country and its private creditors to determine the form of this contribution. This contribution could take many different forms, depending on the circumstances, but it might include: providing new credits; extending the maturities of or rolling over existing credits; otherwise restructuring payments; and perhaps even, in certain extreme cases, debt reduction.

Such an indication would not represent a fundamental shift in the existing framework for crisis management. In the 1980s, the IMF made the provision of its financial assistance to many of its member countries contingent on the rolling-over of many existing credits and the provision of new credits by the countries' private creditors.

Well-established mechanisms already exist to restructure official debt, which can contribute to the resolution of international financial crises (the Paris Club). When a debtor government that enters into a Paris Club debt restructuring also has outstanding obligations to commercial banks, the official sector has linked the restructuring of obligations to the official sector to comparable action by private creditors (the Paris Club principle of comparability), so as to avoid the use of the resources and forbearance of the official sector to finance the repayment of private creditors.

Similar mechanisms either exist or could be augmented to facilitate appropriate private sector contributions to the resolution of future international financial crises. The private sector has contributed to the resolution of previous payments crises through informal mechanisms such as the London Club process for rescheduling sovereign debt owed to commercial banks. Other informal mechanisms have already been used to encourage commercial banks to maintain outstanding interbank credits in certain circumstances. The expanded use of collective action clauses could augment the ability of bondholders to participate appropriately in the resolution of sovereign liquidity crises. Insolvency regimes provide a mechanism for mandating the coordination and fair treatment of the creditors of a distressed firm in the event of financial difficulties.

It may not be easy, in times of crisis, to bring together the government of the crisis country, the private debtors of the crisis country and their foreign private creditors, especially when the indebtedness contributing importantly to the payments crisis is concentrated in the private sector. In such circumstances, some international official involvement may be helpful in facilitating contacts, channelling information and, if appropriate, exercising some moral suasion on both sides of the negotiation. It is important for all parties that such intermediation be even-handed and transparent. In light of recent experience, there may be a need to develop informal understandings to guide the proper provision of such assistance.

4.4 Orderly and cooperative crisis resolution in certain extreme and exceptional circumstances

As has been emphasised previously, countries should make the strongest possible efforts to meet the terms and conditions of all debt contracts in full and on time. The binding nature of contracts augments market discipline and contributes critically to a country’s ability to maintain uninterrupted access to capital markets. Given the economic and financial costs of a temporary suspension of debt payments, such a course should not, and normally will not, be undertaken until all reasonable alternatives have been explored. A hasty or unwarranted temporary suspension of debt payments will only exacerbate the country’s own problems and generate unnecessary external contagion.

A government should consider initiating a temporary suspension of debt payments only when it is clear that, even with appropriately strong policy adjustments, the country will experience a severe fiscal, financial or balance of payments crisis and the government or a substantial portion of the private sector will be unable to meet its contractual obligations in full and on time. In such circumstances, the initiation of an orderly, cooperative and comprehensive workout, while inherently costly, could best serve the collective interest of the debtor, its creditors and the international community. Difficult judgements will need to be made, since undue delay in these extreme circumstances will only encourage additional capital flight and increase the risk of serious macroeconomic instability.

When a country faces the imminent prospect of being unable, even with agreed policy adjustments, to meet its debt service obligations in large measure, and initial consultations with the IMF and other international financial institutions indicate that it cannot expect to obtain sufficient official financing to meet those obligations, it is in the interests of the crisis country, as well as of the international financial system as a whole, that the government avoid disruptive unilateral action and seek to achieve a cooperative solution to its payments difficulties though voluntary negotiations with its creditors.

In contrast to a unilateral or mandatory suspension of payments, a voluntary approach is less likely to have long-lasting adverse effects on the country's access to international capital markets. It is also less likely to cause contagion. While a mandatory suspension of payments on some debt instruments could activate cross-default clauses in debt instruments not covered by the suspension, a voluntary approach may avoid triggering those cross-default clauses. Finally, a voluntary approach is less likely to generate litigation.

Consequently, when a government faces the possibility that it may be unable to meet its own obligations on time and in full, the government should initiate, if practicable, discussions with its private creditors aimed at achieving agreement on a strategy for addressing the government's debt problems. In some cases, the government may ask that its creditors agree voluntarily to roll over or extend their claims to provide the time needed to negotiate a more durable solution to the government's financial problems. When the financial sector may be unable to meet its obligations, the government may still have a role to play. To forestall a disruptive attempt by creditors to reduce their claims on the financial sector and to facilitate orderly negotiations between domestic financial institutions and their foreign creditors, the government may need to approach these foreign creditors and ask that they voluntarily agree to roll over or extend the maturities of their claims.

A voluntary approach is most likely to succeed when a large portion of the country's near-term obligations is owed to a fairly cohesive group of creditors capable of a rapid, coordinated response to the request to roll over or extend the maturities of existing claims. The collective action clauses discussed in section 3.1 could contribute to the success of a voluntary approach by fostering coordination among the relevant creditors. The likelihood of success may also be enhanced if the government is able to propose a framework for devising a more durable solution to the country's problems. In some cases, moreover, the IMF and key creditor country governments may be prepared to signal, by statements of support and/or their own lending, their confidence in the ability of the debtor country's government to deal effectively with its balance of payments problem.

There are certain extreme circumstances that may make a purely voluntary approach difficult. An entirely voluntary debt exchange or debt restructuring will necessarily reflect market conditions. The government may not have the bargaining power to obtain sustainable terms for the restructured instruments; for example, creditors may refuse to reschedule debt payments on a fully voluntary basis without receiving interest rates so high that they generate destabilising debt dynamics that will exacerbate the ultimate crisis. Certain creditors may refuse to participate in a purely voluntary scheme, seeking to free-ride on the restructuring by other creditors and thus precluding an overall agreement. Finally, a purely voluntary approach may consume too much time, which could lead to an erosion of confidence that worsens the country's financial difficulties.

Because of the context in which negotiations are conducted, some voluntary and cooperative agreements will reflect recognition by the creditors that their choices are constrained by the financial conditions at the time. The realities of the country's financial situation may lead creditors to voluntarily accept terms that are more favourable than those that would have been voluntarily accepted in different circumstances in order to create conditions needed to achieve a durable solution to the country's financial difficulties.

Even when a mandatory payments suspension and restructuring are unavoidable, it is crucial for the government of the crisis country to maintain an open, transparent and cooperative approach to the country's creditors in the wake of its decision to interrupt payments. While the financial condition of the country may constrain its ability to make payments in full and on time, the particular form of relief should be determined in cooperative negotiations. A mandatory suspension of debt payments and subsequent restructuring also increases the need for strong policy adjustments in order to build creditor confidence that the debtor's payments capacity will increase over time and to encourage the rapid restoration of market access.

4.5 Considerations during an extreme and exceptional international financial crisis

Because of the high cost associated with a temporary suspension of payments, a suspension of payments should never be contemplated lightly, without due consideration of less costly and disruptive options, or implemented too quickly. Should a temporary suspension of debt payments prove to be unavoidable in certain exceptional and extreme circumstances, it should be carefully designed so as to minimise the disruption to the crisis country's own future creditworthiness and to the international financial system as a whole.

In particular, the scope of the suspension should be carefully designed. The circumstances of the debtor country – the composition of its debt and the maturity profile of each debt category – necessarily will determine the range of debt instruments that should be included in the suspension. In some cases, a suspension could be confined to sovereign debt; in others, it might have to cover certain sorts of private sector debt. In some cases, a mandatory suspension might be imposed on foreign currency debt payments; in others, it might include certain domestic currency debt payments. Although the adverse impacts associated with extending a payments suspension to particular categories of debt should be taken into consideration, no category of debt should be granted an automatic exemption from the suspension if it is contributing substantially to the payments crisis. The coverage should be as narrow as possible, but not so narrow as to lead to excessive inequities among creditor groups or to create a need to widen the coverage subsequently. Consequently, a suspension should be sufficiently comprehensive to include those types of debt that are contributing importantly to a country's balance of payments problem or that can be expected to do so in the near future. It should be designed to foster confidence that, together with strong policy measures, the suspension will contribute to the resolution of the country's problem. This will require difficult judgements.

A selective suspension, even if mandatory, may not require the use of comprehensive capital and exchange controls. A government can suspend its own debt payments, and it may be possible to suspend payments on some types of private sector debt, such as the foreign currency debts of banks, without imposing comprehensive capital controls. An announcement by the government without any binding enforcement mechanism may suffice to induce substantial compliance by most of the main private sector debtors. A selective suspension will be effective only if accompanied by a strong policy adjustment to create confidence in the country's capacity to resume payments quickly and to assure investors that the selective suspension will not need to be extended to other categories of payments.

Any selective suspension of debt payments raises questions about fairness. Why should some foreign currency payments be halted while others are permitted? Why should some domestic debtors be made to interrupt their debt payments at some cost to their own creditworthiness while others are allowed to service their debts and preserve their creditworthiness? Why should some creditors be locked in while others – and domestic residents – are allowed to flee? It should be recognised, however, that the greatest degree of fairness possible can be achieved only at the two policy extremes: i.e. by refusing ever to suspend payments and allowing full convertibility or by prohibiting all capital outflows, even those that are not debt-related, through the imposition of comprehensive exchange and capital controls.

There is a risk that, even when carefully and clearly defined and accompanied by the requisite commitment to needed policy adjustments, a mandatory but selective suspension could give rise to fears that the suspension will be widened or that comprehensive capital controls may be forthcoming. It might therefore lead private creditors to refuse to roll over claims that expire (provided that payments on such claims have not been suspended), or to liquidate their remaining claims and, if relevant, convert the proceeds into a foreign currency, and therefore generate additional instability. Furthermore, a mandatory suspension might be deemed to constitute an event of default under certain debt agreements, which could activate cross-default clauses in debt instruments not covered by the suspension.

4.6 Issues relating to the use of comprehensive capital controls in an extreme balance of payments crisis

Some recent discussion has examined the possible use of controls on capital outflows to break the link between monetary policy and the exchange rate. Advocates of such a policy believe that capital controls could be used when balance of payments pressures arise so as to insulate a country from such pressures, allowing more scope for stimulative domestic policies than would otherwise be possible. In particular, it has been argued that controls on capital outflows could permit a country to pursue a more expansionary monetary policy than would be compatible with a given exchange rate in the absence of such controls. It must however be borne in mind that, in addition to being disruptive, introducing microeconomic distortions and generating opportunities for rent-seeking, such controls also deteriorate in effectiveness over time. Controls on capital outflows tend to deter capital inflows, including long-term capital inflows and foreign direct investment. Finally, controls on outflows may reduce the pressure for needed policy reform and adjustment and thus exacerbate underlying economic problems.

In some cases, governments facing the need for a comprehensive restructuring of debt payments due to exceptional and extreme balance of payments crises have imposed temporary comprehensive capital and exchange controls in order to buttress a temporary suspension of payments. Because all controls on capital outflows are disruptive and costly to the country that imposes them, such temporary comprehensive capital or exchange controls should be avoided if possible. Their use should be considered only in exceptional circumstances and only in conjunction with IMF-supported programmes of policy adjustments to create the conditions required for the restoration of financial and macroeconomic stability and the ultimate restoration of currency convertibility. Even in such circumstances, it may be determined that the large costs associated with the suspension of convertibility, given the extensive ties created by modern financial markets, exceeds the possible contribution such measures could make to limiting balance of payments pressures.

4.7 Mechanisms to facilitate prompt and equitable workouts

Insolvency regimes generally provide a mechanism for the provision of new, senior credits to ensure the ongoing operation of the firm and the restructuring of existing debt. While the analogy to corporate insolvency is imprecise, working out international liquidity crises may also require mechanisms to encourage new capital inflows and supplementary frameworks to facilitate the orderly restructuring of existing debt.

The provision of new credits in the event of a crisis or suspension of certain debt payments could be encouraged by indications, either formal or informal, from the debtor country that it would give greater repayment security to certain new credits. Careful consideration would need to be given to certain critical clauses in existing debt contracts (e.g. pari passu clauses).

It might also be possible to create a standing, privately funded mechanism to provide new credits in the event of a crisis or payments suspension. To increase the probability that funds provided through such a mechanism would be repaid even in the context of a suspension of debt payments, the IMF could indicate that it would not lend into arrears on the repayment of new credits provided through this mechanism. Depending on the structure of the mechanism, it might provide a limited form of de facto seniority without direct participation by the IMF or other official lenders in the mechanism. The financial and legal issues associated with such a mechanism deserve further consideration.

National insolvency regimes provide the standard mechanism and appropriate legal and institutional framework for the restructuring and workout of corporate debt, including foreign currency-denominated corporate debt. However, even effective insolvency regimes can be overwhelmed by a general crisis in the corporate sector. A crisis in the corporate sector can be of sufficient magnitude to threaten the solvency of the financial system in the crisis country.

Consequently, there may be occasions when the government will need to develop a framework for encouraging negotiations between private debtors and their creditors. Such a framework might include:

- the establishment of creditors’ committees;
- the removal of legal and regulatory obstacles to debt restructuring; and
- in certain extreme cases, the establishment of exchange rate insurance schemes to provide an inducement to negotiate and to facilitate the valuation and adjustment of outstanding claims.

4.8 Summary of the considerations that should guide the management and resolution of exceptional and extreme crises

In a strong international financial system, crises that force a temporary interruption in debt payments should be rare. When, in exceptional cases, they become necessary, the damage to the international financial system as a whole, as well as the damage to the future market access of the crisis country, could be reduced if the debt suspension is combined with a strong programme of policy adjustments and strong measures to promote a rapid, orderly and cooperative debt workout. To limit the impact of future temporary interruptions in debt payments that may occur and to facilitate the rapid restoration of normal relations between debtors and creditors, the Working Group recommends the following guidelines for consideration.

- A debtor unable to meet its obligations in full should immediately initiate a dialogue with the IMF and seek an orderly and cooperative solution to its payments difficulties with its creditors.

- A suspension of debt payments should not be undertaken as an alternative to policy reform and adjustment or until all reasonable alternatives have been explored. It should thus be linked to an enhanced programme of policy adjustments to encourage the prompt restoration of confidence.

- A temporary suspension should thus be linked to the onset of good faith negotiations with creditors to lengthen the maturity of existing debt and to provide time for a more comprehensive debt restructuring, if needed.

- The scope of any suspension of debt payments should be clearly defined, in terms of both types of obligations and maturities covered. Those categories of obligations that are creating acute pressure on the balance of payments and a deterioration in market confidence should be targeted.

- The scope should be as narrow as possible, but sufficiently comprehensive to avoid excessive inequities among creditor groups or the need to widen the coverage subsequently.

- A temporary suspension and subsequent restructuring should treat all affected categories and classes of creditors, including foreign and domestic creditors, fairly.

- To the extent possible, secondary market trading should be freely permitted.

- Efforts should be made to encourage new lending by, where possible, granting the servicing of such new lending greater repayment certainty.

- The design of any restructured debt instruments should be determined in orderly and cooperative discussions between debtors, including the sovereign, and their creditors. The manner in which the restructured instruments is designed will have a significant impact on confidence and subsequent restoration of market access.

4.9 An enhanced framework for crisis management

To promote the collective interest of debtors and creditors in orderly and rapid crisis resolution, the international community can and will try to work with countries that initiate debt workouts if such workouts are part of a programme of policy reform and adjustment and the country is seeking a cooperative and orderly solution to its financial difficulties with creditors. This will involve the IMF offering to support policy adjustment, as appropriate, even when the country has accumulated arrears on debt payments that have yet to be resolved through an agreed debt restructuring. Continued IMF support during a crisis allows the international community to maintain strong incentives for the crisis country to undertake appropriate policy adjustment and maintain continued cooperation with creditors even when adverse developments make some interruption in payments inevitable. It thus serves the common interest of debtors and creditors in orderly crisis resolution.

The underlying justification for such support is similar to the justification for certain features of national insolvency regimes – those that encourage creditor coordination and orderly workouts and those that facilitate access to interim financing for a firm experiencing financial difficulties: to maximise the total value of creditors' claims. A signal of the international community's willingness to provide financial support in the context of a temporary interruption of some payments would not be provided if the government of the crisis country took unilateral action as an alternative to reform and adjustment or did not seek a cooperative solution to the country's financial difficulties. Such a signal would only be provided if, in the judgement of the international community, the government of the crisis country is not interrupting debt payments as an alternative to reform and adjustment, is implementing a strong programme of policy reform, and is making a good faith effort to work with creditors in finding a cooperative solution to the country's financial difficulties.

In normal conditions, the IMF extends official finance only in the context of a fully funded adjustment programme and typically requires the clearance of arrears on debt payments before disbursing IMF funds. In the late 1980s the IMF adopted a limited policy of lending into arrears on bank loans owed by sovereign borrowers to facilitate balance of payments adjustment, to support a comprehensive and credible programme of policy reform and to encourage rapid debt restructuring in certain exceptional cases. Lending into arrears prevented private creditors from blocking the disbursement of IMF assistance by refusing to accept a debt rescheduling in order to increase their leverage in restructuring negotiations with sovereign debtors.

The Working Group supports an IMF policy decision to signal its willingness to generalise its policy of lending arrears to bring the policy in line with changes in the international environment since the 1980s. The IMF should signal its willingness to consider providing conditional financial support for policy adjustment despite the presence of actual and/or impending arrears on the country's obligations to private creditors, including arrears on marketable debt instruments, in certain limited circumstances. Such a signal should be provided only if the government of the crisis country is not interrupting debt payments as an alternative to reform and adjustment, is implementing a strong programme of policy reform, is making a good faith effort to work with creditors in finding a cooperative solution to the country's financial difficulties and international support is critical to the success of a strong adjustment programme.

Once the IMF lends into arrears, it should carefully monitor ongoing negotiations between the crisis country and private creditors. If the IMF determines that the crisis country is not negotiating with its creditors in good faith, it should suspend disbursements and cease lending into arrears.

4.10 Protecting sovereign debtors from disruptive legal action[7]

National insolvency regimes, through the imposition of a stay against legal action, can prevent an individual creditor from seizing the assets of a debtor to the detriment of other, similarly-situated creditors and the overall value of the enterprise. Such a stay provides the debtor with the "breathing room" needed to negotiate an orderly workout with its creditors free from interference from possible lawsuits. No international insolvency regime exists to provide similar protection to sovereign debtors.

Generally, a foreign sovereign state is protected from the jurisdiction of a court. However, the issue of sovereign immunity is a complex one. With respect to bonds issued by a sovereign state, the state may in most cases waive its immunity, and, even in the absence of a waiver, there are important exceptions to the immunity that the courts of one sovereign state will accord to another sovereign state. For example, currently most courts will take a restrictive view of the sovereign immunity of a foreign state with respect to commercial matters and determine that they have jurisdiction concerning bonds issued or payable by the foreign sovereign in the court's country.

[7] It should be noted that litigation against private debtors may adversely affect a sovereign's ability to make future payments. This issue may warrant additional consideration.

Relatively few suits have been filed against sovereign debtors in recent years. The paucity of suits may be due to the practical difficulties of recovering funds even if the creditor obtains a judgement. Assets must be identified and attached in a particular jurisdiction, a process that can be complicated, time consuming and expensive. Even if assets of a foreign sovereign can be identified, they may not be attachable prior to judgement if they are held at an official depository.

There has been some debate in recent years about the creation of a legal mechanism that could lessen the likelihood and consequences of legal action by private creditors against sovereign debtors in the event of a temporary suspension of payments. Such a mechanism would allow the international community, in exceptional and extreme circumstances, to provide a sovereign debtor with legal “breathing space” so as to facilitate an orderly, cooperative and negotiated restructuring. This is a complicated and difficult subject that clearly would require additional consideration and reflection.

One possible approach to this subject is to consider amending Article VIII 2(b) of the IMF's Articles of Agreement to provide for a mandatory stay of enforcement actions against a sovereign or against private debtors in the event of an interruption in debt payments. Such an amendment does not appear feasible at the present time.

Chapter 5

LIMITING THE IMPACT OF INTERNATIONAL FINANCIAL CRISES

5.1 Limiting the impact on market access

The international capital markets of the 1990s may restore market access more rapidly than the banks did in the 1980s. Markets have developed for a wide range of emerging market financial instruments, and thus provide a more diverse set of potential creditors than in the 1980s. Payments history has a significant impact on a borrower's credit rating, and thus on the cost and availability of financing. However, capital markets increasingly tend to look forward, at a borrower's capacity to meet future payments, as well as backwards, at past repayments history. Consequently, investors may recognise that a debt restructuring, combined with strong policy adjustments, has increased rather than decreased a country's future creditworthiness. They may not automatically penalise a country for entering into a debt restructuring. There are examples in the most recent decade of countries that have returned to international capital markets after negotiating debt restructurings with their creditors that were voluntary but carried out in the context of forceful efforts by the government of the debtor country to seek the restructuring and reduction of its external debt.

The design of a debt suspension and the subsequent restructuring and workout can have a significant impact on a country's future market access. A selective suspension which is carefully designed to minimise disruption in the markets will facilitate the maintenance of orderly markets and thus accelerate the restoration of full market access. Equally, the design of any restructured instrument may be critical to the restoration of market access. The repackaging of syndicated sovereign debt into "Brady Bonds" in the 1980s, for example, helped to create a liquid market for claims on emerging markets, facilitating the restoration of market access and stimulating the market for emerging market debt instruments more generally.

The stance adopted by the IMF and the official community more broadly towards a government's decision to seek debt restructuring, the policy measures adopted by the government and the stance of a government towards private creditors during the workout will influence the speed with which a country regains market access.

The governments of major financial centers may want to examine possible national regulatory impediments that automatically inhibit countries that suspend their debt payments from regaining market access.

5.2 Limiting contagion

A range of mechanisms exist which may lead a payments crisis in one country to generate additional pressure on other countries. Pressure on a country's reserves and exchange rate can prompt some investors both to scrutinise other countries for similar weaknesses and, in extreme circumstances, to seek to reduce their overall holdings of emerging market debt. Market participants may occasionally view all emerging market debt similarly, without paying sufficient attention to distinctions between different countries. Falling asset prices may also produce contagion; it may weaken certain financial institutions which may then face margin calls that force the liquidation of additional assets, hurting the overall market for emerging market debt instruments. In addition, financial institutions in certain emerging markets have been significant investors in other emerging markets. Such cross-holdings can generate contagion, as falling asset prices in one market can place pressure on financial institutions in other markets. Finally, severe economic contractions, exchange rate depreciations and sharp reductions in commodity prices can place pressure on the export earnings, current account balances and real economies of other emerging market economies.

Improved transparency, improved disclosure and more efficient use of information will help markets distinguish between different countries, thereby limiting contagion. Nonetheless, the increased scrutiny prompted by a financial crisis in one country may require augmented policy adjustments by other countries to address their residual vulnerabilities. The official sector may want to provide additional financing to countries which are pursuing appropriate policies but face increased pressure as a result of the problems encountered by other countries. This would provide a clear signal to the international capital markets of the official sector's continued confidence in the ability of such countries to meet their contractual obligations.

Recent events have demonstrated that an international financial crisis in one country or region can greatly augment market pressure in other countries and regions. During periods of unusual instability in international financial markets, the international community may determine that its interest in averting a systemic crisis exceeds other interests and objectives.

Chapter 6

IMMEDIATE STEPS RECOMMENDED BY THE WORKING GROUP

DOMESTIC AND INTERNATIONAL LEGAL INFRASTRUCTURE

The Working Group endorses the key principles and features of effective insolvency and debtor-creditor regimes contained in Annexes A and B.

The Working Group encourages the wider use of the UNCITRAL Model Law on Cross-Border Insolvency or the adoption of similar mechanisms for facilitating the efficient resolution of cross-border insolvencies.

MARKET INNOVATIONS

The Working Group encourages the governments of emerging markets to explore the possibility of developing and using innovative contractual arrangements that contain a greater degree of contractual risk-sharing between debtors and creditors and that provide additional liquidity during periods of market volatility.

COLLECTIVE ACTION CLAUSES

The wider use of the collective action clauses identified in this report in sovereign bonds issued in foreign offerings could contribute to effective creditor coordination and thus serve the collective interest of debtors, creditors and the international community in orderly, cooperative crisis resolution. The international community should therefore engage in an effort to promote wider use of collective action clauses.

The Working Group endorses the implementation strategy identified in section 3.1 to promote the use of collective action clauses in sovereign and quasi-sovereign bonds issued in foreign offerings.

CRISIS MANAGEMENT

The international community should endorse a framework for crisis management that would allow the international community to signal whether or not it is willing to provide conditional financial support in the context of a temporary interruption of payments on certain financial obligations, in certain limited and exceptional circumstances.

- Such financial support should not be provided if a government undertakes unilateral action as an alternative to policy reform and adjustment or if a government fails to seek a cooperative solution to the country's financial difficulties with creditors.

- Such financial support should be provided only if, in the judgement of the international community, the government's decision to interrupt certain payments temporarily is a reflection of the absence of reasonable alternatives, the government is implementing a strong programme of policy reform, the government is making a good faith effort to work with creditors in finding a cooperative solution to the country's financial difficulties, and international support is critical to the success of a strong adjustment programme.

- If such conditions are met, the IMF should signal its willingness to provide conditional financial support for policy adjustment, despite the presence of actual or impending arrears on sovereign and, in some cases, private obligations.

LIST OF ABBREVIATIONS

BIS	Bank for International Settlements
IMF	International Monetary Fund
MDB	multilateral development bank
NAB	New Arrangements to Borrow
OECD	Organisation for Economic Cooperation and Development
UNCITRAL	United Nations Commission on International Trade Law

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ANNEX A

KEY PRINCIPLES AND FEATURES OF EFFECTIVE INSOLVENCY REGIMES

There are certain key principles and features that can be identified as important to an effective insolvency regime for commercial firms.[1] Such regimes should:

1. Maximise Value of Assets. Insolvency law should provide for an alternative to liquidation in the form of a possibility to reorganise the debtor firm in cases where creditors would not involuntarily receive less than in a liquidation and the value of a firm to creditors and society is maximised by maintaining the debtor in operation. The maximum value for creditors can often be obtained through reorganisation rather than through liquidation. Court supervision of a reorganisation should be streamlined to foster efficiency since business rescues often require quick action.

   New financing is critical to the ability of the debtor to reorganise and to the maximisation of the value of assets, whether in a reorganisation or in a liquidation. Protections, including in the form of priority in eventual liquidation distributions, should be provided to creditors that extend financing after a proceeding has commenced so that they will be encouraged to do business with the debtor.

   When insolvency does not result in payment in full of creditors' claims, consideration should be given in the context of reorganisation to providing a "fresh start" to honest debtors by discharging certain unpaid debts.

2. Strike a Careful Balance Between Liquidation and Reorganisation. An insolvency regime should carefully balance the advantages of near-term debt collection through liquidation and of maintaining the debtor as a going concern through reorganisation. A regime should seek to avoid disruption through liquidations (often the preference of secured creditors) and should seek to maximise going-concern value (often the preference of unsecured creditors). Increasing creditor bargaining power may lead to premature liquidations. On the other hand, increasing debtor bargaining power may incur costs and delays, and may affect the cost and availability of credit to the economy.

[1] The key principles and features of insolvency regimes set forth herein are intended to apply only to the insolvency of commercial firms and not to financial firms. However, an effective insolvency regime is a necessary tool for dealing with failing financial firms. Some of the key principles and features of effective insolvency regimes for non-financial firms, such as equitable treatment of similarly-situated creditors, are clearly appropriate for financial firm insolvencies as well.

Liquidation and reorganisation scenarios alike must contain appropriate incentives for company management.

3. Provide for Equitable Treatment of Similarly-Situated Creditors, Including Similarly-Situated Foreign and Domestic Creditors. Similarly-situated creditors should be treated equitably. The ability to recapture certain transfers of assets, such as transfers that (i) prefer creditors; (ii) remove assets from the reach of creditors for the benefit of strangers to the proceeding; and (iii) are to related parties at less than full value, also generally helps promote equitable treatment among creditors and creditor confidence.

4. Provide for Timely, Efficient and Impartial Resolution of Insolvencies. Insolvencies should be resolved quickly and the operations of the business of the debtor should not be unduly disrupted while the process is underway. Within the context of insolvency, numerous disputes can arise that will require prompt resolution. Deadlines should be established in the law for resolution of specific matters and for the insolvency proceedings as a whole. Consideration should be given to expedited procedures (including "pre-packaged" plans), to the establishment of specialised courts or administrative tribunals, and to allocation of considerable responsibility to the entity administering the debtor's assets to handle insolvency cases efficiently.

5. Prevent Premature Dismemberment of the Debtor's Assets by Creditors. An insolvency procedure should be orderly and prevent premature dismemberment of the debtor's assets by individual creditors seeking quick judgements against the debtor. Collection of individual debts often reduces the total value of the pool of assets available to settle all claims against an insolvent borrower and precludes reorganisations. A stay of creditor action provides a "breathing space" for debtors and trustees to examine the debtor's operations without defending against creditor action and assurance to creditors that similarly-situated creditors will receive similar treatment without having to rush to obtain judgements. A critical issue is whether secured creditors are subject to a stay; if not, they may be able to undermine the proceedings by selling assets they hold as collateral that are vital to the debtor's business. Some mechanism should be put in place that will assure secured creditors that their rights will not be impaired by a stay.

6. Provide for a Procedure that is Transparent and Contains Incentives for Gathering and Dispensing Information. Transparency and incentives for gathering and dispensing information enable courts, the trustee and creditors to assess reorganisation and liquidation options.

7. Recognise Existing Creditor Rights/Respect Priority of Claims with a Predictable and Pre-Established Process. Outside insolvency, creditors may not all have equal rights; for

example, secured creditors may have rights to collateral that are not shared by unsecured creditors. Recognition and enforcement of these differing rights within the context of the insolvency regime create certainty in the market, thereby facilitating the extension of credit.

As a general rule, the hierarchy of claims established outside insolvency, or rule of absolute priority, should be maintained in insolvency. Where an insolvency regime disregards the terms of pre-existing contracts, perverse incentives can be established going forward. Senior claims should therefore be paid in full before more junior claims (including equity). Clear rules for ranking the priority of both existing and post-petition creditor claims are important in order to provide clarity to lenders who may be deterred if there is uncertainty as to where they stand in the event of insolvency proceedings.

One of the principal goals of an insolvency regime is to maximise, to the extent possible, the payment of creditors' legitimate claims and the recognition of creditors' rights. An insolvency regime should provide for effective creditor participation through the provision of effective notice of key matters to creditors and for creditors to have a voice in decisions (this is often done by a creditors' committee).

8. Establish a Framework for Cross-Border Insolvency. In order to coordinate among jurisdictions, an insolvency regime should provide for fair rules on cross-border insolvencies with recognition of foreign proceedings such as that provided for in the UNCITRAL Model Law on Cross-Border Insolvency.

ANNEX B

KEY FEATURES OF EFFECTIVE DEBTOR-CREDITOR REGIMES

Certain key features can be identified as important to an effective debtor-creditor regime:

1. Creation of Security Interest. The law should permit: property to serve as collateral with a legal framework for mortgages (for immovable property) and a legal framework for secured transactions (for movable property); all economically important assets to serve as collateral for a loan; and security interests in tangible property (such as inventory, equipment and livestock) and in intangible property (such as accounts receivable) to be created. All economically important agents should be able to act as lenders and as borrowers in secured transactions and all economically important secured transactions should be permitted. The creation of security interests should be inexpensive relative to the amounts lent.

2. Priority. The law should provide for a simple, inexpensive and unambiguous system of assigning priorities to lenders against the movable and immovable property that secures the loans.

3. Registration of Security Interests. Inexpensive public or publicly-sanctioned private providers of registry services should provide rapid, and totally public registration services to permit lenders to readily determine the priority of their claims against the collateral that secures the loan.

4. Enforcement. Enforcement must be rapid and cheap. If current laws and legal institutions cannot achieve this standard, the law should envision mixtures of public (e.g., courts, sheriffs) and publicly-sanctioned enforcement systems (self-help remedies, continuation of proceeds) that will permit such enforcement.