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Involving Private Creditors in the Prevention and Resolution of International Debt Crises

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Abbreviations

BIS	Bank for International Settlements
EMBI	Emerging Market Bond Index
EMCA	Emerging Market Credit Association
EMTA	Emerging Market Trade Association
G10	Group of Ten (G8 + Belgium and the Netherlands)
G22	Group of Twenty Two (G7 + Argentina, Australia, Brazil, China, Hong Kong, India, Indonesia, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa, Thailand)
G24	Group of Twenty Four (Egypt, Algeria, Argentina, Ethiopia, Brazil, Cote d'Ivoire, Gabon, Ghana, Guatemala, India, Iran, Colombia, Congo, Lebanon, Mexico, Nigeria, Pakistan, Peru, Philippines, Sri Lanka, South Africa, Syria, Trinidad + Tobago, Venezuela)
G7	Group of Seven (Germany, France, UK, Italy, Japan, Canada, US)
G8	Group of Eight (G7 + Russia)
IDB	Inter-American Development Bank
IIE	Institute of International Economics
IIF	Institute of International Finance
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
LIBOR	London Interbank Offered Rate
NGO	Nongovernmental Organization
PSI	Private Sector Involvement
SDDRF	Sovereign Debt Dispute Resolution Forum
SDDS	Special Data Dissemination Standards
SDRM	Sovereign Debt Restructuring Mechanism
UNITAR	United Nations Institute for Training and Research

Executive summary

The need to involve private creditors in the prevention and resolution of international debt crises

In view of the financial crises in Asia (1997), Russia (1998), Brazil (1999), and Argentina (2001) many observers and actors are calling for a reform of the **international financial architecture**, one of the keystones of **global governance architecture** at the level at which international regimes and institutions act. The background of a reform of the international financial architecture is a growing dissatisfaction with the international monetary and currency system, which has not developed in keeping with the profound upheavals that **globalization** has entailed in the international financial markets and which is marked by serious shortcomings. One important element of an improved international financial architecture is **involvement of private creditors** in the prevention and resolution of debt crises, a phenomenon referred to in the literature as bail-in.

One prominent feature of **globalization** is the huge rise in private transboundary capital flows that have accompanied it. In the past decade the net flows of international private debt instruments into emerging markets and developing countries were two to three times as high as the net inflows of public sector credit. On the one hand, by improving the allocation of capital, private capital flows contribute to raising national prosperity. On the other hand, volatile capital movements can trigger crises that undercut prosperity. This volatility of capital flows is the reason why it is necessary to stabilize the international financial markets, a **global public good**.

There are several reasons why **involvement of private creditors** is a condition necessary to preventing and resolving debt crises. One argument advanced for an involvement of private creditors is bound up with the call for equitable burden sharing between private and public sector creditors, with all creditors sharing debt restructuring or debt relief burdens in direct proportion to the level of the liabilities they hold (inter-creditor equity).

Furthermore, the importance of international private debt instruments has grown substantially in relation to international public flows since the early 1990s. And for this reason the public funds available are, on their own, no longer sufficient to prevent or resolve international debt crises. In addition, private creditors should be obliged to assume some responsibility for preventing and eliminating international debt crises as a means of countering the problem of moral hazard.

In involving private creditors in restructuring debt, the following **collective action problems** tend to occur:

- The **rush to the exit problem**: As soon as creditors fear that a debtor may be headed into a debt crisis, they will lose no time in seeking to sell their claims.

- The **rush to the courthouse problem**: This refers to the danger that many creditors may take legal action to recover their claims. The effect would be to lower the values of such bonds to the detriment of all creditors involved.

- The **holdout problem**: Any debt restructuring process that might prove advantageous to a majority of creditors can be blocked by a minority (holdouts), in this way effectively blocking any speedy and orderly settlement.

One instrument alone is insufficient to ensure an involvement of private creditors geared to avoiding or resolving international debt crises, since such instruments have to be deployed in a complementary manner, not as substitutes for one another. This is why what is called for is a set consisting of both crisis prevention instruments and crisis resolution instruments.

In formulating recommendations for economic policy it is essential to distinguish between instruments designed to prevent crises and instru-

ments used to resolve crises, the reason being that these instruments are deployed at different points of time. Some instruments, though, serve both to prevent and to resolve crises.

Looking first at crisis prevention, codes of conduct are at present the instrument for involving private creditors that has at the same time attracted the most attention in the international debate and is regarded by most actors in the international financial markets as the potentially most practicable and effective approach.

As far as crisis resolution is concerned, collective action clauses would appear to be the most effective instrument available to ensure an involvement of private creditors. In addition, this instrument is at present widely accepted by most actors in the international financial markets. Even though at present most actors in the international financial markets reject an international insolvency procedure, this would be an important instrument for use in restructuring sovereign bonds with an eye to solving the three **collective action problems** named above: rush to exit, rush to the courthouse, and the holdout problem. Furthermore, an international insolvency procedure is the only proposal advanced as yet that could be used to aggregate debt classes and to group debts within these classes.

I Approaches to involving private creditors in the prevention of debt crises

Code of conduct

The most important instrument for involving private creditors in the prevention of debt crises is a code of conduct for all market actors – creditors, debtors, and the public sector. While a code of conduct could contribute to solving the **collective action problems** mentioned above it cannot fully remedy these problems. A code of conduct can neither prevent a rush to exit nor offer any formal protection against litigation by creditors nor provide any safeguard against holdout behaviors.

But a well-formulated code of conduct constitutes one element of a roadmap setting out how debtors and creditors ought to coordinate the restructuring of debt in such a way as to restore a given country's debt sustainability. The principles set out in a code of conduct can contribute to solving the following **coordination problems** involved in restructuring debt:

- **Coordination in restructuring a single bond issue**: This can help to prevent a minority of creditors from opting out of a restructuring procedure agreed upon by a majority.

The Example of Argentina
Argentina is a prime example of a state with a high foreign debt held by a large and heterogeneous group of creditors. At the end of 2001 Argentina suspended the service of a large share of its debt to private sector creditors. In 2003 the Argentine government made the private sector holders of its bonds a restructuring proposal under which these bondholders would have received only about one quarter of the value of their bonds. In 2002 Argentina's foreign debt was four time as high as its annual export earnings. The short-term share of its foreign debt was likewise very high: expressed as a percentage of its currency reserves, the figure was 143 % in 2002. The structure of Argentina's foreign debt is a good example of the important role played by sovereign bond issues. In 2001 the public sector accounted for roughly two thirds of Argentina's foreign debt. Sovereign bonds in turn accounted for over 50 % of this debt. Aside from public sector and large private sector creditors such as banks, Argentina's creditors consisted of some 600.000 private sector bondholders, a fact which gave rise to considerable coordination and collective action problems. Another factor unfavorable to a restructuring process was that the bonds involved – a total of more than 150 different issues – were floated in eight different jurisdictions. This example clearly indicates that a restructuring procedure even for one class of debt bonds may entail substantial coordination problems. At the end of 2003 an agreement between bondholders and the Argentinian Government was not reached and not yet in sight. Probably, Argentina has lost the access to international financial markets.

- **Coordination in restructuring different bond issues**: One possible coordination mechanism is the principle of equal treatment which has been adopted by the Paris Club.

- **Coordinating the restructuring of different classes of debt (bonds and loans)**: One possible coordination mechanism is application of the principle of equal treatment, which was adopted by the Paris Club for public sector loans.

- **Coordination of a restructuring process with the economic policy of a debtor country**: A code of conduct may contain principles which provide for coordination of debt restructuring with the economic policy pursued by a debtor country.

- **Creditor coordination** in coming to a decision on possible approaches to restructuring.

The principles set out in a code of conduct should apply equally for all actors involved – creditors, debtors, and public sector institutions. The proposal advanced by Jean-Claude Trichet / Banque de France provides a suitable framework for a code, though it should be enlarged to include some principles from the proposals made by private financial institutions as well as by other actors (see box, below).

Since a code of conduct is voluntary in nature, it is necessary to set **incentives** for actors in the international financial markets to make use of it. One factor crucial to the effectiveness of a code of conduct is that it is accepted by the international community and that the actors involved develop a

Proposal for a Code of Conduct

- **Early dialogue between debtors and creditors**: The UN would offer a suitable forum to foster an early and regular dialogue between creditors and debtors
- **Fair exchange of information between all parties concerned**: As soon as the negotiation process has got under way there is a need to create for a suitable framework to ensure that creditors are sufficiently informed on a debtor's financial situation.
- **Fair creditor representation**: The use of majority clauses for sovereign bond issues is one possibility to ensure that creditors are fairly represented.
- **Speedy and cooperative negotiations**: A standstill agreed upon by both the creditors and the debtor can serve to prevent a minority of creditors from disrupting a cooperative negotiation. Furthermore, delays caused by creditors taking legal action to secure their claims can be averted by agreeing on a voluntary stay of litigation. In addition, the use of exit consents may provide an incentive for creditors to participate in restructuring processes.
- **Equal treatment of all creditors**: To ensure that all creditors are treated equally during a restructuring process, it is essential that negotiations be as transparent as possible
- **Negotiation in good faith**: Compliance with the principles of a code of good conduct could serve as proof that all parties intend to negotiate in good faith. The parties to negotiations should furthermore be willing accept arbitration and mediation procedures which have been defined ex ante.
- **Maintenance of a debtor's financial standing**: One important instrument in this context is a temporary standstill on debt service payments designed to spare a debtor country's currency reserves. Another important means of maintaining a debtor country's financing capacity is the IMF's policy of lending into arrears; in this case the IMF provides new loans while at the same time working of a reform program for the debtor country
- **Speedy restoration of a crisis country's debt sustainability**: The IMF's programs and debt sustainability analyses constitute an important instrument in this context.
- **Continued compliance with existing contracts**: Debtors and creditors should generally guarantee that existing contracts will complied with.
- **No support for moral hazard behaviors on the part of private sector creditors**: Public sector loans should not serve to encourage moral hazard behaviors on the part of private sector creditors.
- **Flanking economic policies**: A debt restructuring process should be linked with a suitable economic policy on the part of the debtor country.

Source: Amplified version of the code of conduct of the Banque de France (2003)

kind of ownership, and for this reason all such actors – creditors, debtors, and the public sector – should be involved in the development, approval, and implementation of the code.

The code should be developed in the framework of a taskforce set up explicitly for the purpose. Once a proposal code of conduct has been worked out, the code should, in a second step, be presented for approval to the private sector (represented by associations of private creditors, e.g. IIF or EMTA, etc.), the public sector (represented e.g. by the IMFC), and the issuers of sovereign bonds (G20, G24, or other relevant groups). Subsequently, and as already proposed in large part by the Banque de France, the following steps should be taken by all of the actors involved to ensure that the code is effectively implemented:

The role of the public sector: The public sector, including e.g. the IMF or the Paris Club, should assume an active role in reviewing the code of conduct. Even though, theoretically at least, negotiations on debt restructuring could take place without any public sector involvement, this would run counter to practical experience, and thus far debt restructuring has as a rule been linked with an IMF program worked out prior to a final agreement between debtor and creditors.

- The **IMF** could promote the code's implementation by making explicit reference to a code of good conduct in its programs and its lending-into-arrears policy.

- The **Paris Club** could urge debtors to implement the code when the latter call for equal treatment by all creditors in connection with debt restructuring talks conducted in the framework of the Paris Club.

The role of debtors: The emerging markets should signal their willingness to adopt a code of conduct by e.g. including the code's principles in the documents for their sovereign bond issues. It might be advisable to publish a list of countries that have adopted the code, perhaps on the model of the Special Data Dissemination Standards (SDDSs).

Contingent credit lines provided by private banks

Even though this instrument has thus far been used only in three countries (Argentina, Mexico, and Indonesia) and experience with it is therefore limited, contingent credit lines do appear to be a good approach to involving private creditors in crisis prevention. Since short-term private capital movements go far beyond the capacity of public sector financial institutions, the private sector could contribute substantially to easing the public sector's burden by making contingent credit lines available.

The volume of these credit lines should be oriented to two variables: short-term capital movements and currency reserves. Since these credit lines are intended mainly to be used to ward off speculative attacks, which are triggered above all by short-term capital movements, these credit lines should serve to close the gap between a country's short-term liabilities abroad and the currency reserves it holds.

The following two conditions should be given to ensure that this instrument can be used successfully: first, the private sector should grant these credit lines in addition to other loans, not as a substitute for them. Second, the interest on these loans should be regularly adjusted the market rate to ensure that the debtor makes use of this facility only in a crisis, and not when it is cheaper to draw on these contingent credit lines than to borrow in the international credit markets.

II Approaches to involving private creditors in the resolution of debt crises

In the short-term, the only instruments available to involve private creditors in the resolution of international debt crises include: collective action clauses, exit consents, and restructuring of interbank loans, since at present most actors in the international financial markets reject an international insolvency procedure. In the medium-term,

though, insolvency procedure may have an important role to play here, since an insolvency regime is the only possible comprehensive instrument that could be used to coordinate various creditor groups and different debt classes prior to and during a debt crisis.

Contractual approach: Collective action clauses

Introduction of collective action clauses serves to simplify the restructuring of sovereign bond issues. New bond issues could, for instance, include majority clauses that would authorize a qualified majority of bondholders to involve minorities in contract amendments. The point of these clauses is to offer both creditors and debtors an incentive to participate in restructuring procedures.

There are four different types of collective action clauses:

- **Majority clauses**: Based on majority clauses, a qualified majority of creditors can modify the terms of bond issues and thus force through a restructuring procedure.

- **Sharing clauses** require creditors who receive payments during a restructuring process to share them with other bondholders on a proportional basis.

- **Aggregation provisions** serve to aggregate bond issues and other debt instruments (loans) for creditor decision processes.

- **Collective-representation clauses** are designed to accelerate the convocation of a representative forum at which both creditor and debtor positions are aired.

Most actors in the international financial markets see collective action clauses as an instrument suited to both preventing and resolving debt crises. Still, only a limited number of countries include collective action clauses in their bond issues. As a rule, collective action clauses are included in bond issues floated under UK and Luxembourg law. Bond issues floated under US, German, and Japanese law, on the other hand, do not include collective action clauses. At the end of 2001 some 75 % of outstanding international bond issues were without collective action clauses (see Table). In 2003, though, some important emerging markets – Mexico and Brazil – floated bond issues amounting to more than US $ 1 bn each and containing collective action clauses. Despite the clauses the demand for these bonds was high – and both issues were oversubscribed.

Over the short- to medium-term collective action clauses constitute an important instrument for restructuring sovereign bond issues in emerging markets. By requiring the participation of minorities in decisions taken by a qualified majority on amendments of bond contracts, collective action clauses alleviate **coordination problems** that occur in restructuring a bond issue.

They furthermore serve to ease three problems of **collective action** that may occur with one bond issue:

- The **holdout problem**: Majority clauses make it more difficult for individual creditors not to participate in a restructuring process, seeking instead to wait until the debtor is in a better financial situation in order then to enforce 100 % of their claims.

- The **rush to the courthouse problem**: Collective action clauses make it more difficult for in-

Table: Stock of Outstanding Bonds by Jurisdiction (End 2001)

Jurisdiction	in % of total	Number in mn US $	Number of bonds (excluding Bradies for USA)
Great Britain	24.1	85,182	156
Germany	10.1	35,864	89
Japan	5.9	20,716	59
USA	59.1	209,199	233
Others	0.8	3,168	21
Total	**100.0**	**354,129**	**558**

Source: IMF (2002e)

dividual creditors to take recourse to litigation to enforce their claims.

- The **rush to the exit problem**: Collective action clauses such as e.g. sharing clauses can serve to prevent creditors from selling their bonds as soon as they see a risk of a financial crisis.

Collective action clauses are, however, bound up with, basically, two disadvantages. First, collective action clauses are not a comprehensive instrument for the restructuring of sovereign foreign debt since they rule out any aggregation of different debt instruments (loans and bond issues). For this reason collective action clauses continue to be faced with holdout problems and problems with litigation between different debt instruments when different bondholder groups decide in favor of different solutions.

Second, it will prove difficult to convert old bond issues without collective action clauses into new issues with such clauses. For this reason only new bond issues should contain collective action clauses – even though this would of course mean that the entire stock of old bond issues would be without collective action clauses. An IMF study published in June 2002 found that it would be roughly ten years before some three quarters of all sovereign bond issue floated in the international financial markets contained collective action clauses. This implies a transition problem that hinges on the volume of new issues, the terms of outstanding issues, and the willingness of issuers to include collective action clauses in their contracts. It is therefore important to set incentives for issuers to include collective action clauses in their bond contracts.

In the framework of its monitoring policy the **IMF**, for instance, could seek to induce countries to make use of collective action clauses. In connection with its regular Article IV consultations the IMF could check to see whether the countries concerned have included collective action clauses in their contracts on new bond issues. The IMF could then prepare a publicly accessible list of bond issues containing collective action clauses. Furthermore, the IMF/ World Bank Guidelines on Public Debt Management could be enlarged to include collective action clauses for bond contracts.

The **G10 countries** should, for the following reasons, provide their international bond issues with collective action clauses:

- First, inclusion of collective action clauses in sovereign bond issues of industrialized countries would provide a signal indicating that the practice is not a sign of poor creditworthiness.

- Second, collective action clauses would in this case no longer constitute an exceptional phenomenon in the legal systems of some countries.

- Third, market actors would in this way become accustomed to the inclusion of collective action clauses in international bond issues.

Exit consents

A restructuring of sovereign bond issues that involves converting old into new issues is often bound up with the problem that some bondholders refuse to vote for the restructuring procedure and are therefore unwilling to go along with conversion. Collective action clauses make it possible to involve a minority of creditors in a restructuring process. Under US law, though, to cite one instance, bond issues are not required to contain collective action clauses, and for this reason payment terms can be amended only when all bondholders agree to do so.

But it is possible, based on a simple majority and the issuer's consent, to amend conditions set out in a bond contract that do not involve its terms of payment. Such modifications are known as **exit consents** or **exit amendments**. These amendments can be used to punish bondholders who decline to participate in a restructuring process, seeking in this way to avoid any losses. What this approach involves is amending the contractual terms of an old issue in such a way as to make it

less attractive than a new one. Such amendments include e.g.:

- Limits on bond liquidity: an old issue is no longer listed for trade on the stock market.
- Cancellation or dilution of financial clauses: it would be possible to eliminate certain financial clauses, for instance cross default clauses. Based on a cross default clause, creditors holding a debtor's bonds can demand immediate payability if the debtor defaults on another bond issue he has floated.
- Elimination of certain clauses which make it generally possible for all bondholders to participate in a restructuring process.
- Waiver of sovereign immunity: in connection with contracts on sovereign bond issues, the issuing government can waive its immunity, since it is here acting in the role of a contracting party (debtor). This waiver of sovereign immunity can be undone on the basis of exit consents.
- Introduction of redemption-free periods.

Even though until now exit consents have been used only in Ecuador and Ukraine, the instrument does play an important indirect role since it serves debtors as a threat potential vis-à-vis their creditors. However, a debtor who used this instrument to force through a restructuring of his bond issue would be putting his reputation on the line. The instrument can be used to limit creditor holdout behaviors because it prevents a minority of creditors from taking advantage of a majority.

Since exit consents can take on different forms and sovereign bond contracts do not always specify which exit consents can be used by debtors, this instrument entails greater uncertainties for creditors than collective action clauses. And for this reason private actors demand that inclusion of exit consents in bond contracts be made contingent on the consent of all bondholders concerned. The possible use of exit consents could provide an incentive to generally include collective action clauses in sovereign bond issues. The use of exit consents should for this reason continue to be an option open to a simple majority of bondholders.

Restructuring of interbank loans

Since the volume and the volatility of short-term interbank loans provided by institutions in industrialized countries and emerging markets may pose a threat to the stability of the international financial system, a timely and orderly restructuring of interbank credits is required to resolve debt crises. Restructuring can provide a substantial contribution to enhancing solvency. Compared with bondholders, the foreign creditors of interbank loans constitute a small and more homogeneous group, a fact which means that restructuring is bound up with fewer coordination problems.

Interbank loans can be restructured in different ways, and the most appropriate approach depends on the specific situation of a given country. To cite an example: during the Korean financial crisis the Korean government supported the restructuring of interbank loans by providing a sovereign guarantee. This solution was appropriate in that Korea had been pursuing a solid financial policy prior to the crisis, and sovereign guarantees therefore did not pose any exaggerated risk to budgetary stability.

Comprehensive approach: the IMF proposal on an international insolvency procedure

The IMF has advanced a detailed proposal on establishing an insolvency procedure which would provide a legal framework for dealing with overindebted countries and make it possible for these countries to engage in an orderly debt restructuring process. There are four good arguments in favor of an insolvency procedure:

- First, an insolvency procedure would largely provide the means needed to solve the three **collective action problems** – rush to the exit,

rush to the courthouse, and the holdout problem.

- Second, an insolvency procedure would set **incentives for a timely restructuring** because, compared with the status quo, the procedure provides for an orderly and predictable course of the restructuring process. This would make it possible to reduce the high costs which result from delays in initiating restructuring processes.

- Third, compared with collective action clauses, the proposed procedure is a **comprehensive approach** that can be used to restructure different types of debt (bonds and loans) at the same time.

- Fourth, the proposed procedure would make it possible to **involve private sector** creditors in the resolution of debt crises.

Many actors in the international financial markets reject an international insolvency. Most **developing countries and emerging markets** do not support the proposal for the following reasons:

- First, developing countries could lose access to the international capital markets once such a procedure had been initiated. But since access hinges on a country's overall economic development, a debtor country would have a chance to improve its reputation following an insolvency procedure by enhancing its economic performance, in this way regaining access to the international capital markets.

- Second, the financial support provided by international financial institutions in cases of crisis might decline in connection with the adoption of an insolvency procedure. The IMF does not, however, intend to tighten up its criteria for lending to countries that have initiated an insolvency procedure.

Private sector creditors, in particular banks and banking associations, generally reject the proposed international insolvency procedure for the following reasons:

- First, the private sector actors in the international financial markets, banks in particular, fear that the procedure might serve to reinforce **debtor moral hazard**. Since the procedure would make it easier for debtors to open insolvency proceedings, they might be tempted to take advantage of the procedure. Whether or not a debtor country will be able to derive benefits from an insolvency procedure will also depend on the negotiations it conducts with its creditors, who have considerable say in the procedure.

- Second, private sector actors are of the opinion that the insolvency procedure might even trigger a financial crisis in debtor countries, since private sector actors would withdraw their short-term capital from such countries as soon as an insolvency procedure was announced. But it should be noted that a financial crisis would be triggered only if actors in financial markets believed that an insolvency procedure was going to lead to a suboptimal result.

- Third, private sector actors criticize the debt categories marked for inclusion in the IMF's proposed insolvency procedure, especially the inclusion of credits provided by multilateral and bilateral international organizations. This would tend to lower the acceptance of the proposed procedure by other creditors, unsettling the markets.

Even though the proposed international insolvency procedure is at present rejected by most actors in the international financial markets, it could prove to be an important instrument for restructuring sovereign bond issues, and one that could solve the three collective action problems outlined above. Moreover, the proposal on an international insolvency procedure would be well-suited to solving the problem of aggregating different debt classes, credits and bonds and grouping debts within these classes.

1 Introduction

Since the 1997 Asian crisis the voices calling for a new international financial architecture have grown louder and louder. This is a reflection of growing dissatisfaction with the international monetary and currency system, which has yet to be adequately adapted to the changes entailed by the quickening pace of globalization.

One important feature of globalization is the huge rise in transboundary flows of private capital that have accompanied it. In the past decade the net inflow of international private debt instruments into emerging markets and developing countries was at times two to three times higher than the corresponding figure for public sector credits. On the one hand, private capital flows contribute to improving capital allocation and thus raising prosperity in the countries concerned. On the other hand, volatile capital movements can trigger crises with adverse effects on welfare. The debt crises in Asia (1997), Russia (1998), Brazil (1999/2002), Turkey (2002), and Argentina (2001) entailed major welfare losses, and not only in the crisis countries themselves but also in many other countries with close economic ties to the countries in crisis. This volatility of capital flows entails a need for stabilization.

Since the funds available to the public sector for crisis resolution are limited, it is necessary to involve the private sector on a regularized basis. Private creditors should be involved in both prevention and resolution of crises. In the literature this is referred to as bailing in the private. An equitable burden sharing between private and public sector creditors is often called for in this connection.

An equitable burden sharing can be achieved better in the framework of clearly defined fixed rules than by ad hoc procedures involving case-to-case decisions, since the latter approach tends to make it easier for individual creditors to realize their interests at the expense of the others. These rules should, though, be flexible enough to accord adequate attention to the specific situation of given countries. Such rules, which should be binding for all actors in the international financial markets, could constitute a generally valid framework for debt restructuring. The instruments used to involve private creditors in the prevention and resolution of international debt crises should set out the procedures under which the task of restructuring is to be tackled.

The present study concentrates primarily on private creditors who lend to both private and public sector borrowers. The approaches for resolving financial crises discussed here focus exclusively on possible means to gain the involvement of private creditors. Most of these private creditors are private banks and private and institutional investors such as pension funds and hedge funds.

Figure 1 presents in a matrix the most important debtor (column) and creditor (line) structures involved in the most recent crises. One striking fact is that in crises private banks have been the most important group of creditors. In Thailand and Korea, for instance, the creditors of most private debtors were private banks.

The present study breaks down as follows. Chapter two discusses the question of why private creditors should be involved in the prevention and resolution of international debt crises. Chapter three looks into some of the problems that may emerge in attempts to involve private creditors. Chapters four and five discuss various possible approaches to involving private creditors in the prevention and resolution of debt crises, pointing to the experiences that have been made thus far with the use of these instruments in different countries. Chapter six presents some recommendations for economic policy action geared both to preventing and resolving debt crises.

Figure 1: Creditor and Debtor Structures of Various Debt Crises

		CREDITOR		
DEBTOR		**Official**	**Private banks**	**Private non-banks**
	Official	Russia (1998)	Mexico (1995) Russia (1998) Argentina (2001)	Mexico (1995) Russia (1998) Argentina (2001)
	Private banks		Korea (1997) Thailand (1997) Argentina (2001)	
	Private non-banks		Indonesia (1997) (mostly)	Indonesia (1997) (partly)

Source: Amplified presentation of Reisen (1999), p. 15

2 Reasons for Involvement of Private Creditors

2.1 Equitable Burden Sharing among Creditors

One reason for involving private creditors in the prevention and resolution of international debt crises is the demand that private and public sector creditors should share an equitable share of the burden. The idea is to require all creditors to bear a share of the burden of debt restructuring or debt relief equivalent to the level of their liabilities (intercreditor equity).

If this principle of equal treatment of all creditors is not adhered to, the consequence is apt to be **holdout behaviors** on the part of creditors: after all, why should an individual creditor participate in a restructuring process if it is more beneficial for him to wait until the debtors are in a better financial position, in order then to demand 100 % of his claims? Restructuring of public sector debt in the framework of the Paris Club is governed, inter alia, by the important principle of equal treatment.[1] Yet the call for equal treatment of all creditors is controversial. One reason why the Emerging Market Trade Association (EMTA)[2] is in favor of flexible treatment of debtors is that common solutions for all creditor classes and creditors fail to accord adequate attention to the specific features of creditors.[3] In September 1999 the EMTA presented its procedural principles for burden sharing between private and public sector creditors (Box 1).

1 See IMF (2000d).

2 The EMTA is a private association of investors and trading companies; it was founded in 1990 in the wake of the debt restructuring efforts engaged in connection with the Brady Plan. With the aim of promoting market mechanisms for the trade in debt instruments, a small group of important international financial institutes founded the LDC Debt Trade Association, which in 1992 was renamed as the EMTA. Its tasks include, for instance, the development of capital markets in developing countries or provision of a discussion platform for traders and investors. In addition, the EMTA provides support for the integration of developing countries in the international financial markets. See EMTA (2001a).

3 See EMTA (1999a).

Box 1: EMTA: Procedural Principles for Burden Sharing between Private and Public Sector Creditors
• The public sector should induce debtors to undertake economic reforms enabling them to service their debts. Debtors should at the same time be compelled by law to service their debts. • Burden sharing between the private and public sectors is appropriate only in exceptional cases; if e.g. a debtor is unable to repay his debts and the public sector provides financial assistance. • Burden sharing may be appropriate on a case to case basis, but it should in any case be flanked by procedural principles. • Generally, all instruments should be included in burden sharing. This, however, is not to say that all instruments should be accorded equal treatment, since it is essential to take into account the different features of these instruments and the impacts they may have, e.g. on access to the international financial markets. • Bond issues should be restructured with the aid of market-oriented instruments. Debtors should in any case be required to meet their payment obligations.
Source: See EMTA (1999b), p. 3

In the eyes of the EMTA, one reason why burden-sharing between the private and public sectors presents difficulties is that the debts held by public and private creditors may often be very different in nature. In the framework of the Paris Club, negotiations are conducted on debts of public institutions held by public sector creditors. These loans are often not provided at normal market terms and are frequently bound up with political or economic goals of the donor countries concerned, e.g. concessionary loans used to finance exports from creditor countries. For this reason the EMTA questions the concept of burden sharing and with it equal treatment of debt held by private and public sector creditors.

The EMTA names examples in which equal treatment, and thus burden sharing by private and public sector creditors, has proven questionable. In August 2000, it notes, the private sector restructured in the framework of the London Club over 99 % of Soviet-era debt, which Russia had taken over in full. The private sector, the EMTA continues, cancelled a substantial share of the nominal value of this debt. Russian negotiators had indicated that they intended to aim for a comparable restructuring of Russian debt during talks set to be held with the Paris Club in late 2000/ early 2001. What this means is that the private sector had taken losses before the public sector had even begun to negotiate with the debtor. In August 2000 the private sector likewise rescheduled the Brady Bonds and the sovereign eurobonds issued by Ecuador before the Paris Club negotiations had got under way.

Since the Paris Club creditors demand that both public sector creditors who are not members of the Paris Club and private creditors should restructure the debt they hold on the same terms as the creditors in the Paris Club, the contractual relations between private creditors and debtor countries are greatly influenced by the agreements reached there. For this reason the EMTA rightly demands that private creditors should be included in the negotiations of the Paris Club and even be given rights of co-decision.[4]

Equal treatment of public and private creditors is needed to induce private creditors to waive part of their claims in connection with restructuring processes. In the same sense, equal treatment of all creditors within given debt classes and in the framework of one debt instrument, for instance a bond issue, is both necessary and more practicable than equal treatment of different debt classes, since credits are granted at roughly the same terms in the framework of one instrument and within one debt class.

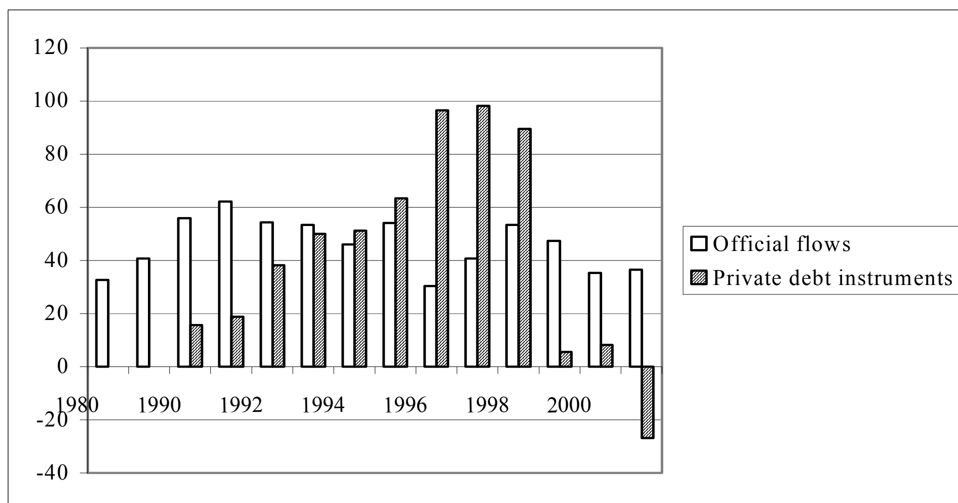
4 See EMTA (2001b).

2.2 Great Significance of International Private Debt Instruments in Relation to Public Sector Flows

The importance of private debt instruments[5] compared with public sector loans has risen sharply since the early 1990s. Public-sector credits are therefore no longer anywhere near sufficient to prevent or resolve international debt crises. One of the main reasons for this is that international private capital flows are substantially more volatile than international public sector capital flows.

How important it is to involve private creditors in the prevention and resolution of international debt crises hinges above all on the development of private debt instruments, which was characterized by two trends in the 1990s. First, net flows of private debt instruments to developing counties rose substantially between 1990 and 1997[6] (Figure 2). The main reason behind the sharp rise in the provision of private funds, e.g. in the form of bond issues for developing countries between 1992 and 1997, was a rise in investor confidence in the solvency of the debtors concerned.[7]

Figure 2: Net Long-term Private and Official Capital Flows[a] to Developing Countries, 1980–2001[b], in Billions of US $



[a] Long-term means that capital flows have a maturity of more than 1 year.

[b] Data for 2001 are preliminary.

Source: World Bank (2002)

5 According to World Bank statistics, bank loans, bonds, and other debt instruments are part of this category, although the term 'other debt instruments' is not clearly defined.

6 The present study uses the term developing countries in accordance with the World Bank's definition. See World Bank (2002). The World Bank also regards emerging markets like Argentina, Brazil, Mexico, Indonesia, South Korea, Hungary, Poland, Russia, or Turkey as developing countries. The foreign debts of emerging markets with private creditors is a particularly relevant factor here.

7 See World Bank (1997), pp. 5–6.

Second, in the 1990s the net inflows of international private debt instruments were far more volatile than the net inflows of international public sector credits, a factor which played a major contributory role in the international debt crises of the 1990s. The decline in international private debt instruments since 1998 is due in essence to the financial crises in Asia (1997), Russia (1998), Brazil (1999), and Argentina (2001).

The structure of capital flows to developing countries has changed substantially in the past two decades. In the 1980s bank loans to government institutions in developing countries accounted for a dominant share of international private debt instruments (Table 1). This is why payment problems were as a rule solved by restructuring and writing off these loans. In the 1990s, on the other hand, it was above all bond issues that began to play a growing role.

2.3 Moral Hazard Behaviors on the Part of Private Creditors

The need for an involvement of private creditors in the prevention and resolution of international debt crises is furthermore justified with the argument that this approach counters moral hazard and therefore may contribute to stabilizing the international financial markets by improving the efficiency of capital allocation.[8]

Creditor moral hazard occurs when creditors, operating on the assumption that public sector financial aids will be made available in crisis situations, accord too little attention to risks in coming to their decisions.[9] This diminishes the incentive for private investors to cautiously examine their lending practices and lend only to solvent borrowers.[10]

Table 1: Structure of Net Long-term[a] Capital Flows to Developing Countries, 1980–2001, in Billions of US $

	1980	1985	1990	1995	1996	1997	1998	1999	2000	2001[b]
Total	82.5	73.4	98.5	260.2	306.6	341.4	336.7	271.8	261.1	196.5
Public flows	32.6	40.7	55.9	54.1	30.3	40.7	53.4	47.4	35.3	36.5
Private flows	41.1	21.8	42.6	206.1	276.2	300.7	283.3	224.4	225.8	160.0
Private debt instruments		21.8	15.7	63.3	96.5	98.1	89.4	5.6	8.2	-26.8
Thereof: Bank credits	30.8	8.5	3.2	30.9	32.2	45.6	51.9	-23.3	-6.1	-32.3
Bonds[c]	1.1	6.0	1.2	30.7	62.3	49.6	40.9	29.5	16.9	9.5
Other debt instruments	9.2	7.3	11.3	1.7	2.1	2.9	-3.4	-0.5	-2.5	-4.0

a Long-term means that capital flows have a maturity of more than 1 year.
b Data for 2001 are preliminary.
c Detailed information about the type of bonds do not exist, but these are probably mostly sovereign bond.

Source: World Bank (1992), p. 18 and (2002), p. 32

8 See Crockett (1999), pp. 1–2.

9 See Roubini (2000a), p. 25.

10 See Mishkin (1997), pp. 12–13 and Mishkin (1999), pp. 4–5.

One point of criticism voiced again and again in connection with the Mexican, Asian, Russian, and Brazilian crises was that the IMF and other international public sector financial institutions had put too much money into resolving the crises and had in this way encouraged moral hazard on the part of private creditors. It was noted that tax revenues were used to resolve the crises, a practice which was in part tantamount to socializing the losses involved. This behavior on the part of international financial institutions, it was further claimed, constituted a false incentive in favor of highly risky capital investments.[11]

The volume of public sector financial aids provided in the crises of the 1990s was substantial. All told, the international community approved financial aids amounting to US $ 181.3 bn during a period of only 16 months (Table 2). With the exception of the aid provided to Mexico,[12] this support went far beyond the aid packages that had been provided previously. The IMF's loans for Brazil (1998), Mexico (1995), and Indonesia (1997) amounted to between 500 % and 700 % of their quotas. The IMF's loans to Korea even amounted to 1900 % of its quota.[13]

Even though the aid packages provided by international organizations were certainly ample, it should not be forgotten that short-term private capital outflows far exceeded the financial aids provided by the public sector.[14] Whether or not the interventions of international organizations – and of the IMF in particular – gave rise to considerable moral hazard problems among creditors is a matter of some controversy in the literature.[15]

Numerous studies based on general theoretical considerations, e.g. those of Cline, Meltzer, Roubini, and Willet, support the thesis that loans provided by the international community do in fact lead to moral hazard in the international financial markets.[16] This is based on the argument that private investors anticipate that in crisis situations the international community will step in to bail out private creditors. Representatives of

Table 2: Volume of Official Flows, July 1997 – October 1998, in Billions of US $

	IMF	Multilateral[a]	Thereof: World Bank	Bilateral	Total
Indonesia	11.2	10.0	5.5	26.1	42.3
Korea	20.9	14.0	10.0	23.3	58.2
Thailand	4.0	2.7	1.5	10.5	17.2
Russia	11.2	1.5	1.5	9.9	22.6
Brazil	18.0	9.0	4.5	14.5	41.0
Total	**65.3**	**37.2**	**23.0**	**84.3**	**181.3**

a Multilateral: World Bank, Asian Development Bank and Inter American Development Bank
Source: World Bank (1999)

11 See Greenspan (1998), p. 3; Haldane (1999), p. 195; Meltzer (1998), pp. 267 and (2000), p. 3; Roubini (2000a), p. 29.

12 The financial aid provided to Mexico in 1994 by international organizations amounted to a total of US $ 51.6 bn. The IMF granted loans amounting to US $ 17.8 bn. See BIS (1998), p. 134.

13 See Goldstein (2000), p. 5; Council on Foreign Relations (1999), p. 15.

14 See BIS (1998), p. 170.

15 For a discussion of the moral hazard behavior of private creditors, see Eichengreen (2000b), pp. 15; Haldane (1999), pp. 191; Lane / Phillips (2000); Meltzer (1998), pp. 267 and (2000); Nunnenkamp (1999).

16 See Cline (2000), p. 6; Meltzer (1998), pp. 267 and (2000), p. 3; Roubini (2000b), p. 29; Willett (1999), p. 4.

the central banks of the US and the UK argue in a similar vein.[17] Furthermore, some authors are of the opinion that moral hazard was involved in Russia, since the investors assumed that Russia was of such great political weight that the international community could not afford not to continue lending to it.[18]

The Institute of International Finance (IIF),[19] on the other hand, proceeds on the assumption that moral hazard plays no more than a minor role, because private creditors have no choice but to anticipate high losses. According to IIF estimates, for example, bondholders and banks lost some US $ 73 bn in connection with the Asian crisis.[20] These figures are, however, not especially cogent in view a lack of clear data on the ratio between losses and overall invested capital, the levels of anticipated gains, and the amount of public sector funds that had been expected.

Some studies are based on empirical tests, although these are bound up with many problems. If it can be investigated at all, the behavior of private investors must be studied indirectly. It would be necessary to prove empirically that private investors take higher risks when they assume that international organizations are willing to bail them out by making funds available in the case of a crisis. Furthermore, it is more than difficult to find suitable indicators. Due to these fundamental problems, empirical studies are as a rule not particularly meaningful.

17 See Greenspan (1998), p. 3 and Haldane (1999), p. 195.

18 See Corrigan (2000), p. 139; Dell'Ariccia et al. (2000); Lane / Philipps (2000).

19 The IIF and the EMTA are the two most important private institutions active in the field of debt problems. The IIF is a federation consisting of international commercial and investment banks as well as a smaller number of insurance companies and multilateral corporations, trading companies and other private multilateral organizations. It was founded in 1983 by 38 banks of leading industrialized countries in the wake of the international debt crisis; its membership has in the meantime risen to over 300. In essence, the Institute has three goals: first, to support members activities in developing countries. It here offers various services, e.g. provision of data or analysis of economic development in developing countries. Second, to offer a discussion platform for private and public sector actors in the international financial markets. Third, to discuss aspects of banking oversight regulations. See IIF (2001a) and (2001b).

20 See IIF (1999a), pp. 59 and 61 and (1999b), p. 13.

3 Problems Encountered in Gaining the Involvement of Private Creditors

Problems involved in coordinating private creditors in debt restructuring constitute an obstacle to an orderly and low-cost restructuring process, especially of sovereign bond issues, which account for the major share of foreign sovereign debt, but also of other claims such as bank loans. The coordination problems involved in the restructuring of sovereign bond issues are greater than those that have to be addressed in rescheduling other debt instruments, because the creditors of sovereign bond issues are more heterogeneous group than the creditors holding other debt instruments. International bank loans, for instance, are often provided by banking syndicates consisting of a small number of large international banks. The fact that these banks are familiar with one another and work together in a number of countries gives rise to a certain mutual interdependence. This is the reason why these banks have an incentive to cooperate in dealing with other banks. Moreover, these banks as a rule agree on a sharing clause according to which all proceeds stemming from litigation against a debtor are shared in keeping with the levels of their claims.[21]

There are three collective action problems that play a significant role in the coordination of private creditors in connection with the restructuring of debt: rush to the exit, rush to the courthouse, and the holdout problem. These problems cannot be fully resolved by one instrument alone.

21 See Dixon / Wall (2000), pp. 142–143.

3.1 Rush to the Exit

As soon as creditors fear that their debtor may be heading into a debt crisis, they will seek to sell their claims as quickly as possible (rush to the exit). For the individual creditor it is rational to sell his claims before the others, since in cases of debtor liquidity bottlenecks bondholders who shed their bonds before other creditors are in a position to make a better deal. Such sales of bonds diminish their value in the international financial markets. This loss in value makes it difficult to issue new bonds or induces creditors to raise their risk premiums, which in turn means rising interest rates for the countries affected. Rising costs may adversely affect the financial situation of debtors, triggering a financial crisis. The risk that this will lead to a financial crisis increases in inverse proportion to the terms of the bonds in question.

3.2 Rush to the Courthouse

Individual creditors have an incentive to sue for their claims if they are the first to take legal action and see a chance to secure the remaining assets or if they manage to establish a first claim to them and are able to enforce their claims on this basis. A rush to the courthouse[22] involves the risk that many creditors will go to court to sue to enforce their claims. This lowers the value of a bond issue as a whole. Coordinated creditor action, on the other hand, can prevent a decline in bond values. For this reason, individual action often leads to poorer results than collective action.[23]

Even though in practice litigation against sovereign states have been a rare occurrence, even the threat of legal action can have adverse effects on bond values.[24] It is generally difficult for private creditors to enforce their claims against a sovereign state, because, first, a state that runs into solvency problems is often not in possession of many valuable and liquid assets which could be used to satisfy creditor claims. Second, suing a sovereign state is a relatively time-consuming process since as a rule states enjoy more legal protection in court cases than private creditors.[25]

3.3 The Holdout Problem

A restructuring procedure that is advantageous for a majority of creditors may be blocked by a creditor minority (holdouts). This can obstruct an orderly and speedy restructuring process. On the one hand, if creditors see a possibility to secure their overall claims following a restructuring process, they can be said to have an incentive to decline to participate in any restructuring that is likely to mean losses for them. On the other hand, creditors have an incentive to reject a restructuring procedure when they see a risk that a minority not involved in the restructuring process may be able to secure their claims after the restructuring process has been completed. If this problem cannot be solved, the risk is that restructuring will prove more costly for all parties involved than a cooperative solution.[26] Box 2 presents a well-known example of holdout behavior.

Box 2: The Elliott Associates Case
One well-known example of the holdout problem is the case of Elliott Associates. In 1996 Elliott Associates purchased Peruvian debt securities worth US $ 20 bn in the secondary market and declined to participate in the restructuring procedure offered by the Peruvian government. In order not to endanger restructuring talks with other creditors as well as to avoid costly and protracted legal action, the Peruvian government decided to agree to a settlement. This enabled Elliott Associates to secure a larger share of their claims than the other creditors involved in the restructuring procedure.
Source: Hefeker (2002), p. 686; IMF (2001a), p. 12; Roubini (2002a), p. 4

22 In the literature rush to the courthouse is also sometimes referred to as the grab race.

23 See Roubini (2002a), p. 3.

24 See Dixon / Wall (2000), p. 143.

25 See Roubini / Setser (2003).

26 See IMF (2002e), p. 3; Roubini (2002b).

4 Approaches to Involving Private Creditors in the Prevention of Debt Crises

It is generally customary to distinguish between measures aimed at preventing and measures aimed at resolving debt crises. As far as individual instruments are concerned, it is not always possible to draw a clean dividing line between these two categories, since some approaches are geared to both prevention and resolution. Still, this distinction is an important precondition for the use of various instruments in situations which have not yet escalated into crises. The present chapter will focus on preventive measures which involve private creditors, such as e.g. a code of conduct, contingency credit lines, and dialogue between creditors and debtors.[27]

4.1 Code of Conduct

4.1.1 Objectives of a Code of Conduct

To achieve an 'equitable' burden sharing, representatives of public and private institutions propose the use of codes of conduct for debtors and creditors the objective of which would be prevent and to resolve crises and which would be used to complement other debt restructuring approaches (e.g. insolvency procedures or contractual collective action clauses). In crisis situations these approaches could e.g. serve to simplify cooperation between creditors and debtors. They could furthermore serve to prevent crises from spreading to other countries by positively influencing investor expectations. The objective of a code of conduct is strike a balance between the interests of creditors and debtors and creditors among one another. For the debtor, compliance with the principles of a code would be an important factor in regaining swift access to the international financial markets. For creditors, a code of conduct can serve to reduce uncertainty over debtor moral hazard.

4.1.2 Possible Formulations of a Code of Conduct

While in principle most market actors[28] support the adoption of a code of conduct geared to preventing and resolving debt crises, opinion differ greatly on possible optimal formulations of a code of conduct. The most important proposals on the formulation of a code include the following:

- the code of good conduct: the Trichet proposal of January 2003, which was published by the French central bank;[29]
- the procedural principles used by the G7 countries to involve the private sector; and
- the proposal on a code of conduct advanced by the most important private financial institutions[30] in January 2003.

The Trichet proposal on a code of good conduct

The code of good conduct proposed by Jean-Claude Trichet would establish rules of conduct (see Box 3) governing the behavior of all parties

27 Other preventive measures which focus on private or public sector debtors but not on private creditors are not relevant for the involvement of private creditors; these would include e.g. monitoring systems for debtor liabilities, introduction of banking-oversight regulations for debtors (Core Principles of the BIS) in debtor countries, or publication of data, in particular on short-term capital flows.

28 See EMTA et al. (2003); Group of 7 (2003); Group of 24 (2003); IMF (2003b), pp. 17.

29 The French central bank's proposal for a code of conduct has become known as the Trichet proposal. See Banque de France (2003).

30 These include the Emerging Markets Trade Association (EMTA), the Institute of International Finance (IIF), the International Primary Market Association (IPMA), the Bond Market Association, the Securities Industry Association, the International Securities Market Association, and the Emerging Markets Creditors Association. See EMTA et al. (2003).

Box 3: Trichet Proposal for a Code of Good Conduct
1) **Early dialogue between debtors and creditors** prior to and during debt restructuring processes. An early and continuous dialogue would make it possible to identify and solve problems in time.
2) **Fair exchange of information between all parties involved**: The code of good conduct would define what information should be provided to creditors to enable them to conduct a satisfactory analysis of a given debt situation.
3) **Fair creditor representation**: Creditors would be fairly represented in consultations and decisions on restructuring modalities. This creditor representation could be based on existing modalities such as those set out in collective action clauses, e.g. majority clauses.
4) **Speedy and cooperative negotiations**: Once restructuring negotiations have got underway, the parties involved would lose no time in reaching agreement; and all possible efforts would be undertaken to ensure a cooperative negotiation process.
5) **Equal treatment of all creditors**: On the one hand, this principle would ensure that all creditors are treated equally during the restructuring process. If they perceive a risk of holdout behaviors, most creditors will hesitate to participate in a restructuring procedure. On the other hand, in some situations some debt categories necessarily have to be excluded from a restructuring process; these would include e.g. export credits needed to avoid damage to a country's economy during the negotiation process.
6) **Fair burden sharing between debtor and creditors**: The costs of restructuring would be shared fairly between debtors and creditors.
7) **Negotiation in good faith**: Creditors and debtors would negotiate in good faith. The debtors would, first, take measures to ensure that the costs of restructuring remain as low as possible for the creditors. Second, debtors would continue to comply with the terms of their contracts as long as possible. The creditors would recognize that it might become necessary to reduce the amount of their claims.
8) **Maintenance of a debtor's financial standing** during restructuring talks: A debtor's financial standing should not suffer as a consequence of restructuring talks, since otherwise his repayment capacity might be impaired.
9) **Speedy restoration of a debtor country's debt sustainability**: In the medium-term the priority goal of negotiations should be to speedily restore a debtor country's debt sustainability.
Source: See Banque de France (2003)

in cases in which a country is faced with financial strain or insolvency. The code is designed to contribute to both preventing and resolving financial crises by improving the predictability and transparency of the negotiation processes involved in debt restructuring. The code of good conduct would not be given a legal foundation. In essence, the code is a market-oriented approach designed to sustain and support existing contractual relations as long as possible.

This code of conduct defines a broad framework for individual solutions or for country-specific arrangements. On the one hand the code would offer investors transparency and certainty; on the other hand, it would pave the way for flexible action and enable actors to use different instruments in appropriate specific combinations.

The following three debt scenarios are intended to show at the conceptual level how adherence to these principles may pave the way to an appropriate solution.

a) Under the first scenario the debtor has short-term problems in meeting his debt service obligations and there is a risk involved that the situation could further deteriorate. Appropriate restructuring procedures and negotiations – e.g. extension of the terms of loans – are required to prevent the situation from deteriorating any further. Adherence to some central principles of conduct can contribute to a speedy restructuring process; one need think here e.g. only of principle 1 – early dialogue between debtors and creditors – or principle 2 – fair exchange of information between all parties involved – neither of which requires protracted renegotiation.

b) Under the second scenario the debtor is still able to service his debt, although his debts are not sustainable in the long run. In this situation the debtor's wish is to initiate new negotiations on his debt. The principles would contribute to reaching the goal of engaging in speedy and equitable negotiations. In this case it would be principle 4 – speedy and cooperative negotiations – and principle 2 – fair exchange of information between all parties involved – that play a key role.

c) Under the third scenario a country's debts are no longer sustainable and the debtor has already suspended his debt service payments. In this situation the aim of the code is to prevent uncooperative restructuring negotiations. An appropriate IMF adjustment program and lending into arrears would contribute to resolving the crisis and ensuring that the code is applied fairly. Here the most important principles geared to paving the way for all parties to a speedy agreement on restructuring are principle 4 – speedy and cooperative negotiations – and principle 8 – maintenance of the debtor's financial standing.

Procedural rules of the G7 countries on involving the private sector in cases of financial crisis

At the 1999 Cologne economic summit the G7 countries[31] reached agreement on a number of procedural principles aimed at gaining the involvement of the private sector in dealing with financial crises (Box 4).

Box 4: G7 Countries: Procedural Principles for Involving the Private Sector in Cases of Financial Crisis

- Involving the private sector in no way implies relieving countries of their duty to honor their contracts and to settle their debts fully and on schedule.
- To ensure that market discipline works, creditors should bear risks themselves, i.e. public sector bailouts should not foster moral hazard.
- It is important to weigh the advantages and disadvantages of debt reduction as regards the private sector. On the one hand, reduction of debts owed to private creditors can help countries to bridge short-term liquidity problems and reduce the amount of public sector funds required. This furthermore serves to induce private creditors to be more cautious in taking investment decisions. On the other hand, there is a real risk involved that debtors from crisis countries may be faced with restricted access to the international financial markets.
- It is important to guarantee equal treatment for various private creditors, ensuring e.g. that the claims of bondholders and banks are treated on an equal footing.
- It is important to promote cooperative solutions between creditors and debtors.

Source: G7 (1999), pp. 11–12

These principles are designed to support an orderly resolution of crises in difficult situations, to simplify cooperation between creditors and debtors in crisis situations, and to positively influence investor expectations, in this way enabling the debtor country to regain access to the international financial markets.[32]

The code of conduct proposal advanced by private actors in the international financial markets

In January 2003 the most important international associations of private creditors[33] published a joint and non-binding code of conduct for dealing with

31 See G7 (1999), pp. 11-12; IMF (2000d), p. 52.

32 See G7 (1999), pp. 11–12.

33 See EMTA et al. (2003).

financing problems in emerging markets (Box 5). As regards crisis prevention, the code's aim is to avert restructuring procedures; and as far as crisis resolution is concerned, the code's aim is to simplify restructuring procedures and restore debtor access to the international financial markets. Representatives of these private financial institutions emphasize that the code does not pursue the aim of having the public sector bail out private creditors.

The proposal also calls for setting up a joint monitoring group to verify whether the principles of the code are being complied with. This group would be made up of representatives of debtor countries, creditor countries, private investors and creditors, the IMF, and the BIS. Creditors or debtors would have the opportunity to consult the group at any time.

4.1.3 Assessment of a Code of Conduct

A code of conduct would be the most important instrument for involving private creditors in the prevention of debt crises, and this goes for all actors alike – creditors, debtors, and the public sector. While a code of conduct can contribute to solving the coordination problems involved – rush to the exit, rush to the courthouse, the holdout problem – it can not fully eliminate these problems. A code can neither prevent a rush to the exit, offer any formal protection against litigation by creditors, nor provide any definitive safeguard against holdout behaviours.

But a well-formulated code of conduct can constitute one element of a roadmap describing how debtors and creditors can coordinate the restructuring of debt in such a way as to render a given country's debt sustainable. The principles set out in a code of conduct can contribute to solving the following coordination problems involved in restructuring debt:

- **Coordination in restructuring a single bond issue**: This can help prevent a minority of creditors from opting out of a restructuring procedure agreed upon by a majority.
- **Coordination of a restructuring of different bond issues**: One possible coordination mechanism is the principle of equal treatment, which has, for instance, been agreed upon by the Paris Club.
- **Coordination of a restructuring measure with the economic policy of a debtor country:** A code of conduct may contain principles which provide for coordination of debt restructuring with the economic policy pursued by a debtor country.
- **Creditor coordination**: A code of conduct can help coordinate creditors in coming to a decision on possible approaches.[34]

These procedural principles offer a generally acceptable framework, one that leaves sufficient leeway to accord proper and flexible consideration to the special features of a given country's debts and/or repayment capacity. On the one hand, these principles are intended to offer investors the transparency and certainty they need; on the other hand, the aim of a code of conduct is to enable actors to set a flexible course and to deploy various instruments in individual combinations appropriate to given situations.

One important difference between the two concepts presented here consists in the fact that the proposal advanced by the private actors[35] distinguishes between principles of conduct for debtors, creditors, and the public sector, including e.g. IMF and G10. Moreover, the proposal advanced by private actors goes beyond the Trichet proposal on a code of good conduct for restructuring processes by calling for the use of economic policy directives in other economic areas as well, including e.g. exchange rate policy or capital controls. One objection raised to this proposal is that it tends more to promote the interests of the private actors involved. By comparison, Trichet's code of good conduct sets out nine principles that would be applied equally to all parties involved.

34 See Roubini / Setser (2003), pp. 9–10.

35 The literature on involvement of private creditors often refers to private creditors, including e.g. banks or other private agents active in the international financial markets, simply as "private actors."

Box 5: Proposal for a Code of Conduct Advanced by Private Actors in the International Financial Markets

I. Crisis prevention

1. Development of smoothly functioning capital markets
2. Thorough analysis and risk management on the investor and creditor side
3. Development of market-based exchange rate systems
4. Development of a central database on sovereign debt
5. Voluntary inclusion of collective action clauses in sovereign bond issues
6. States should comply with the IMF's Special Data Dissemination Standards (SDDS)

II. Crisis resolution

A) As debtors, states should

1. pursue a stability oriented macropolicy and conduct structural reforms aimed at laying the groundwork for new growth
2. work together with the IMF with a view to strengthening their policies and obtaining financial and programmatic assistance
3. engage in an early and intensive dialogue with the most important investors and creditors with a view to regaining the confidence of the financial markets as quickly as possible
4. avoid taking any measures that might impinge on the rights of foreign and domestic investors in order to prevent capital exodus
5. initiate appropriate steps to avoid crises; this would e.g. mean contacting creditor committees and seeking consultations with important creditors
6. meet with creditors on a regular basis
7. not lose any time in embarking on restructuring negotiations, negotiate directly and in good faith with a broad and representative group of creditors
8. disclose all of their financial liabilities and set out the central aspects of their economic policy as well as related reforms and IMF programs
9. treat all creditors on an equal basis
10. seek to engage with bilateral public sector creditors in a comparable restructuring process
11. continue to meet debt service payments during negotiations
12. have engaged in intensive negotiations with bondholders prior to defining the terms of the restructuring process
13. guarantee that the terms agreed upon will be met to the latter

B) Market actors should

1. participate in an active dialogue with debtors in order to enable the latter to regain the confidence of and access to the financial markets
2. assume full responsibility for their investments in emerging markets
3. recognize that the IMF's decisions on provision of credit must be conditioned on harmonization with IMF policy
4. banks and investment institutions should consider participating in a voluntary, industry wide, and time-limited continuation of trade and interbank credits; this would presuppose uninterrupted debt service and commitment to a convincing economic policy in the framework of the IMF's programs
5. undertake steps toward coordinating their approach with that the approach pursued by both the debtor and other creditors, e.g. by setting up a creditor committee, seeking contact with official debtor representatives, etc.
6. remain in constant contact with the debtor and take immediate steps aimed at working together with other creditors in committees once the debtor has indicated his intention to restructure his debts and to negotiate in good faith

C) The IMF und the G10 should

1. support debtor policies and actions that are in keeping with the code of conduct
2. provide policy recommendations keyed to a stability oriented policy
3. provide support aimed at avoiding any default in payments
4. provide financing assistance for the debtor
5. support restructuring of bilateral credits at terms comparable to those used for private claims
6. approve capital controls only in exceptional cases
7. participate in consultations with the most important private creditors
8. suspend disbursements to countries which violate the basic rights of foreign investors and creditors

Source: See EMTA et al. (2003)

4.2 Contingent Credit Lines

In the framework of contingent credit lines,[36] large international banks and other private financial institutes[37] agree ex ante to provide public or private financial institutions in developing countries credit lines denominated in foreign currency on which these institutions can fall back in the event of an impending crisis without having to engage in prior negotiations. The instrument is designed mainly to prevent crises before they emerge, but it can also be used to help resolve a crisis.[38]

The debtor is required to pay a premium for the provision of contingent credit lines, and he is also obliged to furnish security, e.g. in the form of sovereign bonds. In this sense the facility resembles private insurance, with the debtor paying an insurance premium against his potential right to file a claim. The debtor has the right to draw on the credit line at any time and without having to seek the lender's approval.[39]

Argentina

One example in which contingent credit lines were provided is Argentina. In a crisis situation, 16 major international banks provided the Argentine central bank the option of drawing on a credit line amounting to US $ 4.7 bn and made available for a period of two to five years.

36 Sometimes also referred to as contingency facilities.

37 Public sector institutions may also offer contingent credit lines. One example is the IMF, which has provided contingent credits lines since 1999. The aim of the instrument, first deployed in the spring of 2001, is to help prevent financial crises. See Fischer (2000); IMF (1999e), pp. 3-4 and (2000d), p. 77. Since the present study focuses on private creditors, the credits lines provided by public sector financial institutions are not discussed at any length here.

38 See Drage / Mann (1999), p. 56; IMF (1999), pp. 10 and pp. 32 and (2000d), pp. 18–20; Speyer (1999), p. 11.

39 See Drage / Mann (1999), p. 56; Kletzer / Mody (2000), pp. 18–20.

In this sense the facility offered an additional buffer amounting to one quarter of Argentina's currency reserves, which added up to US $ 22 bn at the end of 1997. The central bank had a put option, i.e. against securities furnished in the form of Argentine government bonds, the bank was provided with a certain amount of liquid funds (currency reserves). The standby fee was 0.33 %, and the interest rate charged for use of the credit line was LIBOR plus 2.05 %. When the financial crisis broke out in September 2001, the Argentine central bank drew US $ 1.8 bn.[40]

Mexico and Indonesia

In November 1997, 33 international financial institutions made roughly US $ 3 bn available to the Mexican government, charging it LIBOR plus an interest margin ranging between 0.5 and 1.0 %.[41] The facility was made provided for one year, with a renewal option for one additional year. The credit was to be repaid 18 months after it had been drawn.[42]

The Mexican government made use of this facility (US $ 2.66 bn) shortly after it had been set up. Even though Mexico adhered to the guidelines, it is widely believed that there was no real need for it to make use of the credit line. The reason why Mexico made use of the facility, it is claimed, is that the interest rates agreed upon were distinctly below market levels and the credit line was thus not used as an emergency credit. One way to address this problem is to regularly adjust interest rates to the market rate. In making use of the credit line, Mexico damaged its international reputation. Immediately after Mexico had drawn on the credit line, the interest on Mexican bonds

40 See Hawkins / Turner (2000), pp. 38–39; Speyer (1999), p. 11. There is no information available on any further use made of the facility.

41 For the first six months the interest rate was LIBOR plus 0.5 %, for second six months it was LIBOR plus 0.75 %, and for the last six-month period it was LIBOR plus 1 %. See Sidaoui (2000), p. 129.

42 See Sidaoui (2000), pp. 128–129.

rose briefly (for one week) by 100 base points. In addition, this credit had to be restructured as early as in March of 1999: 70 % of the credit line (US $ 1.9 bn) was converted into instruments with terms of two to five years. Moreover, the Mexican government paid back some US $ 0.5 bn as early as February 1999, using the proceeds from a 10-year government bond issue to do so.[43]

Between 1994 and 1997 a contingent credit line was set up for Indonesia as well. Like Mexico, Indonesia used the facility in the spring of 1998,[44] although it drew on only two thirds of the credit line provided (some US $ 700 bn). The credit lines provided for both Mexico and Indonesia were discontinued once they had been drawn upon. One of the main reasons for this was the fact that the interest rates on contingent credits lines entailed costs too high for the countries concerned, the reason being that the interest rate demanded for the provision of such credits hinges on the expectations of market actors on the probability that they will in fact be used.[45]

Assessment

Even though this instrument has been made available only for three countries (Argentina, Mexico, and Indonesia), and experiences with it are therefore limited, contingent credit lines do appear to be a good approach for involving private creditors in the prevention of crises. Since short-term capital movement far exceed the capacity of public sector financial institutions, the private sector can make a major contribution toward easing the public sector's burden by providing such contingent credit lines.

One of the positive points of this instrument is that it signals the willingness of private banks to provide credit in cases of crisis and serves to underline the confidence of these banks in the economic policy pursued by a given country.[46] If the interest rate charged is in line with interest rates in the capital markets, this facility constitutes an efficient means of insurance at market prices. Involving the private sector with a view to compensating for unfavorable external developments is a good means of more equitably distributing the burden between the private and public sector. Furthermore, since these facilities constitute a financing option in times of crisis, they also have a stabilizing effect.[47]

One disadvantage is that they may encourage moral hazard on the part of debtors. This problem can be addressed by defining precise terms for borrowing. There is also a risk that instead of being provided as a supplement, these credit lines may be granted as a substitute for other loans. These facilities are, however, effective only when they are provided in addition to other credits; and they should not be approved if their effect is to limit the availability of other credits.[48]

Contingent credit lines tend more to be made available to countries which pursue a solid economic policy are marked by solid macroeconomic structures in their business and banking sectors; although it must be said that precisely such countries are less likely to be hit by a financial crisis.[49] This detracts from the instrument's effectiveness. Furthermore, the instrument may serve politicians as an excuse for either not conducting or not forging on with necessary economic reforms. The IIF, though, is of the opinion that this problem will not occur in the long run because, quite apart from credit lines, politicians will recognize the need for reforms.[50]

43 See IMF (1999), pp. 11 and 33; IIF (1999a), pp. 35–36; Sidaoui (2000), pp. 129–130.

44 See IMF (1999), p. 33. There is no further information available on Indonesia.

45 See Eichengreen (2000b), p. 8.

46 See Speyer (1999), p. 11.

47 See IMF (1999), pp. 10–11 and 32.

48 See Kletzer / Mody (2000), p. 19.

49 See Speyer (1999), p. 11.

50 IIF (1999a), p. 37.

4.3 Dialogue Forum for Creditors and Debtors

Objectives of a dialogue forum

The point of an intensive dialogue between creditors and debtors is to minimize information deficits concerning the economic and debt situation of debtor countries and thus to improve transparency. Intensive dialogue therefore helps to build confidence and leads to lower risk premiums. Dialogue can also help prevent crises from spreading to other countries. Thanks to an improved flow of information, creditors are less likely encounter unanticipated problems when they look into a country's economic development picture.[51] Even though dialogue forums are mainly preventive in nature, they can also prove helpful in a crisis situation.

Design and assessment of dialogue forums

Meetings of **corporate analysts** can serve as a model in designing dialogue forums. The meetings should be held on a regular basis (every one or two months). Regular meetings make it possible for the participants to respond rapidly, since the creditors attending them will be informed in time on problems facing bondholders. And compared with a body adjourned only when a crisis is impending, regular meetings conducted in the framework of a dialogue forum do not send out any negative signals.[52]

Of course there are also problems. Selection of participants may pose difficulties, since, first of all, the number of creditors may be very high, e.g. in the case of bond issues, and the costs involved in bringing all creditors together would be prohibitively high. Second, bonds tend to change hands frequently since they are also traded in secondary markets. One possible solution would be meetings attended by permanent and alternating participants. As an alternative, a debtor country could offer regular information dialogues which creditors would be free to attend on a voluntary basis. There is also a risk that some debtors may seek to take advantage of such dialogues to launch restructuring negotiations. If regular meetings involve fewer coordination problems, they also lower the barrier to attempts to negotiate new terms with creditors. Some of the further obstacles to a more intensive dialogue include the highly sensitive nature of some country information, the preference of some important investors for individual talks, and the desire of many bondholders to remain anonymous.[53]

Existing institutions, like the Paris Club or the IMF, could also offer dialogue forums. The IIF proposes stetting up a so called private advisory group which would consist of private financial institutions and could organize a regular dialogue with other market actors.[54]

The Council in Foreign Relations[55] recommends instituting a dialogue on the basis of ad hoc steering committees. A steering committee would be set up when a debtor country is in financial difficulties; it would be made up of the country's most important private sector creditors. All parties concerned – the debtor country, the Paris Club, and other international organizations – would work together with this group.[56] Since a committee would be convened only when a debtor country is threatened with insolvency, this approach could send out a negative signal. For this reason dialogue forums should meet regularly and in particular in situations where a debtor country is not financially embarrassed. Concrete experiences

51 Most authors focus on the instrument's preventive character. See Deutsche Bundesbank (1999), p. 43; IIF (1999b), p. 3; IMF (1999), p. 8 and (2000e), p. 120; Speyer (1999), pp. 8–9.

52 See IIF (1999b), p. 33; Speyer (1999), p. 9.

53 See Eichengreen (1999), pp. 75–77; IMF (2000e), pp. 120–121; Speyer (1999), p. 9.

54 See IIF (2002), pp. 37.

55 The Council on Foreign Relations, a nonprofit organization founded in the US in 1921, is concerned with problems involving US international relations.

56 See Council on Foreign Relations (2000).

with dialogue forums have been made in Mexico, Russia, and Korea.

Mexico

In 1996, in response to the 1994/95 financial crisis, an Investor Relations Office was set in the Mexican finance ministry. The office prepares quarterly reports for investors, an activity which includes telephone conferences for analysts and investors to insure that information is exchanged on an ongoing basis. In addition, Mexican government representatives travel to the major financial centers to discuss the most recent developments in financial markets. All in all, in setting up the Investor Relations Office Mexico has assumed a model function for other countries.[57]

Russia and Korea

Just after its moratorium had been imposed, in August 1998, Russian government representatives met with a small group of Russian and foreign banks to discuss setting up a creditor committee. But since many creditors did not attend, a decision was taken to start out by preparing a complete list of creditors. In addition, the parties attending were unable to reach agreement on the make up of the creditor committee. One other problem that emerged was that representatives of hedge funds demanded to be included in the negotiations, which was not originally intended. This example clearly indicates how difficult and time-consuming it may prove to set up creditor committees during a crisis.[58]

57 See IIF (1999b), pp. 3 and 9–10; Speyer (1999), p. 9.

58 See Eichengreen (1999), p. 75.

5 Approaches to Involving Private Creditors in the Resolution of Debt Crises

The most important approaches to involving private creditors in the resolution of debt crises would include the establishment of international insolvency procedures, inclusion of collective action clauses in sovereign bond issues, agreement on exit consents, standstills, and conversion of short-term banks loans into long-term loans.

5.1 The IMF Proposal on an International Insolvency Procedures: the Sovereign Debt Restructuring Mechanism (SDRM)

In November 2001 the IMF advanced a first proposal on establishing an insolvency procedure; the proposal has been amended several times since then.[59] The main feature of an international insolvency procedure would be that it required countries to restructure their foreign debts in accordance with given rules and on the basis of a majority creditor decision which would have binding force for minorities. Since an insolvency procedure would constitute an innovation, in particular as far as the debt held by private creditors is concerned, the procedure would most likely be used chiefly by emerging markets.

59 The most important amendments of the IMF proposal on a new international insolvency procedure were published by the IMF and by A. Krueger in 2002 und 2003. See IMF (2002a), (2002c), and (2003a); Krueger (2001), (2002), and (2003). Aside from the IMF proposal, the discussion in the literature has centered in essence on two other proposals. The first would formulate an international insolvency procedure along the lines of the procedure governing municipal insolvency in the US (Chapter 9). In the second proposal representatives of NGOs recommend a Fair and Transparent Arbitration Process (FTAP) that would accord equal rights to all parties involved. See Kaiser / Schröder (2002); Paulus (2002); Rogoff / Zettelmeyer (2002); and Raffer (1990) and (2000).

5.1.1 Reasons for the Introduction of an International Insolvency Procedure

An insolvency procedure would pave the way for involving private creditors in the resolution of debt crises. A further reason to adopt an international insolvency procedure is that at present there is no satisfactory procedure, or roadmap, available to restructure the foreign debts a of country faced with insolvency. At present, unregulated and long-drawn-out restructuring processes often stand in the way of a swift solution, as for instance in the cases of Argentina or Brazil, and these processes are very costly both for creditors and debtors.

The lack of an insolvency procedure also frequently induces highly indebted countries to draw out a restructuring process because they fear the high costs associated with restructuring.[60] Delays in starting out with a restructuring process are due, among other things, to uncertainties bound up with the process. This goes in particular for heterogeneous creditor groups, faced as they are with substantial collective action problems that tend to place difficulties in the way of reaching a prompt agreement. In addition, information deficits concerning the treatment accorded to different creditor groups constitute a hindrance to the restructuring process.

Compared with a timely restructuring, these delays lead to high costs that find expression in debtor losses of currency reserves. A speedy restructuring of debt is in the interest of debtors and creditors alike because timely restructuring contributes to safeguarding the value of claims. Furthermore, timely restructuring minimizes uncertainties regarding claims. Such uncertainties increase the risk that investors may sell their claims, depressing prices in the secondary markets.[61]

60 In its publications, the IMF offers a good overview of restructuring processes in various countries. See IMF (2002b).

61 See IMF (2002a); Roubini / Setser (2003), p. 3.

5.1.2 Objectives of an International Insolvency Procedure

In the opinion of the IMF, an **international insolvency procedure** should pursue the following objectives:[62]

- to prevent debt, monetary, and financial crises and in this way to strengthen the international financial architecture;
- to ensure that private creditors are involved in a comprehensive debt restructuring process;
- to ensure an orderly, predictable, and rapid restructuring process;
- to safeguard assets and creditor rights;
- to lower the restructuring costs borne by creditors and debtors;
- to improve the efficiency of the international capital markets.

5.1.3 Features of the IMF Proposal: the Sovereign Debt Restructuring Mechanism

The IMF proposal on an international solvency procedure contains the following features:[63] Only **debtors with unsustainable debt** would be permitted to **open** an insolvency procedure. This means that neither creditors nor the IMF would be in a position to impose an solvency procedure. An insolvency procedure would be opened when a debtor is unable to repay his debt on his own, i.e. when a sovereign debtor is unable to resolve his economic problems on the basis of his own economic policy and his debt is no longer sustainable.[64] The opening of an insolvency procedure

62 See Krueger (2002), p. 4.

63 See IMF (2002c), (2003a).

64 The IMF's First Deputy Managing Director, Anne Krueger, defines unsustainability as follows: "... It is a

need not automatically mean any surrender of **creditor rights**. This goes in particular for existing contracts, which, if possible, would remain in force.

An insolvency procedure would not include the following sovereign liabilities vis-à-vis public- and private creditors:

- All claims subject to national law.
- In addition, privileged claims, e.g. secured claims, would be excluded – although an insolvency procedure would include any part of these claims that is not secured.
- Debt held by international financial organizations would also be exempt, since these funds are provided at terms more favorable than those of other creditors. Provision of fresh funds on favorable terms would be jeopardized if international financial institutions were included.

As far as other types of credit are concerned, the IMF would permit the debtor to choose which credits to include in the procedure, e.g. trade credits or sovereign bond issues. The decision on what should be included in the procedure would be made contingent on a country's specific economic situation.

Since different **debt types** can be broken down into various classes, they can be accorded different treatment in a restructuring process. This means that each class would have to agree separately to a restructuring process.

The debtor would not **suspend** his **debt service** at the same time as an insolvency procedure is opened, since in this case **acceleration clauses** could serve to trigger or exacerbate a crisis. Most credit agreements contain an acceleration clause; it gives the creditor the right to demand repayment of his overall claim as soon as the debtor has missed one instalment of his debt service payments. Creditors can also secure their right to demand repayment of their overall claim with the aid of cross default clauses. The latter can be also used by bondholders to demand immediate repayment if a debtor defaults on a different bond issue.

As regards a general **stay of litigation**, the IMF recommends a middle course which advocates a stay for a brief period to allow creditors to agree on an extension.

New loans provided in the restructuring phase should be exempt from restructuring if this arrangement finds the support of creditors holding at least 75 % of the claims involved. This preference for new loans is intended to offer creditors an incentive to provide fresh credit in a phase in which a debtor's creditworthiness is seen as weak.

An solvency procedure should provide for decisions based on clear majorities (so called super majority votes). Under the IMF proposal a majority vote of this kind would mean that creditors would require a quorum of creditors representing at least 75 % of the overall volume of the debt concerned. This would enable creditor majorities to involve minorities in a restructuring process, in this way avoiding holdout problems and paving the way to speedier agreement among creditors.

A **creditor committee** would ensure a timely and active participation of creditors in an insolvency procedure. In cases of disagreement over the makeup of the committee, a so called **Sovereign Debt Dispute Resolution Forum (SDDRF)** would be authorized to decide. Its costs would be borne by the debtor.

An SDDRF style arbitration board would be responsible for the following tasks:

- administrative functions, e.g. notification of creditors, registration of claims, and holding of votes;

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circumstance when, regardless of the sovereign's efforts, debt relative to GDP (and therefore debt servicing relative to GDP) will grow indefinitely, in those circumstances, the economic net present value of the sovereign's debt is less than the face value of the debt; moreover, it will likely continue to fall until a restructuring is undertaken and growth resumes." Krueger (2003), pp. 2–3.

- dispute settlement;
- administration of votes on debtor restructuring proposals; and
- an obligatory certification of the outcome.

In its actions, the arbitration board should be as independent and transparent as possible, based perhaps on the model of the IMF's Independent Evaluation Office.

An insolvency procedures would be seen as **complete** once the SDDRF had certified an agreement reached by the parties. The debtor would have the right to terminate the insolvency procedure at any time. Furthermore, the SDDRF would be authorized to terminate the insolvency procedure prior to an agreement between debtor and creditors if it sees no prospects of a successful restructuring process.[65]

As a means of ensuring that the debtor pursues an appropriate reform policy and does not take advantage of the insolvency procedure for his own ends, restructuring would be made contingent on certain conditions which the debtor would be required to meet. In addition, some safeguard clauses/securities would be required:

- A debtor country would be required to demonstrate that it was using a stay of litigation to work actively in the interest of a suitable restructuring process and was pursuing an economic policy geared to coming to grips with his debt problems.
- During a standstill the debtor would be obliged not to take any measures detrimental to his creditors; e.g. he would agree not to make any payments to preferred creditors.

In connection with its adjustment programs the IMF would have the power to impose **sanctions** if the debtor, in violation of the Articles of Agreement, provided incorrect information to his creditors.

The most recent proposal of the IMF would provide for a more limited role for the IMF. The formal **role of the IMF** would be limited to amending its Articles of Agreement to include the SDRM. The IMF's role, would, however, not only be restricted to this formal act, because, in connection with on its country program work, the IMF is in any case involved in analyzing debt sustainability, and this would serve make it an important actor in the framework of an international insolvency procedure.

5.1.4 Assessment of the Proposed International Insolvency Procedure

The proposed insolvency procedure is generally well suited to involving private creditors in a comprehensive restructuring process. The SDRM can not only prevent international financial, monetary, and debt crises, it can help to solve them as well. The three coordination problems outlined above – rush to the exit, rush to the courthouse, and the holdout problem – can largely be resolved on the basis of this international solvency procedure. An international solvency regime is the only comprehensive instrument available to coordinate various creditor groups holding different classes of debt both prior to and during a debt crisis.

Advantages of an international solvency procedure

One important advantage of the SDRM is that it would largely provide the means needed to solve the three coordination problems – rush to the exit, rush to the courthouse, and the holdout problem. An international insolvency procedure is furthermore the only proposal advanced thus far on restructuring sovereign debt that would be able to solve the problem of aggregation of various debt classes and grouping debt within these classes. A country's foreign debt would in this case be restructured in the framework of an international

65 See IMF (2002c), p. 10.

regime, and not, as is presently the case, under different national legal systems. In addition, an insolvency procedure could serve to ensure that private creditors are involved in a comprehensive debt restructuring process.

Moreover, the SDRM would set incentives for a timely restructuring because the procedure provides for an orderly and predictable course of the restructuring process. This would serve to increase transparency and the predictability of credit risks. This would make it possible to reduce creditor and debtor costs stemming from delayed restructuring. Looked at in terms of development, an insolvency procedure would benefit debtors countries by providing them with the possibility of engaging in a speedier and more orderly restructuring process that would involve lower social costs. This can contribute to reducing poverty in debtor countries.[66]

Some general disadvantages of an international insolvency procedure

Critics of an international insolvency procedure argue, first, that insolvency procedures serve neither to prevent nor to resolve financial and debt crises. Furthermore, it is claimed, an insolvency procedure can do nothing to avert capital exodus or a rush to the exit. An insolvency procedure, it is further argued, may even lead to a financial crisis in debtor countries, since the first sign or indeed the announcement of an insolvency procedure would induce private actors to withdraw their capital from a debtor country.[67]

The second point of criticism is that it would take a relatively long period of time to implement an insolvency procedure, since the procedure would have to be translated into national legislation, i.e. all countries would have to ratify the procedure. Third, evaluation of sovereign assets is bound up with substantial problems. Fourth, an insolvency procedure would impair national sovereignty because debtor countries would be subject to international law during the course of a restructuring process. It is relatively difficult to threaten sovereign debtors with punitive sanctions, since it is as good as impossible to back up, or to enforce, credit securities by agreeing on a possible seizure of individual state assets.[68]

One further weakness of the proposed insolvency procedure is that it could foster debtor moral hazard. The proposed insolvency procedure would make it easier for debtors to initiate a restructuring process. This would make it possible for debtor governments to take advantage of the procedure e.g. to benefit from debt relief or restructuring without actually implementing the reforms agreed upon.[69]

Some specific disadvantages of the IMF proposal on an international insolvency procedure (the SDRM)

The IMF's proposal has come in for particular criticism on the following points:

- It does not provide for a stay of litigation,
- the volume of the credits that would fall under the SDRM,
- the role foreseen for the IMF, and
- the functions and tasks of the Sovereign Debt Dispute Resolution Forum (SDDRF).

One much discussed feature of the SDRM is the **stay of litigation** it provides for. Having come out for a stay in its first proposal and against one in its second, in its third proposal the IMF has opted for a compromise between the two extremes: a temporary stay that can be extended only on approval of the creditors involved.[70]

66 See Jewett (2003); Roubini / Setser (2003).

67 See EMTA et al. (2003).

68 See EMTA et al. (2003).

69 See Zenker (2002), pp. 12–13.

70 See IMF (2001), (2002c) and (2003a).

The following arguments speak in favor of a stay: first, introduction of a stay would pave the way for a speedy restructuring process. This procedure would give creditors an incentive to embark on negotiations. Second, a stay would contribute to an equitable treatment of all creditors, since payments to creditors would be ruled out during a stay. Third, a stay would give the debtor a grace period without requiring international organizations to provide any majors loans.

Those who object to a stay claim that some payments would have to be made to keep the economies of debtor countries afloat. Payment of trade credits, for instance, would not be suspended so as to permit a debtor country to maintain its foreign trade. Furthermore, a stay that automatically takes effect when a sovereign initiates an SDRM would constitute a unilateral intervention in creditor rights. In addition, a stay would in any case not be necessary in that under the SDRM creditors would have no incentive to go to court; after all, a court decision would take more time to obtain than a settlement under the SDRM.[71]

Two alternatives to a stay have been proposed. The first is the so called **hotchpot rule**, which is aimed at restoring equal treatment of all creditors. Under this rule a creditor who had received payments in connection with litigation initiated after the opening of an insolvency procedure but prior to a restructuring process would, at the end of the restructuring process, receive the same sum as all other creditors. The condition here would be that the creditor's litigation had yielded him less than he would have been entitled to under a restructuring procedure. This would mean that litigation prior to restructuring would offer no advantages for creditors. The second solution proposed is a **return** of funds that a creditor has received after an insolvency procedure has been opened. A debtor or an agent authorized to represent established claims of creditors would be entitled to these funds.[72]

Another contentious issue is the question of **what claims** would be restructured under the SDRM. The principle of equal treatment of all creditors would speak for inclusion of all types of credits. For this reason the IMF and other public sector creditors would not enjoy privileged status. It can, however, be objected here that inclusion of multilateral institutions (like the IMF) would be unjustified because of the limited amount of financial resources available to, say, the IMF. If during the course of an international insolvency procedure some of these resources are used for a few countries that had already opened an insolvency procedures, the IMF would then have proportionately fewer resources for other countries.

There is also dispute on whether **bilateral creditors** should be included in restructuring procedures. While the IMF proposal provides for a parallel negotiation process in the Paris Club, private creditors demand that bilateral public sector creditors should also be involved on an insolvency procedure as a means of guaranteeing equal treatment for all creditors. One further advantage bound up with inclusion of bilateral public sector creditors would be that the latter, like the private creditors, primarily provide trade credits. Moreover, the bilateral public sector creditors constitute the most important group of creditors outside the private sector. If the public sector bi- and multilateral creditors were not included, the only claims restructured under the SDRM would be those held by private creditors. Moreover, inclusion of bilateral creditors would also mean involvement of bilateral creditors countries that are not members of the Paris Club.[73]

One disadvantage of an inclusion of all credits in the SDRM – i.e. including those of public sector bilateral creditors who are members of the Paris Club – is that bilateral creditors often provide trade credits, in particular for exports. Credits of this kind are of course essential to the functioning of an economy. If export credits were blocked, the

71 See Roubini / Setser (2003).

72 See Balz (2003).

73 See Herman (2003), EMTA et al. (2003c).

economic risk would be that a country might be cut off from the world markets.[74]

The **IMF's role** in the SDRM has come in for criticism by NGOs,[75] in particular as regards the IMF's exempt creditor status, the appointment of members of the dispute resolution body, and assessment of debt sustainability.

NGOs have also voiced criticism of the limited role provided for the **Sovereign Debt Dispute Resolution Forum**.[76] They demand, for example, that an independent group experts should not only be authorized to make recommendations but should be given decision rights as well. A further demand is that the dispute body should be empowered to decide on the need to open an insolvency procedure; the reason for this is to prevent any possible debtor misuse of the SDRM. In order to preclude any litigation by individual creditors that might affect other creditors, the dispute resolution body should, it is argued, be empowered to suspend any legal action to enforce a claim. The dispute body should likewise be involved in assessing debt sustainability and be endowed with decision-making competence. In addition, the dispute body should be given the task of monitoring the process of claim verification and be empowered to decide on the legitimacy of claims. This verification process should go above and beyond purely technical and formal aspects.

One other aspect of the IMF proposal that has come in for criticism is appointment of **members** to the **dispute resolution body**, in which the IMF would play a key role. A representative of one NGO[77] has called for discussion of the following two possibilities. First, the parties involved could appoint representatives to the body on a parity basis, with the members subsequently electing an additional person as their chairmen. Second, a neutral group not involved in the negotiations could appoint the members of the body from a given pool of arbitrators. Comparing these two proposed approaches, we find that the first proposal accords a greater say to those involved in a restructuring process; they would therefore be more likely to identify with this proposal. However, the second proposal would be more practicable for a highly heterogeneous group of creditors, like bondholders, because this proposal would make it easier to elect the body, thus saving time.

Furthermore, the IMF proposal does not provide for a neutral third party to steer the dispute resolution process. A neutral arbiter is, however, needed to ensure an impartial and fair restructuring process. One alternative would be to establish an independent legal institution, e.g. on the model of a bankruptcy court of the kind provided for under Chapter 11 of US bankruptcy and settlement law.[78]

In the eyes of **NGOs**, the IMF proposal does not constitute a suitable concept for preventing financial crises and reducing the debt of developing countries. The IMF proposal, for instance, has little to say about securing minimum survival needs in debtors countries.

The IMF proposal provides for an IMF-conducted analysis of debt sustainability. While the IMF could conduct an analysis of this kind, the institution is not independent enough because of its dual role of creditor and auditor – although the IMF would be sufficiently independent if the claims of international organizations were not included in the procedure. This task should be assigned to an independent agency to rule out any monopoly position on the part of the IMF.[79]

74 See Herman (2003).

75 See Kaiser (2003a) and Kaiser / Schröder (2002).

76 See Kaiser (2003a) and van Hees (2003).

77 See Kaiser (2003a).

78 See Kwon (2003).

79 See Kaiser (2003a) and van Hees (2003).

5.2 Collective Action Clauses

The idea behind an introduction of collective action clauses is to simplify the restructuring of sovereign bond issues. Bond issues can, for instance, include collective action clauses that authorize a qualified majority of bondholders to involve minorities in contract modifications. These clauses are intended to provide an incentive to creditors and debtors to participate in restructuring processes.

Most actors in the international financial markets, including most banks, regard collective action clauses as a suitable instrument of both crisis prevention and crisis resolution. Collective action clauses are, however, only included in the bond issues of a limited number of countries. As a rule, such clauses are included in bond issues floated under UK and Luxembourg law. Bonds issued under US, German, and Japanese law, on the other hand, do not contain any collective action clauses.

5.2.1 Possible Formulations of Collective Action Clauses

Currently there are two main types of collective action clause – viz. **collective majority clauses** – that are written into bond contracts:

- **Majority restructuring provisions**: These enable a majority of creditors to involve all creditors of a bond issue in a projected restructuring process either prior to or after a default. The modifiable features of bond issues include, for instance, the interest rate, the due date, or the currency in which the debt is serviced. The size of the majority required differs from issue to issue. As a rule, decisions require the consent of a majority of creditors holding at least 75 % of an issue. If this minimum is not reached, a second meeting can be convened after a certain period of time – usually 15 days – has elapsed. In this case creditors holding only 2 % of an issue are authorized to make decisions.[80]

- **Majority enforcement provisions**: These clauses enable a majority of creditors to limit the rights of minorities following a default – e.g. the right of individual bondholders to demand accelerated payment or to sue to enforce their claims. These clauses thus give both a creditor majority and the debtor a chance to reach agreement on a restructuring process.[81]

Majority clauses can serve to prevent holdout behaviors. They make it possible for creditors, with a qualified majority, to modify the terms of a bond issue and thus to force through a restructuring procedure. This makes it less likely that minorities will be able to block a restructuring procedure; i.e. individual creditors are unable to take legal action because they need a majority to do so. This serves to reduce the coordination problem, paving the way for an orderly and speedy restructuring process.[82]

There are also some disadvantages involved, e.g. moral hazard risks on the debtor side. The fact that majority clauses limit the coordination problems involved in restructuring, simplifying the process, entails the risk that debtors may seek to take advantage of majority clauses. A debtor could e.g. demand restructuring without actually being faced with liquidity problems. Majority clauses may, in other words, constitute an incentive for debtors to seek to evade their payment obligations. Accordingly, bond issues with such collective clauses may lead to higher interest levels because creditors tend to rate these issues as more risky than issues without collective clauses. One approach to encountering this negative effect would be for industrialized countries to adopt such clauses.[83] It is, though, questionable whether

80 See IMF (1999), p. 49 and (2002d), pp. 4.

81 See IMF (2002d), pp. 10–12.

82 See Haldane (1999), p. 195; Roubini (2002a), p. 5; Speyer (1999), p. 14.

83 See Eichengreen et al. (2000c), p. 12; Frenkel / Menkhoff (2000), p. 98; Speyer (1999), p. 14.

this would in fact lower risk premiums for developing countries, since interest levels are determined by anticipated risk, which is of course far lower in industrialized countries than in developing countries.

While it is true that majority clauses simplify an orderly restructuring by preventing minorities from disrupting the negotiation process, these clauses do nothing to simplify the problems involved in contacting and negotiating with a broad and heterogeneous group of creditors. This is the reason why there are discussions on new types of clauses that have not yet been written into bond issues; these include e.g. **sharing clauses** or **collective representation clauses**.[84]

Sharing clauses can be used to prevent creditors from selling their bonds (rush to the exit) as soon as they begin to fear that a financial crisis might be in the making. In addition, sharing clauses can serve to avert creditor litigation. These clauses require creditors who have received interest and redemption payments to share them with other creditors. Syndicated credits, which normally contain sharing clauses, could be used as a frame of reference for these clauses. The effect of such clauses is to oblige every bondholder to share every payment he receives with other bondholders on a proportional basis. The idea is to prevent any creditor from profiting from payments he receives prior to other bondholders, and this is why sharing clauses require creditors to share proceeds from earlier enforcement with other creditors.[85]

Collective representation clauses are intended to accelerate the convocation of a representative forum at which both creditor and debtor positions are aired. The reason for this is that it is difficult for **creditors** to contact a heterogeneous group of creditors and engage them in negotiations. These clauses make it possible for bondholders to be summoned to joint creditor meetings and to appoint a representative for negotiations, e.g. a trustee or other bondholders.[86] The **engagement clause** proposed by former US Treasury Department undersecretary Taylor, which provides for bondholders to appoint a representative for negotiations with a debtors, bears a certain resemblance to collective representation clauses. Under the engagement clause the representative would assume the function of an intermediary.[87]

These clauses have their advantages and their disadvantages. On the one hand, they serve to facilitate early debtor-creditor and intercreditor contacts. On the other hand, some market actors fear that the need to appoint an intermediary could delay the restructuring process by preventing any direct negotiations between the two parties concerned.[88]

Since collective action clauses are used only for individual bond issues, they cannot be seen as a comprehensive instrument. Under such clauses it is, for instance, not possible to aggregate a number of different debt instruments, and this means that the collective action would continue, at least in part, to constitute a problem. One solution to this problems might be sought in **aggregation provisions** which serve to aggregate bond issues and other debt instruments for creditor decision processes. However, private actors in the international financial markets reject such clauses, noting that aggregation makes it possible to manipulate decision processes of groups of creditors that hold different claims on a debtor.[89]

Box 6 presents features of bonds, in addition to collective action clauses, that are issued under different legal systems.

84 See IMF (2002d), pp. 2.

85 See Dixon / Wall (2000), p. 143; G10 (1996), p. 17; IMF (2002d), p. 15; Yianni (1999), p. 79.

86 See Buchheit (2000), pp. 19-20; Dixon / Wall (2000), p. 143; G10 (1996), p. 16; Yianni (1999), pp. 78–79.

87 See Taylor (2002a) and (2002b).

88 See IMF (2002d), p. 16.

89 See IMF (2002d), p. 18.

Box 6: Comparison of Bonds Issued under Different Legal Systems
As a rule, bonds issued under **UK and Luxembourg law** contain **collective action clauses**. These make it possible for debtors, bondholders, and trustees to convene meetings. If a qualified majority is present, even the bonds held by absent creditors can be restructured. The rules on required majorities differ from issue to issue. The usual rule is that the creditors attending must hold at least 75 % of the issue. If this minimum is not reached, a second meeting can be convened after a certain period of time – usually 15 days – has elapsed. In this case the creditors present need to hold only 25 % of an issue to come to a decision. Under **UK, German, or Japanese** law individual bondholders are entitled neither to demand **acceleration** nor to sue to enforce their claims. However, a trustee administering at least 25 % of the capital involved is permitted to initiate litigation and to demand acceleration. The trustee is obliged to share all payments received with other bondholders on the basis of their relative shares of the overall capital involved. This is in effect a sharing clause designed to remove any incentive for investors to take legal action to enforce their claims. At the same time, this arrangement constitutes an incentive for creditors to consent to an orderly restructuring process. Bonds issued under **US law** do **not contain collective action clauses**, i.e. here qualified majorities do not have the right to amend the terms of bond issues. Compared with bonds issued under UK law, individual investors are in this case entitled to sue to enforce their claims. There are limits here on the option to call for acceleration. As opposed to UK law, US law does not provide for a trustee, though it does provide for a fiscal agent who does not represent bondholders in negotiations. This fiscal agent acts more in the capacity of a representative of the debtor side and is mainly entrusted with administrative tasks.
Sources: BIS (1999), p. 23; Buchheit (2000), pp. 7–8; Eichengreen / Mody (2000a), p. 6; IMF (1999), p. 49

5.2.2 Scope of Collective Action Clauses

Most sovereign bonds issued in the international financial markets do not contain collective action clauses. In total, the volume of outstanding international bond issues was US $ 350 bn at the and of 2001 (Table 3). Of these, 59 % were issued under New York law, 24 % under UK law, 10 % under German law, and roughly 6 % under Japanese law.[90]

Between 1990 and 2000, 51.4 % of all new bond issues and 46.5 % of sovereign bond issues were floated under UK and Luxembourg law (Table 4). By comparison, the overall volume of bond issues floated under US, German, and Japanese law – 29.4 % and 36.4 %, respectively – was lower.

The number of new bond issues floated in developing countries without collective action clauses was nearly twice as high as the number containing collective action clauses. But if the objective is to involve private creditors in preventing international debt crises, it would be essential to include collective action clauses precisely in bond issues floated by developing countries.

90 See IMF (2002d), p. 3.

Table 3: Stock of Outstanding Bonds by Jurisdiction (End 2001)			
Jurisdiction	**in % of total**	**Number in m US $**	**Number of bonds** (excluding Bradies for US)
Great Britain	24.1	85,182	156
Germany	10.1	35,864	89
Japan	5.9	20,716	59
USA	59.1	209,199	233
Others	0.8	3,168	21
Total	**100.0**	**354,129**	**558**
Source: IMF (2002e), p. 5			

Table 4: Bonds Issued under Different Legal Systems, 1990–2000, in % of Total Bonds Issued under a Given Legal System						
	UK	**US**	**German**	**Japanese**	**Luxemb.**	**Others**
All bond issues	46.2	18.8	8.7	1.9	5.2	19.2
Sovereign bond issues	45.0	14.7	12.2	9.5	1.5	17.0
Developing countries	30.6	27.5	19.4	13.1	1.9	7.5
Asia	31.7	36.5	3.6	27.0	-	3.2
Latin America	27.5	38.7	22.9	5.3	-	5.6
Europe/others	28.5	15.3	23.0	20.4	5.1	7.7
Source: Dixon/Wall (2000), p. 146						

5.2.3 Assessment of Collective Action Clauses

By requiring the participation of minorities in decisions taken by a qualified majority on amendments of bond contracts, collective action clauses contribute to tackling three collective action problems faced by heterogeneous creditor groups:

- The **holdout problem**: Majority clauses make it more difficult for individual creditors not to participate in a restructuring process, seeking instead to wait until the debtor is in a better financial situation in order then to enforce 100 % of their claims.

- The **rush to the courthouse problem**: Collective action clauses make it more difficult for individual creditors to take recourse to litigation to enforce their claims.[91]

- The **rush to the exit problem**: Collective action clauses such as e.g. **sharing clauses** can serve to prevent creditors from selling their bonds as soon as they see a risk of a financial crisis.

91 See IMF (2002e), p. 3.

Even though collective action clauses are accepted by most private actors as well as by representatives of emerging markets, industrialized countries, and international organizations like the IMF, they are bound up with a number of disadvantages. First, collective action clauses are **not comprehensive instruments** for the restructuring of public and private debt since they rule out any aggregation of different debt instruments. Bondholders here decide on modifications of individual bond issues, and not for all of a debtor's bond issues at the same time. For this reason collective action clauses continue to be bound up with holdout problems and problems with litigation between different debt instruments when different bondholder groups decide in favour of different solutions. Since aggregation clauses are also relatively impracticable, this instrument is suited to solving the collective action problem only for individual bond issues. Furthermore, while these clauses can be integrated into bond issues, they cannot be made part of bank loans or other credit instruments.[92]

Second, collective action clauses can be agreed on only for **new issues** and are therefore not applicable for a debtor's overall stock of old bond issues. This implies a transition problem that may be quite protracted since the bonds issued at present typically have terms of up to 35 years. An IMF study published in June 2000 found that it would be roughly ten years before most bond issues contained collective action clauses. The speed at which collective action clauses are written into international bond issues hinges on the volumes of new issues and the terms of outstanding bond issues as well as on the willingness of issuers to accept collective action clauses. Some 50 % of bonds already issued have a residual term of only five years – although the terms of the remaining bond issues are up to 35 years. In ten years some 72-73 % of bond issues would contain collective action clauses, after 15 years have elapsed the figure would be roughly 78-79 %, and in 20 years the corresponding figure would be 88 %. Even though after five years have elapsed some 50 % of bond issues would contain collective action clauses, the outstanding bond issues without collective action clauses would pose problems in coming up with a solution to the problem of collective action.[93]

As a contract-based approach to solving this problem, JP Morgan[94] has proposed converting old bond issues without collective action clauses into new issues with such clauses. The first phase of this approach would see conversion of old issues into new ones containing collective action clauses. The second phase would be used to define the conditions for restructuring. JP Morgan here proposes a carrot and stick approach. As a carrot to induce them to convert, creditors would be given a cash payment in advance, and exit consents would be used as a stick to make old bonds less interesting than new ones. Whether or not bondholders would accept a conversion of the kind would depend on the amount of the advance payment they receive as well as on the terms of conversion. One further point of criticism leveled at this proposal is that under it the IMF would finance this advance payment, which means that the IMF would have to appropriate the funds required. It is for these reasons questionable whether the approach is practicable. According to an IMF study, most private actors in the international financial markets reject a conversion of bonds without collective action clauses into issues containing such clauses.[95]

Third, there is a risk that introduction of collective action clauses could lead to a constant rise in risk premiums because bondholders fear that debtors might take advantage of these clauses. A number of empirical studies have looked into the impacts of collective action clauses on bond yields, but without coming to any clear cut results.

92 See Roubini (2002a), pp. 5–6.

93 See IMF (2002e), p. 11.

94 See Bartholomew (2002).

95 See IMF (2002e), p. 6.

Dixon / Wall[96] compared the yields of sovereign bonds with and without collective action clauses. The bonds investigated were denominated in the same currency and had the same terms and liquidity characteristics. The study found that collective action clauses had very little effect on the yields of bonds issued by the six emerging markets under study.[97] Since the number of countries investigated is low and the study did not take county risks into account, this result does not present a sufficient basis on which to assess collective action clauses.[98]

A study by Eichengreen / Mody[99] indicates that in less creditworthy countries collective action clauses lead to higher margins between interest on investment and interest on credit, although these margins tend to decline again for highly creditworthy countries. For the authors the explanation of this finding is that the advantages of collective action clauses, e.g. the chance of an orderly restructuring process which they present, outweigh the disadvantages, which include moral hazard risks and default risks.

A BIS study[100] finds that the yields of bonds issues under UK law are about 40 points higher than those issued under US law. However, the BIS also notes that this analysis is not statistically significant because factors other than collective action clauses play a more important role here – for instance the possibility to trade bonds in the US.

The costs for the **first issuer** of sovereign bonds with collective action clauses could prove to be higher than they would be for subsequent emitters. The reason why the first mover would be faced with this disadvantage is that it would take some time for the market to accept bonds with collective action clauses issued under New York law.

Furthermore, a signal problem occurs when a country issues bonds with collective clauses under a legal system in which collective clauses are not customary. Market actors could interpret the inclusion of collective action clauses as a sign that the issuing country is aiming for a future restructuring procedure involving collective action clauses. This problem would not occur if all bond issues contained collective action clauses.[101]

5.3 Exit Consents

One problem frequently encountered in a restructuring of sovereign bonds involving conversion of an old bond issue into a new one is that some bondholders will withhold their consent and are thus not prepared to accept conversion. Collective action clauses make it possible to involve a minority in a restructuring procedure. But bonds issued under e.g. US law contain no collective action clauses, which means in effect that modifications of payment terms require the consent of all bondholders.

But there is one possibility for a simple majority and the issuer to agree on an amendment of the terms of a bond contract without actually changing the terms of payment. Such modifications are referred to as **exit consents / exit amendments**. These amendments are used to penalize bondholders who decline to participate in a restructuring process, seeking in this way to avoid any losses. In this case the contract on an old bond issue is amended in such a way as to make the old issue less attractive than a new one. Such amendments may, for instance, include:

- Reduction of bond liquidity: Old bonds are no longer listed on stock exchanges and are thus barred from trade.

96 See Dixon / Wall (2000).

97 These countries are China, Lebanon, the Philippines, Poland, Turkey, and Hungary.

98 See Dixon / Wall (2000), pp. 146–147.

99 See Eichengreen / Mody (2000a), pp. 15.

100 See BIS (1999), pp. 21–22.

101 See IMF (2002e), p. 10.

- Abandonment or dilution of financial contract clauses: It is possible to cancel financial clauses, e.g. cross default clauses. These clauses enable bondholders to demand immediate payment from a debtor who defaults on another bond issue.

- Cancellation of clauses that generally permit bondholders to participate in a debt restructuring process.

- Waiver of sovereign immunity: In this case a sovereign issuer, acting in his capacity as a party to a contract (i.e. as debtor), waives his immunity in a bond contract. This waiver of immunity can in turn be cancelled on the basis of exit consents.

- Agreement on redemption free periods.[102]

The objective of exit consents is to prevent hold-out behaviors on the part of creditors.[103] This serves to make original bond issues less attractive for creditors than the new bonds offered in connection with a restructuring process. On the one hand, amending the terms of old bond issues can reduce their value in secondary markets. On the other hand, this approach can make it more difficult for holders of these bonds to sue to enforce their claims.[104] This sets an incentive for creditors to participate in restructuring.

Assessment

Even though exit consents have thus far only been used in Ecuador and Ukraine, the instruments plays an important indirect role by serving as a debtor threat potential for restructuring processes – although a debtor who sought to force through a restructuring process with the aid of this instrument would of course be running the risk of damaging his reputation.

One major advantage of exit consents is that they make it impossible for a creditor minority to take advantage of a majority, e.g. by engaging in hold-out tactics. Compared with collective action clauses, exit consents offer the advantage that they do not require amendment of either laws or bond documents. Since exit consents can only be used if a majority of creditors consent to a debtor country's restructuring proposals, a debtor cannot be sure in advance that his proposals will be accepted. Seen in these terms, exit consents indirectly strengthen the negotiating position of creditors.[105]

Exit consents do, however, also have some disadvantages for creditors and debtors alike. Since exit consents can be formulated in a great number of different ways and contracts do not specify which exit consents can be used by debtors, creditors are unable to anticipate what amendments of contract terms debtors might opt for. Viewed from the creditors' point of view, exit consents are bound up with uncertainties. From the debtors' standpoint, use of exit consents can make it difficult to regain the confidence of bondholders following a restructuring procedure and to bring their debt into a sustainable form.

Ecuador

Since no collective action clauses had been included, the Ecuadorian government decided, for the first time, to use exit consents in restructuring its sovereign bond issues. The aim was to weaken the contractual rights of bondholders unwilling to participate in restructuring. The contract amendments adopted included e.g. cancellation of cross default clauses and reduction of bond liquidity; the old bonds were no longer listed on the Luxembourg stock exchange and thus could no longer be traded there.[106]

102 See IMF (2001a), pp. 8 and 11.

103 See IMF (2002e), p. 19.

104 See Buchheit / Gulati (2000).

105 See Buchheit / Gulati (2000).

106 See Buchheit (2000), pp. 23–24; IMF (2001a), pp. 8 and 11.

5.4 Standstills

In the literature there is no uniform definition of the term standstill. The G10 distinguishes between standstill and moratorium. Under a standstill the debtor suspends his payments, with creditor consent, for a given period of time. By comparison, the main feature of a moratorium is that the debtor decides unilaterally to suspend payment. But the boundary between these two types of suspension of payment is not clearly defined, and a moratorium can win the tacit approval of creditors after the fact.[107] For the IMF there is no difference between standstill and moratorium: standstill is the generic term used for measures aimed at reducing net debt payments.[108] The present study subscribes to the IMF's definition.

A standstill can involve different types of debt instrument, e.g. sovereign bonds or bank loans. The instrument can be used by both private and public sector debtors.[109] A voluntary standstill has better chances with a homogeneous group of creditors – like those involved e.g. in interbank loans – than with heterogeneous creditor groups – e.g. holders of sovereign bonds. Furthermore, it is easier to reach agreement on a voluntary standstill if the creditors concerned are interested in conducting business on a long-term basis, such as e.g. in the case of trade and bank loans.[110]

Assessment

This instruments can be used to limit three problems bound up with collective action – the **hold-out** problem, the **rush to the exit** problem, and the **rush to the courthouse** problem. A standstill agreed upon between creditors and debtor can serve to prevent a creditor minority from disrupting a cooperative negotiation. Furthermore, a standstill makes it more difficult for creditors to sell their debt instruments. It would be possible to prevent litigation by amending the IMF's Articles of Agreement – in particular VIII2b – to include the instrument.

The main advantage of a standstill is that it gives the debtor time to improve his liquidity situation. When a liquidity crisis occurs, a standstill of debt service payments can help to limit the option of a rush to the exit or a rush to the courthouse.[111]

One disadvantage of a standstill is the risk that the measure may be adopted by other countries, i.e. that investors may fear standstills in other countries as well. This entails a risk that investors may withdraw their capital from other countries that have not yet imposed a standstill with an eye to securing their capital before debt service payments are suspended; in other words, even an expectation that a standstill may be in the works may trigger a crisis. This problem can only be resolved on the basis of clear cut rules that provide for an automatic standstill under certain specific conditions.[112] In addition, the standstill option may encourage moral hazard on the part of debtors.[113]

Another disadvantage of standstills is that a debtor who imposes a standstill risks losing his reputation. Creditor fears that a standstill may be imposed again the future tend to raise risk premiums and thus the debtor's interest costs as well. Indeed, there is even a risk that by imposing a standstill a debtor could lose access to the international financial markets.[114]

107 See G10 (1996), p. 21.

108 See IMF (2000b), p. 18.

109 A distinction must be made here between suspension of interest payments and suspension of redemption payments. Since market actors regard interest payment as the more important of the two, they rate default on interest payments as more serious than default on redemption payments. See G10 (1996), p. 22.

110 See G10 (1996), pp. 19.

111 See Haldane (1999), p. 201. This advantage is of course only possible if a standstill does not lead to capital exodus and turbulence in exchange rates and stock prices.

112 See Lipworth / Nystedt (2000), pp. 13–14; Roubini / Frankel (2000b), p. 46.

113 See IMF (2000b), p. 5.

114 See Frenkel / Menkhoff (2000), pp. 93–94.

In view of the fact that a standstill can trigger a major capital exodus, capital controls may be imposed at the same time, as they were e.g. in Pakistan and Malaysia. In 1998 Pakistan froze all foreign-currency deposits, at the same time prohibiting the purchase of convertible currencies. In Malaysia capital controls were imposed mainly to prevent outflows of short-term capital.[115]

Russia

In August 1998 the Russian government imposed a 90-day moratorium on liabilities of resident legal entities. These included redemption payments to foreign creditors for loans with a term of over 180 days, insurance premiums, and liabilities stemming from currency transactions. An exception was made for debt service payments on sovereign bonds issued after the Soviet Union had been dissolved.[116] This moratorium covered debt of US $ 17 bn that was held by private foreign creditors and valued at the exchange rate noted prior to the crisis. In November 1998 the Russian government reached agreement with foreign banks on a restructuring of sovereign bonds amounting to US $ 10 bn. The foreign banks were given 90 % of their claims in bonds and 10 % in cash.

Even though Russia has improved its economic picture and regained access to the international financial markets, the moratorium weakened confidence in the Russian financial markets. Foreign investors withdrew their capital from the country: prior to the moratorium Russia's capital account was in surplus, following the moratorium it was in deficit.[117] In the wake of the Russian crisis, the moratorium also had adverse effects on the stock markets of other countries in the region, e.g. the Baltic countries.

Generally speaking a standstill is an emergency solution and should not be imposed unilaterally since a measure of this kind can adversely affect investor confidence for years. This can mean that a country may be cut off from access to the international capital market for a protracted period of time.

5.5 Conversion of Short-term into Medium-term Interbank Loans

Conversion of interbank loans is an important approach used to preserve debtor solvency. It serves above all to overcome crisis situations, its main aim is to restrict capital outflows. The approach is used to restructure existing liabilities. As a rule, this means extending the terms of loans in order to provide debtors with temporary relief. This calls for a timely and orderly conversion which does not lose sight of a country's institutional and political setting.

While conversion of private interbank loans provides temporary relief for debtors, enabling their banking systems to recover and preventing liquidity bottlenecks from spreading to the real sector, conversion does not wholly resolve the debt problem since it merely shifts the debt burden into the future. Furthermore, the usefulness of conversion depends in large measure on the size of the foreign debt of domestic banks.[118]

Between 1989 and 1996 the share of short-term bank loans provided to developing countries grew in relation to long-term loans from roughly 40 % to 56 %, fuelling the risk of crisis.[119] As was pointed out above with reference to Korea, short-term interbank loans can constitute a risk to the international financial system as a whole. In this case experts feared at the end of 1997 that a failure of attempts to convert Korea's interbank loans could trigger a crisis threatening the overall international

115 See IMF (2000b), pp. 20-21 and pp. 28–29.

116 See Buch et al. (2000), p. 33; DIW et al. (1998), p. 955.

117 See IMF (2001b).

118 See Kampffmeyer (1988), p. 43.

119 See BIS (2000).

national financial system.[120] But involvement of international banks in the resolution of short-term liquidity problems contributed in this case to averting a crisis of the international financial system. Private creditor banks were also involved in resolving liquidity problems faced by private banks in Indonesia and Brazil. The following examples show that conversion of short-term bank loans into medium- to long-term loans is an important instrument for involving private creditors in the resolution of international debt crises.

Korea

Short-term interbank loans were the main source of Korea's foreign debt. In December 1997 Korea's domestic banking system was hit by a liquidity crisis that threatened the whole of the international banking system. At this juncture Korea's financial situation was characterized by low currency reserves (US $ 6 bn) and interbank liabilities amounting to US $ 28 bn and due by February of the following year. The rating agencies had downgraded Korean banks by five points. The consequence of the deterioration of Korea's macroeconomic situation was that more and more capital was withdrawn from the country, and this in turn caused liquidity bottlenecks in the interbank market. In this situation even sovereign guarantees of US $ 20 bn and IMF loans of US $ 10 bn failed to reassure the markets.

On December 22, 1997, the Federal Reserve Bank of New York convened a meeting of the most important US banks with a view to convincing them of the need to restructure their Korean loans. Public sector international financial institutions also agreed to provide support. The banks concerned initially agreed to maintain their credit lines for at least one week. Similar meeting were held in all of the worlds important financial centers, including Japan, Germany, the UK, and France. In the end agreement was reached to complete the restructuring process by March 31, 1998. This agreement was supported by a debt-monitoring system set up by the Korean central bank and the IMF. This day-by-day surveillance of all Korean banks induced nearly all foreign banks to keep their promise to maintain their credit lines.[121]

The improved macroeconomic data published at the end of December/beginning of February 1998 encouraged many foreign banks (134) and other foreign financial institutions to agree to restructure short-term liabilities amounting to US $ 21.8 bn. This involved an extension of the terms of short-term loans due in 1998 to one, two, or three years. The creditor banks were able to chose between the three following alternatives:[122]

i one-year term at an interest rate based on the six-month LIBOR plus 2.25 % (US $ 3.8 bn);

ii two-year term at an interest rate based on the six-month LIBOR plus 2.5 % (US $ 9.8 bn);

iii three-year term at an interest rate based on the six-month LIBOR plus 2.75 % (US $ 8.3 bn).

The total short-term debt of Korean banks and business enterprises fell sharply from 1996 to 1998, with their share in Korea's overall debt declining from 56.6 % to 20.6 % (Table 5).

To mitigate the risk of possible high losses for the international banks involved, the Korean government furnished sovereign guarantees for all short-term loans with terms of up to one year (US $ 24 bn), which meant that foreign financial institutions now held claims against the Korean state.[123]

A survey conducted by the IMF found that the restructuring process in Korea was not conducted voluntarily by the market actors involved – international banks in particular – since these banks

120 See IMF (2000e), p. 130.

121 See IMF (2000c), pp. 130.

122 Although no one single creditor was allowed to convert more than 20 % into one-year bonds. See IMF (2000a), p. 31; Lane / Schulte-Ghattas (1999), p. 22.

123 See IMF (2000e), p. 133; Lane / Schulte-Ghattas (1999), pp. 22–23.

Table 5: Short-term External Liabilities of Financial Institutions and Enterprises in Korea

	1996	1997	1998
Short-term external liabilities in % of total external liabilities	56.6	39.9	20.6
Short-term external liabilities in bn of US $	93	63.6	30.7
Thereof: Financial institutions[a]	73	42.4	18.9
Domestic corporations	20	21.2	11.8

a Includes commercial banks, specialized banks, merchant banks, and development institutions.
Source: IWF (2000a), p. 35, Table III.3

had to be more or less pressured to participate. These experiences influenced other countries faced with similar problems. In the Brazilian crisis, for instance, the banks concerned were not forced to restructure because of a risk that foreign banks would have curtailed their credit lines for Brazilian banks.[124]

Indonesia

The devaluation of Indonesia's currency effected in summer/autumn of 1997 forced many domestic companies with liabilities with international banks denominated in foreign currency to default. In Indonesia only 10 % of the foreign debt concerned consisted of interbank loans. The remaining 90 % was debt of Indonesia's business sector, and this meant that restructuring had to focus primarily on maintaining credit lines for trade. One factor that made the restructuring process problematic was that the Indonesian government was initially unwilling to furnish sovereign guarantees. Coordination among banks also proved difficult because, unlike the case of Korea, none of the major industrialized countries (Japan, Germany, France, and the US) was prepared to assume a leadership role.

At the end of January 1998 the Indonesian government suspended its debt service to foreign private creditors, although it did provide guarantees for the foreign debts of Indonesian banks. Furthermore, in June 1998 Indonesian debtors and their foreign creditors reached agreement on a restructuring of business debts as well as on maintaining their trade and interbank credit lines. Loans from foreign banks that were due by the end of March 1999 were converted into new loans with terms of one to four years and at interest rates ranging between 2.75 % and 3.5 % plus LIBOR. The new loans were covered by a US $ guarantees provided by the Indonesian central bank. In addition, nearly all trade credits were extended for a further year at the rate in effect at the end of April 1998. The debt-monitoring system set up in March of 1998 was designed to ensure that the international bank loans agreed upon were not curtailed.[125]

Brazil

As in Korea, interbank loans played a central role in the Brazilian crisis (at end of 1998). In the second half of 1998 international banks curtailed their loans in Brazil by US $ 5.7 bn.[126] In the second quarter of 1998 US $ 6.6 bn in short-term interbank loans fell due; but only some US $ 4 bn. was restructured by the creditor banks, a conversion rate of 62 %.[127] From mid-October to mid-November 1998 the conversion rate in the interbank market for Brazil's ten largest banks declined to 20 %. During a calmer period due to the announcement that the IMF was to provide financial support, in December of 1998, the conversion rate for interbank credit lines rose to 70 %.

But the end of December saw the emergence of new pressures due to the fact the Brazilian congress failed to pass important reform legislation, and this caused investors to question the credibility of the existing exchange rate regime. In January/February 1999 the conversion rate again fell back to 65 %. In mid-March, however, some creditors announced their intention to maintain

124 See IMF (1999), p. 15 and (2000c), pp. 133–134.

125 See IMF (2000e), p. 131; Lane / Schulte-Ghattas (1999), p. 23.

126 See IMF (2000e), p. 131.

127 See Baig / Goldfajn (2000), pp. 15–16.

their interbank and trade credit lines for Brazilian banks at the levels of February 1999.[128]

Once this agreement had been announced, all bank loans dues were regularly rescheduled. In April 1999 some international banks raised the volume of their loans in Brazil, thus even going beyond the agreement that had been reached. This reason for this was that devaluation did not lead to a banking crisis, and many domestic banks were showing profits in the first quarter of 2001 and the Brazilian economy was well on the way to recovering from the negative impacts of devaluation.[129] Still, in the first half of 1999 foreign banks reduced the loans they provided to Brazilian banks by a total of US % 10.6 bn.[130]

6 Policy Recommendations

It can be noted here as a general conclusion that the sharp growth in and volatility of private debt instruments in the 1990s has led to a situation in which the public sector alone lacks the funds needed to avert or to resolve financial crises. What this means is that it is absolutely essential for the private and public sectors to share the financial burdens of restructuring by involving private creditors in restructuring processes. Furthermore, involvement of private creditors serves to reduce incentives for moral hazard on the part of creditors.

One single instrument is not sufficient to secure the involvement of private creditors in the prevention or resolution of international financial crises because the instruments called for have to be used complementarily, not as substitutes for one another. What is needed is therefore a toolkit consisting of instruments geared to preventing crises and instruments suited to resolve crises.

128 See IMF (1999c), p. 163.

129 See IMF (2000e), p. 132.

130 See BIS (2000).

6.1 Instruments to Prevent Debt Crises

In the future it would be important to focus more on preventing crises. Promising approaches to involving private creditors in the prevention of international debt crises include a code of conduct and contingent credit lines.

Code of conduct

The most important instrument for involving private creditors in the prevention of debt crises is a code of conduct for all market actors – creditors, debtors, and the public sector. An appropriately formulated code of conduct can contribute to setting out a roadmap describing how debtors and creditors can best coordinate debt restructuring in such a way as to ensure that a country's debt is sustainable. In crisis situations the code of conduct would serve to positively influence investor expectations and to facilitate cooperation between creditors and debtors.

For the following reasons, a code of conduct must be seen as an instrument complementary to an insolvency procedure. First, prior to the outbreak of a crisis a code of conduct can serve as an instrument of crisis prevention. Second, a code of conduct can contribute to improving the predictability of a restructuring process during the transition phase between a decision in favor of an insolvency procedure and its implementation. Third, a code defines principles of conduct to which the participants are bound during an insolvency procedures as well. A code of conduct is likewise an instrument that can be used to complement collective action clauses.

Since a code of conduct is voluntary in nature, it is necessary to create **incentives** for the actors in the international financial markets to adhere to such a code. One factor crucial to the effectiveness of a code of conduct is that it is accepted by the international community and that all of those involved develop a sense of ownership; and for this reason all parties concerned – creditors, debtors, and the public sector – should be involved in

the formulation, approval, and implementation of a code of conduct.

Such a code of conduct should be developed by a taskforce expressly appointed for the purpose. Once a proposal for a code has been worked out, the code should, in a second step, be approved by the private sector (represented by associations of private creditors like e.g. the IIF or the EMTA etc.), the public sector (represented e.g. by the IMFC or the IMF's Development Committee), and the issuers of sovereign bonds (G20, G24, or other relevant groups). As soon as the code has been approved by the relevant market actors, as proposed in large measure by the Banque de France, the following concrete steps should be taken by all parties concerned; their aim is to foster a smooth and effective implementation of the code.[131]

Role of the public sector: The public sector, including e.g. representatives of the IMF or the Paris Club, should assume an active role in reviewing the code of conduct. Even though, theoretically at least, restructuring negotiations could proceed without public sector participation, in practice this will not be the case. The experiences made thus far indicate that restructuring processes have been conditioned on an IMF program worked out prior to the final agreements reached by debtors and creditors.

- The **IMF** could promote the code's implementation by explicitly including the code of conduct in its programs and lending-into-arrears policy.

- The **Paris Club** could induce debtors to implement the code when debtors demand equal treatment of all creditors in connection with restructuring in the framework of the Paris Club; that is, when debtors demand that all creditors, and not just those belonging to the Paris Club, should be involved in restructuring processes, as has been agreed upon by the Paris Club.

Role of debtors: The emerging markets should signal their willingness to adopt a code of conduct, e.g. by including the code in the documents for sovereign bond issues. A list of countries that adhere to the code of conduct could be made publicly available, for instance on the model of the Special Data Dissemination Standards (SDDS).

Role of private creditors: These proposals show that it is possible to create an incentive mechanism for the debtor; but it is difficult to devise suitable incentives to induce creditors to comply with a code of conduct. Even if a creditor majority adhered to a code, it is always possible that a minority would decline to comply since a code of conduct would not be embodied in law.

The code of conduct should contain **principles** which apply for all actors concerned – creditors, debtors, and public sector institutions. The Trichet proposal for this reason offers a suitable framework for an appropriate code, which should be enlarged to include both principles from the code proposed by the private financial institutions and other principles. The individual principles of conduct set out by this enlarged Trichet proposal could be implemented in connection with the following measures:[132]

- **Early dialogue between debtors and creditors**: As a relatively neutral institution, the UN would be a good forum for a timely and regular dialogue between creditors and debtors. As opposed to the IMF or the World Bank, the UN is not dominated by the industrialized countries, and hence, at least in tendency, by the creditors.

- **Fair exchange of information among all parties concerned:** As soon as the negotiation process has got underway, it is essential to create a suitable framework that ensures that creditors are sufficiently informed on a debtor's financial situation. This would require data on a debtor country's economic pic-

131 See Banque de France (2003).

132 Some of these measures are contained in the Banque de France proposal. See Banque de France (2003).

ture, its outstanding debts, and a proposal on restructuring modalities. A debtor could, for instance in cooperation with the IMF, prepare a central database and make it publicly available.

- **Fair creditor representation:** The use of majority clauses for sovereign bond issues would be one possibility to guarantee a **fair** representation of creditors.

- **Speedy and cooperative negotiations:** A standstill agreed upon by creditors and debtor may serve to prevent a small number of creditors from disrupting a cooperative negotiation. Furthermore, a voluntary stay of litigation could serve to avert delays caused by creditors seeking to sue to enforce their claims. And exit consents could be used to give creditors an inventive to participate in restructuring.

- **Equal treatment of all creditors:** To guarantee that all creditors are **treated equally** during a restructuring process, negotiations should be as transparent as possible. Principles such as fair exchange of information among all parties involved or negotiation in good faith constitute important preconditions for a fair treatment of all creditors.

- **Negotiations in good faith:** Compliance with the principles of a code of conduct may be seen as evidence of an intent to negotiate in good faith. Furthermore, the parties to negotiations should agree to accept arbitration and mediation procedures that have been defined ex ante.

- **Maintenance of the debtor's financial standing:** One important instrument here is a temporary standstill on debt service designed to avoid depleting the debtor country's currency reserves. Another instrument that may play an important role in maintaining the debtor's financing capacity is the IMF's lending-into-arrears policy, under which, during a restructuring process, the IMF provides new loans, at the same time working out a reform program.

- **Speedy restoration of a crisis country's debt sustainability:** The IMF's programs and debt-sustainability analyses are an important instrument for use in restoring a country's debt sustainability. These IMF analyses offer creditors important background information which they need to work out, together with the debtor, a viable restructuring proposal.

- **Continued compliance with existing contracts:** Both debtors and creditors should guarantee that existing contracts will continue to be complied with.

- **No support for moral hazard behaviours on the part of private creditors:** Public sector credits should not encourage any moral hazard behaviors on the part of creditors.

- **Flanking economic-policies**: A debt restructuring process should be accompanied by suitable economic policies. These would include, for instance, a stability-oriented macropolicy as well as structural reforms in the financial and business sectors.

Over the medium-term a code of conduct could become established as customary law. One precondition for this would be that the code were formulated in such a way as to be acceptable to most of the parties concerned. It would be preferable for all parties concerned to give their official blessings to a code of conduct. It would, for instance, be conceivable for the parties concerned to recognize the code of conduct in the framework of a UN resolution, perhaps on the model of the Millennium Development Goals.

Contingent credit lines

Contingent credit lines are a good approach to involving private creditors in the prevention of crises. By providing contingent credits lines, the private sector can play a major role in easing the burden of the public sector. The volume of such credit lines should be geared to two variables: short-term capital movements and currency reserves. Since the main purpose of contingent

credit lines to ward off speculative attacks, which are usually triggered by short-term capital movements, these credit lines should be used to close the gap between short-term liabilities abroad and actual currency reserves.

If this instruments is to be used successfully, the following conditions should be in place: first, the private sector should provide contingent credit lines in addition to other credits, and not in place of them. Second, the interest rate should be regularly adjusted to the market rates to ensure that the debtor will fall back on this facility only in cases of need, and not when it is cheaper to draw on contingent credit lines than it is to borrow in the international financial markets. If market interest rates are distinctly higher than the interest rates on the facility, the debtor will have an incentive to draw on these credit lines rather than seek to borrow in the capital market. This would run counter to the purpose for which these facilities are provided in crisis situations: to ward off speculative attacks. If, on the other hand, market interest rates were markedly lower that the interest rates on these credit lines, the facility would not be drawn upon and would therefore be useless.

6.2 Instruments to Resolve Debt Crises

Since at present most actors in the international financial markets reject the proposed international insolvency procedure, the only instruments available in the short-term to resolve international debt crises are collective action clauses, exit consents, restructuring of interbank loans, and standstills. In the medium-term, though, the international insolvency procedure may play an important role, since it is the only comprehensive instrument that is suited to coordinating various creditor groups holding different classes of debt prior to and during a debt crisis. Looking at short-term crisis-resolution instruments, we find that collective action clauses are the most important instruments suited to gaining the involvement of private creditors.

Collective action clauses

Despite some disadvantages, collective action clauses constitute, in the short-term, the most important instrument available to involve private creditors in the restructuring of sovereign bond issues in emerging markets, the reason being that they substantially facilitate an involvement of private creditors. Collective action clauses serve both to prevent and to resolve debt crises.

Since this instrument makes it possible to involve minorities in the decisions taken by a qualified majority on bond contract amendments, collective action clauses limit in particular three problems of collective action, at least for individual bond issues: the **holdout problem**, the **rush-to-the-exit problem**, and the **rush-to-the-courthouse problem**. Collective action clauses should, however, only be used in a fashion complementary to other instruments.

While most actors in the international financial markets have agreed to the introduction of **majority clauses**, there is no agreement on how they should be concretely formulated. Majority clauses would give a qualified majority of bondholders the authority to involve minorities as well. Views differ as to how great the required majority should be.

The 75 % majority rules which are normally applied for bond issues floated under UK law, and were used for a Mexican sovereign bond issue recently floated, are seen as too low by most private actors. Private actors propose the following majority rule: bondholders who hold 85 % of the nominal value of a bond issue should have the option to amend the bond's terms of payment. This, though, would presuppose that bondholders in possession of 10 % or less of the nominal value of a bond issue would not vote against restructuring. Due to this collateral condition, the actual majority rule is not 85 % but in effect 90 %. International institutions like the IMF, on the other hand, are in favor of a 75 % majority rule.[133] Since overly high limits for majority rules do nothing to

133 See EMTA et al. (2003); IMF (2002d) and (2002e).

simplify restructuring procedures, a 75 % majority rule may be seen as adequate.

Inclusion of clauses other than majority clauses, for instance **sharing clauses**, **aggregation provisions**, or **collective representation clauses**, should be conditioned on the extent to which they contribute to resolving the holdout problem and the rush-to-the-courthouse problem. Collective representation clauses may facilitate an orderly restructuring procedure, since this approach makes it is easier to contact a group of heterogeneous creditors and engage them in negotiations. While aggregation provisions would serve to resolve the problems posed by the need to aggregate multiple bond issues and debt instruments, they may prove relatively complicated in practice, since they pose problems involving the coordination of a number of different creditors.

Since it is likely to prove relatively difficult to convert bond issues without collective action clauses into new bond issues containing such clauses, it would be advisable to include collective action clauses only in new bond issues. Even though this approach would serve to resolve only the collective action problems involved in some bond issues, it would lead to a more rapid and orderly restructuring of sovereign bond issues.

As soon as collective action clauses have found acceptance in the markets, first-mover disadvantages and signal problems would be a thing of the past. Therfore it is important to create new incentives to induce issuers to include collective action clauses in their bond contracts. In connection with its monitoring policy, for instance, the **IMF** could seek to induce countries to make use of collective action clauses. In connection with its Article IV consultations the IMF could check to see whether countries concerned have included collective action clauses in their contracts on new bond issues. These countries could also regularly provide the IMF with copies of their bond contracts. The IMF could then prepare a publicly available list of bond issues containing collective action clauses. Furthermore, the IMF/World Bank guidelines on public debt management could be enlarged to include collective action clauses for bond contracts.[134]

The **G10 countries** should, for the following reasons, provide their international bond issues with collective action clauses: first, inclusion of collective action clauses in sovereign bond issues of industrialized countries would provide a signal indicating that the practice is not a sign of poor creditworthiness. Second, collective action clauses would in this case in this case no longer constitute an exceptional phenomenon in the legal systems of some countries. Third, market actors would in this way become accustomed to including collective action clauses in international bond issues.

Exit consents

Among the instruments used to resolve debt crises, exit consents play an important indirect role since they serve debtors as a threat potential vis-à-vis their creditors. The instrument can be used to limit creditor holdout behaviors because it prevents a minority of creditors from taking advantage of a majority.

Since exit consents can take on different forms and sovereign bond contracts do not always specify which exit consents can be used by debtors, this instrument entails greater uncertainties than collective action clauses. And for this reason private actors demand that inclusion of exit consents in bond contracts be made contingent on the consent of all bondholders.[135] The possibility to use exit consents could provide an incentive to generally include collective action clauses in sovereign bond issues. The use of exit consents should for this reason continue to be an option open to a simple majority of bondholders.

134 See IMF (2002e).

135 See EMTA et al. (2003).

Standstills

While standstills can contribute to resolving a debt crisis, this instrument should be used only when it is the only one available, since it entails a lot of problems. One particularly doubtful point is that the use of this instrument can trigger a new debt crisis by provoking a major capital exodus. If a standstill is to prove successful the following conditions must be met:[136]

- It is very important that creditor interests not be seriously harmed by a standstill. A debtor can boost his credibility by providing sovereign guarantees.

- Standstills should be used only in exceptional cases and with creditor consent, since the use of a standstill entails a high risk that debtors may lose access to the capital market, and a standstill may lead to capital exodus.

- A standstill should apply for all of a debtor country's debt categories. Otherwise there is a risk that creditors may invoke cross default and acceleration clauses. The consequence would be that other of the debtor's liabilities would fall due as well.[137]

- Investors must be convinced that a standstill is only temporary and that the measure is required by the debtor to win time to improve his liquidity situation. A standstill should therefore be kept as brief as possible with a view to limiting the negative impacts bound up with the measure.

- Debtors should duly inform creditors on the debtor country's economic picture and debt structure with an eye to permitting creditors to come up with a viable assessment of the country's debt situation. This serves to improve both transparency and debtor credibility.

In order to improve the ability of creditors to predict a possible standstill, it would be possible to adopt formal methods as a basis for coming up with decisions on standstills. This would be one way to provide a signal to creditors that a standstill is meant only as a temporary measure; the **IMF** could play a key role here. One way to formalize this instrument would be to enlarge the IMF's rights by amending its Articles of Agreement – VIII2b in particular. This would give the IMF the right to impose a temporary stay of litigation for certain creditors, a move that would force creditors to hold off on taking any legal action for a certain period of time.

Such an enlargement of the IMF's rights would have the advantage of providing a breather for debtors. Furthermore, the chances of an orderly restructuring process would be better if some creditors were forced to stay litigation. The time gained in this way would serve to raise the chances of a successful course of negotiations. It is, however, questionable whether such an enlargement of the IMF's powers vis-à-vis creditors minded to sue would be legally valid. A move of this kind would infringe on valid contracts, possibly seriously and permanently affecting investor confidence.[138]

Restructuring of interbank loans

In view of the fact that the volume and the volatility of short-tem interbank loans provided by financial institutions in industrialized countries and emerging markets may pose a threat to the stability of the international financial system, a timely and orderly restructuring of interbank loans is required to resolve debt crises. Restructuring can provide a substantial contribution to enhancing debtor solvency. Compared with bondholders, the foreign creditors of interbank loans constitute a

136 See IMF (2000b).

137 One example of a failed selective standstill involving secured Brady Bonds is Ecuador. Here the consequence of the standstill was that the creditors invoked cross default and acceleration clauses. The bottom line was that the creditors demanded immediate payment on Ecuador's unsecured Brady Bonds and eurobonds. See Eichengreen (2000b), pp. 9–10.

138 See Deutsche Bundesbank (1999).

small and more homogeneous group, a fact which means that restructuring is bound up with fewer coordination problems.

Interbank loans can be restructured in a number of different ways, and the most appropriate approach depends on the specific situation of a given country. To cite an example: during the Korean financial crisis the Korean government supported the restructuring of interbank loans by providing a sovereign guarantee. This solution was appropriate in that Korea had been pursuing a solid financial policy prior to the crisis, and sovereign guarantees therefore did not pose any exaggerated risk to budgetary stability. The approach used to resolve the Korean financial crisis can be transferred to other countries only if they have pursued a solid financial policy prior to the outbreak of crisis. This approach is, however, bound up with moral hazard problems for Korean and international banks.

An international insolvency regime

One factor crucial to the implementation of an insolvency procedure is that it be accepted by the countries concerned, since, first, **governments** would be required to incorporate it in their national statutes. Second, the governments represented in the IMF's Executive Board would have to agree to an amendment of the Articles of Agreement to incorporate the SDRM in them.[139] But since some important creditors and debtors of sovereign bonds issued in the international financial markets – e.g. the private sector and the governments of the US and some emerging markets – reject the adoption of an insolvency procedure for sovereign states, the procedure has no chance of being implemented in the short-term.

Among the **industrialized countries** opinions differ greatly on the SDRM. While the EU countries, the Nordic-Baltic countries, and Australia support the SDRM, both the US and the IMF's International Monetary and Financial Committee, which is dominated by the industrialized countries, reject the proposal.[140]

In fact, even most representatives of **developing countries** and **emerging markets** do not support the proposal, fearing, first, that they could lose access to the international capital markets once such a procedure had been opened,[141] and second, that the financial support provided by international organizations might decline in connection with the adoption of the procedure.

Private creditors, in particular banks and banking associations, generally reject the proposed international insolvency procedure for the following reasons. First, the private actors in the international financial markets, banks in particular, fear that the procedure might serve to reinforce debtor moral hazard. Since the procedure would make it easier for debtors to open insolvency proceedings, they might be tempted to take advantage of the procedure. Second, private actors are of the opinion that the insolvency procedure would tend more to trigger a financial crisis in debtor countries, since private actors would withdraw their short-term capital from such countries as soon as they saw any signs of an insolvency procedure, to say nothing of the case that one was announced. Third, private actors criticize the debt categories marked for inclusion in the IMF's proposed insolvency procedure, especially the inclusion in it of credits provided by multilateral and bilateral organizations. This would tend to lower the acceptance of the proposed procedure by other creditors, unsettling the markets.[142]

In the opinion of **NGOs** the IMF proposal does not constitute a suitable concept for preventing financial crises or for relieving the debt of developing countries. The IMF proposal, for instance,

139 See Filho (2003); Li Ruogu (2003).

140 See Snow (2003); US Treasury (2003); Campbell (2003); Haarde (2003); Solbes (2003); IMF (International Monetary and Financial Committee) (2003). The US has declined to explain why it rejects the proposed international insolvency procedure.

141 See Filho (2003); Roubini / Setser (2003), pp. 3–4.

142 See IPMA et al. (2002c).

has little to say about securing minimum survival needs in debtor countries. Furthermore, it is noted, the IMF proposal contains no equitable and transparent arbitration procedure for restructuring debt.

Despite this criticism of the IMF proposal on an international insolvency procedure, the IMF proposal does constitute a suitable framework for an international insolvency procedure. It is generally difficult to come up with a proposal on an insolvency procedure that would be acceptable to all parties, since these parties' interests diverge considerably. One reason why some actors in the international financial markets are not able to identify with the IMF proposal is that they were not involved in working it out. The following features of the IMF proposal should be modified:

- An insolvency procedure should not be incorporated in the IMF's Articles of Agreement; it would be better off in a separate treaty based with a neutral institution. A **separate treaty** would have the one advantage of not casting the IMF in the dual role of creditor and arbitrator. This, however, would mean that only the parties to the treaty would be bound by it. Inclusion of the insolvency procedure in the IMF's statutes would, on the other hand, serve to bring together creditors and debtors under one legal roof, because the procedure would in this case be binding for all IMF member countries. One way to avoid assigning the IMF this problematic dual role would be to base the international insolvency procedure with a **neutral institution**, for instance with the United Nations. Since the voting rights of the developing countries have greater weight in the decision-making bodies of the UN than in those of the IMF, shifting the overall process to the United Nations would mean greater acceptance of it by developing countries.

- The **IMF** should assume a role less significant than that provided for in its proposal on an international insolvency procedure. The IMF should have no voice in appointing the members of the dispute-settlement body. But the IMF should play an important part in assessing debt sustainability, because the IMF, thanks to its country work, has unparalleled expertise here and is also in possession of the data needed to assess and analyze countries. It would, for instance, be possible to set up an advisory board consisting of IMF staff, representatives of private institutions, debtor counties, and other creditors.

- **Bilateral creditors** should be involved in restructuring as a means of ensuring that all creditors are treated equally. If the public sector bilateral creditors were not included, the SDRM would only be able to restructure claims held by private creditors.

- A temporary stay which could be extended only with the consent of the creditors involved should be part of an insolvency procedure, because stays help to ensure that all creditors are treated equally and stays permit the debtor to conduct reforms with funds that would otherwise have been used for debt service.

- In keeping with the NGO proposal, a **dispute resolution forum** should be set up; the forum should consist of a group of independent experts, and it should not be restricted to making recommendations but should have decision-making rights as well. To prevent successful litigation by individual creditors, the forum should be authorized to suspend the enforcements of claims. Furthermore, the dispute-settlement forum should monitor the claim verification process and decide on the legality of the claims concerned. The body should have the power to decide on the need to open an insolvency procedure; this would serve to prevent any misuse of the SDRM by debtors. In addition, the forum should be involved in assessing debt sustainability.

Even though the international insolvency procedure is at present rejected by most actors in the international financial markets, it could prove to be an important instrument for restructuring sovereign bond issues, and one that could solve the three coordination problems outlined above: rush to the exit, rush to the courthouse, and the holdout

problem. Moreover, the proposal on an international insolvency procedure is the only approach that would make it possible to aggregate different debt classes and to group debts within these classes. And for these reasons the insolvency procedure will, in the medium-term, come to play an important role in the prevention and resolution of international debt crises.

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