September 2015

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

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

September 17, 2015

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

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INTRODUCTION

1. As part of the Fund's ongoing work on sovereign debt restructuring, in October 2014 the Executive Board endorsed the inclusion of key features of enhanced *pari passu* provisions and collective action clauses (CACs) in new international sovereign bonds.[1] Specifically, the Executive Board endorsed the use of: (i) a modified *pari passu* clause that explicitly excludes the obligation to effect ratable payments and (ii) an enhanced CAC with a menu of voting procedures, including a "single-limb" voting procedure that enables bonds to be restructured on the basis of a single vote across all affected instruments, a two-limb aggregated voting procedure and a series-by-series voting procedure.

2. Directors supported an active role for the Fund in promoting the inclusion of these clauses. Under the three-pronged approach outlined in the 2014 paper and endorsed by the Board, staff would promote the inclusion of the contractual provisions in international sovereign bonds by: (i) collecting detailed information on the stock of existing international sovereign bonds, including the use of CACs and *pari passu* provisions, residual maturities, and authorities' intentions regarding future issuances to raise awareness among the membership, which could include periodic surveys of public debt managers; (ii) engaging with the membership by promoting and participating in dialogue with member countries on the merits of the enhanced contractual provisions in various fora, including the Fund's annual Public Debt Management Forum and meetings of the International Monetary and Financial Committee (IMFC) and the G20; and (iii) informing the Board and the public by providing periodic progress reports with respect to the status of sovereign issuers' inclusion of the enhanced contractual provisions in international sovereign bonds. Consistent with its approach with respect to the design of CACs in the past, the Fund's focus is on international sovereign bonds.[2]

3. The Fund's endorsement was followed by calls from the IMFC and the G20 to promote the use of the enhanced clauses and report on their inclusion in international sovereign bonds. In October 2014, the IMFC issued a communiqué calling on the Fund, its member countries and the private sector to actively promote the use of the enhanced clauses.[3] Shortly thereafter in November 2014, the G20 called for the inclusion of the enhanced clauses in international sovereign bonds and encouraged the international community and the private sector to actively promote their

[1] See *The Chairman's Summing Up—Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring*) and *Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring* (the "2014 paper").

[2] International sovereign bonds are defined as bonds issued or guaranteed by a government or central bank under a law other than the law of the issuer (or where a foreign court has jurisdiction over claims arising under the bond), in freely traded form with fixed maturities, normally in excess of one year. Consistent with the approach taken in the 2014 paper, staff has not focused on the incorporation of the enhanced clauses in international sovereign *guaranteed* bonds.

[3] See *Communiqué of the Thirtieth Meeting of IMFC,* Washington, October 11, 2014.

use.[4] The G20 in February 2015 called on the Fund to report on progress on the inclusion of the strengthened CACs and *pari passu* clauses in international sovereign bonds and on the Fund's efforts in promoting them.[5]

4. Since October 2014, staff has conducted extensive outreach with issuers and other stakeholders. These outreach activities include: (i) seminars during the public debt management events held by the World Bank and the Fund in December 2014 and June 2015, respectively; (ii) a number of meetings in New York, London and Paris with private sector legal advisors for debtors and underwriters; and (iii) surveys of the public debt management offices of selected member countries regarding their views and experience with respect to the enhanced clauses (see Annex 1 for details regarding outreach). Staff has also set up a database to collect and analyze information on international sovereign bond issuances.[6]

5. This paper provides an update on progress regarding the inclusion of the enhanced contractual provisions in international sovereign bonds and related issues. Section II reports on the inclusion of enhanced contractual provisions in international sovereign bonds with a focus on those governed by New York and English laws, which represent the vast majority of foreign law-governed bonds.[7] Section III provides an update on the outstanding stock of international sovereign bonds. Section IV discusses the relative merits of using trust structures, and Section V sets out next steps. This paper does not discuss contractual provisions related to the process of engagement with creditors in the context of a debt restructuring. These will be discussed in the context of a subsequent paper on the review of the Fund's Lending into Arrears Policy.

[4] See *G20 Leaders' Communiqué,* Brisbane, November 16, 2014.

[5] See *Communiqué of the G20 Finance Ministers and Central Bank Governors Meeting*, Istanbul, February 9-10, 2015. In September 2015, the G20 also welcomed the progress achieved on the implementation of strengthened contractual provisions and stressed the importance of accelerating their implementation. See *G20 Leaders' Communiqué*, Istanbul, September 5, 2015.

[6] Perfect Information, a London-based financial information and research company, has been contracted to track and regularly provide information on all new issuances of international sovereign bonds. The information provided is tailored to the needs of the Fund based on a custom spreadsheet designed by staff, which includes data on the inclusion of key contractual provisions (e.g., CACs and *pari passu* clauses), pricing information, bond governance structure, and governing law, as well as the underlying bond documentation.

[7] As of July 31, 2015, of the total outstanding stock of international sovereign bonds, approximately 50 per cent are governed by New York law and approximately 46 percent by English law (as a share of nominal principal amount).

ENHANCED CONTRACTUAL PROVISIONS

A. Collective Action Clauses

Uptake of Enhanced Clauses

6. The enhanced CAC endorsed by the Executive Board includes a "single-limb" aggregated voting procedure designed to limit the ability of holdout creditors to undermine a restructuring. A "single limb" voting procedure enables bonds to be restructured on the basis of a single vote across all instruments or a subset of instruments, thereby preventing a creditor or a group of creditors from obtaining a blocking position in a particular series and nullifying the operation of CACs in that series. To safeguard the interests of creditors when using the single-limb voting procedure, Directors agreed that the CAC should require all affected bondholders to be offered the same instrument or an identical menu of instruments (the "uniformly applicable" condition) and include a voting threshold of 75 percent of the aggregated outstanding principal of all affected bond series. Moreover, to allow for flexibility to differentiate amongst creditors, the CAC should include a menu of voting procedures: a single-limb voting procedure, a two-limb aggregated voting procedure, and a series-by-series voting procedure. Directors also noted that the CAC should accommodate a broad range of debt instruments, including bonds denominated in different currencies and governed by different foreign laws, and include both a disenfranchisement provision in line with market practice and an information covenant consistent with Fund policy. During the October 2014 Board discussion, Directors noted that bonds issued by euro area sovereigns are required to include a CAC that allows for either a series-by-series or a two-limb aggregated voting procedure. Taking into account the fact that bond issuances by euro area sovereigns are, in most cases, governed by domestic law, and that this type of CAC has been positively received by market participants over recent years, Directors considered that this approach is appropriate for such bonds.

7. Since the Executive Board's endorsement, substantial progress has been made in incorporating the enhanced CACs in new international sovereign issuances (Annex II). Based on information available as of July 31, 2015, there have been 73 international sovereign bond issuances, by 37 sovereign issuers, since October 1, 2014, for a total nominal principal amount of approximately US$ 86 billion.[8] Of these, 42 issuances, representing about 60 percent of the nominal principal amount of total issuances, have included the enhanced CACs. The 21 issuers that have included the enhanced CACs are:

[8] The figures presented in this paper are based on information available to staff through the Perfect Information database. The sample includes international sovereign bonds issued between October 1, 2014 and July 31, 2015, except: euro area sovereign issuances (as they are required by law to include euro area-specific CACs), China's domestic issuances under Hong Kong law, and GDP warrants. International sovereign bonds issued by euro area countries during the period October 1, 2014 to July 31, 2015 did not include enhanced CACs and included euro area-specific CACs (the issuers were: Lithuania, Cyprus, Finland, Luxembourg and Spain). There may also be international sovereign bond issuances (e.g., private placements) that have not been captured by the Perfect Information database and thus are not reflected in staff's findings.

- *Under New York law*: Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Indonesia, Jamaica, Mexico, Panama, Turkey, and Vietnam; and

- *Under English law:* Armenia, Bulgaria, Croatia, Egypt, Ethiopia, Gabon, Kazakhstan, Montenegro, Tunisia, and Zambia.[9]

8. For purposes of understanding why certain bond issuances have *not* included the enhanced CACs, it is helpful to divide the international sovereign bonds issued since October 1, 2014 into two categories. The first category comprises new issuances, which are issued either on a stand-alone basis or under a new "shelf" registration statement or a new medium term note program[10] established on or after October 1, 2014, and which account for approximately 70 percent of all issuances (as a share of total nominal principal amount). About 85 percent of these issuances included the enhanced CACs (as a share of nominal principal amount).[11] The second category consists of re-openings of previous issuances or take-downs under programs established prior to October 1, 2014, which accounts for the remaining 30 percent of all issuances (as a share of nominal principal amount). None of the bonds conducted as re-openings or take-downs under existing programs included the enhanced CACs;[12] all of the bonds that included these clauses were either new standalone issuances or take-downs under programs established on or after October 1, 2014.

9. The fact that the enhanced CACs have not been included in re-openings or take-downs under existing programs reflects current market practice. Frequent issuers who wish to move quickly so as to take advantage of favorable market conditions for debt management reasons will often rely on re-openings or take-downs because of faster execution times and lower issuing costs (in particular, legal costs)[13], as compared to conducting a new issuance or amending an existing note program. This is achieved because, under either a re-opening or a take-down, the general contractual terms and conditions – including CACs – are not typically amended, in order to achieve fungibility of the new bond series with existing bond series.[14] Issuers are normally reluctant to

[9] The UK has also included enhanced CACs in its recent English law-governed US dollar-denominated bonds issued by the Bank of England.

[10] Frequent issuers often file a "shelf" registration statement or medium term note program with a base prospectus that may then subsequently be used for multiple future issuances, at which time prospectus supplements are filed that set forth the specific terms of the individual issuance.

[11] The issuers in this category that did not include the enhanced CACs are: under English law, Cote d'Ivoire, Pakistan and Poland; and under New York law, Mongolia, the Philippines and Sri Lanka. Also, recently issued sukuk, such as those issued by Malaysia, Hong Kong and Turkey (all under English law), have not included the enhanced CACs (the Hong Kong and Turkey issuances included series-by-series CACs, whilst Malaysia also included a two-limb aggregated CAC).

[12] The issuers that conducted re-openings or take-downs under existing programs and did not include the enhanced CACs are: Under New York law, Colombia, Lebanon, Paraguay, Peru, Turkey, Uruguay and under English law, Poland, Romania, Kenya and Sweden. Namibia's June 2015 issuance under South African law and Indonesia's May 2015 sukuk issuance under English law also did not include the enhanced CACs.

[13] The current market practice for re-openings involves the launch and closing of an offer within a short time period, often within one day.

[14] According to market participants, fungibility increases the liquidity of the bond series.

amend bonds issued under existing programs as amending these programs would risk distorting the price of a particular bond series and would require the consent of existing bondholders.

10. The uptake of enhanced CACs was greater for new issuances under New York law than English law. *Of the new issuances*, approximately 92 percent of the New York law-governed bonds included the enhanced CACs, while approximately 75 percent of the English law-governed bonds included the enhanced CACs (as a share of total nominal principal amount). Of the 92 percent, approximately 71 percent were issued by Latin American issuers.

11. It is too early to identify definitive reasons for non-incorporation of the enhanced CACs in some new issuances and the uptake differential between the New York and English jurisdictions. However, consultation with public debt managers and market participants points to a degree of inertia in adopting these clauses. This could be due to a lack of awareness or understanding on the part of issuers, lead underwriters and their advisors of the benefits of the enhanced clauses and concerns about their impact on pricing, despite the fact that no impact on pricing at the time of issuance has been observed, as discussed below. This consultation also indicates that "infrequent" issuers seem to give less importance to incorporating the aggregated voting procedures since they currently have few outstanding bond series that would need to be aggregated, reflecting a short-term perspective that ignores the benefits of the enhanced clauses in supporting an orderly restructuring process in the future. With respect to the differential in the uptake of the enhanced clauses between New York and English law-governed bonds, some market participants indicated that Latin American sovereign issuers may be influenced by Mexico's lead in including the clauses in its November 2014 issuance under New York law and tend to move together as a market practice. In contrast, the English law bonds were primarily issued by African, Asian and (non-Eurozone) European sovereigns where the levels of awareness and acceptance of the enhanced clauses appear to be more varied.

Formulation

12. While the issuances that incorporated the enhanced CACs included the key features endorsed by the Board, the formulation of the clauses has evolved to reflect their use and market preferences, as anticipated by staff in the 2014 paper. In November 2014, a group of legal advisors, in consultation with market participants, formulated a New York law version of the ICMA model clauses to reflect the stylistic preferences of the New York market. While most issuances under New York law have generally followed this formulation, there have been variations. For example, a number of issuances, beginning with Mexico in November 2014, did not include the phrase "on the same terms" in the definition of "uniformly applicable" under the single limb voting procedure. While this omission led to concern from some creditors that an issuer could offer more favorable terms of exchange to certain bondholders, even if the instruments or the menu of instruments being offered were the same, market participants and relevant issuers indicated that this omission was not intended to change the "uniformly applicable" requirement. A few New York issuers have also included a version of the clause that limits use of the two-limb aggregated voting

procedure only to offerings that are not "uniformly applicable" (i.e., the two-limb voting procedure cannot be used if the condition for the use of the single-limb voting procedure is met).[15]

13. To avoid uncertainty, while at the same time accommodating stylistic differences between legal markets, ICMA published in May 2015 two different versions of the model clauses—one for English law and another for New York law bonds. [16] This reflects the deliberate efforts of ICMA to achieve two objectives. First, while recognizing that there may be stylistic differences between the two jurisdictions, the model clauses ensure substantive alignment. Second, within each jurisdiction, the objective is to ensure consistency of formulation, thereby addressing some of the uncertainties that have arisen when these clauses were initially introduced. For both versions, the model clauses clarify that the "uniformly applicable" condition would not be satisfied if each exchanging, converting or substituting bondholder is not offered the same amount of consideration per amount of principal and interest (accrued and past due), as that offered to each other exchanging, converting or substituting bondholder of any bond series affected by the modification (and where electing the same option under the menu of instruments, if applicable). In addition, the model clauses under New York law clarify that the use of the two-limb voting procedure is not limited to situations in which the "uniformly applicable" condition cannot be met, consistent with the approach under the English law clauses.

B. Pari Passu

14. As discussed in the 2014 paper, recent litigation has highlighted the need to modify the *pari passu* clause in international sovereign bonds. In *NML v. Argentina,* the New York courts found Argentina in breach of the *pari passu* clause in its New York-law governed sovereign bonds and issued an injunction requiring Argentina to pay the holdout creditors on a ratable basis with bondholders holding restructured bonds. While the New York courts' decision is final, litigation between holdout creditors and Argentina stemming from the decision continues.[17] Moreover, the

[15] Mexico (November 2014 and January, February and April 2015) and Chile (December 2014 and May 2015). In June 2015, Mexico filed a registration statement with the SEC which included amendments to its November 2014 trust indenture to include the revised definition of "uniformly applicable" as set forth in ICMA's New York law version of the model clauses.

[16] http://www.icmagroup.org/assets/documents/Resources/ICMA-Standard-CACs-Pari-Passu-and-Creditor-Engagement-Provisions---May-2015.pdf.

[17] The English High Court did not address the viability of the U.S. District Court's construction of the *pari passu* provision in its judgment of February 13, 2015, which held that the payment made by Argentina to the Eurobondholders on June 26, 2014 was being held by Bank of New York Melon in trust for the Eurobondholders and subject to English law. While there is no clear judicial precedent on the interpretation of the *pari passu* clause under English law, the prevailing view is that English courts would not follow the interpretation of the *pari passu* clause adopted by the New York courts, nor grant remedies against a sovereign similar to those granted by the New York courts. See, e.g., "Analysis of the Role, Use and Meaning of *Pari Passu* Clauses in Sovereign Debt Obligations As a Matter of English Law," Financial Markets Law Committee, April 2015.

extent to which the New York courts' interpretation of the *pari passu* clause in the Argentine litigation will apply to other sovereigns remains unclear.[18]

15. In light of the uncertainty created by the New York court decisions, the Executive Board supported the widespread use of modified *pari passu* provisions in international sovereign bonds. The modified *pari passu* provision significantly mitigates the risk that a court would interpret the clause similarly to the interpretation given by the court in the Argentine litigation, as it explicitly states that the clause does not require the issuer to pay external indebtedness on an equal or ratable basis. The widespread use of this modified provision could help enhance legal certainty and consistency across jurisdictions.[19]

16. Staff's analysis indicates that the modified *pari passu* clause is being incorporated as a package with the enhanced CACs. All post-October 1, 2014 issuances that have included the enhanced CACs also include modified *pari passu* clauses. Cote d'Ivoire (English law) and Mongolia (New York law), which did not include the enhanced CACs, have also included modified *pari passu* clauses in their recent issuances. Conversely, there were no issuers that declined to include the modified *pari passu* clauses but decided to include enhanced CACs in their international sovereign bonds. Euro area sovereigns, which are required under the ESM treaty to include the two-limb euro area CACs in all new issuances, have generally not included modified *pari passu* clauses.[20] While there have been variations in the formulation of the modified clauses, they all specifically disavow the obligation to make ratable payments.

17. Consultations indicate that market participants generally view the modified *pari passu* clause favorably. While certain creditors expressed concerns that bonds with the modified provisions may be considered subordinate (de facto) to an issuer's legacy debt that does not include the modified provisions, there is no evidence that this concern is directly inhibiting the incorporation of the modified *pari passu* clause. Indeed, there were no issuances that incorporated only the enhanced CACs and not the modified *pari passu* clause; moreover, there were issuances that incorporated the modified *pari passu* clause but not the enhanced CACs.

C. Market Impact

[18] In February 2015, the case between Grenada and the Export-Import Bank of Taiwan Province of China, in which Taiwan POC's Ex-Im Bank alleged that Grenada had violated the *pari passu* clause in its loan agreements, was dismissed with prejudice and without costs to any party in light of the December 15 settlement agreement that "fully resolve[d] the issues in dispute". See Exp-Imp. Bank of the Republic of China v. Grenada, No. 13 Civ. 1450, 2013 U.S. Dist. LEXIS 117740, at 11-13 (S.D.N.Y. Aug 19, 2013.)

[19] See *The Chairman's Summing Up—Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring*.

[20] Lithuania has included the modified *pari passu* clause in its new international sovereign bond issuance, while Cyprus, Finland, Luxembourg and Spain have not. Cyprus, Finland and Spain's issuances were take-downs from pre-October 2014 note programs. Greece also included a modified *pari passu* provision in its pre-October 2014 issuance.

18. Market acceptance of the enhanced contractual provisions has been strong with no observable impact on pricing. While there has been no published study on the market impact of the enhanced clauses, according to public debt managers and market participants, the inclusion of the enhanced contractual provisions has not had a material impact on the pricing of new bonds at the time of issuance.[21]

19. Empirical analyses of traditional, series-by-series CACs have not indicated any consistent causal relationship between inclusion of CACs and market prices. While there has been no published study on the market impact of the enhanced clauses, the empirical analyses of traditional, series-by-series CACs are indicative. For example, Bardozzetti and Dottori (2013) find that CACs have little impact on the cost of borrowing for sovereign issuers with high and low credit ratings, but generally reduce the cost for mid-rated issuers, as these countries can benefit the most from an orderly restructuring. They argue that, since there is a very low probability for high-rated countries to default, there would be no impact from including CACs. Further, since moral hazard concerns are prevalent for low-rated countries, the cost-reducing impact of CACs is at least partially offset by the higher risk premium. Moreover, Bradley and Gulati (2013) found that the inclusion of CACs in a sovereign bond contract is associated with a lower cost of capital, especially for financially-weak issuers, due to an expectation of speedier restructurings.[22]

OUTSTANDING STOCK

20. As discussed in the 2014 paper, even if the Fund is successful in promoting the inclusion of the enhanced clauses in new international sovereign bond issuances, this will not affect the large outstanding stock of debt. The extent to which the outstanding stock of debt will undermine the debt restructuring process will depend, in large part, on how courts interpret *pari passu* clauses in future litigation.[23] As of July 31, 2015, the outstanding stock is estimated at approximately US$ 915 billion, as compared to a total outstanding stock of approximately US$ 900 billion as of September 2014. This difference can be attributed to a number of factors, including that the amount of new bond issuances since September 2014 was greater than the amount of bonds maturing during the same period.[24] Of the outstanding stock, approximately 46 per cent are governed by English law and approximately 50 percent by New York law. Approximately 6 percent of the outstanding stock includes enhanced CACs, of which New York law governed bonds account for approximately 4 percent. The maturity profile of the outstanding stock is broadly unchanged

[21] Results of the March and June 2015 surveys sent by the Fund staff to public debt managers indicate that members that have included the enhanced clauses did not note any discernible effect on the pricing of newly issued bonds.

[22] This study analyzed primary market data on euro area sovereign bond issuances during 1990-2010 (Bradley, Michael and Gulati, G. Mitu, (2013) *Collective Action Clauses for the Eurozone: An Empirical Analysis*).

[23] See 2014 paper (Section II).

[24] As noted in the 2014 paper, the estimate of the total amount of the outstanding stock based on the Bloomberg and Dealogic databases may be subject to certain inaccuracies. The figures for the current outstanding stock are based on information obtained through the Perfect Information database.

from September 2014: approximately 71 percent of this total stock will mature within the next ten years, while the remaining 29 percent will take 10 years or more to mature. For those bonds governed by New York law where, as noted in the 2014 paper, the risks are more acute given the New York court decisions, approximately 39 percent will take ten years or more to mature.

21. No sovereign issuer is known to have engaged in liability management operations to accelerate the incorporation of the enhanced contractual provisions. The 2014 paper recognized that one approach to dealing with the large outstanding stock of international sovereign bonds that do not contain the enhanced contractual provisions would be to encourage issuers to accelerate the turn-over through liability management operations, including bond buybacks and bond swaps. It noted, however, that issuers and investors had thus far expressed little appetite for such an exercise, particularly as at the time no issuer had yet included enhanced CACs in their international sovereign bonds. While there is no longer a "first mover" problem and no pricing impact has been observed at issuance, consultations with issuers indicates that they are reluctant to conduct a liability management operation solely to incorporate the enhanced clauses, unless it would also be in their best financial interests to do so, particularly in terms of their cost of funding. In this regard, it should be noted that, in the context of the Fund's Debt Managers Forum, among those issuers that have already adopted the enhanced clauses, Mexico stated that it would be evaluating a liability management exercise in the future. As noted in the 2014 paper, consideration could also be given to addressing the outstanding stock problem through legislative solutions in the event that future courts interpret the New York court decisions broadly and in a manner that seriously undermines the restructuring process.[25]

BOND GOVERNANCE STRUCTURES

22. Recent consultations with market participants highlight the role of trust structures in facilitating an orderly restructuring process. International sovereign bonds are typically issued under either fiscal agency agreements (FAAs) or trust structures.[26] Under an FAA, the fiscal agent serves as an agent of the issuer, and its main responsibility is the making of principal and interest payments to the bondholders.[27] Under trust structures ("trust indenture" under New York law or "trust deed" under English law), a bond trustee acts on behalf of, and has a number of responsibilities to, bondholders as a group.[28] Historically, international sovereign bonds governed by

[25] See 2014 paper (Section IV), discussing proposals by some observers to amend the U.S. Foreign Sovereign Immunities Act.

[26] *The Design and Effectiveness of Collective Action Clauses* .

[27] The fiscal agent may also perform, on the issuer's behalf, certain administrative functions including the publication of notices to the bondholders and acting as a depositary for the issuer's accounts.

[28] Trust deeds are used in connection with bonds governed by English law while trust indentures are used in connection with bonds governed by New York law. Trust structures are a concept peculiar to common law jurisdictions and are not customary in civil law jurisdictions. However, many civil jurisdictions have developed devices other than the trust to represent the bondholders as a group. For example, the Japanese Commercial Code provides for the establishment of a commissioned company for bondholders to represent bondholders as a group.

New York and English laws tended to be issued under FAAs; as FAAs are marginally cheaper and easier to implement than trust structures, trust structures were generally used only when the transaction was more complicated or secured. FAAs and trust structures provide bondholders different means to enforce their rights against a sovereign debtor after a default. More specifically, and as described further below, they vary with respect to bondholders' ability to (i) declare the full amount of the bond due and payable ("acceleration"), (ii) commence legal proceedings against the sovereign, and (iii) receive amounts recovered from the sovereign after litigation.

Acceleration

23. Individual bondholders' rights to accelerate after a default are typically more limited under trust structures than FAAs. Following an event of default, bondholders often have the right to declare the full outstanding amount of the bonds to be due and payable ("accelerate"). To accelerate, trust structures typically require that bondholders holding a minimum principal amount of the bond issue (normally 25 percent) request the trustee to accelerate. In that case, the trustee normally has the discretion, upon receipt of such request, to accelerate on behalf of all bondholders. FAAs can differ from trust structures in mainly two respects. First, some FAAs allow each individual bondholder to accelerate its own bond (but not the entire issue) without limitation.[29] Second, while some FAAs require bondholders holding a minimum principal amount of the bond to give notice to the fiscal agent and issuer to accelerate, the acceleration is more automatic as, unlike the typical trust structure, the fiscal agent does not have discretion, but rather the bonds are automatically accelerated by the issuer upon receipt of such notice. In practice, however, this legal difference is of less significance as trustees rarely exercise their discretion and would normally accelerate when requested to do so by the bondholders. Restricting individual bondholders from disrupting the restructuring by enforcing their claims after a default and prior to a restructuring is particularly relevant when a cross default is triggered. This limitation will assist a sovereign that has a number of different outstanding issuances to limit the consequences of its failure to make payments with respect to a single bond issue or single bondholder.[30]

Initiation of Litigation

24. Under trust structures, the trustee commences litigation against the sovereign on behalf of the bondholders. Under an FAA, individual bondholders have the right to initiate legal proceedings against the debtor following an event of default for the amount that is due and payable. However, when a trust structure is used, the right of individual bondholders to initiate legal proceedings is, with some limitations, effectively delegated to the trustee who is required to initiate

[29] This rule applies to bonds issued under German law.

[30] Normally, acceleration under both trust structures and FAAs can also be reversed by bondholders holding a requisite percentage of outstanding principal (typically 50 percent) if all payment defaults relating to the originally scheduled payments (excluding any amounts due as a result of acceleration) have been cured or waived. Allowing a majority of bondholders to rescind an acceleration can act as a deterrent against litigation during the negotiation period.

proceedings only if: (i) it is requested to do so by bondholders holding a requisite percentage of the bond issue (typically 25 percent of the principal amount) and (ii) it has received adequate indemnification.[31] In this case, an individual bondholder will only be able to initiate proceedings if the trustee fails to do so after both of these conditions have been met. While the trustee may also initiate proceedings at its own discretion (i.e., in the absence of a request by a requisite percentage of bondholders), it will not normally do so due to the risks and costs involved.[32] Trust structures effectively prohibit individual bondholders from pursuing litigation while they are negotiating a restructuring agreement with the sovereign after a default. In addition to providing temporary protection for the sovereign's assets, such a brake may enhance the prospects of a successful negotiation since creditors may be more willing to exercise forbearance and negotiate in an orderly manner if they do not feel that other creditors are taking advantage of their forbearance by seizing a limited supply of assets held in foreign jurisdictions by the sovereign.

Sharing of Proceeds

25. Trust structures ensure pro rata distribution by the trustee among all bondholders of any amounts recovered through litigation. As a consequence of the trustee's authority to initiate legal proceedings on behalf of all bondholders, any amounts recovered by the trustee through such proceedings are for the benefit of the bondholders as a group and, therefore, are distributed pro rata amongst them. Even if a bondholder wishing to pursue litigation has managed to acquire a sufficient percentage of bonds to enable him to request the trustee to initiate litigation, the sharing requirement that the trustee distribute any amounts recovered through such litigation to all bondholders on a pro rata basis will reduce such bondholders' incentive to do so. In contrast, under an FAA that permits individual bondholders to litigate, the proceeds of litigation brought by individual bondholders remain theirs alone. This "sharing" requirement deters minority bondholders from initiating litigation to disrupt restructuring negotiations between the debtor and the majority of bondholders.

Recent experience

26. The Executive Board discussed the benefits of trust structures for an orderly debt restructuring in the early 2000s.[33] Views of Executive Directors were mixed as to whether the costs

[31] English trustees are also often given the discretion to determine whether the basis of an acceleration request is "materially prejudicial" to the bondholders, which is not granted to U.S. trustees.

[32] Under a typical U.S.-style trust indenture, while the right of individual bondholders to enforce *accelerated* claims is effectively delegated to the trustee, each bondholder maintains the right to bring an individual enforcement action against the issuer to recover any non-accelerated principal or interest payments that are not paid to him when due. However, certain trust indentures have been drafted so as to centralize all enforcement powers in the trustee (e.g., Grenada, Belize, Cote D'Ivoire).

[33] The Design and Effectiveness of Collective Action Clauses; *Collective Action Clauses – Recent Development and Issues*. The G-10 Working Group Report of September 2002 recommended the inclusion of provisions found in trust deeds that concentrate the power to initiate litigation within a bondholder representative and ensure the pro rata distribution of proceeds. However, in recognition that trust deeds may not be compatible with all legal systems, it noted alternative structures may need to be relied on by some countries to achieve a similar result.

of such a structure justified its inclusion in international sovereign bonds, as recommended by staff at the time. Many Directors noted that the use of trust deeds or an equivalent legal structure can play an important role in the restructuring process and the potential benefits may justify the limited financial cost of using them. However, some Directors felt that the financial costs of trusts may outweigh their benefits. It was noted that this was an issue for issuers and investors to determine.[34]

27. Since then, there has been an increase in the use of trust structures, primarily under New York law.[35] Approximately 45 percent of international sovereign bond issuances between October 1, 2014 and July 31, 2015 used trust structures, and approximately 83 percent of these were under New York law. Large emerging market issuers, such as Mexico and Chile, have recently switched to using trust indentures in their New York law governed bonds due to the reasons discussed above. Issuers under English law appear to prefer FAAs. According to market participants, this may reflect lack of awareness and the fact that many lower income countries typically issue under English law and may be more sensitive to the higher costs associated with the use of trust structures.

28. It should be recognized that while trust structures can help alleviate collective action problems in sovereign debt restructurings, they are not a panacea. The key benefit of trust structures as discussed above is that, after default and prior to reaching a restructuring agreement, the limitations on individual enforcement action under trust structures help to prevent a minority of bondholders from undermining the restructuring negotiations between the debtor and the majority. This benefit exists even if bonds contain enhanced CACs, as trust structures will help support an orderly restructuring process to facilitate the reaching of an agreement with the sovereign debtor by the qualified majority of bondholders across affected series. However, to the extent a restructuring agreement has been reached but holdout creditors remain, the benefits of trust structures are limited, as holdout creditors will control the full amount of the unresestructured bonds and can therefore instruct the trustee to accelerate or commence litigation against the debtor. Moreover, the fact that the proceeds of litigation are shared among all bondholders would no longer be a disincentive since the holdout would be the exclusive beneficiary. As such, the inclusion of enhanced CACs is particularly important, as it reduces the likelihood of holdouts remaining after the qualified majority of bondholders have agreed to restructure the bond.[36]

[34] *The Acting Chair's Summing Up – Collective Action Clauses – Recent Developments and Issues* .

[35] See Buchheit (2007), Supermajority Control Wins Out, International Financial Law Review 26(4):2; Häseler, Sönke, 2010, Trustees versus Fiscal Agents and Default Risk in International Sovereign Bonds, Institute of Law and Economics, University of Hamburg.

[36] It has also been argued that the concentration of individual enforcement rights in the trustee may reduce market discipline and increase the incentives for sovereigns to strategically default. However, empirical research does not reveal any meaningful impact on sovereign bond default risk from using trust structures (Häseler, Sönke, 2010).

NEXT STEPS

29. Staff will continue to promote the inclusion of modified *pari passu* clauses and enhanced CACs in international sovereign bonds using the three-pronged approach endorsed by the Board. Staff will continue to: (i) collect information on the stock of existing international sovereign bonds, including the use of CACs and *pari passu* provisions, residual maturities, and authorities' intentions regarding future issuances; (ii) engage on related issues with the membership through various fora, including the Fund's Public Debt Management Forum and meetings of the IMFC and the G20; and (iii) inform the Board and the public periodically on the status of sovereign issuers' inclusion of the enhanced contractual provisions in international sovereign bonds.

30. In light of the lower uptake rate in certain jurisdictions and regions, staff will conduct more targeted engagement. As staff has noted, the rate of uptake of the enhanced contractual provisions was lower for English law-governed bonds as compared with New York law governed bonds. To the extent that this is caused by a lack of awareness or understanding of the benefits of enhanced contractual provisions, more targeted engagement with the debt management offices of members in specific regions – notably Africa, Asia and non-euro area Europe - as well as their underwriters and legal advisors will be warranted. This could be done through organizing workshops, including possibly at the Fund's regional training facilities.

31. With regard to issuances conducted as re-openings or take-downs, consideration could be given to amending existing bond documentation to include the enhanced contractual provisions. As staff has noted, a large majority of the post-October 2014 issuances that did not include the enhanced clauses were conducted as take-downs under pre-existing shelf registrations and note programs, or re-openings of existing issuances. However, consultation with market participants and issuers indicate that incorporating the enhanced clauses in these issuances is not advantageous from a market perspective, as it would undermine the fungibility of these issuances with existing bond series, which could have negative liquidity and trading implications. Amending the terms also may not be practical for re-openings, which are often conducted within a short time frame. However, consultations indicate that issuers may be more willing to incorporate the clauses if they are making amendments to the existing program for other debt management reasons.

32. Trust structures act as an important deterrent to disruptive litigation that could undermine restructuring negotiations after a default. Building on the increasing market acceptance of trust structures, at least in the New York market, staff will engage with its membership to increase understanding of the benefits of trust structures.

33. Staff will also closely monitor and assess whether liability management represents a viable solution for accelerating the turnover of the outstanding stock of bonds. In this regard, Mexico's anticipated evaluation of liability management operations to address the outstanding stock issue will act as an important indicator of the viability of this approach.

Annex I. Timeline of Key Events

The following is a list of the primary events related to staff's promotion of the use of enhanced contractual provisions in international sovereign bonds since October 1, 2014:

October 11, 2014: The IMFC issues a communiqué calling on the IMF, its member countries, and the private sector to actively promote the use of the enhanced contractual clauses. 1/

October 27, 2014: Staff participates in meetings held with legal advisors in New York regarding the formulation of the enhanced contractual clauses for New York law-governed bonds.

November 16, 2014: The G20 welcomes the international work on strengthened collective action and *pari passu* clauses, calls for the inclusion of the clauses in international sovereign bonds, and encourages the international community and the private sector to actively promote their use. 2/

November 19, 2014: Staff presents on the IMF's endorsement of key features of the enhanced contractual provisions at the Paris Club's regular Tour d'Horizon meeting.

December 2, 2014: As part of the World Bank's Sovereign Debt Management Forum, the IMF and the IDB co-host a roundtable discussion on the enhanced clauses with public debt managers, primarily from emerging market members.

February 10, 2015: G20 calls on the IMF to report back on progress on the inclusion of the strengthened collective action and *pari passu* clauses in international sovereign bonds and the Fund's efforts in actively promoting their use. The communiqué states that the G20 will discuss the progress achieved, with a view to expanding its understanding.

March and June 2015: IMF staff conducts a survey of selected public debt management offices of its member countries to inquire about their views and experience with the enhanced clauses. Staff received responses from 32 members, who were all aware of the enhanced contractual clauses and acknowledged the benefit of including these clauses in international sovereign bond contracts.

April 28, 2015: Staff participates in meetings held with legal advisors in New York regarding the revisions to the ICMA model CACs for New York law bonds and ways to promote the use of the enhanced clauses and to address the outstanding stock issue.

May 5, 2015: The IMF and the Financial Markets Law Committee (FMLC) hold a consultative forum with creditors and legal advisors to discuss: (i) amendments to the ICMA model CACs to address issues regarding formulation; and (ii) ways to increase incorporation of the enhanced clauses in new issuances.

June 2, 2015: During its periodic Public Debt Management Forum, the IMF hosts a session to inform public debt managers about the enhanced clauses and to seek their views. The session was well-attended and received by public debt managers from a broad range of the IMF's member countries.

June 23, 2015: Staff participates in the annual joint meeting of the Paris Club and the Institute for International Finance (IIF) and presents on the use and uptake of enhanced contractual provisions.

September 4-5, 2015: G20 welcomes increased adoption of strengthened collective action and *pari passu* clauses in international sovereign bond issuances and stresses the importance of accelerating their implementation. 3/

1/ See *Communiqué of the Thirtieth Meeting of IMFC*, Washington, October 11, 2014.

2/ See G*20 Leaders' Communiqué*, Brisbane, November 16, 2014.

3/ See *G20 Leaders' Communiqué,* Istanbul, September 5, 2015.

Annex II. Incorporation of Enhanced Sovereign Bond Clauses (From October 1, 2014 to July 31, 2015)[37]

A. Issuances including the Enhanced Clauses (includes *both* enhanced PP *and* enhanced CAC)

Country	*Date*	*Size/Tenor*	*Governing Law*	*Structure*
Kazakhstan	Oct 2014	US$ 1.5 bn 10Y US$1 bn 30Y	English	FAA
Vietnam	Nov 2014	US$ 1 bn 10Y	New York	FAA
Mexico	Nov 2014	US$ 2 bn 10Y	New York	Trust Indenture
Chile	Dec 2014	US$ 1.06 bn 11Y EUR 0.8 bn 11Y (US$ 1bn)	New York	Trust Indenture
Ethiopia	Dec 2014	US$ 1bn 10Y	English	FAA
Mexico	Jan 2015	US$ 1bn 10Y US$ 3.01bn 31Y	New York	Trust Indenture
Indonesia	Jan 2015	US$ 2bn 10Y US$2 bn 30Y	New York	Trust Indenture
Colombia	Jan 2015	US$ 1.5 bn 30Y	New York	Trust Indenture
Tunisia	Jan 2015	US$ 1bn 10Y	English	FAA
Dominican Republic	Jan 2015	US$ 1bn 10Y US$1.5 bn 30Y	New York	Trust Indenture
Mexico	Feb 2015	EUR 1.25bn 9Y (US$ 1.4bn) EUR 1.25 bn 30Y (US$ 1.4bn)	New York	Trust Indenture
Panama	Mar 2015	US$ 1.25bn 10Y	New York	FAA
Croatia	Mar 2015	EUR 1.5 bn 10Y (US$ 1.6bn)	English	FAA
Armenia	Mar 2015	US$ 0.50 bn 10Y	English	FAA
Bulgaria	Mar 2015	EUR 1.25 bn 7Y (US$ 1.4bn) EUR 1 bn 12Y (US$ 1.1bn) EUR 0.85 bn 20Y (US$ 0.9bn)	English	FAA
Montenegro	Mar 2015	EUR 0.5 bn 5Y (US$ 0.5bn)	English	FAA
Ecuador	Mar 2015	US$ 0.750 bn 5Y	New York	Trust Indenture
Costa Rica	Mar 2015	US$ 1 bn 30Y	New York	Trust Indenture
Colombia	Mar 2015	US$ 1bn 30Y	New York	Trust Indenture
Mexico	Apr 2015	EUR 1.5bn 100Y (US$ 1.6bn)	New York	Trust Indenture
Turkey	Apr 2015	US$ 1.5 bn 11Y	New York	FAA
Chile	May 2015	EUR 0.95 bn 15Y (US$ 1.1bn) EUR 0.44 bn 10Y (US$ 0.5bn)	New York	Trust Indenture
Dominican Republic	May 2015	US$ 0.5 bn 30Y US$ 0.5bn 10Y	New York	Trust Indenture

[37] The dataset is based on information available to staff and includes international sovereign bonds whose issuances were announced between October 1, 2014 and July 31, 2015, except: euro area sovereign issuances (as they are required under law to include euro area-specific CACs – see footnote 20 above with respect to the inclusion of *pari passu* clauses); China's domestic issuances under Hong Kong governing law; and GDP warrants. There may also be international sovereign bond issuances (e.g., private placements) that have not been captured by the database relied upon by staff and thus are not reflected in staff's findings.

Ecuador	May 2015	US$ 0.750 bn 5Y	New York	Trust Indenture
Gabon	June 2015	US$ 0.50 bn 10Y	English	FAA
Egypt	June 2015	US$ 1.5 bn 10Y	English	FAA
Kazakhstan	June 2015	US$ 2.5 bn 10Y US$ 1.5 bn 30Y	English	FAA
Zambia	July 2015	US$ 1.25 bn 12Y	English	FAA
Jamaica	July 2015	US$ 1.35bn 13Y US$ 0.65 bn 30Y	New York	Trust Indenture
Indonesia	July 2015	EUR 1.25 bn 10Y (US$ 1.37 bn)	New York	Trust Indenture

B. Issues without New Clauses (missing *either* modified CAC *or* modified PP)

B1. New standalone issuances and take-downs under new note programs

Country	*Date*	*Size/Tenor*	*Governing Law*	*Structure*	*Enhanced CAC*	*Modified Pari Passu*
Turkey (Sukuk)	Nov 2014	US$ 1bn 10Y	English	Trust deed	No – Series by series	No
Pakistan	Dec 2014	US$ 1bn 5Y	English	Trust Indenture	No – Series by Series	No
Philippines	Jan 2015	US$ 2 bn 25Y	New York	FAA	No – Series by series	No
Cote D'Ivoire	Mar 2015	US$ 1 bn 13Y	English	FAA	No – Series by Series	Yes
Malaysia (Sukuk)	April 2015	USD 1bn 10Y USD 0.5bn 30Y	English	Trust structure (declaration of trust)	No – two-limb aggregation	No
Poland	May 2015	CHF 0.58 bn 3Y (US$ 0.6bn)	English	FAA	No – EuroCACs	No
Hong Kong (Sukuk)	May 2015	US$ 1 bn 5Y	English	Trust Indenture	No - Two-limb aggregation	No
Sri Lanka	May 2015	US$ 0.65bn 10Y	New York	Trust Indenture	No - Series by series	No
Mongolia	June 2015	CNY 1.0 bn 3Y (US$ 0.2bn)	New York	FAA	No – Series by Series	Yes

B2. Re-openings of old issuances and take-downs under pre-October 1 2014 note programs

Country	*Date*	*Size/Tenor*	*Governing Law*	*Structure*	*Enhanced CAC?*	*Modified Pari Passu?*
Colombia	Oct 2014	US$ 0.50 bn 10Y US$ 0.50 bn 30Y	New York	FAA	No – Series by series	No
Romania	Oct 2014	EUR 1.5bn 10Y (US$ 1.9bn)	English	FAA	No – Series by series	No
Peru	Oct 2014	US$ 0.50 bn 36Y	New York	FAA	No – Series by series	No
Sweden	Nov 2014	US$ 3bn 3Y	English	FAA	No – Series by series	No
Kenya	Nov 2014	US$ 0.25 bn 5Y US$ 0.25 bn 10Y	English	FAA	No – Series by Series	No
Turkey	Jan 2015	US$ 1.5bn 28Y	New York	FAA	No – Series by series	No
Sweden	Jan 2015	US$ 2.5bn 3Y	English	FAA	No- Series by series	No
Sweden	Feb 2015	EUR 1.5bn 5Y (US$ 1.7bn)	English	FAA	No – Series by series	No
Lebanon	Feb 2015	US$ 0.80 bn 10Y US$1.4bn 15Y	New York	FAA	No – Series by Series	No
Uruguay	Feb. 2015	US$ 1.2bn 35Y	New York	Trust Indenture	No – Series by series	No
Sweden	March 2015	US$ 1.5bn 2Y US$ 2bn 5Y	English	FAA	No – series by series	No
Peru	March 2015	US$ 0.545 bn 35Y	New York	FAA	No – series by series	No
Paraguay	April 2015	US$ 0.28 bn 8Y	New York	Trust Indenture	No – Two-limb aggregation	No
Poland	April 2015	EUR 1 bn 12Y (US$ 1 .1 bn)	English	FAA	No – EuroCACs	No
Indonesia (Sukuk)	May 2015	US$ 2bn 10Y	English	Trust structure (declaration of trust)	No – series by series	No
Sweden	May 2015	US$ 2.25bn 3Y	English	FAA	No – Series by series	No
Namibia	June 2015	ZAR 0.3 bn 5Y (US$ 0.02bn)	South Africa	FAA	No – series by series	No