INTERNATIONAL MONETARY FUND

Fund Policy on Lending into Arrears to Private Creditors—Further Consideration of the Good Faith Criterion

Prepared by the International Capital Markets, Policy Development and Review and Legal Departments

(In consultation with the other Departments)

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I. INTRODUCTION

1. Conceived in the late 1980s as a means of resolving the debt crisis, the scope of the Fund's policy concerning lending into sovereign external payments arrears to private creditors was broadened in 1999 to encompass arrears on bonds and other nonbank forms of financing from private creditors.[1] Directors agreed that Fund lending into sovereign arrears to private creditors (including bondholders and commercial banks) should be on a case-by-case basis and only where: (i) prompt Fund support is considered essential for the successful implementation of the member's adjustment program; and (ii) the member is pursuing appropriate policies and is making a good faith effort to reach a collaborative agreement with its creditors. Previously, the scope of the policy had been limited to arrears to commercial banks.

2. Issues have arisen in the application of the policy concerning the meaning of "good faith efforts to reach a collaborative agreement with creditors." Specific questions relate to the nature and extent of dialogue between a member and its creditors required to satisfy this condition. This paper gives further consideration to issues that have a bearing on the "good faith" judgment. In particular, it proposes general principles that should guide a timely and substantive dialogue between a debtor and its creditors in the context of elaborating restructuring proposals, and discusses possible modalities of such dialogue in view of the diversity of country circumstances and creditors' readiness to engage in a collective negotiating framework. In this regard, the paper is designed to provide greater clarity to the elements of the process of restructuring.

3. The clarification of the good faith clause in the lending into arrears policy aims at improving the process for restructuring sovereign debt. In this respect, the Fund's policy on lending into arrears complements the recent proposals advanced by the First Deputy Managing Director, Mrs. Krueger, for the adoption of a statutory framework (SDRM) for the resolution of sovereign debt restructuring by debtors and their creditors and a complementary approach under which contractual provisions in sovereign bonds would help to provide a framework for the engagement of a debtor with its creditors.[2] Although the legal basis for these approaches differs, both proposals recognize that an early approach to creditors is a necessary feature of a framework that would reduce the cost of restructuring for all concerned parties. Within the existing framework, the Fund's decisions on the availability of its

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[1] See: The Acting Chairman's Summing Up on Fund Policy on Arrears to Private Creditors-Further Considerations (EBM 99/64, 6/14/99).

[2] The Design and Effectiveness of Collective Action Clauses, SM/02/173.

resources will have an impact on the willingness of a member and its creditors to engage in a constructive dialogue concerning debt restructuring.

4. This paper does not address the circumstances when it may be necessary and desirable for a member to suspend payments to its creditors or pursue restructuring, nor does it deal with issues related to the design of appropriate policy frameworks in lending into arrears cases, as Fund support in these circumstances is taking place when the Fund has reached agreement on a set of policies enabling the member to regain balance of payments viability. Issues concerning lending into nonsovereign arrears to private creditors stemming from the imposition of exchange controls or other regulatory or administrative actions of the sovereign are also beyond the scope of this paper.

5. The rest of this paper is organized as follows. Section II summarizes the evolution of the Fund's policy regarding sovereign external payment arrears. Section III provides an overview of issues concerning the process and scope of dialogue between a debtor and its creditors as an element in assessing "good faith" during restructuring discussions. Section IV discusses options for adapting the criteria for good faith efforts to changing circumstances. Finally, Section V and VI offer concluding observations and suggest issues for discussion.

II. Background and Rationale for Lending Into Arrears

6. The Fund's policy regarding sovereign arrears to private creditors has undergone a number of developments in response to the evolution of international capital markets. The policy is intended to support the twin objectives of enabling the Fund to promote effective balance of payments adjustment, while providing adequate safeguards for the use of its resources.

A. Pre-1989 policy: Nontoleration of Arrears

7. At the onset of the 1980s debt crisis, the Fund maintained its policy of nontoleration of arrears to private creditors. Specifically, Fund-supported programs required the elimination of existing arrears and the non-accumulation of new arrears during the program period. This policy had the effect of linking the availability of Fund resources in support of a member's adjustment efforts to agreement with commercial bank creditors on a financing package that typically included some combination of a restructuring of arrears and principal maturing during the program period, and new money that helped members meet interest obligations. In implementing this policy, the Fund adopted the convention that the acceptance of a term

sheet by banks holding a "critical mass" of principal[3] was treated, for program purposes, as eliminating arrears and providing adequate assurances regarding bank financing.[4]

8. Members adopted the practice of negotiating financing packages with steering committees composed of a representative sample of the principal bank creditors. Negotiations would typically cover the details of the restructuring and new money package, against the background of the macroeconomic framework being negotiated with the Fund staff.[5] The discussion of the economic program addressed issues concerning the coverage of restructurings (and specifically arrangements to preserve normal trade credit), as well as economic policies and prospects. These served, inter alia, to allow banks to perform due diligence. Although banks took advantage of the opportunity to exchange views regarding the conduct of policies, then, as now, the international community looked to the Fund for judgments regarding the appropriateness of economic policies.

9. The success of the policy of nontoleration of arrears in the 1980s was attributable, in part, to banks' recognition that cooperation in the financing of Fund-supported programs was in their self-interest. By the late 1980s, however, banks became increasingly reluctant to provide the financing assurances that the Fund required. This unwillingness—which resulted in growing delays in Fund support for adjustment programs—was attributable to a variety of factors, not least the strengthening of banks' balance sheets and the development of secondary market trading in banks' claims. At the same time, the growing recognition that problems faced by many debtors were those of sustainability rather than liquidity, and that a comprehensive resolution of the debt difficulties might entail some reduction in the debt burden reinforced the difficulty of reaching agreement on conventional financing packages. As a result of these developments, the Fund's policy began to have the unintended consequence of providing creditors with excessive leverage over debtors, as it gave bank creditors a de facto veto over Fund arrangements.

B. 1989 Modification Permitting Lending into Arrears to Commercial Bank Creditors

10. In 1989 the Fund modified its arrears policy to tolerate temporary arrears to commercial banks in order to remove banks' de facto veto over Fund support. As a further

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[3]This was generally taken to mean the agreement of banks holding about 90 percent of banks' total exposure. The precise level was a matter of judgment by the steering committee that the remaining banks would not jeopardize the deal.

[4] The actual elimination of arrears (from a legal perspective) did not occur until the conclusion of the restructuring agreement.

[5] Steering committees established economic subcommittees to provide an independent view on economic prospects.

means of facilitating agreement between a member and its commercial bank creditors, the Fund established a policy on making its resources available to members to help finance the up-front cost of Brady debt and debt-service reduction (DDSR) operations.

11. Under the terms of the 1989 decision, approval for lending into arrears to commercial bank creditors could be granted in circumstances in which: (i) prompt Fund support was considered essential for the successful implementation of the member's adjustment program; (ii) negotiations between the member and its commercial bank creditors on a restructuring had begun; and (iii) it was expected that a financial package consistent with external viability would be agreed within a reasonable period. Purchases made while the member had outstanding arrears to bank creditors were made subject to financing reviews, which provided an opportunity to bring unexpected developments to the attention of the Board and to draw the member's attention to the need to make progress with its creditors.

12. This modification permitted Fund support for members' adjustment programs before agreement had been reached with commercial bank creditors on a financing package that would provide for the elimination of arrears and new financing during the program period. Indeed, it was envisaged that, pending agreement between the member and its private creditors, financing for the adjustment program would be provided, inter alia, through further accumulation of arrears. Nevertheless, the policy maintained the requirement that, at the time of the approval of a Fund arrangement, the member would have initiated negotiations with its creditors. This requirement facilitated an exchange of views between members and their creditors concerning the economic program, as well as the terms of eventual restructurings. In most cases, Fund support for programs in which the member had arrears to private creditors proceeded against the background of negotiations with bank steering committees. In a few cases, however, (mainly but not exclusively low-income countries with relatively small bank debt) discussions between members and their creditors had been initiated at the start of Fund-supported programs, but had not reached the stage at which steering committees had been formed.

C. The 1998 and 1999 Modifications

13. The 1989 policy provided for lending into arrears only on debt to foreign commercial banks.[6] As a result of changes in the composition of capital flows to emerging market sovereigns international bonds replaced syndicated bank loans as the primary vehicle for financing sovereigns, and it was anticipated that the Fund might need to support a member while it was in arrears on such bonds. In 1998, the scope of debt owed to private creditors to which the lending into arrears policy could be applied was broadened to encompass

[6] EBM/89/61, May 24, 1989.

international sovereign bonds.[7] Directors agreed that such lending would be on a case-by-case basis and only where (i) prompt Fund support was considered essential for the successful implementation of the member's adjustment program; (ii) negotiations between the member and its private creditors had begun; and (iii) there were firm indications that the sovereign borrower and its private creditors would negotiate in good faith on a debt restructuring plan. The first two criteria replicated the first two criteria of the 1989 policy, while the third criterion was intended to address specific concerns with regard to bond restructuring.[8]

14. In a further discussion of the lending into arrears policy in 1999, it was recognized that in most cases private creditors would be willing to enter into negotiations with sovereign debtors with a view to preserving the value of their assets.[9] At that time, however, it appeared that there were a variety of reasons why creditors might delay negotiations following a default. First, the heterogeneity of the creditor base could result in coordination difficulties, complicating the task of assembling a representative group. Second, the creditor base might include a large element that has no ongoing commercial interest in the debtor. As a result, the incentives to negotiate with the aim of returning the debtor to good standing in the international financial community might be less than for the commercial bank creditors of the 1980s, who were generally seen as having long-term business interests in the debtor country. Finally, given the magnitude of the financing available to emerging market borrowers, the outcome for debtors of losing market access was likely to be at least as serious as in the 1980s. This could have led creditors to raise their reservation price in any negotiation (i.e., they would be less disposed toward a settlement). There was also a concern that, if any combination of the above were to prevail, the Fund could be precluded from lending even if the member's policies were appropriate and Fund support was essential to the adjustment effort, since the second and third criteria under the 1998 policy would not be met. These criteria were therefore replaced with a test based upon an assessment of whether the member was making *good faith efforts* to reach a collaborative agreement with its creditors.

15. Under the 1999 policy, the Fund retains its capacity to lend into arrears if this were judged to be essential for the success of the member's adjustment program. Lending in such cases would help limit the scale of economic dislocation and destruction of asset values. It would also send a strong signal to the international community regarding both the strength of the member's policy framework, and the need for the member and its creditors to reach agreement on a debt restructuring that provides adequate financing during the program period and paves the way toward a return to medium-term sustainability.

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[7] SM/98/8, January 9,1998.

[8] These included concerns that negotiations with boldholders could be more protracted or reach a stalemate, as well as the risk of litigation.

[9] EBS/99/67, April 30, 1999.

16. The initial reaction of private investors to the 1998 and 1999 modifications of the lending into arrears policy was mixed. Some investors expressed a concern that signaling the willingness of the Fund to provide financial support for a debtor following a default would give rise to debtor moral hazard. This was thought likely to weaken the credit culture and have an adverse effect on the ability of emerging markets to mobilize resources from private capital markets. In more recent contacts, creditors recognize that debtors have gone to extraordinary lengths to avoid default, notwithstanding the change in the Fund's lending policies, and that initial concerns may have been overstated. Other investors noted the role of the lending into arrears policy in helping to limit economic dislocation during crises, and thereby to preserve the capacity of the member to generate resources for debt service. These investors have tended to welcome the combination of early implementation of appropriate policies and official financing following default.[10]

D. Recent Experience

17. Experience with bond restructurings since 1999 suggests that the difficulty of identifying bondholders and coordinating meetings with creditors are not as severe as many had feared. Indeed, in the cases of Ecuador and Russia, and more recently Argentina, bondholders have demonstrated a desire to engage debtors through the use of committees. Moreover, while many bondholders may have little long-term commercial interest in the debtor, investors who mark-to-market (and are therefore forced to recognize losses in the secondary market value of their claims) nonetheless face incentives to conclude a deal that, through a normalization of creditor-debtor relations, offers the prospect of capital gains.

18. While debtors were able to reach restructuring agreements with their creditors, the restructuring processes were in some cases protracted and burdened with considerable uncertainty about the course of action. Delays in reaching agreement on a restructuring may reflect normal reactions to extreme uncertainty on the part of debtors and creditors alike, rather than market failures. At the nadir of a crisis, there is likely to be substantial uncertainty surrounding factors that have a bearing on a debtor's capacity to generate resources for debt service, such as medium-term prospects for economic activity, tax revenue, and the fiscal costs of resolving financial and corporate sector difficulties. In these circumstances, debtors may be reluctant to commit to an early restructuring agreement, in order to avoid the possibility of having to reopen a deal at a later stage. At the same time, creditors may judge that their interests are best served by countenancing a temporary standstill and interruption to debt-service payments, while retaining the legal status of their original claims. Nonetheless, an

[10] As Fund credit is extended on a senior basis, on account of the Fund's preferred creditor status, investors draw a parallel between the extension of Fund credit to a sovereign with arrears to private creditors and debtor-in-possession (DIP) financing to distressed nonsovereign debtors in the context of workouts.

unduly protracted default period is not in the interest of the debtor country or its creditors. It would delay a member's return to the capital markets, exacerbate costs in terms of economic dislocation, and could impair the country's capacity to generate resources to repay creditors, including the Fund.

19. In informal contacts, a wide range of portfolio managers who specialize in emerging market debt have raised concerns relating to the leeway debtors appear to have regarding the scope and process of dialogue with creditors. Various private creditor groups have pointed to the substantial confusion and uncertainty this creates concerning issues pertaining to intercreditor equity, the definition of the debt-service payments envelope, and the design of individual instruments issued in the restructurings.[11] In recent sovereign debt restructuring cases, debtors have adopted modalities that varied from limited contacts (Ecuador, and so far in Argentina) to the use of a committee-based structure (Russia).[12] Private creditors argue that there should be a presumption of closely and timely consultations with creditors on steps to remedy the underlying problem and the development of restructuring proposals. Now that bonds have replaced syndicated bank loans as the principal financing vehicle, bondholders consider that recognition should be accorded to bondholder committees similar to that given to bank steering committees in cases where bondholders have been able to establish a sufficiently representative committee in a timely manner. Greater clarity concerning the framework for possible debt restructurings would strengthen the capacity of investors to assess recovery values under alternative scenarios, thereby facilitating the evaluation and pricing of risk and enhancing the value of emerging market debt. Debtors, on the other hand, have expressed concern about losing flexibility as to how to restructure their indebtedness and the time-consuming nature of negotiating within an organized framework.

20. In the context of surveillance and programs alike, the Fund has advised members to maintain a close dialogue with private investors. Channels of communication and relationships established during periods of relative tranquility are likely to be particularly valuable in periods of stress.[13] The Fund has also advised members seeking a debt

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[11] Creditors have made reference to the absence of a predictable framework for restructuring international sovereign bonds and the framework provided by Chapter 11 of the U.S. bankruptcy code used for restructuring high-risk corporate bonds (the principal competing high-yield asset class).

[12] The experience in restructuring international sovereign bonds, including the modalities of dialogue with creditors, was discussed in detail in the paper "Involving the Private Sector in the Resolution of Financial Crises – Restructuring International Sovereign Bonds" , (EBS/01/3), January 11, 2001.

[13] A recent report prepared by a CMCG working group provided specific recommendations concerning the establishment of Investor Relations Offices. Investor Relations Programs—

(continued…)

restructuring to engage in a constructive dialogue with their creditors, so as to maximize the possibility of securing sufficiently broad creditor support for a restructuring that will enable the member to regain balance of payments viability.

21. The impact of uncertainty surrounding the processes used to restructure international sovereign bonds, or the spillover effects on other borrowing countries and the supply of capital, are difficult to quantify. While empirical evidence concerning the long-term consequences is limited, greater clarity concerning the procedural aspects of restructuring could serve the interest of debtors and creditors alike. At the same time, however, the Fund's lending into arrears policy must be sufficiently flexible to enable the Fund to fulfill its core mandate – which is to provide timely balance of payments assistance to members that are implementing sound adjustment policies. Accordingly, any framework must strike a reasonable balance between the objective of improving the functioning of capital markets (which would benefit from greater procedural clarity), on the one hand, and the objective of providing timely assistance in individual cases (which would benefit from greater flexibility). The paper's proposal to refine the "good faith" requirement of the Fund's lending into arrears policy attempts to achieve such a balance. [14]

III. Contacts between a Debtor and its Creditors in the Context of Restructurings

22. This chapter outlines a framework of general principles and procedures to guide a creditor-debtor dialogue as an important element in the "good faith effort". As elaborated below, the framework could include the following elements: the expectations about ways in which the debtor is presumed to engage its private external creditors, the possible modalities of a dialogue in the context of elaborating restructuring proposals, and the implications of such dialogue for the parties involved until a restructuring agreement is reached.

A. Objectives and Principles of Dialogue between a Debtor and its Private External Creditors

23. There are two primary objectives of engagement between debtors and their private external creditors in the context of elaborating restructuring proposals. The first is to increase the likelihood of achieving broad creditor participation in restructuring deals by providing a mechanism that can help address the difficult issue of intercreditor equity. The second relates to the efficient operation of capital markets, more generally. Establishing a more predictable

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Report of the Capital Markets Consultative Group—Working Group on Creditor-Debtor Relations (SM/01/174, 6/19/01).

[14] Summing Up by the Acting Chairman on Involving the Private Sector in the Resolution of Financial Crises—Restructuring International Sovereign Bonds, BUFF/01/17 (2/2/01).

process for debt workout increases the likelihood that the adverse effects of individual restructurings on the asset class will be reduced. As a means of achieving the above objectives, it would seem reasonable that, at a minimum, the dialogue between the debtor and its private external creditors should be guided by the following general principles:

- When a member has reached a judgment that a restructuring of its debt is necessary, it should engage in an early dialogue with its creditors, which should continue until the restructuring is complete.

- The member should share relevant, nonconfidential information with all creditors on a timely basis. Such information would normally include:

  - An explanation of the economic problems and financial circumstances that justify a debt restructuring.

  - A briefing on the broad outlines of a viable economic program to address the underlying problems and its implications on the broad financial parameters shaping the envelope of resources available for restructured claims.

  - The provision of a comprehensive picture of the treatment of all domestic and external claims on the sovereign, including those of official bilateral creditors, and the elaboration of the basis on which the debt restructuring would restore medium-term sustainability.

- The member should provide creditors with an early opportunity to give input on the design of early restructuring strategies and the design of individual instruments. This could help address the specific needs of different types of investors, thereby increasing the likelihood of high participation in the restructuring.

Within the framework outlined above, members that need to restructure their debt will need to decide on the most appropriate modality for conducting a dialogue with their creditors. The potential diversity of situations suggests that the modalities will need to be tailored to the specific features of individual cases. It would be expected, however, that a member would initiate a dialogue with its creditors prior to the member's agreement with the Fund on a Fund-supported program.

B. Modalities of Dialogue between a Debtor and its Creditors in the Context of Elaborating Restructuring Proposals

24. Two principal factors have a bearing on the judgment concerning the appropriate modalities for dialogue. First, the complexity of the individual cases, and the associated difficulty of achieving an acceptable degree of intercreditor equity among private creditors. Second, views expressed by creditors concerning their desire to negotiate the terms of a

restructuring within a formal collective framework. In practice, creditors are likely to express a strong preference for more formal mechanisms for dialogue only in complex cases in which intercreditor equity issues are expected to be particularly difficult.

25. In cases in which a debtor is seeking agreement on a restructuring *prio*r to a default (albeit in the shadow of a credible threat of default), the limited capacity to sustain contractual debt-service payments will typically constrain the scope and timing of dialogue. In such cases, the debtor would need to take informal market soundings, and to move forward expeditiously with a restructuring proposal with a view to maximize creditor participation. In cases in which a debtor is seeking to restructure debt that is already in default, there is likely to be a need for a more extensive dialogue in order to identify restructuring proposals that can attract wide support.

26. In cases in which the instruments to be restructured are held by a small number of similarly situated investors, it may be straightforward to address issues related to intercreditor equity and to develop a menu of restructuring options that attract broad investor support. In such cases, it may be possible to achieve adequate consultation through informal contacts. As the number and heterogeneity of creditors increases, however, and the range of instruments to be covered by a restructuring becomes more diverse, restructurings will become more complex. Moreover, the greater the reduction sought in the contractual value of creditor claims, (involving the acceptance of new instruments with secondary market values that are well below par), the greater the need for creditors to be persuaded that the terms of the restructuring are warranted by underlying economic prospects.[15]

27. In cases in which major creditors have indicated their desire to participate in a collective negotiating framework, for example, through the formation of a steering committee supported by private creditors holding a significant portion of principal, a formal dialogue with this committee on elaborating a restructuring proposal could serve the debtor's best interest and could help muster the necessary support for a restructuring. As will be discussed below, however, reliance on such a framework will require the debtor to take actions that go beyond those embodied in the principles outlined above.

[15] This will be amplified by fund managers' fiduciary responsibilities. In these more complex cases there will be a greater need for discussions between a debtor and its creditors to address issues relating to the debtor's payments capacity and to develop a menu of options that can attract broad creditor support.

C. Features and Implications of an Organized Negotiating Framework

28. In circumstances in which creditors have organized a representative committee on a timely basis, the debtor's best interest would normally be served by working closely with this committee on elaborating a restructuring proposal. The private sector has drafted a set of best practices guiding the establishment and operation of an organized negotiating framework for the restructuring of sovereign debt. In many respects, work in this area builds upon the principles that guided the operation of bank steering committees that operated successfully during the 1980s, while recognizing the need for adjustments to take into account recent developments in the capital markets.[16]

29. Where a representative committee of creditors has been established on a timely basis, it would be expected that the debtor would normally negotiate the terms of a restructuring on the basis of the following principles, which would supplement those that are set forth in the previous section:

- A collective framework could be established for the sovereign debtor to negotiate a restructuring of its debt with a steering committee representative of all private creditors. In complex restructurings, there may be a number of subcommittees that channel into the steering committee.

- The debtor would share information with the steering committee, including—where necessary—confidential information, to enable creditors to make informed decisions regarding the terms of a restructuring. Committee members would need to commit to take appropriate steps to preserve confidentiality.

- Creditors represented on the committee would agree to a standstill on litigation during the negotiating process.

- The steering committee would retain financial and legal advisors and the reasonable costs of these advisors would be borne by the debtor. To expedite complex restructurings, the committee and the debtor may choose to appoint a mediator to facilitate the negotiating process.

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[16] In this regard, the work to develop principles in the context of nonsovereign workouts has also been beneficial, since the challenge of organizing a diverse and diffuse creditor body also applies in that context. See, for example, INSOL International, Statement of Principles for a Global Approach to Multi-Creditor Workouts, 2000; Involving the Private Sector in Resolving Financial Crises-Corporate Workouts-Preliminary Consideration, SM/01/8 (1/9/01).

- The steering committee would not be able to take decisions that would be binding on creditors. At the same time, the debtor would not be required to secure unanimous support of the committee for restructuring proposals.

30. Negotiating the terms of a restructuring agreement within an organized framework will have important implications on the type of dialogue that a member will engage in with its creditors. These implications may be summarized as follows:

31. **Implications for debtors**. Sovereign debtors aim at negotiating the most favorable terms possible for restructuring, as expeditiously as possible; seeking, once a default has occurred, to minimize the risk of litigation; and regaining, once the restructuring has been achieved, access to capital markets as soon as possible. Sovereign debtors have at times found it expedient to adopt a strategy that avoids negotiations with any organized group of creditors and, in some cases, limits the availability of information. An organized negotiating framework would limit the ability to resort to this strategy but could bring other advantages to debtors:

- *Investment climate and new financing*. A collaborative approach to resolving creditor-debtor relations could be helpful in calming market fears that could, potentially, lead to both domestic capital flight and a withdrawal of trade-related and other short-term financing. It is unclear whether this could facilitate the provision of new private financing during the period of negotiation, as without a mechanism to give other creditors (such as commercial banks) de facto seniority for new financing over existing debt, such creditors will typically not be willing to extend new financing.[17]

- *Speed of negotiations*. Debtors and their advisors have expressed concerns that negotiating within such a framework would be time-consuming. Unlike commercial banks, bondholders generally mark-to-market and, therefore, have a strong interest in achieving a rapid and orderly restructuring. Nevertheless, there is a question as to whether both the number and diversity of creditors would complicate the formation of the committee—and the subsequent negotiating process.

- *Standstill*. During the 1980s debt crisis, commercial banks refrained from taking legal action against the debtor during the negotiations. A critical question is whether such an approach would be effective where there are a large number of creditors, some of whom may be more inclined to initiate litigation against the debtor as a means of securing a

[17] During the 1980s, steering committees would often facilitate new financing by signaling that financing provided after a specified date would be excluded from any future rescheduling. Whether a collective approach will be effective where there are a large number of creditors will depend, in part, on whether a creditors' committee is sufficiently representative. In those cases that it is, such a signal could help catalyze new financing.

restructuring on preferential terms. Such action would clearly have an adverse impact on the willingness of the majority of creditors to exercise forbearance during the negotiating process. For the above reasons, the effectiveness of a voluntary standstill will be enhanced by the existence of a legal framework that enables a qualified majority to restrain disruptive behavior by the maverick creditors.

- *Confidentiality*. One of the key features of a negotiation that distinguishes it from other forms of dialogue is the presentation of offers and counter-offers by the respective parties. Such information is clearly confidential and market sensitive. Debtors have pointed to the inability of bondholders to safeguard the confidentiality of information normally shared during negotiations. Bondholders could be represented on the committee by professional advisors who would have signed confidentiality agreements. While such a professional advisor would be able to advise their clients as to the overall merits of the restructuring being negotiated, it would be precluded from passing on to them any specific confidential information.

- *Payment of Fees.* One issue that may raise concerns relates to the requirement that debtors should bear reasonable costs associated with legal and financial advisors retained by a creditors committee. This was an established practice in the 1980s with commercial bank steering committees and is standard practice in the context of debt workouts with nonsovereign borrowers.

32. **Impact on creditors.** Private creditors can be differentiated according to their investment strategies and objectives. At one end of the spectrum, there are the buy-and-hold dedicated or crossover investors in emerging market debt that either extended the credit in the first place or are likely to have purchased the debt at or near face value. These investors, some of which are active in the secondary market, often assess their performance against movements of broad indices, such as the J.P. Morgan EMBI+. The key question here is whether a move toward a predictable process for restructuring international sovereign bonds, which is perceived as being generally fair, will improve the ability of investment funds that hold emerging market debt to attract savings. At the other end of the spectrum there are creditors who purchased debt on the secondary market at a trading opportunity. These investors play an important role in establishing prices in secondary markets. It is unlikely that an organized negotiating framework would be of particular benefit to this second group. Financial companies that specialize in high-yield, high-risk assets (including distressed debt) are likely to continue to be active in the secondary market regardless of the process used to restructure bonds. For such investors, the principal effect of changes in the predictability of the restructuring process is likely to be the price at which they are willing to acquire individual assets. Indeed, if the premise that the absence of a predictable process contributes to the decline of the value of the debt following a default is accepted, then the absence of a predicable process presents an opportunity for a distressed debt purchaser, who can purchase the debt at a discount and may reasonably expect that the terms of the exchange offer will enable a profit to be made.

33. **Implications for other emerging market sovereigns**. Emerging market members could be affected by the process used by countries in crises to restructure external debt, to the extent that such processes have an influence on the magnitude of spillover effects on these members' ability to mobilize resources from international capital markets. While it is premature to provide quantification, emerging market borrowers have obvious interests in ensuring that countries facing crises resolve their difficulties in a fashion that does the least harm to the general operation of capital markets.

IV. Adapting the Good Faith Efforts Clause to Changing Circumstances

34. The Fund's approach to crisis resolution must not undermine the obligation of members to meet their debts in full and on time. Otherwise financial flows that are crucial to growth could be adversely affected. Nevertheless, market discipline can only work if creditors bear the consequences of the risks that they take. Private credit decisions need to be based on an assessment of the potential risks and returns associated with particular investments, not the expectation that creditors will be sheltered from adverse developments by the official sector.

35. In cases in which a member needs to approach its creditors for a restructuring, the interests of the members and its creditors alike would be best served by an early initiation of a dialogue and an agreement on a restructuring that avoided a default. This offers the best prospects of being able to limit economic dislocation and loss of asset values, while putting the member's debt onto a sustainable basis.

36. In practice, however, delays may occur and members may confront circumstances in which default is unavoidable. The Fund is able to provide early support for members' adjustment programs in such circumstances by lending into arrears, provided that this is judged to be essential for the success of the program. But the credibility of the Fund's policy will depend, in part, on a perception that the Fund actively promotes collaborative resolution to debt difficulties that are seen as being generally fair to all parties. In this regard, the approach to the resolution of debt difficulties should complement other efforts to promote effective communication between debtors and their creditors. Accordingly, there should be incentives for all parties to make rapid progress toward collaborative agreements that allow for a normalization of creditor-debtor relations and pave the way toward a return to medium-term viability, while balancing debtors' financing needs against the need to respect creditors' rights.

A. Engagement with Creditors

37. The Fund's policy on lending into arrears should provide sufficient flexibility concerning requirements for establishing "good faith efforts" between a member and its creditors to enable a diverse range of cases to be addressed effectively. As discussed above, while it is difficult to draw firm lines, it is clear that in some cases informal mechanisms may suffice. In other cases, however, where the debt situation is complex, and where a large

portion of creditors have indicated their desire to participate in a collective negotiating framework, the use of a more organized negotiating framework may be appropriate. Against this background, a number of approaches could be envisaged for refining lending into arrears policy regarding the need for a member to make good faith efforts to reach a collaborative agreement with its creditors.

38. *A first approach* would be to leave the existing policy unchanged. This would maintain the practice under which members have considerable discretion in deciding upon both the process and scope of dialogue with creditors. Maintaining this approach would not preclude the Fund in some future case deciding that a member was not making good faith efforts, though the criteria by which such a judgment could be reached would remain undefined for the time being.

39. *Under a second approach,* there would be a presumption that a debtor would in all cases invite creditors to participate in an organized negotiating framework. Progress in this area would be the principal factor that would be taken into consideration by the Fund in applying the good faith test. Under this approach, there would be an expectation that the debtor would make good faith efforts to enter into a meaningful dialogue with a creditor committee in accordance with the core principles outlined above.

40. *Under a third approach,* while the form of substantive dialogue would be left to the debtor and its creditors, the debtor would be expected to engage in an early and continuous dialogue with its creditors consistent with the principles laid out in Section III (A). In cases where creditors have been able to form a sufficiently representative committee within a reasonable period, there would also be an expectation that the debtor would make good faith efforts to enter into negotiations with this committee in accordance with the principles outlined in Section III (C).

Assessment of the Possible Approaches

41. The first approach—the maintenance of the status quo under which members have considerable discretion regarding the scope of dialogue with their creditors - is in conflict with the Fund's more general policy recommendations regarding the importance of members maintaining open dialogues with their creditors, and promoting transparency.[18] A wide range of participants in international capital markets has raised concerns on the grounds that the ambiguity of the present framework creates uncertainty regarding the process for sovereign debt restructuring. A particular concern from the perspective of the Fund is that techniques used by one member to resolve its debt-servicing difficulties could have spillover effects on the ability of other members to access international capital markets.

[18] Investor Relations Programs—Report of the Capital Markets Consultative Group—Working Group on Creditor-Debtor Relations, SM/01/174, (06/19/01).

42. The second approach—requiring members to invite creditors to form a committee—would appear to lack the flexibility required for a policy that could credibly be applied to a wide range of specific circumstances. In particular, it would require members to invite creditors to form a committee even in cases in which more informal techniques—such as those used successfully by Ukraine and Pakistan—could be effective. Moreover, it does not address uncertainties concerning whether a committee would be formed within a reasonable period, and whether such a committee would be reasonably representative.

43. The third approach attempts to strike a balance between the need to promoting dialogue between a debtor and its creditors, on the one hand, and the diversity of individual country circumstances and uncertainties concerning whether or not creditors would organize a representative committee in a timely fashion, on the other. While it respects the responsibility of debtors to manage creditor-debtor relations, it establishes a burden on the debtor to demonstrate adequate consultation. In cases in which an organized negotiating framework is warranted by the complexity of the case and creditors' timely organization of a representative committee, there would be an expectation that the member would enter into good faith negotiations within the general framework of the core principles discussed above. By the same token, in less complex cases, or where creditors have not organized a representative committee within a reasonable period, the member would be expected to engage creditors through a less structured dialogue that is consistent with the general principles set forth in Section III(A) above.

Making the Third Approach Operational

44. If the third approach outlined above were to be adopted, the Fund would need to assess when there should be an expectation that the member should make good faith efforts to enter into negotiations with a creditor committee or to pursue a less structured dialogue. Decisions would need to be based upon judgments based on the merits of each case regarding whether or not: (i) the complexity of the case warranted the use of a collective negotiating framework; (ii) a creditor committee is sufficiently representative; (iii) a reasonable period had elapsed to allow for the formation of a committee; and (iv) the member was making good faith efforts to enter into a meaningful dialogue with a committee. These could be informed by the factors described below.

- In assessing *the complexity of the case,* account could be taken of factors such as the number and diversity of creditors, the range of instruments to be covered by a restructuring, the prevalence of intercreditor equity issues (relating, for example, to the diversity of international and domestic instruments held by private creditors, as well as claims of official bilateral creditors), and the potential size of the debt and debt-service reduction likely to be required for a restoration of sustainability.

- In assessing whether *a committee is sufficiently representative*, consideration could be given to factors such as the proportion of principal held by creditors that have signaled

their support for the committee, as well as the coverage of major types of creditors represented in the committee. It would not appear to be advisable to establish a numerical threshold for the assessment whether the committee is representative. Instead this could be assessed on a case-by-case basis noting, for example, a higher rate of participation might reasonably be expected among institutional than among retail investors.

- In assessing whether *a reasonable period had elapsed to allow for the formation of a representative committee,* the characteristics of the investor base should be considered.[19] Account could also be taken of the extent (if any) to which the member had taken steps to facilitate or frustrate creditors' efforts to form a committee. In any event, experience in corporate restructurings suggests that it is typically possible to establish a representative committee within 90 days of default. It is worth noting that a Fund policy that establishes a presumption that debtors would enter into good faith negotiations with a representative creditor committee would likely help to catalyze the formation of such a committee by establishing incentives for creditor coordination.

45. In cases in which a representative committee was established promptly, the Fund might need to assess whether or not the member was *making good faith efforts to negotiate* with this committee. For purposes of making this assessment, the Fund would evaluate the extent to which the debtor and the creditors are adhering to the principles set forth in Section III (C). The Fund would also need to take into consideration whether the creditors were cooperating in seeking an agreement that fitted within the parameters that may have been established under a Fund-supported program. In cases, for example, where negotiations have become stalled because the demands of creditors are inconsistent with these parameters, the Fund would need to be able retain the flexibility to continue to support the member despite the lack of progress in negotiations.

B. Timing of Dialogue with Creditors

46. In principle, it would be expected that a member would initiate a dialogue with its private creditors *prior* to the approval of a Fund arrangement. This would provide an opportunity for an exchange of views to ensure mutual understanding of unfolding events, the financing needs and payment constraints of the country, and give an opportunity to the authorities to explain their adjustment program. In cases in which there is a significant period between a default and the conclusion of negotiations with the Fund on a program, and where creditors have been able to organize a representative committee, there would be a case for the debtor to enter into good faith negotiations with the committee prior to the approval of an

[19] For example, the process or organizing retail investors spread over several different countries is likely to be more protracted, than the process of organizing professional money managers located in a few financial centers.

arrangement. In these cases, creditors are likely to express views as to the appropriate dimensions of the program's financing parameters, which may not yet have been established. While it would be generally acceptable to receive input from creditors on these issues, it would clearly be inappropriate for private creditors to have a veto over the design of the program since, in the final analysis, it is the Fund that will need to make a determination as to whether the program merits its own financial support.

47. In cases in which the period between a default and approval of a Fund-supported program is relatively brief, it may only be feasible for the debtor to conduct limited consultations and dialogue with its creditors. On the one hand, in the early days of a crisis following a default, when decisions regarding the design of the financing plan may need to be made, creditors may not have had sufficient time to organize a representative committee. On the other, the authorities' limited administrative capacity may be stretched by the need to elaborate and implement an adjustment program. In these cases, it would at a minimum be important that the dialogue between a debtor and its creditors continue *after* the approval of a Fund program and before the launch of a restructuring proposal. This would allow discussion on the design of a restructuring proposal that fits the program parameters as well as addresses investors' specific needs and resolves intercreditor equity issues. Such negotiations could help secure a restructuring agreement with the broader group of creditors. Clearly, in light of the incentives facing a debtor and its creditors discussed above, it would generally be neither feasible nor desirable for agreement to be reached on a restructuring before there is clarity regarding the medium-term prospects. The timing of a dialogue would need to be assessed on a case-by-case basis. Following the approval of an arrangement under which the Fund would be lending into arrears, relations between a debtor and its creditors would be monitored by the Fund through regular financing reviews, which would provide an opportunity for the Board to consider any unexpected developments.

V. Concluding Observations

48. Over the past few years, experience has been gained with the restructuring of international sovereign bonds and the application of the Fund's policy of lending into arrears. This policy is essential to help limit the scale of economic dislocation for a debtor that is prepared to implement an appropriate economic adjustment program, and to help preserve asset values for its creditors. In implementing the policy, the Fund has advised debtors to engage in a constructive dialogue with their creditors and reach a collaborative agreement that would help the debtor regain viability.

49. Engagement of a debtor with its creditors during the restructuring process and in the context of elaborating restructuring proposals serves the interests of both. Such engagement should be guided by general principles that can be summarized as follows: the debtor should engage in an early dialogue with its creditors, which should continue until the restructuring is complete. As part of this process, the member should share relevant information with all creditors on a timely basis. Such information would normally include an explanation of the

economic problems and financial circumstances that justify a debt restructuring, a briefing on the broad outlines of a viable economic program and its financial implications, and the provision of a comprehensive picture of the treatment of all claims on the sovereign. The member should provide creditors with an early opportunity to give input into the design of restructuring strategies and the design of individual instruments.

50. In refining the lending into arrears policy regarding the criterion that the debtor would make good faith efforts toward a collaborative agreement with its creditors, several approaches are possible. If the suggested approach were to be adopted, the debtor would be expected to engage its creditors promptly after a default and until a restructuring is complete, consistent with the above principles. In cases where creditors have been able to form a sufficiently representative committee, the debtor would be expected to engage into a negotiation with this committee, consistent with the best practices discussed in the paper. Such an approach attempts to strike a balance between the need for an effective dialogue and the need to retain sufficient flexibility to address the diversity of individual country circumstances.

51. In making operational the suggested approach for the Fund to assess whether a debtor is making good faith efforts to reach a collaborative agreement with its creditors, a number of factors would need to be considered. These factors include the complexity of individual country cases, the creditors' readiness to form a creditor committee within a reasonable time frame, the extent to which the committee is adequately representative, and the behavior of both the debtor and the creditors in the negotiations (taking into consideration best practices in this area). To the extent that negotiations become stalled because creditors are requesting terms that are inconsistent with the financing parameters that have been established under a Fund-supported program, the Fund would retain the flexibility to continue to support members notwithstanding the lack of progress in negotiations.

52. In circumstances where creditors have initiated a dialogue with the debtor prior to the approval of a Fund arrangement, it can be expected that creditors will seek to provide input on the dimensions of the financing parameters that have yet to be established. While such input could be constructive, private creditors could not be given a veto over the design of the program—only the Fund can make a determination as to whether the program merits its own financial support.

VI. Issues for Discussion

- Directors may wish to comment on whether it would not be helpful in facilitating the restructuring process (and protecting Fund resources) to clarify the elements of the judgment concerning the "good faith effort" for a member to reach a collaborative agreement with its creditors.

- The paper identifies a number of principles for a constructive dialogue between debtors and their creditors. Do Directors view these principles as appropriate guideposts to a constructive dialogue?

- Directors may wish to comment on the suitability of relying on an organized negotiating framework in the context of complex debt restructurings and on the outlined set of best practices that could guide the establishment and operations of such framework. Do Directors consider these best practices appropriate?

- Directors may wish to express their views regarding the three approaches envisaged for clarifying the content of the good faith efforts criterion in the context of the lending into arrears policy. Do Directors consider the suggested third approach appropriate?

- The paper discusses key factors that would have a bearing on assessing whether a member is making good faith efforts to enter into a meaningful dialogue with its creditors. Directors may wish to comment on how the suggested approach would be operationalized.

- In circumstances where the debtor engages in a dialogue with its creditors prior to the approval of a Fund-supported program, creditors may seek to provide some input on the dimensions of the financing parameters that are to be established. Directors may wish to express views on appropriateness—and limits—of such input.