Involving the Private Sector
in the
Resolution of Financial Crises—Restructuring International Sovereign Bonds

Prepared by the Policy Development and Review
and Legal Departments

INTERNATIONAL MONETARY FUND

Contents

Conventions

The following conventions have been used in this report:

– Between years or months (for example, 1997–1998) to indicate a fiscal or financial year.

“Billion” means a thousand million; “trillion” means a thousand billion.

“Basis points” refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

Minor discrepancies between constituent figures and totals are due to rounding.

As used in this report, the term “country” does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

Summing Up by the Acting Chairman

Involving the Private Sector in the Resolution of Financial Crises—
Restructuring International Sovereign Bonds
Executive Board Meeting 01/8
January 24, 2001

Executive Directors welcomed the opportunity to discuss the experience gained from the recent cases of international sovereign bond restructuring. They noted that this experience, while valuable, was still too limited to lead to firm conclusions and therefore stressed the preliminary nature of today's discussion, emphasizing that the risk of systemic contagion in the three cases cited—Ecuador, Pakistan, and Ukraine—seemed limited. Directors noted that there was now a general recognition in financial markets that international sovereign bonds are not immune from debt restructuring, and that, if borrowers face severe liquidity crises, bondholders along with other creditors may need to contribute to the resolution of such crises. Directors observed, however, that recourse to restructuring sovereign bonds should be guided by the same basic principle that guides recourse to the restructuring of other claims, i.e., it should be limited to exceptional circumstances when financing needs are large and the prospects for a member in crisis regaining voluntary market access are poor.

Directors noted that, while the approach to debt restructuring employed by the sovereign borrowers differed across the recent cases, a reasonably timely and orderly agreement with creditors was secured through voluntary debt exchanges that provided cash-flow relief and a repayment profile that helped move the balance of payments toward medium-term viability. Directors also noted that participation rates in the debt exchanges were high and that creditor litigation had not materialized in these three cases. Looking forward, Directors noted, however, that the aggressive litigation strategy employed against Peru could encourage creditors to hold out in future debt restructurings. In this context, many Directors underscored the advantages of collective action clauses that provide a mechanism for binding in dissident creditors.

More generally, Directors noted the useful role that voluntary collective action clauses in bond contracts could play in the orderly resolution of crises, and agreed that their explicit introduction in bond documentation would provide a degree of predictability to the restructuring process. Many Directors noted that exit consents, as used in the Ecuador exchange, provided an innovative, albeit controversial, initiative that could be used in the context of restructuring international sovereign bonds that do not contain collective action clauses. Some Directors considered that uncertainties associated with ex post modification of the contractual provisions of instruments through the use of exit consents, and the way in which exit consents can adversely affect the instruments held by creditors who decide not to participate in an exchange, could strengthen the incentives for investors to agree to the inclusion of collective action clauses in bond contracts.

Directors considered the impact of the processes used to restructure international bonds by sovereign debtors facing liquidity crises on future market access for the member concerned and for other emerging market sovereigns, more generally. Directors noted that, while the restructuring of international sovereign bonds may have contributed to market uncertainty, an assessment of the impact on future capital market access for the member concerned and for other emerging market countries could only be speculative at this stage. Some Directors requested that further research be done on this issue.

Nevertheless, Directors expressed concern that the processes used to restructure international sovereign bonds may have adverse spillover effects that could affect the efficient operation of international capital markets, and urged members to make good faith efforts to reach collaborative agreements with their creditors.

Directors welcomed the attention given by the private sector to the process issues that arise in restructuring operations, evident, for example, in the recent proposal by a working group of the Council on Foreign Relations (CFR) of principles for a collaborative framework for negotiations between sovereign debtors and their creditors. Directors noted that these principles will need to be discussed between creditors and debtors, but appear to provide flexibility in the modalities of individual restructurings. They welcomed the support for collective action clauses expressed in the principles, although they viewed the 90 percent threshold as being too high and not consistent with existing market practices. Some Directors also expressed reservations concerning the suggestion that debtors should bear the full burden of fees and expenses of professional advisors retained by the creditors' steering committees.

Notwithstanding the positive features of the CFR proposal, some Directors noted that a rigid application of such a framework might put the sovereign debtor at a disadvantage in negotiations with its creditors, possibly increasing the difficulty of reaching an agreement that could secure a return to medium-term viability. Directors noted, however, that, circumstances may arise in which both creditors and the debtor might consider that the establishment of a collective and collaborative framework might be the most effective approach to securing rapid agreement on an orderly resolution of the crisis.

Directors reiterated their support for the Fund's policy of lending into arrears, implying that the Fund should provide, in exceptional cases, early support for a member's adjustment efforts, provided that the member was making a good faith effort to reach a collaborative agreement with its creditors. While Directors considered that the principles on debtor-creditor negotiations, as proposed by the CFR, could provide one of a number of possible approaches to reaching a collaborative agreement, they generally did not consider it appropriate for the Fund to endorse these principles. Most Directors emphasized that the responsibility for debt negotiations should rest squarely with the debtor and its creditors, while the Fund's principal role in this regard should be to set out, with the member, the medium-term external prospects for the country and help assess whether the terms of a proposed restructuring are consistent with the program's financing needs and the member's medium-term external financial sustainability. Some Directors, however, considered that the Fund should play a more central role in debtor-creditor negotiations.

In general, Directors underscored the importance of member countries engaging their creditors in constructive dialogues, both during normal periods and when addressing emerging pressures in the external account. Directors noted that the Fund has an important role to play in supporting this dialogue, by encouraging creditors and debtors to share relevant information in a timely manner.

Preface

This paper was prepared by the staff of the International Monetary Fund, for consideration by the IMF's Executive Board in the context of the Board's deliberations on the status of private sector involvement in the prevention and resolution of financial crises and standstills. The views expressed in the paper are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities. The Board's views on this topic, as expressed at meetings on January 24, 2001, at which the staff's paper was discussed, are highlighted in the summing up at the front of this report.

The paper was prepared by staff from the Policy Development and Review Department under the direction of Jack Boorman, Director, and the Legal Department under the direction of François Gianviti, General Counsel. The primary contributors to the papers were Matthew Fisher (Assistant Director of the Capital Account Issues Division of the Policy Development and Review Department) and Sean Hagan (Assistant General Counsel of the Legal Department). Ms. Yan Liu (LEG) and Mr. Srinivasan (PDR) prepared the Appendix.

The authors are grateful to numerous colleagues in the IMF for detailed comments on drafts of this paper. They would also like to thank Lucia Buono, Julia Baca, and Maame Baiden for their dedicated assistance throughout the preparation of the paper.

I

Introduction

At its recent meeting, the International Monetary and Financial Committee (IMFC) agreed that:

> "[t]he operational framework for private sector involvement must rely as much as possible on market-oriented solutions and voluntary approaches. The approach adopted by the international community should be based on the IMF's assessment of a country's underlying payment capacity and prospects of regaining market access…. *In yet other cases, the early restoration of full market access on terms consistent with medium-term external sustainability may be judged to be unrealistic, and a broader spectrum of actions by private creditors, including comprehensive debt restructuring, may be warranted to provide for an adequately financed program and a viable medium-term payments profile [emphasis added]*. This includes the possibility that, in certain extreme cases, a temporary payments suspension or standstill may be unavoidable. The Committee also noted that the Fund should continue to be prepared to provide financial support to a member's adjustment program despite arrears to private creditors, provided the country is seeking to work cooperatively and in good faith with its private creditors and is meeting other program requirements. The Committee urges progress in the application of the framework agreed in April 2000, and in further work to refine the analytical basis for the required judgments, and it looks forward to a progress report by its next meeting."[1]

This paper is a first step in responding to this request.

The highlighted attention being given by the Fund to crisis prevention is expected to reduce both the frequency and severity of crises. Nevertheless, crises will occur, and private investors will need to bear the risks inevitably associated with the extension of credit. There is now a general recognition in financial markets that international sovereign bonds are not immune from restructuring in the event that the debtor encounters serious financial difficulties. In the recent cases of Ukraine, Pakistan, and Ecuador, the official community was not willing to provide large-scale financing in order to allow bonds to continue to be serviced in the midst of severe crises. The instruments in question were successfully restructured. This helped to build a recognition in capital markets that, in certain cases, concerted forms of private sector involvement could be required, particularly if the financing gap is large and the member has poor prospects for regaining market access in the near

[1] Communiqué of the IMFC, September 24, 2000 (www.imf.org/external/np/sec/pr/2000/pr0054.htm).

future, or if the member has an unsustainable debt burden.[2] The reluctance shown by these and other members to restructure bonds (notably Romania) suggests that debtor moral hazard has not been a significant issue to date.

The recent experience with bond restructuring has highlighted a number of considerations that have a bearing on the prospects for reaching an orderly agreement on terms that provide both immediate cash-flow relief and a repayment profile that helps to facilitate the member's return to medium-term viability. These have been discussed in previous papers, and are summarized in Box 2.1.

Box 2.1. Factors Affecting Bond Restructuring

Recent experience with bond restructurings has highlighted a number of critical issues for influencing debtors' ability to reach an orderly settlement with their bondholders. These include:

- The success of a restructuring of bonds, after a debtor has lost spontaneous access to international capital markets, depends critically on the credible threat of default (Pakistan and Ukraine).

- The comprehensive restructuring of outstanding bonds appears to be more likely to produce a satisfactory debt-service profile than efforts to restructure individual instruments in a piecemeal fashion (Ukraine). A comprehensive approach strengthens the debtors' leverage in negotiation, and is likely to improve the chances of reaching agreement on a restructuring on terms that are consistent with a return to medium-term viability. Moreover, a comprehensive approach helps to make the debtor's strategy transparent and helps to resolve issues concerning inter-creditor equity, which are difficult to address in piecemeal approaches.

- Efforts by debtors to limit the scope of restructuring to one class of bonds while seeking to protect another class of instruments may pose problems of inter-creditor equity. This may affect different types of international bonds (for example, Ecuador initially tried to limit the restructuring to Brady bonds, but decided that the eventual success of a restructuring depended upon broadening the scope to include Eurobonds), as well as domestic debt (for example, in the cases of both Russia and Ecuador foreign investors were unwilling to show forbearance if that meant allowing investors holding domestic instruments to exit).

- In the recent case of Ecuador, which successfully restructured international bonds that had been in default for a sustained period, progress toward a restructuring was not impeded by creditor litigation as some had feared might be the case. Nevertheless, in that case, the threat of litigation limited the authorities' scope for maneuver. Specifically, it precluded mobilizing resources through a new oil-backed facility, as investment banks were not willing to accept the legal risk that bondholders holding distressed claims might be able to interfere with security mechanisms in the form of pledged assets or receivables.

[2] Summing Up by the Chairman—Involving the Private Sector in the Resolution of Financial Crises—Status Report and Standstills: Preliminary Considerations (www.imf.org/external/np/pdr/sstill/2000/eng).

Despite the apparent success of recent bond restructurings, there is a question of whether the process by which bonds have been restructured risks creating adverse spillover effects on the market for debt instruments issued by other emerging market sovereign borrowers. This paper provides a preliminary discussion of such possible spillover effects, and recent private sector proposals concerning principles that could guide restructurings in future cases. It also provides a preliminary consideration of the implications of possible spillover effects for the application of the Fund's policy of lending into arrears to private creditors.

These issues are being discussed in other fora (including in the private sector). This paper is intended to give the Executive Board an early opportunity for preliminary consideration of the issues. It aims to provide an evenhanded treatment to help stimulate discussion, but does not attempt to draw a firm conclusion. The limited experience with the restructuring of international sovereign bonds—coming as it has against the background of relative turbulence in international capital markets—makes the analysis in this paper necessarily speculative. Also, experience to date is limited to restructuring the liabilities of the relatively small debtors, only one of which (Ecuador) had instruments that were widely traded on secondary markets in the principal financial centers.

The rest of this paper is organized as follows. Section II provides a summary of the approaches to restructuring international sovereign bonds adopted by Pakistan, Ukraine, and Ecuador. Section III provides a preliminary examination of whether the mechanisms used to restructure debt may have spillover effects to the wider market for international sovereign bonds. Section IV provides a discussion of a recent private sector proposal for principles that could guide the process of debt restructuring. Finally, Section V provides a preliminary discussion of implications of decisions concerning the process of debt restructuring for the application of the Fund's policy on lending into arrears to private creditors. Appendix I provides details of recent bond restructurings.

Issues concerning the relative treatment of the claims of private creditors and those of Paris Club and other official bilateral creditors will be considered in a later paper.

II

Recent Experience with Restructuring International Sovereign Bonds

Since late 1998, three members have restructured international sovereign bonds. These operations have covered a broad range of instruments, including English law governed bonds issued under trust deeds and fiscal agency agreements (which included collective action clauses[3]), as well as New York law governed bonds, including Brady bonds, which did not include such clauses. The restructuring of Brady bonds included Discount and Par bonds (which had both principal and interest collateral), as well as Past-Due Interest bonds (which are uncollateralized). In the case of Pakistan and Ukraine, exchange offers were launched while the debtors were still current on payments.[4] In the case of Ecuador, in contrast, the exchange offer was launched after the instruments in question had been in default for almost a year.

Each of the restructurings involved an exchange offer in which bondholders were invited to exchange their instruments for new longer maturity bonds. Within this broad framework, there were a number of important differences concerning the way the individual agreements were reached with regard to both the legal arrangements and the dialogue with creditors (Boxes 2.1–2.4 and Appendix I). In each case, country authorities managed the restructurings with the assistance of professional legal and financial advisors. This is fully consistent with the principle endorsed by the IMFC that the responsibility for debt negotiations lies squarely with the debtor and its creditors.

[3] Collective action clauses that can be found in international sovereign bonds consist of (i) majority restructuring provisions, which enable a qualified majority to bind a minority to a restructuring plan (including payment terms) either before or after a default; and (ii) majority enforcement provisions, which enable a qualified majority to limit the ability of a minority to enforce their rights following a default.

[4] In the case of Ukraine, the exchange offer was launched after the scheduled payment date, but within the grace period.

Box 2.2. Bond Restructuring by Pakistan

In the context of an adjustment program being supported by arrangements under the Extended Fund Facility and Enhanced Structural Adjustment Facility, and against the background of an agreement with Paris Club creditors, in November 1999 Pakistan launched an offer to exchange outstanding Eurobonds for a new amortizing bond with an overall maturity of six years including a three-year grace period and with a coupon of 10 percent. The outstanding bonds consisted of three Eurobonds governed by English law and issued under trust deeds, which had bullet redemptions during December 1998–February 2002. The coupons on the original instruments ranged from 6.01 to 11.5 percent. The bond restructuring was completed without the emergence of arrears other than on the claims that were not tendered for the initial exchange (approximately 6 percent of outstanding principal). The exchange offer was subsequently extended, and final participation reached 99 percent.

Dialogue with creditors

Pakistan's bonds are believed to have been widely held by financial institutions and retail investors in the Middle East.[1] On the basis of information concerning the purchasers of the primary issue, and limited information on the pattern of secondary market trading, the authorities and their advisors were able to contact investors holding approximately 40 percent of principal. With the benefit of informal discussions with these investors the authorities were able to make an offer that proved to be acceptable to most bondholders.

Restructuring mechanics

Though the three Eurobonds subject to the exchange offer contained collective action clauses, the authorities chose not to make use of such clauses to modify the payment terms of the bonds. They were concerned that the qualified majority required for such modification might not be achieved at a bondholders' meeting and calling a bondholder meeting might facilitate the organization of bondholders opposed to a restructuring. The concern was reinforced by the then-vocal opposition expressed within the private financial community to the inclusion of a bond restructuring as an element of the financing package of a Fund-supported program and as a requirement of Paris Club creditors under the comparability of treatment clause of the Agreed Minute. Thus, the authorities decided to restructure the bonds through a voluntary exchange offer, even though such an approach would not provide a mechanism for binding in dissident creditors (see Appendix I for further details).

1/ The U.S. and European investment firms that have extensive holdings of emerging market debt generally had small holdings of the Pakistani bonds. Moreover, the secondary market was thin and located mainly in the Middle East; the instruments were generally not traded in European and U.S. secondary markets.

Box 2.3. Bond Restructuring by Ukraine

In early 2000, Ukraine announced a comprehensive exchange offer for all outstanding international sovereign bonds. This was made in the context of an arrangement under the Extended Fund Facility and a request for a debt restructuring by Paris Club creditors (though at the time of the exchange offer, Ukraine's right to draw under the arrangement had been temporarily interrupted). Under the terms of the offer, investors were able to exchange their claims for new amortizing instruments with maturities of seven years, including a grace period of one year. Investors were offered a choice of a Euro-denominated bond bearing a coupon of 10 percent, and a U.S. dollar-denominated bond with an 11 percent coupon.

The outstanding instruments consisted of: (i) three bonds (governed by Luxembourg law) that included collective action clauses allowing investors holding a qualified majority of principal to modify the payment terms; and (ii) a bond (governed by German law) that did not include such collective action clauses. The yields on the original instruments ranged from 11 percent to 21 percent. (The instruments included bonds that paid the full yield in the form of coupons, as well as zero-coupon instruments that were issued at a discount.)

In order to resolve inter-creditor equity issues relating to interest payments, the authorities decided that investors tendering their instruments for the exchange should receive a cash payment equivalent to accrued interest. Similarly, in order to help to avoid inter-creditor equity concerns, Ukraine decided not to make a principal payment falling due on one of the bond issues in January 2000 and a coupon payment falling due on another bond issue in February 2000. As the grace period for both payments expired during the period that the exchange offer was open, Ukraine was temporarily in default during the debt exchange, and was as a result exposed to the risk of litigation.

Dialogue with creditors

Three of Ukraine's bonds were held by a relatively limited number of investment banks and hedge funds. The authorities had little difficulty in identifying these investors and conducting an informal dialogue concerning the possible terms of a restructuring. While the actual terms of the exchange offer were not known with certainty ahead of the public announcement, the broad parameters of the proposed deal were reasonably well known among the relevant investors. This enabled the authorities to gauge likely market reaction to the proposed offer. Proposals by one fund manager to use litigation to block progress toward an agreement did not attract support among other investors—most considered that, from a commercial perspective, the proposed restructuring was more attractive than the uncertainties and costs associated with litigation.

The remaining Ukrainian bond issue (which did not contain collective action clauses) was widely held in the household sector in Europe. The large number of individually small holdings—many bondholders held the minimum denomination of DM 10,000—made it impractical to establish a dialogue with investors holding this instrument. Instead, the authorities relied on the sales forces of four investment banks to identify the bondholders and to encourage them to accept the terms of the exchange offer.

Restructuring mechanics

The Ukrainian bonds were restructured using an innovative hybrid mechanism that combined an exchange offer for all of the instruments with the use of collective action provisions in three of the instruments. Investors holding the instrument that did not include collective action clauses were offered a one-step exchange to the final bond. Investors holding the bonds that included collective action provisions were invited to tender their instruments, and at the same time to grant an irrevocable proxy vote to be cast at bondholder meetings. To ensure that the proposed amendments to the payment terms of the original instruments would be adopted at bondholders' meetings, the authorities predicated the calling of such meetings upon the receipt of sufficient irrevocable proxies in favor of the proposed amendments. The use of irrevocable proxies ensured that bondholders who had tendered proxies could not change their minds and reject the proposed amendments at the meetings without incurring substantial civil liability. Following the bondholder meetings, which modified the payment terms of the original instruments (thereby binding all holders of the issue), bondholders tendered their modified instruments in the exchange for the new issues with the same payment terms. Using a tender process permitted numerous additional modifications of nonpayment terms to be adopted without bondholders formally having to accept each as an amendment to the old bond and ensured that the four original bond issues were merged into two relatively large issues, which differed only by currency of denomination and the associated coupon.

Box 2.4. Bond Restructuring by Ecuador

In September 1999, Ecuador missed coupon payments on its (collateralized) Discount Brady bonds. Ecuador's proposal that investors holding the Discount bond agree to release of interest collateral did not attract the necessary support. Also the authorities' initial position that the Eurobonds should be exempted from a restructuring so as to preserve the integrity of this instrument as a vehicle for reentering capital markets was not favorably received by bondholders. Ecuador subsequently defaulted on both the Eurobonds, the collateralized Par Brady bonds, the uncollateralized Past-Due Interest and Interest Equalization Brady bonds.

Almost 11 months following default, Ecuador announced on July 27, 2000, a comprehensive exchange offer to swap the defaulted bonds into a single global U.S. dollar-denominated step-up 30-year bond carrying a 4 percent interest rate that increases 1 percent a year to a maximum 10 percent in 2006 and thereafter. Bondholders were offered an option to convert the 30-year bond into a U.S. dollar-denominated 12-year bond with a coupon of 12 percent in return for additional debt reduction. Bondholders were also offered a cash payment of accrued, but unpaid, interest on the Discount and Par Brady bonds. In the case of the collateralized Brady bond, this interest payment was funded through the release of the interest collateral. In addition, the government committed to retire a certain portion of the bonds outstanding each year through purchases in the secondary market, by debt-equity swaps for privatization or by any other means. Failure to meet the reduction target would trigger a mandatory partial redemption of the relevant bond in an amount equal to the shortfall.

Finally, the 30-year bond includes a principal reinstatement clause requiring Ecuador to issue additional bonds equivalent to the amount of the debt reduction obtained through the exchange if an interest payment default occurs on or prior to the 10th anniversary of the issue date and such default continues for a period of 12 months. This clause would restore to the participating bondholders part of their claims against Ecuador that were surrendered in the exchange in the event that a further restructuring is necessary in the future. In addition, it was intended to discourage casual defaults on the new bonds by giving the authorities an incentive to continue making payments.

Dialogue with creditors

Ecuador's bonds were widely held by investors with substantial holdings of emerging market debt. During the period prior to the default, their Brady bonds were among the most heavily traded bonds issued by emerging market sovereigns. The default triggered a wave of selling pressure. The market uncertainties triggered by the first ever default on a Brady bond were reflected in a sharp widening of the buy-sell spread on the defaulted instruments, as well as a general sell-off of Brady bonds issued by other countries. (In the period immediately following Ecuador's default, the stripped spread on Mexican Brady bonds increased by 400 basis points.)

Following the default and in the run up to the exchange offer Ecuador maintained only limited contacts with creditors. The authorities established a so-called Consultative Group, which consisted of eight representative institutional bondholders with large exposures. Two meetings were held with this Group, which provided a forum for the exchange of views. The group was given information about Ecuador's economic and financial position and this information was simultaneously made available to other interested bondholders through the medium of the Emerging Market Traders Association (EMTA) in New York. However, the authorities decided not to share any confidential information with the group because of the concern that the members were not able to safeguard the confidentiality of information due to the lack of appropriate internal "fire walls". In addition, arguing that U.S. securities laws limited their room for maneuver, the authorities refused to share any information concerning the bond restructuring with bondholders in general. They also resisted strongly calls from a minority of bondholders for a move toward full-fledged negotiations, with the establishment of a bondholder committee. The authorities considered that a move toward negotiations would increase creditors' leverage, and, by limiting their ability to maintain the initiative, would reduce their ability to secure agreement on the most favorable terms.

Box 2.4. (concluded). Bond Restructuring by Ecuador

With the strong encouragement of the Fund, following the approval of the Stand-By Arrangement in mid-May 2000, the authorities held an open meeting with bondholders in New York. At that meeting, the authorities presented their economic program, and the Fund staff described the principal features of the arrangement and prospects for the balance of payments. The projections were disseminated through the EMTA website. These presentations were received with interest, but triggered a muted response.

Restructuring mechanics

The absence of collective action clauses for modifying bond payment terms forced the authorities to rely on an exchange offer to restructure its debts. The restructuring had a number of innovative features, including creditors' choice of instruments, the mandatory prepayment arrangement, the mandatory reinstatement of principal in the event of a subsequent sustained default in the first ten years of the life of the new instruments, and the use of exit consents (also known as "exit amendments") to weaken the legal rights of bondholders who decided not to participate in the exchange. Under the Ecuadoran exchange offer, bondholders tendering instruments in the exchange automatically voted in favor of a list of amendments to the instruments that they were about to leave. The amendments were designed to make the old bond less attractive by deleting the following: the requirement that all payment defaults must be cured as a condition to any recision of acceleration, the provision that restricts Ecuador from purchasing any of the Brady bonds while a payment default is continuing, the covenant that prohibits Ecuador from seeking a further restructuring of Brady bonds, the cross-default clause, the negative pledge covenant, and the covenant to maintain the listing of the defaulted instruments on the Luxembourg Stock Exchange. The authorities predicated the completion of the exchange on bondholders holding the requisite majority consenting to the amendments. As a result, minority bondholders who refused to participate in the exchange and became a majority of the original instruments after the exchange would not be able to reverse the amendments without the consent of the authorities. The novel use of exit consents in the Ecuador debt restructuring proved effective in reducing the incentives for holdout creditors not to participate in the exchange in the hope of obtaining subsequently a more favorable settlement.

The first of the recent restructurings, by Pakistan, tarnished the halo surrounding international sovereign bonds. The official community insisted that Pakistan proceed with efforts to secure a voluntary agreement with its private creditors to reduce net payments of principal in order to help ensure that the program was fully financed. (In particular, the Paris Club required comparable treatment of the claims of bondholders as a condition of the restructuring of its own claims.) This was pivotal in building recognition in the private sector that, during a financial crisis, the official community was not willing to make available large-scale resources to allow payments to the bondholders to be made on schedule.

This recognition was reinforced, in particular, by the default by Ecuador. This was the first default on Brady bonds and Eurobonds that are widely traded on secondary markets in London and New York. It was also the first default on bonds that are included in standard indices of emerging market debt.[5] This demonstrated that despite the progress made during protracted discussions of a possible program, the Fund was unwilling to compromise on the

[5] Ecuador has a weight of about 2 percent in the J.P. Morgan Emerging Market Bond Index (EMBI).

quality of economic policies required for the use of Fund resources in order to provide the financing that could have allowed a member to avoid default on coupon payments. Indeed, market commentaries at the time even suggested—incorrectly—that the Fund had encouraged Ecuador to default.

In each case, it was possible to secure agreement on comprehensive restructurings that both provided immediate cash-flow relief and contributed toward putting the member's debt onto a basis consistent with a return to medium-term viability.[6] In each case, participation rates were high, and there was no creditor litigation. Moreover, in the case of Ecuador, it was possible to secure agreement on a deal that provided for a substantial reduction in the face value of, and medium-term burden of servicing, external debt.

The private sector does not yet have a clear understanding of the process by which sovereign debtors will seek to restructure bonds, and of the approaches that the Fund would be willing to accept in the context of its policy of lending into arrears.

- *In the case of Pakistan, the process of reaching agreement on a restructuring was collaborative, and involved significant, albeit discreet, contacts between the debtor and its creditors*. Nevertheless, as the instruments in question were not widely held by the large institutional investors active in emerging market debt instruments, the process used for the restructuring was not seen as establishing a precedent for the restructuring of other more widely-traded bonds.

- *In the case of Ukraine, the process of reaching agreement was also collaborative*. Notwithstanding the inevitably tense discussions between the debtor and its creditors (which included U.S. and European financial institutions), the outcome was seen by a number of commentators as providing an equitable and efficient mechanism for debt restructuring. Similarly, there was general acceptance that the decision by the Fund to lend into arrears[7] was an appropriate means of supporting Ukraine's adjustment efforts, in view of the proximity to a final agreement.

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[6] The medium-term prospects for Ecuador, Pakistan, and Ukraine are beyond the scope of this paper. In all cases, however, there are questions about the medium-term sustainability of the external accounts notwithstanding the restructuring of international debt.

[7] To allow additional time for creditors to submit their instruments, the exchange offer was extended beyond the end of a grace period on an amortization payment due in January 2000, resulting in a default on the bond issue in question.

- *The restructuring by Ecuador was the subject of close scrutiny by financial markets*. Private creditors expressed concern about the approach adopted by the Ecuadoran authorities, although it was recognized that the default and subsequent restructuring occurred against the background of a severe economic crisis and a complex political situation. In particular, investors pointed to the absence of the regular provision of information and the limited willingness of the authorities to engage in an open dialogue, let alone to engage in negotiations. Moreover, some investors were concerned that the authorities were not dealing with their private creditors in good faith and that, by lending into arrears to private creditors, the Fund was encouraging a member to behave improperly. This, in turn, led some private commentators to raise questions concerning the impact of these restructuring operations on the willingness of investors to commit future savings to this emerging market debt instrument.

The experience with Ecuador has highlighted an important development in efforts by a debtor and a majority of its creditors to resolve difficulties associated with collective action in a restructuring. As noted above, the bonds restructured by Ecuador did not include collective action clauses that could have enabled investors holding a qualified majority of principal to modify the payment terms of their instrument in a way that would be binding on all holders of the issue. As a result, there was a potential difficulty with investors who might decide not to participate in the exchange offer, in the hope of being able to obtain subsequently settlement on more favorable terms.[8] If there had been a concern that those not participating would receive a more favorable settlement, this could have reduced sharply the acceptance rate even among investors who favored the deal in principle. In the case of Ecuador's exchange offer, however, the attractiveness of the bonds that were not tendered for the exchange, and the concomitant incentives for investors to tender their claims, were modified in the process of the exchange offer through the use of so-called exit consents.[9] As described in detail in Appendix I and Box 2.5, the use of exit consents allowed a majority of bondholders to modify the bond terms other than those relating to payment before they exited into the new bonds, in a fashion that made the original instrument less attractive to investors who decided not to participate in the exchange. This reduced the leverage of the holdout creditors. (Dissenting creditors could not be forced to accept a revised payments schedule due to the absence of collective action clauses in the instruments in question.)

[8] This would be consistent with the classic behavior of so-called vulture creditors. These creditors tend to buy distressed debt at a steep discount and wait until the "decks have been cleared" through a restructuring before attempting to apply pressure for a favorable settlement, in many cases, through litigation.

[9] For a general discussion of issues concerning exit consents, see Lee C. Buchheit & G. Mitu Gulati, Exit Consents in Sovereign Bond Exchanges, 48 UCLA Law Review 59 (October 2000).

Box 2.5. Exit Consents in Sovereign Bond Exchange

Exit consents (also known as "exit amendments"), as a technique to encourage full creditor participation in a bond exchange, can be used to restructure international sovereign bonds, governed by New York law, which do not contain majority restructuring provisions for payment terms. These bonds typically require unanimity to modify payment terms. They do, however, permit a simple majority to modify (with the issuer's consent), either during a bondholder's meeting or by written consent, other bond provisions—such as waiver of sovereign immunity, submission to jurisdiction, financial covenants and listing. Exit consents are designed to make the bond less attractive through modification of such nonpayment provisions, thereby reducing the leverage of the holdout creditors that cannot otherwise be bound because of the absence of a collective action clause.

In the context of an exchange offer, exit consents are used to allow bondholders, by tendering bonds in the exchange, automatically to vote in favor of the amendments to certain terms of the bonds that they are about to leave. The completion of the exchange offer is predicated on bondholders holding the requisite majority agreeing to the amendment. Even if there were holdouts who refused to participate in the exchange offer and therefore became a majority of the old bond (as everyone else exited), the holdouts would not be able to reverse the amendments without the consent of the sovereign issuer.

The amendment of some of the nonpayment provisions could adversely affect the secondary market value of the old bond after the exchange, or make it more difficult for remaining holders of the old bonds to pursue legal remedies against the sovereign issuer. For example, if the sovereign immunity waiver were removed from the bond terms through an exit amendment, holdouts would be stripped of the ability to attach the sovereign issuer's assets (at least in those jurisdictions recognizing the amendment) in connection with a lawsuit based on the old bonds. Such an amendment would reduce the attractiveness of the old bonds, thereby deleting the incentives for investors not to participate in the exchange offer in the hope of being able to subsequently obtain a more favorable settlement.

Exit consents have been used to a limited extent in corporate bond exchanges in the United States and have withstood legal challenges in U.S. courts. In general, U.S. courts have read the terms of the bond strictly, and have been reluctant to imply any fiduciary duties among creditors other than those explicitly in the bond terms. For example, U.S. courts have refused to invalidate exit consents that removed important bondholder rights and protections, including financial covenants. (See, e.g., *Katz v. Oak Industries, Inc.,* 508 A.2d 873 (Del. Ch. 986.))

Ecuador was the first sovereign to employ exit consents (See Box 2.4).

The use of exit consents may provide an important precedent for future sovereign restructurings of international sovereign bonds governed by New York law. Moreover, the availability of this technique provides a potentially useful tool for sovereigns that may need to restructure a range of bonds that do not include collective action clauses. The possibility that in future cases debtors and a majority of their creditors may decide to modify the original instruments in a fashion that limits the legal rights of holdout creditors may give impetus to efforts to introduce collective action clauses into bond contracts. The inclusion of such clauses in the original bond documentation offers a degree of predictability to the restructuring process, which can be reflected in asset prices. (If collective action mechanisms were used to bind in dissident creditors, once the requisite level of support had been achieved for a restructuring, individual creditors would be unable to hold out. As a consequence, the use of exit consents would be relevant in such cases.) Investors may consider this preferable to the uncertainties associated with *ex post* modification of the contractual provisions of their instruments through the use of exit consents.

Notwithstanding numerous threats by creditors, the above restructurings were not accompanied by litigation. The recent success of the litigation strategy employed by a distressed debt buyer against Peru, however, has caught the attention of many market participants (see Box 2.6 for details). The distressed debt buyer in question (Elliott Associates), who had held out when the debt had been restructured into Brady bonds, was able to exercise considerable leverage by putting Peru in a situation where, if it had refused to pay the creditor in question in full, payments intended to be made to Brady bondholders could have been seized to service the distressed debt. It remains to be seen whether the use of exit consents could provide a measure for protection from this type of litigation. More generally, there is a question of whether this litigation strategy will have an impact on future restructurings.

Box 2.6. Elliott Associates vs. The Republic of Peru

The recent success of the litigation strategy employed by a distressed debt purchaser against Peru may have the effect of encouraging creditors to hold out in future debt restructurings. In effect, the debt purchaser in question was able to pressure Peru into satisfying its claim in full by taking legal measures that almost forced Peru to default on its Brady bonds.

In October 1995, Peru announced a Brady restructuring in the context of a Fund-supported program (and used Fund resources to help finance the acquisition of collateral for the new instruments). While most bank creditors tendered their claims for the exchange, a few creditors with relatively small exposure decided to hold out for better terms. Some 18 months after Peru announced the Brady deal, a vulture creditors called Elliot Associated purchased US$20.7 million of commercial loans that had been guaranteed by Peru. Unlike most other creditors, Elliott did not accept Brady bonds in exchange for Peruvian debt. Rather than participate in this restructuring, Elliott held out and on its own behalf filed a lawsuit in New York for recovery of the full face value plus interest on the loans that it held. After several proceedings, Elliott in June 2000 obtained a judgment against Peru for US$56 million and an attachment order against Peru’s assets that were used for commercial activity in the United States.

Elliott was tenacious in seeking to enforce its judgment. One of its targets was the interest payments due to be paid by Peru to its Brady bondholders. First, Elliott sought to attach the Brady interest payments at the level of Chase Manhattan, the New York fiscal agent under the Brady bonds. Elliott successfully obtained a restraining order against Chase Manhattan from making payments, arguing that the cash was still the property of Peru and was thus subject to attachment to satisfy Elliott’s claim. Second, Elliott sought to capture payment at the level of the clearing house, Euroclear, in Brussels. Elliott successfully obtained an order in the Brussels court restraining Euroclear from accepting payment or paying out cash from Peru to pay the interest due on the Brady bonds. Elliott obtained this order without the defendants Euroclear and Peru being given an opportunity to present their counter-arguments. One of the arguments used by Elliot was that Peru, by paying its Brady bond creditors rather than Elliott, was violating a clause in the loan agreement held by Elliott, which provided that the loan in question ranked equally with all other external indebtedness (the *pari passu* clause).

With insufficient time to appeal the orders obtained by Elliott, Peru decided to settle with Elliott in order to avoid default on the Brady bond payments.

The legal bases upon which Elliott litigated its case—particularly its reliance on the *pari passu* clause—are somewhat controversial. Given the settlement of the case, these legal issues were not definitively determined. However, the Elliott case illustrates the extent to which a creditor can exercise considerable leverage on a debtor by putting the sovereign in a position where it might be forced to default on its payments to other creditors.

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In conclusion, the experience in recent years has demonstrated the following points:

- *There is now a general recognition in financial markets that international sovereign bonds are not immune from restructuring by members facing severe financial crisis*. In future cases, this should be helpful in providing appropriate incentives for the creditors of members that have lost spontaneous market access to participate in voluntary agreements to help ensure that programs are financed while at the same time allowing default to be avoided.

- *The difficulty of securing agreement on the restructuring of bonds is not as great as had been feared*. In the three cases to date, it was possible to obtain broad acceptance of restructurings that provided both immediate cash-flow relief and helped to move the member's debt-service obligations toward a sustainable basis. Moreover, to date, the threat of creditor litigation has not materialized, though as discussed above, questions have arisen concerning the possibility of litigation in future cases as a result of the recent experience in Peru.

- *The use of exit consents in the restructuring of Ecuador's debts may strengthen incentives for investors to agree to the inclusion of collective action clauses in bond contracts*.

- *Notwithstanding the success in securing agreement in the recent restructurings, concerns have been raised regarding whether the absence of a predictable process for restructuring bonds—that allows risks to be priced—may have adverse effects on the efficiency of the market for international sovereign bonds*. These concerns, if well-founded, would suggest that acceptance rates in bond exchanges might not provide a good measure of the "success" of individual operations. It is to these issues that the paper now turns.

III

Could the Process Used to Restructure International Sovereign Bonds Have Adverse Spillover Effects on Private Capital Flows to Emerging Markets?

This section provides a preliminary discussion of the ways in which the process of restructuring bonds by sovereign debtors facing severe liquidity crises may affect the prospects for the member concerned for regaining market access, and may affect the ability of other emerging market borrowers to place new bond issues. It summarizes recent discussions with a range of primary investors in international sovereign bonds issued by emerging market borrowers.

Clearly, the limited experience with the restructuring of international sovereign bonds makes it difficult to predict either the impact of the process used to restructure international sovereign bonds on the member concerned, or spillover effects on emerging market sovereigns more generally.[10] In the absence of empirical evidence, a discussion of the likely effects is speculative. Nevertheless, on the next occasion that a sovereign is faced with the need to decide on the process to be used with only limited evidence concerning the long-term consequences. Moreover, in the event of the emergence of arrears to private creditors, the Fund would need to reconsider how to apply its lending-into-arrears policy. Yet the consequences of these decisions, in terms of the relative leverage of creditors and debtors, and the pattern of global capital flows to emerging markets, could be significant.

Country authorities have indicated that the rationale for the approach adopted for restructuring sovereign bonds has been to allow the debtor to retain the initiative during a restructuring. This is seen as allowing the debtor to obtain a restructuring on the most favorable terms (in terms of both maximizing immediate cash-flow relief, and minimizing the medium-term debt-service burden). Debtor countries have expressed a concern that

[10] The limited number of cases—all of which occurred during periods of more general turbulence in international capital markets—complicates the task of estimating the magnitude of spillover effects by econometric techniques. This is clearly a priority area for further research.

entering into formal negotiations would help facilitate organization and cooperation among creditors, and could thereby substantially increase creditors' leverage during the restructuring process. This could confront debtors with a choice between agreeing to a deal that may not be consistent with a return to medium-term viability, and protracted delays in reaching a settlement. (They note that commercial bank steering committees in the 1980s generally required extended periods to reach agreements.) Debtors also noted that the unanimity requirement concerning agreement by members of steering committees on a term sheet gave individual committee members considerable leverage, and tended to foster agreement at the level of the most recalcitrant creditor. Finally, debtors have expressed concern that many investors in emerging market debt do not have in place the internal firewalls to ensure that any confidential information provided to creditors in the context of negotiation could not be used to influence trading decisions.

The authorities of some debtor countries that have restructured their international sovereign bonds have argued that the impact on market access of the process used to restructure bonds, if any, will be short lived. They note that memories in capital markets are short. As countries implement stabilization measures and make progress toward medium-term viability, investors in search of high yields will be willing to extend new credit based on an analysis of economic fundamentals and payments capacity with little regard to the ways in which debt restructurings during previous crises were conducted. These authorities cite examples of countries that are now major borrowers in international capital markets, but which, in the context of the 1980s debt crisis, had an uneven record of maintaining orderly relations with both domestic and foreign creditors.

Creditors, in contrast, have indicated that the current system allows debtors experiencing stress in their external accounts—even when the stress has become acute and has led to a default—to avoid conducting a meaningful dialogue with their investors. They consider this inimical to the general objective of constructive engagement with the private sector. They point to the contrast with the experience with the resolution of the 1980s debt crisis when debtors were expected to consult with the bank's steering committees in the event of emerging difficulties. In the absence of a dialogue with the debtor, investors face the choice between accepting a "take-it-or-leave-it" offer presented by the debtor,[11] on the one hand, and the substantial uncertainties and costs associated with seeking to enforce contractual obligations through litigation, on the other. They note that the current system provides incentives following a default for debtors to drive down the price of their claims (through intermittent delays in moving toward an exchange offer and through public statements by country authorities) so as to create room for an eventual exchange offer that

[11] In the event that a take-it-or-leave-it is not accepted, the need for the debtor to normalize relations with creditors would remain. Nevertheless, creditors may be concerned that the substantial uncertainty concerning both the timing and process of future efforts to reach an agreement may lead to further declines in secondary market values.

will give substantial capital gains.[12] This is seen as imposing substantial losses on the investors in the primary market (many of whom are forced to liquidate positions in the face of emerging payment difficulties[13]), while offering secondary market debt traders the prospect of substantial profits. Establishing a predictable process of debt restructuring would allow greater predictability of the outcome of a restructuring (for given economic prospects), and would help reduce the fluctuation of secondary market prices.

Discussions with managers of dedicated emerging market funds and so-called cross-over investors have highlighted a concern that the absence of an established process for restructuring international sovereign bonds is perceived as being unfair and as having a deleterious effect on their ability to attract savings into this asset class.[14] It has been noted that players who believe themselves to have been hard done by tend to leave the field after exacting whatever near-term justice they can. Players who lose but believe in the game tend to return to the field. Investment fund managers have drawn a comparison between the experience of investment funds specializing in U.S. corporate bonds and those specializing in emerging market debt. Both are high yield and high risk and neither have lenders of last resort; they are widely seen as being competing asset classes. The informal out-of-court workouts of distressed corporate debt (which are conducted in the shadow of bankruptcy) provide a predictable process for reorganizing distressed corporate debt. This provides a basis for pricing risk, as it provides greater clarity in the estimation of how a range of possible states of the world would be reflected in possible restructurings. This is seen by some fund managers as making corporate bonds a more attractive asset class relative to emerging market debt.

[12] It seems possible that if this process were to be repeated frequently, investors already in the primary market might be less inclined to sell distressed debt, thereby reducing the amplitude of price movements. An increased frequency of restructuring, however, would reduce the attractiveness of emerging market debt as an asset class and investors' willingness to buy these instruments. If bond restructurings continue to be relatively infrequent, however, swings in secondary market prices may remain substantial.

[13] Investment fund managers operate within the framework of contractual arrangements with the investors whose money they manage; these limit the types of assets that the funds may hold and may force the sale of assets that fall below a specified credit rating. Moreover, open-end mutual funds may need to liquidate their holdings in order to meet redemptions, including those triggered by developments in the secondary market value of assets in the fund's portfolio.

[14] Dedicated emerging market investors account for only about 30–40 percent of total holdings of emerging market bonds. The remaining demand comes from retail and high-yield, crossover investors.

Regarding the possible process of negotiation, investors have noted that the creditor committees of the 1980s provide a poor guide to the likely process for bonds. In contrast to commercial banks in the 1980s, bondholders typically mark to market and have therefore already recognized losses. Such investors face strong incentives to move forward with a restructuring expeditiously, so as to preserve asset values from further erosion. Moreover, compared to commercial banks, investment funds typically have limited staff resources to devote to restructurings, and so legal and financial advisors, operating under the general supervision of the bondholder, would likely conduct the economic analysis and discussions with the debtor. Investors have noted that the recommendations of a bondholder committee could not be binding on bondholders as a whole. Accordingly, there would be no need for unanimous agreement among the investors involved in negotiations. Finally, investors have indicated that they are routinely, if not frequently, involved in corporate restructurings for which they had adequate internal procedures for handling confidential information.

Managers of investment funds have noted that commercial banks—the predominant source of financial credits prior to the 1980s debt crisis—have virtually ceased providing financial credit to sovereigns. The return of emerging market borrowers to capital markets following the resolution of the 1980s debt crisis reflected the development of the bond market. If this source of financing were to be impaired, it would likely be difficult to find alternative sources of private sector financing for sovereign debtors.

IV

A Private-Sector Proposal For Bond Restructuring

To promote a more predictable restructuring process, a recent Council on Foreign Relations Report[15] proposes principles as best practices for the conduct of private creditors and the sovereign in connection with a sovereign debt restructuring (the Principles) (Box 2.7).[16] In a number of respects, the Principles build on established practices for nonsovereign debt workouts. Such practices are regular features of the financial landscape in several industrial and—to an increasing extent—some developing countries. They provide a mechanism by which a corporation's debt service can be reprofiled and, if necessary, reduced in a fashion that complements other efforts to return the corporation to viability. Although the Executive Board has discussed a number of general issues relating to the merits of creditor committees, the Principles represent the first significant proposal by the private sector in the area of bondholder organization.

A basic premise underpinning the principles is that the techniques that are effective in the nonsovereign setting (which operate in the shadow of the applicable insolvency legal framework) could also work in a sovereign setting to which insolvency laws are not applicable. As evidence that the Principles are of relevance for sovereign debt, the proponents point out that the framework reflected the negotiating process during the debt crisis in the 1980s. A key question is whether such a framework can be effectively adapted to the prevailing environment, where there is far greater diversity in the number—and interests—of creditors.

[15] Roundtable on Country Risk in the Post-Asia Crisis Era: Identifying Risks, Strategies, and Policy Implications. Key Recommendations from Working Group Discussions 10/99–9/00. The Working Group included participants from a broad range of private financial institutions (including managers of investment funds, secondary market debt traders, investment and commercial bankers), financial advisors, and attorneys who specialize in debt restructurings. Staff from the IMF, BIS, Federal Reserve Board, the U.S. Treasury, the Bank of England, and Banco Central do Brazil attended as observers (www.cfr.org/public/pubs/CountryRisks_Recom_Report.html).

[16] A number of other private sector organizations, including the Institute of International Finance (IIF), have initiated studies of the possible modalities of bond restructurings.

Box 2.7. Principles for Sovereign Bond Restructurings[1]

Organization of creditors. When a sovereign encounters financial difficulties triggering or likely to trigger a debt default, it should encourage a dialogue with affected creditors. Major private creditors may choose to initiate the formation of an *ad hoc* Steering Committee to be representative of all major, relevant private creditor groups. Within this Steering Committee, significant creditor groups, such as bondholders, may elect to form a subcommittee from their group as the vehicle for participating in the Steering Committee. Where one or more subcommittees have been formed, all references in these Principles to the Steering Committee should be deemed also to constitute references to any subcommittees. Thus, a Principle urging the provision of financial information to the Steering Committee should be construed as also urging contemporaneous provision of the same information to each subcommittee.

Cooperation of the sovereign. The sovereign should cooperate with the Steering Committee. Such cooperation should include: (i) providing to the Steering Committee information and analysis regarding the current financial situation of the sovereign and its economic prospects, (ii) holding discussions with the Steering Committee with regard to a financial solution, including the mechanism to be used to accomplish the solution, and (iii) providing information to the Steering Committee regarding any proposed additional debt.

Retention of Professional Advisers. The Steering Committee (including each subcommittee) may retain legal advisers and financial advisers to assist in the discussions and in the development of financial and economic analyses. Where feasible, financial advisers should be jointly retained by the Steering Committee and each subcommittee in order to develop consistent analyses. The sovereign should pay the reasonable fees and expenses of these professionals and should reimburse members of the Steering Committee for its out-of-pocket expenses.

Coordination with the Paris Club. The Paris Club and the Steering Committee should consult, including sharing of financial and economic analyses with regard to the sovereign and discussing respective creditor contributions to a solution to the sovereign's difficulties.

Sharing of information. Information should in most circumstances be provided to the entire investment community whether or not a Steering Committee has yet been formed. If it is necessary to protect confidential sovereign information or market-sensitive information, the sovereign should not be required to share such information except with Steering Committee and subcommittee members, and/or their professional advisers, who enter into appropriate confidentiality agreements.

Participants in a restructuring. Unless otherwise agreed, all relevant private and Paris Club debt should be included in any restructuring in a manner that fairly represents each such creditor group's position with respect to the sovereign. As to omitted creditor groups, normally the sovereign bears the burden of persuading the Steering Committee that such groups are not relevant to any restructuring.

Voluntary stay of legal action. Creditors should refrain from taking legal action or advancing any pending lawsuits provided the sovereign is engaging in conduct, including good faith negotiations, in accordance with these Principles.

Changes in bond documentation. Consideration should be given to changing bond documentation, to the extent possible, to assist in the implementation of these Principles, including insertion of collective action clauses (requiring supermajorities, i.e., 90 percent of principal, excluding bonds owed directly or indirectly by the sovereign) and provision for the appointment of Trustees to assist in the early formation of committees, preferably prior to a default.

[1]Report of Council on Foreign Relations Working Group (www.cfr.org/public/pubs/CountryRisks_Recom_Report.html).

The Principles envisage the establishment of a framework whereby the sovereign debtor would agree to negotiate a restructuring of its debt with a representative group of its major creditors (the Steering Committee). To enable the creditors to make informed decisions about the terms of a restructuring, the debtor would agree to share information with the Steering Committee, including confidential information. For their part, creditors would agree to a standstill during the negotiating process. Moreover, although it is not stated explicitly in the Principles, there is a general recognition that, based on past experience, the Steering Committee could facilitate the provision of new financing by providing the assurance that such finance would be excluded from the restructuring process.

Nonexclusivity

The principles attempt to provide flexibility in the modalities of individual restructurings. First, they acknowledge that the establishment of a Steering Committee and other features of a collective negotiating framework set forth in the Principles only would occur when the major creditors of the debtor decide to act on the basis of the Principles. Accordingly, if such creditors fail to take the initiative to organize themselves into a negotiating committee, the debtor would not be expected to follow the Principles and would be free to follow the type of strategies that were relied upon in the cases of Pakistan, Ukraine and Ecuador.

Second, the Principles do not identify a preferred method by which the debt is to be restructured. Thus, for example, even if creditors decided to negotiate with the sovereign by relying on a Steering Committee, the final restructuring could be achieved by an exchange offer, rather than through a modification of the original debt instruments.

For purposes of assessing the merits of the Principles, it may be helpful to examine separately the impact that their application would have on the debtor, creditors and other emerging market borrowers, and the implications for the official sector.

Impact on Debtors

The objective of sovereigns in the context of debt renegotiations is to obtain the most favorable terms possible for restructuring, as expeditiously as possible. Moreover, once default has occurred, the sovereign will seek to minimize the risk of litigation. Finally, once the restructuring has been achieved, the sovereign will wish to regain access to capital markets as soon as possible. As a means of securing the most favorable restructuring terms, sovereign debtors have adopted a strategy that is at odds with the framework contemplated under the Principles. Specifically, sovereigns have tried to keep the initiative by avoiding negotiations with any organized group of creditors and, in some cases, limiting the availability of information. As noted above, the lack of a negotiating process has increased the authorities' leverage, and thereby contributed to the degree to which they were able to obtain favorable terms. It is premature to judge whether, and if so, to what extent the approach followed will have an impact on sovereigns' ability to regain capital market access.

Would the Principles, in and of themselves, deprive a debtor of the type of strategy that has been used so far? As discussed above, the Principles are nonexclusive; i.e., they would only apply in those cases where the debtor's major creditors choose to act upon them; to date, there are no cases in which creditors have been inclined to insist on this approach. It is possible, however, that the official sector's endorsement of them would help catalyze such an initiative among creditors.

Notwithstanding the loss of leverage associated with ceding the ability to retain the initiative, what advantages could the application of the Principles bring to debtors?

Climate for normalization of creditor-debtor relations and new financing

A move toward a more collaborative approach to resolving creditor-debtor relations could potentially bring a number of benefits in terms of movements of private capital. A perception that the debtor was making efforts to engage its creditors in a constructive fashion could help to calm market fears that could, potentially, lead to both domestic capital flight and a withdrawal of trade-related and other short-term financing.

A move toward a more collaborative approach may help facilitate the provision of new private financing during the immediate recovery from a crisis. Although the Principles do not specifically address this issue, experience demonstrates that a collective negotiating framework can facilitate the availability of new financing. During the 1980s, new financing was extended to sovereigns on the basis of an assurance to the bank steering committees that such financing would be exempt from future rescheduling. Similarly, in the nonsovereign context, it is common for creditor committees to agree to exempt new financing required to keep a firm in operation for restructuring. The question arises as to whether the committee of creditors as envisaged under the Principles would provide an effective vehicle for creditors to give such an assurance, provided they were of the view that new financing was, in fact, necessary. (It is not expected that bondholders would provide the new financing. Nevertheless, without a mechanism that could allow other creditors—such as commercial banks—to obtain assurances regarding the *de facto* seniority of new financing over existing debt, such creditors will typically not be willing to extend new financing.)

Speed of negotiations

Regarding the speed at which the restructuring can occur, debtors and their advisors have expressed concern that the collective negotiations contemplated by the Principles would be time consuming. As an example, they point to the protracted negotiations that took place with bank steering committees during the 1980s debt crisis. The question arises as to whether this comparison is meaningful, given that the nature of interests of creditors has evolved considerably: 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 make the formation of the committee—and the subsequent negotiating process—more complicated.

Standstill agreement and collective action clauses

The Principles envisage that creditors will agree to a stay of legal action against the debtor in circumstances where the debtor is negotiating in good faith in accordance with the Principles.[17] In this respect, the Principles envisage a process similar to that prevailing during the 1980s debt crisis, where commercial banks refrained from taking legal action against the debtor during the negotiations. As in the 1980s, the Principles envisage an informal standstill; i.e., while creditors would express their intentions, there would be no written agreement that would legally preclude creditors from taking action. A critical question is whether such an approach would be effective where there are a large number of creditors, some of whom may be less interested in a collective negotiating process and more inclined to initiate litigation against the debtor to secure a restructuring on preferential terms. Such action would clearly undermine the willingness of most creditors to exercise forbearance during the negotiating process.

In many respects, the support for collective action clauses expressed in the Principles must be understood in the context of the above-stated free rider problem. To the extent that the terms of a bond enable a qualified majority of bondholders to block litigation by a disruptive minority either prior to or after the restructuring in question, such provision will contribute to both the willingness and ability of the qualified majority to engage in negotiations.[18] Indeed, the inclusion of collective action clauses in the Principles is evidence of the private sector's assessment that, in light of the fact that bonds are no longer immune from restructuring, such clauses are in creditors' interest, since they facilitate an orderly and rapid restructuring. The qualified majority identified in the Principles as triggering the activation of such collective action clauses (90 percent) is, however, higher than the threshold that generally exists in existing collective action clauses (normally 75 percent).

Confidentiality

Debtors have pointed out that one of the reasons why a negotiated restructuring is not feasible is that bondholders are not able to safeguard the confidentiality of information that is normally shared during negotiations. In contrast to the large financial institutions that made up the steering committees during the 1980s debt crisis, many of the debt purchasers that play such a large role in emerging markets are not large enough to have the type of internal "firewalls" that serve to ensure that confidential information received by a representative of a

[17] There is a question, however, concerning the value of the additional protection from litigation. To date, creditor litigation following a default has not been a significant factor in determining either the timing or the terms of restructurings.

[18] Majority enforcement provisions enable a qualified majority to limit the ability of a minority to enforce their rights following a default.

bondholder during negotiations will not be used for trading purposes by the same firm. Drawing upon techniques commonly relied upon in the corporate restructuring process, the Principles contemplate that, where appropriate, bondholders could be represented on the committee by professional advisors who would have signed confidentiality agreements. Under this approach, 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 information considered to be confidential.

Prospects for regaining access to capital markets

Inevitably, the discussion of the extent to which the application of the Principles would affect the ability of the sovereign to regain access to capital markets is necessarily speculative. The competing arguments are set out above. The staff considers that it would not be prudent to dismiss lightly the arguments of investors that restructurings that are seen as being equitable and transparent would make a resumption of lending following the resolution of crises more likely.

Impact on Creditors

For purposes of assessing the impact of the Principles on creditors, it is necessary to distinguish between at least different two groups of creditors.

- *The first group consists of those creditors who either extended the credit in the first place or who purchased the debt at or near face value*. These investors, some of which are active in the secondary market, assess their performance against movements of broad indices, such as the J.P. Morgan EMBI+. They would include banks and the long-term purchasers in the primary market (such as long-term dedicated and cross-over investors in emerging market debt). 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 have implications for the ability of investment funds that hold emerging market debt to attract savings. This was discussed in Section III, above.

- *The second group consists primarily of creditors who purchased debt on the secondary market at steep discounts*. These investors play an important role in establishing prices in secondary markets. The Principles are not likely to 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.[19]

Scope for negotiation

What is the potential scope for negotiation on the part of a bondholder's committee? If it is accepted that the approach adopted by the international community to the design of financing packages should be based on the Fund's assessment of a country's underlying payment capacity (both during the program period and over the medium term), and the requirements for comparability of treatment are determined by Paris Club creditors, then it could be argued that a creditor committee would serve little purpose. The following points have a bearing on this issue.

*First, the Fund's role in determining payment capacity and the Paris Club's requirement for comparability of treatment were features of the resolution of the 1980s debt crisis, yet there was general acceptance at that time that commercial bank steering committees provided an appropriate mechanism to reach agreement on a restructurin*g.[20] In part, this reflected the fact that banks were reasonably well organized and were only willing to accept a restructuring in the context of a committee-style negotiation. It may also have reflected recognition that, from the perspective of persuading banks to maintain trade lines, the process by which agreement was reached on a restructuring consistent with the payments capacity defined by the Fund was important.

Second, the substantial uncertainties concerning the medium-term prospects (particularly for members at the nadir of a crisis) may tend to compound concerns related to the conflict of interest faced by the Fund in its role in assessing payments capacity, on the one hand, and its position as a creditor, on the other. A move toward a negotiated framework, which could allow financial advisors appointed by creditors to examine

[19] 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.

[20] Moreover, Russia has recently renegotiated a previous restructuring of debts to commercial banks using a conventional committee structure.

medium-term projections (and the underlying assumptions), could facilitate creditors in the performance of their due diligence obligations.

Third, within the parameters of an overall payments envelope, there is considerable scope for discretion in the structure of a restructuring package. As features of restructured instruments over and above the repayment terms may contribute to, or detract from, the secondary market value of the instruments, creditors will inevitably want a say in the design of the new instruments.

Implications for Other Emerging Market Sovereigns

Emerging market members could be affected by the choice of process used by countries in crises to restructure external debt, to the extent that such choices 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 a quantification, concerns raised by some investment fund managers suggest that approaches to restructuring debt that are seen as being unfair, and that do not entail a willingness to enter into a constructive dialogue with investors following a default, may reduce the volume of savings available for investment in this class of asset. If spillover effects prove to be significant, emerging market borrowers would 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.

Implications of the Principles for the Official Sector

Although the primary focus of the Principles is the sovereign debtor's relationship with its private creditors, the Principles also make reference to the Paris Club and the Fund. With respect to the Paris Club, the Principles provide that "all relevant private and Paris Club debt should be included in any restructuring in a manner that fairly represents each creditor group's position with respect to the sovereign." The Principles do not address questions concerning the relative treatment of the claims of Paris Club and private creditors.

The Principles request that the Fund support their application through its lending-into-arrears policy. Under the existing policy, the Fund will only provide financing to a member with sovereign arrears to private creditors if it finds that: (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. It is on this basis that the Principles request that "to the extent that the major private creditors of a sovereign choose to act upon the principles set forth below, the sovereign's willingness to negotiate within the framework established by these principles will be of relevance to the IMF when it makes its judgment to provide financing." As suggested by this language, a debtor's cooperation under the Principles would only be one of a number of factors to be taken into consideration by the Fund when it applies its "good faith" test. Moreover, consistent with other aspects of the

Principles, the language clarifies that cooperation of the debtor under the Principles would only be expected if major creditors decided to act upon them.

V

Concluding Observations

The development of the Fund's framework of involving the private sector has been guided by a number of principles. These include:[21]

- The approach to crisis resolution must not undermine the obligation of countries to meet their debts in full and on time. Otherwise, private investment and financial flows that are crucial for growth could be adversely affected and risk of risk of contagion increase.

- Market discipline will work only if creditors bear the consequences of the risks they take. Private credit decisions need to be based on an assessment of the potential risk and return associated with a particular investment, not in the expectation that creditors will be protected from adverse outcomes by the official sector.

- In a crisis, reducing net debt payments to the private sector can potentially contribute to meeting a country's immediate financing needs and reducing the amount of finance to be provided by the official sector. It can also contribute to maintaining appropriate incentives for prudent credit and investment decisions going forward. These potential gains must be balanced against the impact that such measures may have on the country's own ability to attract new private capital flows, as well as the potential impact on other countries and the system in general through contagion.

- No one category of private creditors should be regarded as inherently privileged relative to others in a similar position. When both are material, claims of bondholders should not be viewed as senior to claims of banks.

- The aim of crisis management wherever possible should be to achieve cooperative solutions negotiated between the debtor country and its creditors, building on effective dialogues established in advance.

In a number of important respects, recent developments regarding the relationship between sovereign borrowers and their bondholders have been in conformity with these principles. Sovereigns have generally been reluctant to breach contractual obligations, in part because of concerns relating to the impact on their access to private capital both during the

[21] See, for example, Involving the Private Sector in Resolving Financial Crises—Status Report, Box 1 (www.imf.org/external/np/pdr/sstill/2000/eng/).

recovery from crisis and over the medium term. In a few extreme cases, however, sovereigns have found it necessary to approach their bondholders for a restructuring. These agreements helped alleviate immediate cash-flow difficulties, and at least helped moving the external accounts toward medium-term viability.

Private capital markets have also generally recognized that sovereign bonds do not enjoy a *de facto* immunity from restructurings, and that if borrowers face severe liquidity crises, bondholders may need to contribute to the resolution of such crises. Indeed, the debate among private creditors has shifted from the importance of avoiding a bond restructurings at all costs, to questions concerning the process by which bonds are restructured.

Finally, the application of the Fund's policies has conformed with the principles. In extreme cases, when members have not appeared to have strong prospects for an early return to spontaneous capital market access, the Fund has supported members' efforts to seek a restructuring of the obligations to private creditors, including bondholders. Moreover, in such cases the Fund has been willing to provide early support to members' adjustment efforts ahead of agreement with private creditors under its policy of lending into arrears.

An issue that now confronts the international community is whether there is a case for trying to establish broad parameters concerning the process by which bonds are restructured. The Principles discussed in the previous section are a private sector initiative that attempts to define a process that would envisage a collective negotiating framework between the debtor and its creditors, at least in those circumstances where creditors requested such a framework. If there is a concern that the absence of such a framework in the restructuring of bonds of one member may have important spillover effects on other emerging market members, a case could be made for the Fund taking into consideration the approach adopted by the debtor to bond restructuring (possibly including adherence to the framework) when applying its lending-into-arrears policy. *At the same time, it must be recognized that a negotiating framework will most probably strengthen the position of creditors in the event that a borrower encounters payment difficulties and may further complicate the task of the member concerned in reaching an agreement with its creditors that both addresses the immediate cash-flow needs of the adjustment program, and helps to move the external accounts toward medium-term viability*. Careful account would need to be taken of this in any possible consideration of the reformulation of Fund policies in this area.

Appendix I

Recent Sovereign Bond Restructuring

In the context of seeking private sector involvement in the resolution of crises, three countries—Pakistan, Ukraine, and Ecuador—have restructured international sovereign bonds since late 1998. Each of the restructurings involved an exchange offer in which bondholders were invited to swap existing bonds for new instruments. The three restructurings, however, differ with regard to the instruments involved, the restructuring techniques, and the timing of launching the exchange offers. In the case of Pakistan and Ukraine, the restructuring included bonds governed by English and Luxembourg law, which included collective action clauses.[22] Pakistan did not invoke the collective action clauses because of various concerns, including the uncertainty about the outcome of any bondholders' meeting. In contrast, Ukraine employed a novel use of the collective action clauses by predicating the calling of a bondholder's meeting on the receipt of sufficient irrevocable proxies in favor of the proposed amendments to payment terms of the bonds.

In the case of Ecuador, the debt restructuring included Brady bonds and Eurobonds governed by New York law, which did not include collective action clauses for payment terms. To address the potential holdout problem, Ecuador used exit consents (or exit amendments) to modify certain nonpayment terms in order to make the old bonds less attractive, thereby adding to incentives for bondholders to participate in the exchange. Finally, the exchange offer by Pakistan was launched prior to default; the exchange offer by Ukraine was launched soon after a default; and the exchange offer by Ecuador was launched after the bonds had been in default for a sustained period.

This appendix will elaborate on these three cases of bond restructuring. It will also feature a brief discussion of the price of traded instruments that would reflect investor sentiment toward the restructuring process.

[22] Collective action clauses consist of majority restructuring provisions, which enable a qualified majority to bind a minority to any restructuring plan either before or after a default, and majority enforcement provisions, which enable a qualified majority to limit the ability of a minority to enforce their rights following a default.

Pakistan

Exchange offer. *On November 15, 1999, Pakistan launched an offer to exchange three outstanding Eurobonds falling due in December 1999 and February 2002*[23] *worth US$608.3 million for a new dollar-denominated six-year amortizing Eurobond with a three-year grace period and a 10 percent coupon. The new bond offered no "haircut" in principal, but, based on a sovereign spread of 1,500 basis points at the time of the exchange, the reduction in NPV of the outstanding stock of Eurobonds was about 27 percent. The bondholders judged favorably both the terms of the exchange and the ability of the government to honor those terms. The bond exchange enjoyed widespread participation and, in the end, over 99 percent of all bondholders tendered.*

Immediately after the announcement, Reuters (November 15, 1999) noted that quotes on the December 1999 bond were stable at approximately 55 percent of face value, while quotes on the May 2000 bond were stable at about 45 percent. On November 17, 1999, Bloomberg noted that "traders said the price of Pakistan's debt had fallen to about 45 percent of face value, compared with a cash price of about 54 percent for the floating rate notes on November 15." The price of the new bond was then flat at about 74 percent of face value from the exchange of instruments on December 13, 1999 through January 2000, implying a yield to maturity of 17.3 percent. It subsequently fell to around 68 in February 2000 and is now trading at about 65, implying a yield to maturity of a little over 21 percent.

Dialogue with creditors. Based on the acceptance documentation, coupled with market soundings, it appears that the bonds were widely held by financial institutions and retail investors in the Middle East. Based on information concerning the purchasers of the primary issue and limited information on the pattern of secondary market trading, the authorities and their advisors were able to contact the key creditors and conduct informal dialogues concerning the bond restructuring proposal. The informal discussions with these investors enabled the authorities to formulate the terms of the exchange offer that proved to be acceptable to most bondholders. The special nature of the investor base in the case of Pakistan is regarded by some as limiting the usefulness of the Pakistan example for future sovereign bond restructuring.

Exchange mechanism. As noted above, the three Eurobonds subject to the exchange were governed by English law and issued under trustee deeds. Pakistan chose not to invoke the collective action clauses embedded in these bonds to modify the payment terms because of concern that the qualified majority required for such modification might not be achieved at a bondholders meeting. In addition, when the exchange offer was launched, there had been a

[23] US$150 million Bear Stearns, 11.5 percent Notes due December 22, 1999, US$150 million (US$158.3 million issued) 6 percent *Exchangeable Notes* due February 2002 with put option that could be exercised February 26, 2000, and US$300 million ANZ Floating Rate Notes due May 2000.

default on the bonds; as a result, bondholders could not require the trustee to accelerate the issue or to take legal action against the debtor. The authorities were concerned that a bondholders' meeting might provide bondholders with an opportunity to formulate plans to take such action or take other actions disruptive to the restructuring process, if and when an event of default occurred in the future. Therefore, the authorities decided to restructure the bonds through a voluntary exchange offer.

Unlike a restructuring through the use of collective action clauses, a voluntary exchange offer did not provide a mechanism to allow the qualified majority to bind in the dissenting bondholders. Bondholders who refused to participate in the exchange continued to have a legal claim to the original amount under the old bonds. Since the bondholders favoring the exchange had exited into new bonds after the exchange—leaving only dissenters holding the original instruments—it would be extremely difficult for the debtor to use successfully the collective action clauses in any future restructuring of the old bonds. In addition, the restraints imposed by the collective action clauses on the ability of a minority of bondholders to initiate lawsuits against the debtor would have little effect after the exchange; the dissenting bondholders might use the threat of acceleration and legal action in pursuit of a more favorable settlement. Although in the case of Pakistan the holdouts controlled claims that are so small that their failure to participate in the exchange is unlikely to be disruptive, it is possible that in future restructurings by sovereign borrowers holdouts might represent claims of sufficient magnitude to cause a problem.

Ukraine

Exchange offer. Ukraine pursued a piecemeal restructuring of its sovereign bonds in 1998-99 that featured large up-front costs (with cash payments of at least 20 percent), short maturities for new debt (no more than two years) and high yields (up to 21 percent a year). The debt restructuring placed an undue strain on the balance of payments and failed to provide exit instruments and any assurances of a return to medium-term viability. Against this background, and in the face of substantial maturities of bonds in the period through February 2001, Ukraine launched on February 4, 2000, a comprehensive exchange offer involving four different Eurobonds and the "Gazprom" bonds maturing in 2000 and 2001.[24]

Under the exchange offer, bondholders could swap their claims for a dollar-denominated seven-year amortization Eurobond with an 11 percent coupon, or a Euro-denominated seven-year amortization Eurobond with a 10 percent coupon, depending on the type of bond they were holding. The new bonds offered attractive terms: no debt

[24] DM 1.5 billion Eurobonds due February 2001 with a 16 percent coupon; US$500 million Eurobond due March 2000 with a 14.75 percent coupon, US$74 million Euronote due October 2000 with a 16.75 percent coupon, US$258 million Euronote due September 2000 with a zero coupon, US$280 million short–term Gazprom bonds due 2000–01 with an 8.5 percent coupon, and US$735 million long-term Gazprom bonds due in 2002–2007 with an 8.5 percent coupon.

forgiveness or reduction in principal, no interest-free grace period, amortization starting in 2001, and cash payment of all accrued, but unpaid interest on the outstanding bonds upon completion of the exchange offer. The cash payment offer was a key incentive in bringing retail participants to the table. To address inter-creditor equity concerns, Ukraine decided not to make a principal payment falling due on one of the bond issues in January 2000 and a coupon payment falling due on another bond issue in February 2000. As the grace period of both payments expired while the exchange offer was still open, Ukraine was in default during the exchange and was exposed to the potential risk of litigation. Bondholders, however, chose not to accelerate their claims and initiate legal actions, and instead decided to participate in the exchange. Ukraine's exchange achieved a very high level of participation; 99 percent of the old bonds were tendered in the exchange.

The price of the Eurobond relating to the largest issue (DM 1.5 billion) and which was maturing in 2001 declined rather steadily in the days prior to when Ukraine failed to make an interest and partial principal payment on one of its bonds. From 60.50 on January 6, 2000, the price of the Eurobond declined sharply to 47.50 on January 20, 2000, the day of the default. In light of market soundings of a possible debt swap, the price bounced back by about 16 percent the following day and rose further by about 18 percent through February 4, when the government officially announced the comprehensive exchange offer. The price continued to increase through the day of the exchange offer when it reached 69.0. As of January 30, 2001, the bond was trading at about 73.0, implying a yield to maturity of a little over 18 percent.

Dialogue with creditors. Three of Ukraine's bonds were held by a relatively limited number of investment banks and hedge funds. Like the Pakistan bond exchange, the authorities were able to engage in informal discussion with these investors concerning the terms of the restructuring. However, the fourth bond issue was widely held by retail investors scattered throughout Asia and Europe, making it difficult for the authorities to identify and consult the retail investor base. The authorities retained four investment banks to identify, and market the exchange to, retail investors, relying heavily on the internet as well as on more traditional methods.

Restructuring mechanism. In contrast to the Pakistan bond exchange, to facilitate the exchange, Ukraine employed a novel use of the collective action clauses embedded in the three bonds governed by Luxembourg law.[25] To ensure that the proposed amendments to the payment terms of the bonds would be adopted at a bondholders' meeting, the authorities predicated the calling of a meeting on the receipt of a qualified majority of proxies in favor of the proposed amendments. Once the sufficient proxies had been received, a bondholders' meeting was called, the proxies were voted and the amendments were adopted and binding on all bondholders. In addition, the proxies could not be revoked without bondholders

[25] The fourth bond, governed by German law, did not contain a collective action clause. Investors holding such instrument were offered a simple exchange for the new bond issues.

incurring substantial civil penalties. This ensured that bondholders who had already tendered proxies could not change their minds and reject the proposed amendments during the meeting. Following the meeting, bondholders participated in the exchange by tendering the modified instruments for the new issues. Using a tender process permitted numerous additional (though minor) modifications to be adopted without the bondholders formally having to adopt each as an amendment to the old bond and ensured that the four original issues were merged into two relatively large issues which differed only by currency of denomination and the associated coupon. Ukraine's innovative use of the collective action clauses to restructure sovereign bonds solved the potential holdout problem faced by Pakistan. Even if dissenting bondholders refused to participate in the exchange, they would still be bound by the amendments to payment terms adopted by the qualified majority.

Ecuador

Exchange offer. The recent bond exchange by Ecuador represents the first restructuring of Brady bonds and Eurobonds governed by New York law. In September 1999, Ecuador became the first country to default on its Brady bonds when it failed to make scheduled payments on its Discount Brady bonds. Bondholders holding Discount bonds did not accept the authorities' proposal to draw on the interest collateral for the payment on the bonds and instead voted to accelerate their claims. Subsequently, Ecuador defaulted on its other international bonds including Eurobonds, the collateralized Par Brady bonds, and the uncollateralized Past-Due Interest and Interest Equalization Brady bonds.

After almost 11 months since its default on Discount bonds, Ecuador announced on July 27, 2000, an exchange offer to swap the defaulted bonds into a single global U.S. dollar-denominated step-up 30-year bond carrying a 4 percent interest rate that increases by 1 percent a year to a maximum 10 percent. Bondholders were offered an option of converting the 30-year bond into a U.S. dollar-denominated 12-year bond with a fixed coupon of 12 percent at the exchange ratio of 0.65 to 1. However, this option required bondholders to accept a further discount from the face amount of the 30-year bond they would otherwise have received. In addition, bondholders were offered a cash payment in full of accrued, but unpaid interest on the Discount and Par Brady bonds. In the case of the collateralized Brady bond, this interest payment was funded through the release of the interest collateral.

The exchange offer incorporated several innovative legal features designed to reduce the likelihood of future bond restructuring. Both the 30-year and 12-year bonds require Ecuador to retire the aggregate outstanding amount of each type of bond by a specified percentage each year commencing, in the case of the 12-year bonds, six years after issuance and, in the case of the 30-year bond, 11 years after issuance. The repayment can be effected through purchases in the secondary market, by debt-equity or debt-for-privatization exchanges, or by any other means. This feature is intended to give bondholders some assurance that the aggregate amount of the new bonds would be reduced to a manageable size prior to their maturity dates while giving Ecuador flexibility to manage its debt profile. In addition, to deter Ecuador from future defaults on the new bonds, the 30-year bond includes a principal reinstatement clause requiring Ecuador to issue additional bonds equivalent to the amount of the debt reduction obtained through the exchange if an interest payment default occurs on or prior to the 10th anniversary of the issue date and such default continues for a period of 12 months. Thus, bondholders' claims would be adjusted upwards to reverse the impact of the debt reduction in the event that a future restructuring proves necessary in the future.

The pricing of the offer was very enticing. Market commentators agreed that Ecuador and its lead managers (Salomon Smith Barney and J.P. Morgan) priced the operation so as to induce the tender of at least 85 percent of the Brady and Eurobonds. Brady bond prices rose from 10 percent (Pars) to 31 percent (PDIs) the day after the announcement of the offer (July 28), before declining somewhat subsequently. (The price of PDI bonds declined by 9 percent from July 28 to August 4). Moreover, Brady bond prices had risen considerably in the days before the announcement on rumors that Ecuador was about to make the offer public. For example, PDI bonds rose by 53 percent from July 17 when these rumors began through July 28. In line with the increase in Brady bond prices, the spreads of Brady bonds with respect to comparable U.S. debt instruments narrowed from 1,500 basis points to 1,000 basis points following the announcement**.** Having increased in price by about 15 percent since their inception, the new 12-year bonds were trading at about 72.5 as of January 30, 2001, with a yield-to-maturity of about 17 percent. The new 30-year bonds were trading at abut 43.5 as of January 30, with a yield to maturity of about 18 percent.

Dialogue with creditors. The bondholder community for Ecuador had been far less concentrated and far more diverse than in the case of Pakistan. Among bondholders were various types of institutional investors, including commercial banks, insurance companies, and hedge funds, but relatively fewer retail investors. After the default, the authorities refused to engage in negotiations with minority bondholders or establish a bondholder's committee. This refusal owed to, among other things, the concern that forming a truly representative creditor committee would present a considerable challenge given that the restructuring would cover six series of bonds having very different financial characteristics. Instead, the authorities established a so-called Consultative Group, which consisted of eight institutional holders with large exposures. Two meetings were held with this group, providing the group with information about Ecuador's economic situation and recovery program. All of the information was simultaneously made available to other interested bondholders through the medium of the Emerging Markets Traders Association in New York. However, the authorities chose not to share any confidential information with the group out of concern that the members did not have appropriate internal firewalls to safeguard the confidentiality of information. In addition, citing certain U.S. securities law concerns, the authorities decided not to share with bondholders any information about the terms of the restructuring proposal.[26] Following the approval of the Stand-By Arrangement

[26] Under the U.S. Securities Act of 1933 (the "Securities Act"), an issuer or its officers or agents cannot disclose and distribute information relating to an upcoming public offering to "precondition" the market; all material information relating to the public offering should be contained in disclosure documents filed with the U.S. Securities and Exchange Commission.

by the Fund, the authorities held an open meeting with bondholders in mid-May 2000 to discuss Ecuador's dollarization program, economic recovery measures, and program-related financing. Fund staff attended the meeting and described the key features of the arrangement and medium-term balance of payments prospects. The presentations were received with interest.

Exchange mechanism. As discussed above, the Brady bonds and Eurobonds included in the exchange offer did not contain collective action clauses with respect to payment terms. Without such clauses, it is impossible for a qualified majority to bind a minority to a change in those terms. However, the bonds did include provisions that allow bondholders holding a simple majority of principal, either during a bondholders' meeting or by written notice, to bind a minority with respect to amendments of bond clauses other than those regarding payment—such as waiver of sovereign immunity, submission of jurisdiction, financial covenants and listing. Ecuador is the first sovereign to use those amendment clauses through exit consents to deal with the potential holdout problem in a restructuring of international sovereign bonds that do not contain collective action clauses applicable to payment terms.

An exit consent (or exit amendment) is a written consent to an amendment that is tendered along with an acceptance of an exchange offer (i.e., the consent is given as a bondholder exits the bond). In the case of Ecuador, the terms of the exchange offer required that each bondholder who agreed to tender any defaulted bond in the exchange consent to a list of amendments of nonpayment terms of such a bond. The amendments included the deletion of the requirement that all payment defaults must be cured as a condition to any annulment of acceleration, the provision that restricts Ecuador from purchasing any of the Brady bonds while a payment default is continuing, the negative pledge covenant, and the covenant to maintain the listing of the defaulted instruments on the Luxembourg Stock Exchange. Such amendments were designed to make the old instruments less attractive, thereby reducing the leverage of the holdout creditors who cannot otherwise be bound because of the absence of collective action clauses applicable to payment terms. Like the Ukraine exchange offer, each tender for the exchange was irrevocable and the completion of the exchange was predicated on bondholders holding the requisite majority consenting to the amendments. Of course, even if there were holdouts who refused to participate in the exchange and therefore became a majority of the old bonds after the exchange (as other bondholders exited), the holdouts would not be able to reverse the amendments without the consent of the sovereign issuer. The use of exit consents to reduce the incentives for holdouts to abstain from participating in the exchange in the hope of obtaining a more favorable settlement proved effective in the Ecuadoran bond restructuring. Upon the expiration of the exchange offer, 97 percent of the bondholders agreed to participate in the offer.