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Summing Up by the Acting Chairman
Involving the Private Sector in Forestalling and Resolving Financial Crises—Additional Considerations
Executive Board Meeting 99/100
September 8, 1999

Directors welcomed the opportunity to have a further round of discussions concerning the complex and challenging issues associated with involving the private sector in forestalling and resolving financial crises. They noted that the Fund's approach to involving the private sector was still evolving.

Prevention

Directors reiterated that prevention remained the key to forestalling financial crises, and welcomed the emerging consensus in the Fund and in other fora regarding the principle requirements for preventing the buildup of vulnerabilities to crises and noted the importance of close attention to an enumeration of vulnerabilities in the context of Fund surveillance.

Directors welcomed the recent publication of a Consultative Paper by the Basel Committee on Banking Supervision, and looked forward to having the opportunity to discuss its recommendations more fully. In preliminary remarks, however, a number of Directors urged caution regarding the use of adherence to standards, including subscription to the SDDS, or the views of credit rating agencies, as input to decisions regarding capital adequacy standards.

Ex Ante Mechanisms to Facilitate Crisis Resolution

Bond Contracts

With respect to collective action clauses, most Directors agreed that there would be considerable benefits if the type of majority restructuring and majority enforcement provisions found in existing international sovereign bonds issued under trust deeds were included in other issues. Some Directors felt that this could best be achieved if industrial countries included such terms in their own bond issues. Other Directors, however, were of the view that such a "demonstration" strategy was of limited relevance or utility, especially given the fact that few industrial countries issued sovereign bonds internationally.

Directors also discussed the merits of including collective representation provisions in international sovereign bonds that would specifically authorize a trustee to negotiate with the debtor on behalf of the bondholders, but which would not authorize the trustee to legally bind bondholders to any agreement. While such representation provisions are not currently found in international sovereign bonds, most Directors believed they could potentially contribute to an orderly and speedy restructuring process and encouraged members to explore the feasibility of including such provisions in new international issues.

UDROP

Regarding suggestions for a universal debt rollover option with a penalty (UDROP), a few Directors considered that this could provide a useful device for providing liquidity in a crisis. However, many other Directors considered that it appears to share the limitations of earlier suggestions for the inclusion of call options in short-term interbank lines discussed by the Executive Board on previous occasions, including the risk that market concerns about the triggering of such mechanisms in the run-up to crises could lead to a loss of maturing credit lines and the activation of dynamic hedges, thereby exacerbating liquidity difficulties in the subject country or even beyond and making crises more likely, and should not be pursued.

The Fund's Approaches to Securing Private Sector Involvement in Crisis Resolution

Directors welcomed the opportunity to review the principles that have guided the Fund in seeking to secure the involvement of the private sector in crisis resolution. Directors considered that, in most cases, it would be appropriate for the Fund to rely on its traditional approach to securing private sector involvement, i.e, the catalytic effect of Fund supported programs in generating spontaneous capital inflows. This was seen as the preferred approach, notwithstanding the inevitable uncertainties at the outset of an arrangement regarding the likely pace of renewed market access, with the concomitant uncertainties regarding the extent and duration of any withdrawal of private capital. Nevertheless, in cases in which the catalytic effect does not appear to be working or in which the member does not appear to have serious prospects for obtaining private sector financing within a reasonable period, Directors agreed that consideration would need to be given to concerted approaches for securing private sector involvement.

Some Directors noted that recent cases illustrated the difficulties of making firm judgments regarding members' prospects for regaining or deepening market access during periods of liquidity stress, which in some cases might occur against the background of more general turbulence in global financial markets. More generally, in cases in which some element of private sector rollover of existing exposure or provision of new financing is required, Directors asked the staff to seek to strengthen the analytic and informational basis for deciding how such private sector involvement could be obtained. In some cases, such involvement could involve restructuring some obligations

and the question then arose of whether individual bond issues should be restructured on an ad hoc basis as they mature (an approach that was followed in the case of Ukraine), or whether the member concerned should seek a comprehensive restructuring of the relevant instruments. Directors also noted the importance in such cases of the implications of proposed debt restructurings for medium-term sustainability, and more generally, of the medium-term sustainability of financing packages associated with Fund programs.

Directors discussed the possibility of specifying in advance a set of rules or guidelines for involving the private sector so that the private sector would understand ex ante what would be expected of it in the event of stress or crisis in a country's external position. Some Directors considered that additional efforts should be made to establish a predictable rules-based system, although they recognized that some degree of flexibility would inevitably be needed in applying such rules to individual cases. Most Directors, however, considered that at this early stage of this evolving policy on private sector involvement, it would not be feasible to lay down specific rules for such involvement. These Directors considered that the wide disparity in country circumstances regarding, for example, debt structures, banking system soundness, and medium-term financial viability make it difficult to specify in advance a rules-based system that is likely to prove robust across cases. However, over time, as experience builds, Directors considered that it would be possible to move toward a framework. In the meantime, individual cases would need to continue to be handled on the basis of their specific circumstances. In this connection, Directors considered that the balance of the various considerations reflected in the report by G-7 Finance Ministers to the Köln Economic Summit provides a helpful framework within which the international community can work to address individual cases that may arise.

Regarding the specification of program performance criteria in cases in which there is a concerted effort to secure private sector involvement, Directors noted that this raised complex issues that warranted further consideration. Nevertheless, many Directors were inclined to the view that conditionality regarding private sector involvement should continue to be specified in terms of floors on net international reserves and ceilings on net domestic assets and bank credit to government so as to focus conditionality on ensuring adequate program financing. However, these Directors generally considered that in circumstances in which net international reserves fall well short of a reasonable level (from the perspective of providing adequate protection against vulnerabilities and safeguards for Fund resources), there should be a presumption that stronger than programmed performance in the external accounts should be used to reconstitute reserves beyond the original program targets rather than diminish the required degree of private sector involvement. Most Directors did not consider that specifying conditionality in terms of net payments in respect of a particular class of instruments would prove operationally feasible, or be desirable from the perspective of the Fund.

Directors considered it important to reiterate the principle that staff and management should not participate in negotiations between a member and its private

creditors. Although they recognized that Fund staff and management would inevitably be drawn into such discussions, most Directors considered that every effort should be made to limit such involvement. These Directors considered that the role of the staff and management should be to specify the broad parameters of financing needs (regarding, for example, the cash flow during the program period, the medium-term implications, and range of acceptable instruments). The negotiation of the specific features of the agreement with private creditors would be the responsibility of the member concerned and its legal and financial advisors.

Directors agreed that the extent of private sector involvement would need to be assessed in terms of the cross border extension of credit and exposure to counterparty risk. Accordingly, they considered that loans supported through collateral, such as through the pledge of gold or other assets or through liens on export receivables, would generally not produce meaningful private sector involvement. Nevertheless, a few Directors considered that collateralized borrowing, if held under appropriate restraint, could be a helpful device for regaining capital market access during difficult periods, and could pave the way for uncollateralized borrowing.

Restructuring Sovereign Bonds

Directors noted that recent developments had highlighted a number of additional issues that could be faced by members seeking an orderly refinancing of obligations falling due on international sovereign bonds. Directors noted that the difficulties of contacting bondholders prior to a default could be considerable, and suggested (as noted earlier) that members explore with their financial advisors the possibility of including collective representation provisions in future international issues.

Directors gave preliminary consideration to the desirability and feasibility of a member trying to implement a debt subordination strategy through a selective restructuring of Brady bonds, while continuing to service other types of international sovereign bonds. Directors were generally skeptical and negative on this suggestion. They considered that no one category of private claims should be regarded as being inherently privileged relative to others in a similar position, and questioned whether an effort to implement a debt subordination strategy would be effective in helping to pave the way for a rapid return to capital markets. Moreover, some Directors were concerned about the impact of an attempt to restructure Brady bonds by one member on other members' future access to capital markets, as well as on the balance sheets of banks in emerging markets that had invested in such instruments. Nevertheless, some Directors noted that while such an approach was fraught with uncertainties, it could be considered on a case-by-case basis. A few Directors doubted whether the Fund should endorse any specific subordination of private sector debts, because they considered that this was a matter which should be settled between creditors and debtors. Directors also noted that it might be impractical to attempt to involve every private sector creditor equally in crisis resolution, given the costs associated with attempting to coordinate such an involvement.

Most Directors agreed that, after a member has lost spontaneous capital market access, its ability to mobilize concerted financing (whether in the form of new money or the restructuring of existing liabilities) may depend importantly on the credibility of a threat of default. Directors considered that, in the absence of such a threat, creditors might not be willing to provide new financing, or could do so only at very high yields. Directors noted that if members who are unable to reach agreement on voluntary restructurings or the provision of new money redeem the instruments in question, and replenish reserves from official sources, this would reinforce the halo effect surrounding bonds, and make it harder to bail in bondholders and other private creditors in future crises. However, they emphasized that priority should be on attempting to reach voluntary agreements with creditors, and on improving the incentives for voluntary agreements.

Directors noted that early approval of a Fund arrangement, and the concomitant decrease in uncertainties surrounding the stance of economic policies and availability of official financing, are likely to be perceived by financial markets as reducing the likelihood of a default. Directors considered that it would not be appropriate to withhold early financial support from members facing liquidity crises, providing that they have adopted an appropriate program of macroeconomic and structural reform, and were engaged in good faith negotiations with their creditors. Indeed, these considerations were reflected in the Board's decision to extend the scope of the Fund's policy on lending into arrears.

Temporary Stay on Creditor Litigation

Several Directors asked that further consideration be given to adopting a mechanism that could—in extreme circumstances, and subject to carefully defined criteria—allow the international community to sanction a temporary stay of creditor litigation.

Fund Lending into Arrears

In the context of Fund lending into arrears stemming from the imposition of exchange controls, Directors gave further consideration to the adoption of mechanisms that would seek to protect the interests of creditors. Several Directors saw attractions in the establishment of escrow accounts into which debtors would deposit the local currency counterpart of scheduled debt service obligations. Directors generally agreed that the question of who should bear the exchange rate risk would need to be considered on a case-by-case basis, although they felt that in general the risk should not be borne by the sovereign.

Other Issues

Creditor Committees

Directors noted that creditors' committees might have a role to play in resolving financial crises in an orderly and expeditious manner. They generally did not believe that the creation of a single standing committee would be feasible, but advised that consideration should be given to ad hoc arrangements in appropriate cases.

Drawing on the efforts that are being made in the nonsovereign context, most Directors supported the development of principle and procedures that could be relied upon to guide the establishment and operation of such creditors' committees. These Directors were also of the view that these efforts could usefully be complemented by the development of principles and procedures regarding the use of mediation and facilitation services provided by independent professionals. Such services, which have begun to be used in the nonsovereign context, would be designed to (i) facilitate the rapid and orderly creation of a collective framework (including the establishment of a creditors' committee) and (ii) mediate negotiations between the sovereign debtor and the creditors' committee. To this end, they encouraged staff to work with the private sector with a view to developing principles that could be proposed for endorsement by the Board, other members of the official community, and the private sector.

Other Directors, while acknowledging the utility of developing principles and procedures in this area, were concerned about the Fund's involvement, emphasizing that the success of a collective framework for negotiation would ultimately depend on whether the participants believe that it would meet their own self interests. All Directors agreed that it would be essential that the participants take full ownership of the framework and that the role of the official sector be limited. Thus, while it may be useful, where necessary, for the Fund to assist in the initiation of a mediation or facilitation process, it is imperative that efforts be made to ensure that any mediators and facilitators be neutral and acceptable to the key participants.

Regaining Market Access and Debt Flexibility

Directors noted the selective use of innovative techniques, such as the issuance of warrants in sovereign bonds and structured notes, to allow sovereign borrowers to regain access to international financial markets after periods of turbulence. They also noted, however, that while a number of such approaches, notably collateralization, could have benefits to debtors and creditors alike, the extensive granting of collateral reduces a country's flexibility in mobilizing and managing foreign exchange and could increase its potential vulnerability to shocks. Directors encouraged the staff to continue to monitor developments in this area.