

INTERNATIONAL MONETARY FUND / THE WORLD BANK

Amendments to the Guidelines for Public Debt Management

Prepared by the Staffs of the International Monetary Fund and the World Bank

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I. INTRODUCTION

1. **IMF and World Bank Staffs propose adding two new guidelines to the IMF/World Bank Guidelines for Public Debt Management.** There have been a couple of developments in the public debt management field since the Guidelines were published in March 2001. In particular, the last two years have witnessed extensive discussions on the ways in which one can assess the sustainability of member countries' public debts, and on some of the legal features that should be included in bond instruments. Although the Guidelines cover a broad range of debt management activities, issues of public debt sustainability and legal features were not discussed. Now that a broad consensus is beginning to emerge on the appropriate framework to guide debt sustainability discussions and on some of the legal features of debt instruments, IMF and World Bank Staffs would like to propose two new guidelines that would address these issues so that the Guidelines remain current and reflect sound practice in the public debt management field.^{1 2}

2. **The remainder of the paper is structured as follows.** The next section outlines the proposed new guideline for the role of debt managers in debt sustainability analysis and discussions. Section III outlines the proposed guideline on legal features, as well as a new box that summarizes some of the key features of collective action clauses.

II. ROLE OF PUBLIC DEBT MANAGERS IN ASSESSING DEBT SUSTAINABILITY

3. **Assessing the sustainability of public debt is an important task of macroeconomic policy.** Judgments about debt sustainability—whether a country's public debt can be serviced without unrealistically large future corrections in income and expenditures—underpin the conduct of fiscal policy, in particular by helping to determine the magnitude of the adjustment that would be required and a prudent level of debt. As a result, various analytic frameworks have been developed to guide member countries on the sustainability of their public debt.

¹ The IMF/World Bank Guidelines for Public Debt Management can be found on the IMF and World Bank websites at: <http://www.imf.org/external/np/mae/pdebt/2000/eng/index.htm>; and <http://www.worldbank.org/pdm/guidelines.htm>.

² No changes are planned at this time to the Accompanying Document to the Guidelines, since it would be very costly and time-consuming for both IMF/World Bank Staff and the authorities in member countries to keep it up to date on a continuous basis. The use of collective action clauses by the case study countries is briefly discussed on page 29 of that Document, although the discussion has become dated in light of recent events.

4. **Public debt managers are well-placed to help inform judgments on the sustainability of public debt.** Although the responsibility for ensuring prudent debt levels lies with fiscal authorities, debt managers' analysis of the debt portfolio's cost and risk may contain useful information for fiscal authorities' debt sustainability analysis (and vice-versa). In addition, debt managers play an important role in setting the composition of that debt through their borrowing activity in financial markets on behalf of the government. This places them in direct contact with market participants, and their observation of investor behavior in both the primary and secondary market as well as their discussions with market participants may provide useful insights into the willingness of investors to hold that debt. This window on investors' views can be a useful input into fiscal authorities' assessments of debt sustainability, and may help policymakers promptly identify emerging debt sustainability concerns.

5. **In light of the growing attention being paid to debt sustainability issues, IMF and World Bank Staffs propose to add a new guideline to the *IMF/World Bank Guidelines for Public Debt Management* to highlight the role that debt managers can play in public debt sustainability analysis and discussions.** The role of debt managers in debt sustainability discussions is mentioned in several places in the current version of the Guidelines, most notably in Section 1.3 (Coordination with Monetary and Fiscal Policies), where the first guideline in that section notes that "...Debt managers should convey to fiscal authorities their views on the costs and risks associated with government financing requirements and debt levels." However, this suggestion is currently coupled with one that "debt managers, fiscal policy advisors, and central bankers should share an understanding of the objectives of debt management, fiscal, and monetary policies given the interdependencies between their different policy instruments..." Moreover, the explanatory text to that guideline focuses on the latter point, rather than on the role of debt managers in debt sustainability discussions. Consequently, the Staffs propose to give greater prominence to the second sentence of the first guideline in Section 1.3 by making it a separate guideline. The revised version of the current guideline would be: "Debt managers, fiscal policy advisors, and central bankers should share an understanding of the objectives of debt management, fiscal, and monetary policies given the interdependencies between their different policy instruments." A new debt sustainability guideline would then be added at the end of Section 1.3 as follows.

A. Proposed New Debt Sustainability Guideline

6. **Debt managers should inform the government on a timely basis of any emerging debt sustainability problems.** Although the responsibility for ensuring prudent debt levels lies with fiscal authorities,³ debt managers' analysis of the cost and risk of the debt portfolio may

³ Various analytic frameworks have been developed to guide member countries on the sustainability of their public debt. For example, those used by the IMF in its surveillance activities can be found on its website: "Assessing Sustainability" <http://www.imf.org/external/np/pdr/sus/2002/eng/052802.htm>; "Debt Sustainability in Low-Income Countries—Towards a Forward-Looking Strategy," <http://www.imf.org/external/np/pdr/sustain/2003/052303.htm>; and "Sustainability

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contain useful information for fiscal authorities' debt sustainability analysis (and vice-versa).⁴ In addition, debt managers play an important role in setting the composition of that debt through their borrowing activity in financial markets on behalf of the government. This places them in direct contact with market participants and their observation of investor behavior in both primary and secondary markets, as well as their discussions with market participants, may provide useful insights into the willingness of investors to hold that debt. This window on investors' views can be a useful input into fiscal authorities' assessments of debt sustainability, and may help policymakers identify any emerging debt sustainability concerns. Thus, debt managers should extract relevant indicators from their debt portfolio cost-risk analysis, and gather and analyze financial market participants' views on the sustainability of the government's debt in a systematic fashion. They should also have the appropriate communication channels in place so that they can share this information with fiscal authorities on a timely basis.

III. LEGAL FEATURES

7. **The international community and investors are devoting more attention to the legal features of sovereign bond issues in international markets, and their potential role in helping to make sovereign debt restructurings more orderly and predictable.** It is important for debt managers to receive appropriate legal advice and to ensure that the transactions they undertake are backed by sound legal documentation. In doing so, debt managers can help governments clarify their rights and obligations in the relevant jurisdiction. One issue that has received attention in recent years is the design of collective action clauses and the incorporation of such clauses in international bond documentation. If a government is forced to restructure its debt in a crisis, these clauses allow a super-majority to bind all bondholders within the same issue to the financial terms of a restructuring before or after a default, and to limit the ability of a minority of bondholders to disrupt the restructuring process by enforcing their claims after a default. In a debt restructuring process, there is a risk that a minority of holdout investors could slow or disrupt an agreement that a super-majority would be prepared to support. By mitigating this risk, collective action clauses could contribute to more orderly and rapid sovereign debt workouts.⁵

Assessments—Review of Application and Methodological Refinements,”
<http://www.imf.org/external/np/pdr/sustain/2003/061003.htm>.

⁴ Further information on the analysis of the cost and risk of the debt portfolio can be found in Sections 4 and 5 of the Guidelines, which deal with debt strategy and the risk management framework.

⁵ In its April 12, 2003 Communiqué, the International Monetary and Financial Committee (IMFC) reiterated its support for collective action clauses, and welcomed the contributions of the European Union, the G-10 countries, emerging market countries, and the private sector to

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8. **To highlight the importance of sound legal features, IMF and World Bank Staffs propose to add a new guideline to the IMF/ World Bank Guidelines for Public Debt Management.** A new guideline encouraging debt managers to make sure they have received appropriate legal advice and that the transactions they undertake are backed by sound legal documentation would reflect best practice in this area. In addition, the text accompanying the guideline would encourage countries to consider using collective action clauses in their new international borrowings to facilitate collective action by creditors during a restructuring process, and help ensure that debt restructurings are not disrupted by legal actions of individual creditors.

9. **In recognition of the conceptual nature of the Guidelines, the new legal features guideline has been formulated in a general way.** Further details and cross-references for more information on collective action clauses are provided in a new box, which would also be inserted in the Guidelines. In the Staffs' view, the most appropriate place for the new guideline and box would be at the end of Section 3.2 (Management of Internal Operations, which should be renamed: Management of Internal Operations and Legal Documentation).

A. Proposed New Legal Features Guideline

10. **Debt managers should make sure that they have received appropriate legal advice and that the transactions they undertake incorporate sound legal features.** It is important for debt managers to receive appropriate legal advice and to ensure that the transactions they undertake are backed by sound legal documentation. In doing so, debt managers can help governments clarify their rights and obligations in the relevant jurisdictions. Several issues deserve particular attention, including: the design of important provisions of debt instruments, such as clearly defining events of default, especially if such events extend beyond payment defaults on the relevant obligations (e.g., cross-defaults and cross-accelerations); the breadth of a negative pledge clause; and the scope of the waiver of sovereign immunity. Disclosure obligations in the relevant markets must be analyzed in detail because they can vary from one market to another.

11. One issue that has received increasing attention in recent years is the design of collective action clauses, and the incorporation of such clauses in international bond documentation. If a government is forced to restructure its debt in a crisis, these clauses allow a super-majority to bind all bondholders within the same issue to the financial terms of a restructuring, and to limit the ability of a minority of bondholders to disrupt the restructuring process by enforcing their claims after a default. In a debt restructuring process, there is a risk that a minority of holdout investors could slow or disrupt an agreement that a super-majority

the development of these clauses. Moreover, the IMFC looked forward to the inclusion of these clauses in international bond issues becoming standard market practice, and called on the IMF to promote the voluntary inclusion of collective action clauses in government securities governed by foreign laws in the context of its surveillance activities.

would be prepared to support. By mitigating this risk, collective action clauses could contribute to more orderly and rapid sovereign debt workouts. When issuing sovereign bonds governed by foreign laws, debt managers should consider including these clauses in new borrowings, in consultation with their financial and legal advisors.⁶ Box 2 describes some of the key features of collective action clauses.

Proposed New Box 2: Collective Action Clauses

Although the inclusion of collective action clauses (CACs) in bond documentation has been a longstanding market practice in some jurisdictions, including notably bonds governed by English law, 2003 has witnessed a clear shift towards the use of CACs in New York law-governed bonds (which represent a large portion of emerging market government bond issues). For example, emerging market countries such as Brazil, Mexico, the Republic of Korea, and South Africa have included CACs in their recent international bond issues governed by New York law. In addition, many advanced countries have also committed to include CACs in their international bond issues so as to encourage their adoption as standard practice in the market. These clauses enable a qualified majority of bondholders to take decisions that become binding on all creditors of a particular bond issue, thereby helping to bring about a more orderly and prompt restructuring. They could also help governments avoid the large macroeconomic costs that might ensue if they are unable to restructure unsustainable debts in an orderly and predictable fashion. Though some concern has been expressed that their inclusion might increase borrowing costs for some governments, there has not been any evidence of a premium associated with the use of CACs in bonds issued in 2003.

One of the most important features of CACs is the *majority restructuring provision*, which enables a qualified super-majority of bondholders to bind all bondholders within the same issue to the terms of a restructuring agreement, either before or after a default.¹ Majority restructuring provisions are typically found in bonds governed by English, Japanese, and Luxembourg law, while those governed by New York law did not include these provisions until very recently. In Germany, while CACs are possible in principle, further legal clarification is underway to facilitate a broader use of CACs in foreign sovereign bond issues.

Another type of CAC is the *majority enforcement provision*, which is designed to limit the ability of a minority of bondholders to disrupt the restructuring process by enforcing their claims after a default but prior to a restructuring agreement. Two of these provisions can be found in bonds governed by English and New York law: (i) an affirmative vote of a minimum percentage of bondholders (typically representing 25 percent of outstanding principal) is required to accelerate their claims after a default, and (ii) a simple or qualified majority can reverse such an acceleration after the default on the originally scheduled payments has been cured. An even more effective type of majority enforcement provision can be found in trust deeds governed by English law, but which are also possible for bonds issued in other jurisdictions. A key feature is that the right to initiate legal proceedings on behalf of all bondholders is conferred upon the trustee subject to certain limitations.

Further information on collective action clauses can be found in: “Collective Action Clauses—Recent Development and Issues” at <http://www.imf.org/external/np/psi/2003/032503.htm>; “The Design and Effectiveness of Collective Action Clauses” at <http://www.imf.org/external/np/psi/2002/eng/060602.htm>; and “Collective Action Clauses in Sovereign Bond Contracts—Encouraging Greater Use” at <http://www.imf.org/external/np/psi/2002/eng/060602a.htm>. There is also the report of the G10 Working Group on Contractual Clauses, available at <http://www.bis.org/publ/gten08.htm#pgtop>.

1/ Thresholds that have been used for amending payment terms have ranged from 66 2/3 percent to 85 percent of either outstanding principal or the claims of bondholders present at a duly convened meeting.

⁶ The IMF is committed to promoting the use of CACs in sovereign bonds governed by foreign laws, and monitors their use in its surveillance activities.