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To: Members of the Executive Board

From: The Secretary

Subject: **Involving the Private Sector in Forestalling and Resolving Financial Crises—The Role of Creditors' Committees—Preliminary Considerations**

This paper provides background information to the paper on involving the private sector in forestalling and resolving financial crises—additional considerations, which was circulated as EBS/99/152 on August 10, 1999 and is tentatively scheduled for discussion on Friday, September 3, 1999.

Mr. S. Hagan (ext. 37715) and Mr. M. Buchanan (ext. 35467) are available to answer technical or factual questions relating to this paper prior to the Board discussion.

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Involving the Private Sector in Forestalling and Resolving Financial Crises: The Role of Creditors' Committees—Preliminary Considerations

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Introduction

1. Creditors will be more likely to contribute to forestalling and resolving crises if they act collectively. Not only does such collective action generate greater efficiencies in terms of the availability of information, but experience demonstrates that creditors will be more willing to bear a portion of the responsibility for dealing with a crisis if they perceive that the responsibility will be shared among them in an equitable manner. Discussions to date on various mechanisms to foster such collective action have focused on measures that would attempt to forestall the disruptive behavior of individual creditors, including through the introduction of "collective action" clauses in bond contracts, which are discussed in detail in another background paper entitled "Collective Action Provisions in International Sovereign Bonds."[1]

2. As a complement to measures that attempt to promote debt restructuring by constraining disruptive action by individual creditors, this paper explores the possible role that creditors' committees or other bodies acting in the common interests of creditors could play in creating a collective framework for negotiation between creditors and sovereign debtors. As will be discussed, committees are already established by creditors on a regular basis in the context of the restructuring of both sovereign and nonsovereign debt. Creditors recognize that the efficiencies such groups create during the negotiating process serve to enhance the value of their claims. This paper explores whether measures could be taken to further enhance the role of such groups both prior to and during a crisis, and whether there is a meaningful role for the official sector and, in particular, the Fund, to play in this process.

3. This paper focuses on the benefits of creditors' committees and standing bodies that negotiate with the debtor in the interests of creditors and make recommendations to them in an advisory capacity. It does not consider proposals that would give such committees or bodies the legal power to bind all creditors to the restructuring terms. As will be discussed, however, the effectiveness of the voluntary framework that is discussed will ultimately depend upon the extent to which creditors perceive that it is preferable to the available alternatives (in other words, that negotiation within a collective framework will maximize the value of their claims).

4. It should also be noted that the primary purpose of the paper is to explore mechanisms that could be relied upon at an early stage of a crisis and onwards, where problems of confidentiality, adequate representation and conflict of interests need to be addressed. The paper does, however, also briefly describe types of open fora that could be used at all times by debtor countries as a means of making information publicly available to—and exchanging views with—the creditor community. The establishment of such open fora would serve an important preventive function and could take a number of forms. However, for reasons that

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[1]See SM/99/207 (8/11/99).

will be discussed in the paper, once a crisis begins to develop, relying on such fora for purposes of negotiating the terms of a possible restructuring raises a number of difficult issues.

5. The first section of this paper briefly describes the role that creditors' committees presently play in providing a framework for the restructuring of both sovereign and nonsovereign debt, highlighting a number of recent problems that have placed the operation of these committees under increasing strain. As will be discussed, establishing a collective framework for negotiation has become increasingly difficult as a result of the growing diversity of creditors and the complexity of financial instruments, as illustrated in the recent negotiations regarding Ukrainian and Russian debt. On the basis of this analysis, and drawing upon historical precedent, the second section discusses the possible benefits of establishing a "standing" body whose function would be to negotiate in the interest of creditors and whose objective would be to forestall and help resolve financial crises, and identifies the most difficult problems that would need to be addressed in implementing this concept. The third and final section identifies possible alternative structures to address these issues, including through the formulation of principles and procedures to enhance the effectiveness of creditors' committees, and principles and procedures regarding the use of facilitation and mediation services provided by independent professionals, whose services could eventually be delivered through an independent standing body.

I. The Present Role of Creditors' Committees

The general features of the collective framework

6. In circumstances where a nonsovereign debtor has a number of private creditors, the establishment of a creditors' committee is an important component of a framework for debt restructuring[2] that has generally been referred to as the "London Approach".[3] This approach has been applied—with important differences—in the sovereign context. Although variations of the London Approach have evolved, they all seek to establish a collective framework for negotiations through the application of nonbinding principles that provide for the formation of creditors' committees, the sharing of information between debtors and creditors, and the establishment of a voluntary standstill, often in conjunction with new financing. In the context of the Asian crisis, Thailand, Indonesia and Korea are all relying on a framework of this

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[2]For purposes of this paper, debt "restructuring"is meant to include the modification of the original terms of an instrument, often done in conjunction with new financing.

[3]The London Approach is named after the collective framework for negotiation that was developed by the Bank of England in the early 1990s, which lent its good offices to set in motion a corporate restructuring process, the success of which relied upon creditor banks' adherence to certain nonbinding principles that emphasized collective action among them.

general nature as a means of restructuring private sector debt, with specific adaptations to the particular circumstances of each country. In the context of sovereign debt, such principles also guided the debt restructuring process during the debt crisis in the 1980s. The essential features of the London Approach, described below, require the active involvement of a committee that is adequately representative of creditors.

7. ***Resolution of inter-creditor issues.*** One of the biggest stumbling blocks when negotiating a restructuring agreement is the resolution of inter-creditor problems that arise when there are a large number of creditors with divergent interests (e.g., secured vs. unsecured creditors). The formation of a committee that is sufficiently representative of all creditors provides an important method of forging a common position among creditors. This is often achieved, for example, through the reliance on a single financial and legal advisor who is responsible for negotiating among creditors and who is retained by the committee rather than by individual creditors.

8. ***Creditor Assessment.*** Although a committee cannot legally bind the general creditor body, one of the reasons why its recommendations to this group often carry considerable authority is that creditors assume that any proposal made by the debtor regarding a restructuring that is recommended by the committee has been effectively vetted by the committee to ensure that it is both equitable and appropriate. For example, once established, the committee will generally establish a subcommittee that is charged with studying the relevant financial information regarding the debtor and assessing the extent of its problems.[4]

9. ***Preserving confidentiality.*** As a general principle, a debtor and its creditors will be reluctant to engage in meaningful negotiations unless they feel that they have sufficient information to make informed decisions. Much of this information should be transparently available to all, but certain information may need to be handled confidentially.

10. Information that should be made publicly available in a timely manner to market participants consists of data and assessments regarding the debtor's economic condition that is of particular relevance to creditors, e.g., reserve levels, the maturity structure of outstanding debt, and off-balance sheet liabilities. By allowing market participants to compare information on potential borrowers against known benchmarks, lending and investment decisions are better informed and policy makers can be held more accountable, thereby contributing to an improved economic performance and a strengthening of the international financial architecture. To facilitate such a flow of information, the Fund has developed the Special Data

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[4] Subject to limitations, the costs incurred in the operation of creditors' committees are normally borne by the debtor.

Dissemination Standard (SDDS) as a "best practice" in data dissemination for countries active in or seeking access to international capital markets.[5]

11. The second category of information that is of particular value to creditors is of a more qualitative nature and is not always appropriate for public dissemination. It may include explanations of policy motivations behind past official actions and expressions of intentions with respect to future actions. Experience demonstrates that debtor countries may wish to "sound out" creditors in advance with respect to possible restructuring proposals. However, a debtor will only be willing to do so if confidentiality can be credibly guaranteed. Creditors will only be willing to respond if the same assurance exists. Creditors' committees have generally provided an effective vehicle to achieve such confidential exchanges of information. In the nonsovereign context, the members of the committee have signed confidentiality agreements that, among other things, preclude them from trading on the basis of the information received. Moreover, in the context of both sovereign and nonsovereign debt involving publicly-traded securities, the securities laws of the principal financial centers impose criminal penalties on members of the committee that trade on the basis of this information. As a means of ensuring compliance with such laws, large financial institutions have established "fire walls" and other internal procedures to ensure that representatives of an institution participating in a creditors' committee do not share this information with divisions of the firm that actually trade in securities, either on a proprietary or agency basis. In some cases, the institutions refrain from trading altogether.

12. ***Standstill and new financing.*** To the extent that a creditors' committee is made up of the debtor's principal creditors, the existence of the committee can often facilitate the provision of new financing. The means by which this is achieved will depend on whether the debt in question is nonsovereign or sovereign, the differences arising from the inapplicability of bankruptcy laws in the latter case.

13. In the case of *nonsovereign* debt, the members of the committee will generally agree to sign "standstill" agreements in which they undertake not to initiate bankruptcy proceedings against the debtor during the period when the debtor is negotiating in good faith and providing creditors with all relevant information. They also often agree to subordinate their claims to creditors that are willing to provide new financing after the date on which the standstill agreement is signed. This contractual subordination is given effect, *inter alia*, through the application of the insolvency law: in the event of liquidation, the subordinated creditor will receive the proceeds of liquidation only after the claims of unsubordinated creditors have been paid in full.

14. In the case of *sovereign* debt, new financing has generally not been generated by formal standstill and subordination agreements. However, a form of *de facto* subordination

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[5]In the nonsovereign context, greater transparency can be furthered by the development and adherence to standards in such critical areas as accounting and auditing.

has developed as a means of generating new financing, as was demonstrated during the multiple reschedulings that took place in the context of the London Club negotiations during the 1980's, whereby creditors agreed to generally exclude new financing provided by a private creditor after a certain date from any future rescheduling.[6] In the same vein, all private creditors are effectively subordinated to financing provided by the multilateral financial institutions.

Recent developments and issues

15. The growing number and diversity of creditor interests have made the operation of the collective framework described above—and the establishment and operation of creditors' committees in particular—more difficult. This is true in both the sovereign and the nonsovereign context. For the past 50 years and until recently, the largest portion of sovereign debt was held by banks. Although the economic interests of various banks differed (e.g., secured vs. unsecured debt), there was sufficient commonality of interests for the process to work smoothly.[7] However, with the growing volume of bonds that are actively traded in the secondary market and the more widespread use of credit derivatives that give rise, inter alia, to fiduciary relationships, establishing a collective framework and a workable creditors' committee has become more challenging. Why?

16. First, as is discussed in the companion paper, *many bond instruments by their legal nature* do not lend themselves to a collective framework for negotiation. Many bonds require unanimous consent of the bondholders to achieve a restructuring of key terms, and additionally do not limit the ability of bondholders to press their claims individually and keep all amounts that are recovered. Moreover, even in those cases where collective action clauses exist, obtaining adequate representation of bondholders at a committee meeting presents difficult challenges where the bonds are widely held. While some bonds provide for a trustee to represent the interests of bondholders, concerns regarding their own liability may limit the willingness of trustees to represent bondholders—even on an advisory basis—in restructuring discussions.

17. Second, the greater *diversity of economic interests among creditors* has made the restructuring process far more complicated. The commercial banks that historically were

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[6]This is similar to the practice applicable to the rescheduling of Paris Club debt, where "post–cut–off debt" is excluded from future rescheduling.

[7]The sovereign debt workouts of the 1980s, which involved primarily syndicated bank debt, illustrate this point. These workouts were typically spearheaded by Bank Advisory Committees which, although they lacked legal authority to bind the banks (the syndicated loan agreements required all lenders to agree to any rescheduling), nonetheless disseminated information and negotiated restructuring and new financing on a consensual basis amongst the hundreds of banks involved.

sovereign creditors—i.e., the London Club—were influenced by similar factors, such as reputational considerations (including future business with the debtor) and regulatory suasion. However, these considerations do not apply to many of the individuals and entities that have purchased their instruments on the secondary market and have no ongoing relationship with the debtor. This does not mean that bondholders will necessarily be a negative force in the restructuring process. On the contrary, to the extent that they purchased the instruments on the secondary market at a deep discount or are willing to record a loss by selling the instrument in the secondary market, they may have more flexibility to agree to significant debt reduction. Moreover, since many record the value of their instruments at the current secondary market price ("mark to market"), they are likely to support an orderly and rapid restructuring agreement over a protracted stalemate if they perceive that such an agreement will enhance the value of their claims. In contrast, investors who record claims at face value, and are not required to maintain loan/loss provisions equivalent to the difference between the face and secondary market values, may be reluctant to participate in a restructuring that would force them to recognize a loss.

18. Third, *the existence of fiduciary relationships* arising from the separation of interests between the primary lender (lender of record) and end-investors (the beneficiaries holding the economic interest) has made the collective framework for negotiation far more difficult to implement. In these circumstances, the lender of record may not be in a position to speak on behalf of the end–investors, particularly where the end–investors are widely dispersed or where the interests of different end-investors are in conflict with each other. Such relationships are an increasingly common feature of instruments such as credit derivatives and asset–backed securities. Moreover, different but related problems arise with respect to more traditional investors such as pension or mutual funds, where the economic interests of the end–investors are managed by professional money managers who have contractual obligations to protect the interests of these investors.

19. Finally, the emergence of nontraditional investors as major holders of sovereign debt has raised concerns regarding the *maintenance of confidentiality*. As noted earlier, members of a creditors' committee will often receive confidential, nonpublic information and may be subject to criminal penalties if they trade on the basis of this information. Unlike banks and investment houses, however, many of the institutions that purchase sovereign debt (such as hedge funds) are too small to implement the type of internal safeguards that are designed to provide some credible assurance that they will maintain the confidentiality of nonpublic information and avoid trading on the basis of this information. For this reason, debtors and large institutions have expressed reservations regarding the participation of such investors on committees, which can be particularly problematic when these investors hold a significant amount of the debt.

20. The strains imposed by the above considerations have begun to manifest themselves in a number of sovereign debt negotiations, including Russia, where the diversity of creditors and confidentiality concerns have impeded negotiations, and Ukraine, where restructuring has

been complicated by the separation of interests between the lender of record and the end-investors.

II. General Considerations Regarding a Permanent Body

21. In light of the issues discussed in the previous section, the question arises as to whether the effectiveness of the collective framework for restructuring sovereign debt could be enhanced through the establishment of a single, permanent creditor body that would be responsible for actually negotiating with a sovereign in the interest of creditors. Such a body would be more than just a forum for an exchange of views on publicly available information. Some commentators have argued that such a "standing" negotiating committee would benefit all parties by creating greater efficiencies in the negotiating process. Given the growing difficulties and delays that arise when trying to establish and operate *ad hoc* creditors' committees in the middle of a crisis, the existence of a permanent body that is already in place when a crisis develops could mitigate its effects—or even assist in avoiding the crisis altogether. Once a default occurs, the value of a creditor's claim is likely to decline if the negotiating process is delayed by difficulties in resolving the type of complex inter–creditor issues described in the previous section, particularly if default is followed by litigation. Moreover, the establishment of a permanent body that has adopted internal procedures to guarantee confidentiality could make it easier for a debtor to approach its creditors at a sufficiently early stage of a crisis, thus increasing the chances that a restructuring agreement can be reached before a default and, more generally, before a general erosion of confidence had made a solution more difficult.

22. Historical precedent regarding the establishment of standing bodies to negotiate with sovereign debtors in behalf of bondholders provides some guidance in this area. The Council of Foreign Bondholders was established in London in 1868 to help British bondholders pursue debt recovery against defaulting foreign governments. The Foreign Bondholders Protective Council, Inc. was established in the 1930s in the United States for similar reasons. Neither of these bodies had the authority to bind bondholders to the terms of a restructuring agreement that it had reached with the debtor. However, the recommendations of these bodies regarding the appropriateness of such agreements were normally accepted by the bondholders. As is discussed below, and is further elaborated in Box 1 and the Appendix, however, many of the circumstances that gave rise to these standing bodies and shaped their operations are only of limited applicability today.[8]

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[8]The standing bodies generally fell out of use after the 1940s with the advent of syndicated bank loans and because the international capital markets were slow to recover from the 1930s crisis; they continued limited activities, however, and the U.S. council was active in debt workouts as late as the 1970s.

Box 1. Standing Bodies—Historical Experience

During the 19th and early 20th centuries, standing bodies were established in a number of countries for the purpose of protecting the interests of holders of foreign sovereign bonds in default through negotiations with debtor governments. The first of the standing bodies, the Council of Foreign Bondholders, was established in London in 1868, and eventually evolved into the Corporation of Foreign Bondholders ('London Corporation'). Drawing on the experience of the London Corporation, a number of other European countries such as France and Belgium established similar standing bodies at the end of the 19th century. In 1933, the Foreign Bondholders Protective Council, Inc. was established in the United States ('U.S. Corporation') for a similar purpose in the wake of a wave of sovereign defaults brought about by the global depression.

Although these standing bodies differed in a number of respects, they all shared important common features that were shaped by the circumstances of the time. While some of these circumstances continue to be relevant today, others are not.

The creation of centralized bodies was designed to address the problems caused by having a number of committees—many of which were in competition with each other—representing different creditors of the same defaulting government. The primary purpose of these bodies was to negotiate in the interests of bondholders following a default by foreign sovereigns. They generally did not enter into discussions with the sovereign issuer prior to a default regarding the need for a restructuring or new financing. The main strategy was to encourage temporary relief through rescheduling rather than permanent debt reduction, on the grounds that the problems facing sovereign issuers were temporary and would be resolved eventually (in the case of the U.S. Corporation, once the global depression of the 1930s abated).

The standing bodies played an advisory role. A body had no authority to bind all creditors to the terms of an agreement it had reached with the debtor. With respect to the make up of these bodies, approaches differed. For example, the London Corporation relied on both 'wise persons' with professional expertise that were drawn from the financial community and representatives of the bondholders in question. Although the Charter of the Corporation was adopted by Parliament, great efforts were made to ensure that the body was led by the financial community and was independent from the government. In the case of the U.S. Corporation, wise persons played the dominant role in the negotiations and the Corporation had close links to the U.S. government, particularly the State Department, which sponsored its formation.

Although negotiations were often very protracted, the bodies were relatively successful in obtaining approval from the general bondholder body with respect to the terms of any settlement they negotiated. The willingness of the bondholders to defer to these bodies was influenced by the fact that, given the comprehensive scope of sovereign immunities that existed at the time, bondholders had no alternative means of pressing their claims. In light of these limitations, a major way in which the London Corporation exercised leverage over a sovereign issuer was to deny it access to the London Stock Exchange for new issuances. In the case of the U.S. Corporation, its leverage was derived, in part, from the active support and involvement of the U.S. government.

The need for international cooperation became apparent soon after the emergence of a number of national committees, especially in Europe. Cooperation among European bodies was relatively productive; in some cases, for example, the committee representing the largest stake would be authorized by the others to negotiate with the debtor. In contrast, relations between the U.S. Corporation and its European counterparts were less effective. This arose, in part, as a result of the divergence in the terms of their respective bonds.

23. The creation of a permanent creditors' body that would act in the interests of creditors in negotiations with the debtor would require the resolution of a number of difficult issues. Perhaps the most important is that of representation. Specifically, if the goal is to create a standing body comprised of creditors themselves, it would be difficult to achieve this on an *ex ante* basis since, given the complexity of modern capital markets and the growing diversity of creditors who purchase and sell debt on the secondary market, the composition of creditors will change depending on the debtor in question and, moreover, will shift over time.

24. In recognition of this problem, consideration could be given to an alternative approach that would involve creating a creditors' body made up of "well-regarded" individuals who would be charged with defending the interests of creditors in their negotiations. One of the key issues to be resolved when implementing such a "wise persons" approach would be the degree to which their independence and objectivity could be safeguarded. As noted in the Appendix, the Foreign Bondholders Protective Council established in the United States relied on experts—rather than bondholder representatives—to conduct negotiations and these experts operated with support from the Department of State. The willingness of bondholders to accept this official affiliation was, in large part, attributable to the fact that they had no choice but to make this a political issue: the comprehensive sovereign immunity doctrine that prevailed at the time made it difficult for them to pursue traditional legal remedies.[9] On the other hand, if the wise persons are prominent representatives of the financial industry, there may be concerns regarding a conflict-of-interest in situations where one of the institutions with which a wise person is affiliated has connections with a particular class of creditor (giving rise to the inter-creditor problems discussed above) or has a long-standing relationship with the debtor (e.g., an investment bank).

25. Moreover, even if the independence and impartiality of such wise persons could be safeguarded, there is a question as to whether creditors would be willing to defer to their advice. In recent years, creditors have generally accepted the role of committees on the grounds that the creditors sitting on them were those with the largest financial interest in the restructuring. In addition, representation attempts to reflect a cross section of the particular creditor group in question, both in terms type of debt and geographical location of the creditor. Thus, the overall credibility of a creditors' committee is derived, in part, from the fact that it is perceived as being adequately representative of the creditors of the particular debtor in question; a standing body made up of wise persons would not be.

26. Interestingly, the British Corporation of Foreign Bondholders (which was established in 1873 and evolved from the Council of Foreign Bondholders) and some other European bodies adopted an approach that attempted to rely partially on independent wise persons and partially on bondholder representation. As is discussed in Box 1 and the Appendix, the

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[9]As has been discussed in earlier papers, the sovereign immunity doctrine has been significantly limited in recent times to allow for litigation against a sovereign that has borrowed in the market.

permanent governing body of the Corporation, the Council, did not actually negotiate the terms of sovereign restructuring. Rather it coordinated the establishment and operation of the *ad hoc* creditors' committees conducting the negotiations, which included bondholder representatives. As is discussed below, such a hybrid approach may provide some guidance with respect the establishment of a standing body that could enhance the effectiveness of the negotiating process between creditors' committees and the sovereign.

27. It should be emphasized that the difficulties of establishing a standing body that would be responsible for negotiating a restructuring agreement on a confidential basis do not in any way preclude the establishment of fora that are designed to allow for an open exchange of views on the basis of publicly available information. It should be straightforward to establish a forum or fora where investors and analysts would be provided with the opportunity to participate in a question/answer session with relevant authorities, on the basis of the type of information released under the SDDS and otherwise available. One format that has proven successful is the type of periodic teleconference initiated by Mexico in 1996 in response to the crisis that occurred in 1994–95. This forum facilitates interchange between the market and the authorities regarding the latter's concerns and motivations, and allows the authorities to receive early warnings from the market. In addition, along the lines of recent Institute for International Finance (IIF) recommendations, countries could supplement such briefings with direct meetings between officials and private sector investors and analysts in major financial centers.[10] Such meetings and briefings should be held consistently through noncrisis and crisis periods, and should help creditors distinguish risks and thereby reduce the tendency for investors to rush for the exits in a range of countries simultaneously due to superficial similarities. Box 2 summarizes a number of recent IIF proposals in this regard.

III. Enhancing the Collective Framework for Negotiation

28. In light of the foregoing discussion, consideration could be given to the implementation of measures that would further enhance the efficiencies of the collective but nonbinding framework for negotiation described in Section I but which, at the same time, would seek to avoid the problems associated with *ex ante* representation and potential conflicts-of-interests described in Section II. These additional measures would be designed to streamline the negotiating process so as to avoid the types of delays that are detrimental to the interests of both debtors and creditors.

29. As described below, the first of these measures would enhance the effectiveness of creditors' committees. It would involve the formulation of principles and procedures regarding the operation of *ad hoc* creditors' committees that would be endorsed by both the

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[10]Strengthening Relations between Emerging Market Authorities and Private Investors/Creditors: A Country-Focused Approach, Institute of International Finance, April 1999.

Box 2. Recent Proposals by the Institute of International Finance

Recent IIF publications have promoted reforms in **precrisis periods** that are broadly similar to the Fund's push for a more open dialogue between creditors and debtors.[1] They have suggested that emerging market economies should organize quarterly meetings or teleconferences, supplemented by periodic meetings between investors and analysts in major financial centers. The IIF has stressed that the information flow must continue in both calm and crisis periods, and allow authorities to explain any corrective actions envisaged as difficulties emerge, and to get the market's assessment of the proposed measures. The IIF also advocates the creation of an "Investor Relations Office" to serve as a focal point for contact with the private financial community. The IIF has also addressed the nature of the information emerging economies should provide, calling for more timely and comprehensive data on reserves, increased disclosure of Fund program details, and more information on the health of the financial sector.

The IIF suggests that, **once market access becomes difficult**, authorities should choose interested financial firms with whom to initiate intensive consultations to identify policy changes to maintain or reinvigorate sustainable flows of private capital. As the policies are formulated and new information becomes available, the IIF encourages the authorities to engage in a broader dialogue with all relevant market participants. At such times, the IIF advises authorities to continue to look to the Fund as a source of vital policy advice and financing, and promotes extensive discussions between the Fund and market participants to ensure widespread acceptance of the adjustment program.

Once market access has been lost, the IIF suggests a vigorous investor relations effort can help ensure that, as policies and performance are improved, market sentiment will be reinforcing. The IIF views precrisis contact between creditors and the sovereign as crucial for successful recovery if they build a fabric of familiarity and trust between the country and the global investment community.

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[1]This box summarizes *Strengthening Relations between Emerging Market Authorities and Private Investors/Creditors: A Country–Focused Approach to Crisis Avoidance* (April 1999).

official and private communities; such committees would be formed in the context of a crisis. Under the second set of measures, principles and procedures would be formulated with respect to the use of independent professionals who would be charged with facilitating negotiations and mediating between a debtor and its creditors; eventually, these services could be delivered through an independent standing body.

Enhancing the operation of creditors' committees

30. Because of the growing complexities that have arisen in implementing the London Approach in both the sovereign and nonsovereign context, there has been discussion within the private sector regarding the need to establish a more effective framework for the establishment and operation of creditors' committees, particularly given the desire among all parties to reduce delays in the restructuring process. For example, in the nonsovereign context, INSOL International (the International Federation of Insolvency Practitioners) is preparing nonbinding principles and procedures based substantially on the London Approach. The INSOL principles and procedures will seek to address a number of the complexities that arise when more complex instruments and nontraditional creditors are integrated into the collective framework that has been described in this paper. They will also seek to address not only the criteria that would govern the selection of a creditors' committee but also the code of conduct and procedures to be followed once the committee has been formed (subordination, standstill, confidentiality, etc.).

31. As noted in Section II, the principles and procedures applicable to the restructuring of nonsovereign debt will differ—in a number of important respects—from those that are of particular relevance to sovereign debt since formal bankruptcy procedures apply in the former case but not in the latter. Nevertheless, many of the features of the London Approach have been utilized in the sovereign context. Accordingly, the principles and procedures being prepared by INSOL International might serve as a useful starting point for the development of a similar nonbinding protocol that would provide guidance regarding the establishment and operation of *ad hoc* committees in the context of sovereign debt restructuring. With the encouragement of the official community, these principles and procedures could be developed by a group of private sector professionals (in consultation with the Fund and other official bodies) that have proven experience in sovereign debt restructuring, with a view to eventual endorsement by both the private and official sectors.[11] Issues that would need to be addressed when formulating these principles and procedures would include those discussed above, including, in particular:

32. *Committee representation criteria.* Given the growing diversity of creditors as discussed above, it would be desirable for the principles to provide adequate guidance as to

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[11]While some of the inter-creditor difficulties experienced in individual sovereign workouts could emerge in the discussion of these principles, it is likely that consensus would be easier to reach in the absence of the additional tension of an ongoing crisis.

the committee selection process, so as to give all types of creditors some assurance that the process will be fair and equitable. The principles would need to address ways of identifying and involving widely dispersed creditors, including those that purchased their debt on the secondary market. Moreover, creditors holding a large portion of the debt would not be excluded solely because they are not large financial institutions. In this context, it will be necessary for the collective framework to be broader than traditional creditors' groups such as the London Club, although such groups could still play a role within the framework. Moreover, to the extent possible, it would be useful to explore means by which committee representation could accommodate situations where creditor interests are divided between the lenders of record and end-investors.

33. *Confidentiality procedures.* Given the fact that many of the non-traditional investors are too small to incorporate the type of "fire walls" that are designed to safeguard against trading on the basis of nonpublic information, it would be particularly useful to develop alternative procedures that would enable such investors to participate actively in the committee process while, at the same time, providing some credible assurances regarding confidentiality and nonabuse of nonpublic information. One approach that has been recently used involves the creditor "out-sourcing" participation on the committee to a well-respected professional that is precluded from divulging the information to his principal.

34. *Subordination, standstill and new financing.* As noted earlier, issues relating to subordination, standstill and new financing may require special resolution in the sovereign case because of the absence of bankruptcy laws. Given the financial instruments-complexity and creditor-diversity issues discussed above, new methods may need to be developed that will effectively induce new financing during the restructuring process. For example, notwithstanding the inapplicability of bankruptcy laws, contractual subordination by principal creditors may provide some inducement for new financing. While the provision of security might provide an additional powerful inducement, relying on such a mechanism in this context raises a number of difficult issues, which are discussed in the background paper that addresses market access.[12]

Facilitation and mediation

35. In addition to formulating the types of principles and procedures outlined above, consideration could also be given to establishing principles and procedures regarding the use of facilitation and mediation services performed by independent professionals that have demonstrated experience in the workout area. As discussed below, this service could be delivered through a single independent standing body. The purpose of such a service, which

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[12] As discussed in greater detail in the related background paper, the provision of security has the effect of reducing the flexibility of a country's external position and, by reducing the authorities' room for maneuver in the face of future payments difficulties, increases the risks borne by unsecured creditors, including the Fund.

has recently been developed in the nonsovereign context, would not be to negotiate with the sovereign debtor on behalf of the creditors. Rather, its mandate would be to (i) facilitate the rapid and orderly creation of the collective framework (including the establishment of a creditors' committee) when a crisis emerges, in accordance with the agreed-upon principles and procedures mentioned above, and (ii) mediate negotiations between the debtor and the creditors' committee once the collective framework has been established.

36. The active involvement of experienced but independent professionals that are capable of establishing and coordinating the operation of the collective framework would help provide confidence to all participants that the negotiating process will be fair and efficient. For example, in Indonesia, the mediation and facilitation services provided by the Jakarta Initiative Task Force for purposes of implementing the collective framework called the Jakarta Initiative is providing an important contribution to restructuring efforts in the nonsovereign context. A similar collective framework being implemented in Thailand (the Bangkok Rules) will also increase reliance on such services. (It should be noted, however, that in both of these examples, experience with actual implementation of these mediation and facilitation services is still relatively limited.)

37. The principles and procedures would identify the method by which the debtors and creditors would select a mediator and would also define the terms of reference of these professionals. As noted earlier, the Council of the British Corporation of Foreign Bondholders was also responsible for coordinating the activities of the negotiating committees and did not conduct the negotiations itself. Following this approach, the principles and procedures regarding the use of the above-described facilitation and mediation service could actually be implemented—and developed—by a single independent body.[13] A number of the features of this body would need to be carefully considered. For example, membership and financing of this body could be sought from both the public and private sectors so as to ensure its independence and neutrality. Moreover, while the mediation services could be provided by the staff of the body itself, the body could, alternatively, merely finance such services and license the qualified mediators that would be eligible for selection by the debtors and creditors.

38. Following a more incremental approach, the principles regarding the use of facilitation and mediation services could be implemented on an *ad hoc* and experimental basis, with a view to possible conversion into a standing body if the international community believes that the benefits of this service so merit. In this context, the list of eligible mediators could, for example, be drawn up by the Fund for selection by the parties. As is discussed below, the Fund's formal role in this entire process would need to be limited. Absent a standing body, the principles would need to establish a mechanism by which the costs of this service would be

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[13]The Council, however, represented the interests of the bondholders. A standing body providing a mediation service would, of course, need to be independent.

adequately shared among the debtor and its creditors.[14] As a means of initiating this process, the question arises as to whether it would be appropriate for the first "pilot" service to be financed by the official sector.

Relationship with other initiatives and the Fund

39. While the above approaches could serve to enhance the establishment and operation of a collective framework for negotiation, creditor participation in the framework would continue to be voluntary. Accordingly, whether or not creditors decide to engage in this process will ultimately depend on whether, in terms of their own self–interest, they view it as being preferable to other options available to them. Viewed from this perspective, the effectiveness of the collective framework along the lines discussed above would clearly be enhanced if creditors perceived that, absent a voluntary restructuring, there is credible risk of default. This would depend, in turn, on the official sector's ability to send a clear signal that no class of private sovereign debt will be considered immune from a restructuring, and that such a restructuring may, if necessary, have to be achieved after a default has occurred.

40. Once creditors perceived that a default on sovereign debt is a distinct possibility, the benefits of participating in an orderly restructuring would be weighed against the alternative of litigation. While many creditors would wish to eschew this latter option, they would be concerned that their forbearance would be abused by those "free riders" that would not participate in the restructuring and would, instead, hold out for full payment through the threat of litigation. It is for this reason that the effectiveness of the voluntary framework would be further enhanced by the inclusion of provisions in bond contracts that would allow a majority of creditors to restructure a debt instrument over the objection of a minority. In terms of the negotiating dynamics that they create, these provisions in sovereign bond contracts can be viewed as the analogue to the judicial approval provisions of bankruptcy laws applicable to nonsovereign debt (which allow a restructuring to be approved by a court over the objections of a minority of creditors). In both cases, existence of such provisions plays a critical role in giving creditors an incentive to engage actively in the restructuring process. As discussed in this paper, this incentive would increase if the operation of the collective framework is perceived as being efficient and fair.

41. Since the viability of the collective framework for restructuring would ultimately be driven by the self-interests of the creditors and the sovereign debtor, careful consideration would need to be given to the role of the official sector in enhancing the effectiveness of this framework. In cases where the Fund is an official creditor, private creditors could perceive that any formal role played by the Fund in the operation of the collective framework would give rise to a conflict of interests. The Fund would, of course, be very much involved on an

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[14]It is recognized that it may not be desirable to postpone the use of such a service until the relevant principles and procedures are in place. In such a case, however, the mediators would still need to be approved by the debtor and its principal creditors.

informal level: in cases where a member has—or is negotiating—a program with the Fund, the Fund would need to make a determination as to whether—and when—the financing assumptions under the program require some combination of new financing and/or a restructuring of existing debt. However, while the Fund may wish, therefore, to advise the country as to when to activate the mediation and facilitation service discussed above, it would be critical that the professionals providing the service be selected by the relevant parties and not be considered as agents of the Fund. Similarly, while the Fund and the rest of the official sector could assist in the development of the principles and procedures regarding the operation of creditors' committees and would also need to endorse them, it would be critical that, to the extent possible, the private sector actively participate in the process and take ownership of the final product.

42. The Fund could actively support the operation of the collective framework through the application of its policies on the use of its resources. Specifically, in advance of a crisis, but where payments difficulties are envisaged, the Fund could encourage members to approach creditors for purposes of establishing the collective framework for negotiation described above. In circumstances where this framework is in operation after a default has occurred, a positive determination regarding the debtor's efforts—perhaps as independently verified by the mediator—could provide the basis for the Fund's assessment that the member is making "a good faith effort to reach a collaborative agreement with its creditors," within the meaning of the recently amended policy on lending into arrears. Conversely, a negative assessment could preclude the debtor from receiving financial assistance from the Fund.

STANDING BODIES: AN HISTORICAL OVERVIEW[15]

43. During the 19th and early 20th centuries, standing bodies were established in a number of countries for the purpose of protecting the interests of holders of foreign sovereign bonds in default by representing them in negotiations with debtor governments. The first of these bodies, the Council of Foreign Bondholders, was established in London in 1868, and eventually evolved into the Corporation of Foreign Bondholders. Drawing on the experience of this Corporation, a number of other European countries, such as France and Belgium, established similar standing bodies at the end of the 19th century. In 1933, the Foreign Bondholders Protective Council, Inc. was established in the United States for a similar purpose in the wake of a wave of sovereign defaults brought about by the global depression. This note briefly summarizes the structure and functions of these bodies.

THE BRITISH CORPORATION OF FOREIGN BONDHOLDERS

44. The first centralized body to be established for the purpose of protecting the interests of holders of defaulted foreign sovereign bonds was established in Great Britain in 1868. Prior to that, British holders of sovereign bonds had been represented by competing committees which were either self-constituted or appointed informally by the bondholders. As the number of a defaults by sovereign debtors grew in the early 19th century, there was a growing recognition that a more centralized approach would be more efficient and effective, if only because it would enhance bondholder leverage in negotiations with the sovereign debtor.

45. When the Council was established in 1868, it was comprised of representatives of financial houses, the London Stock Exchange and private bondholders. The body's composition was designed to be a guarantee of not only its professionalism and the solidarity

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[15]The analysis is contained in this Appendix draws upon the following publications: Edwin Borchard, *State Insolvency and Foreign Bondholders*, Volume 1 (1952); J. Reuben Clark, Jr., *Collecting on Defaulted Foreign Dollar Bonds*, Editorial Comment in The American Journal of International Law, Vol. 34, p. 119 (1940); Frank Dawson, *The First Latin American Debt Crisis* (1990); Barry Eichengreen, *Toward a New International Financial Architecture, A Practical Post-Asia Agenda*, Institute for International Economics (1999); Barry Eichengreen and Richard Portes, *After the Deluge: Default, Negotiation, and Readjustment during the Interwar Years*, in The International Debt Crisis in Historical Perspective, Eichengreen and Lindert ed. (1989); Foreign Bondholders Protective Council, Inc., *Report 1965 through 1967*; Foreign Bondholders Protective Council, Inc., *Report for the Years 1968 through 1970*; Foreign Bondholders Protective Council, Inc., *Report for the Period January 1, 1971 through December 31, 1975*; Leland Hamilton Jenks, *The Migration of British Capital to 1875*, (1927); Rory Macmillan, *Toward a Sovereign Debt Work-out System*, Northwestern Journal of International Law and Business, Vol. 16, p. 57 (1995); United States Securities and Exchange Commission, *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees*, Part V (1937).

of the entire financial community, but also its independence from political forces. The leverage exercised by the Council in its negotiations with debtors was financial rather than legal. The sovereign immunity laws that prevailed at the time prevented bondholders from pursuing legal actions against defaulting governments. Instead, these governments were effectively denied access to the London Stock Exchange and other exchanges for purposes of raising additional financing. For example, in 1874, the Council persuaded London and the other major European stock exchanges to block the listing of new Mexican issues; three years later, Turkey was refused access to the markets until it settled its debts under previous unpaid bonds.

46. With time, however, the effectiveness of Council's leverage diminished as other European exchanges made efforts to induce foreign issuers to raise capital in their markets. As standing bondholder councils were established in other countries, including France, Belgium and, in 1933, the United States (see below) efforts were made to coordinate the activities of these councils to enhance creditor solidarity in negotiations. These efforts were undermined by differences in the terms of bonds issued in various countries and, as a consequence, there were disagreements over how these different categories of bonds should be treated.

47. As a body that was established for the purpose of protecting the interests of bondholders, it is not surprising that the Council was generally opposed to settlements that involved debt reduction or the forgiveness of interest arrears. However, in the interest of reaching a settlement that would, in turn, maximize recovery for the bondholders, the Council did negotiate settlements that involved some debt reduction. For example, the Council negotiated an agreement with Brazil in 1943 which provide that bondholders could opt for writing off principal in return for a cash payment and a higher interest rate.

48. The institutional structure and operations of the Council evolved over time. In 1873, the Council became the governing organ of the Corporation of Foreign Bondholders, whose constitution was officially adopted through Parliament's enactment of the Corporation of Foreign Bondholders Act in 1898. Under this structure, the Council still drew its membership from the leading members of the financial community and holders of foreign bonds. However, separate committees were established for purposes of actually negotiating with governments. These committees were made up of holders of the bonds in question (or their representatives) and technical experts (the president and vice-president of the Council also became ex officio members of each committee and their chairman and vice-chairman, respectively). Once the Council had endorsed a proposed settlement reached between a committee and the government, the settlement would be submitted to bondholders for final approval. In the absence of alternative legal remedies, approval was usually unanimous or nearly so.

49. The method of financing of the Corporation also evolved. While it obtained financing for a limited period through membership subscriptions, it generally relied on fees received from bondholders and, in particular, the governments that had been involved in settlements. Members of the Council were entitled to modest annual remuneration and members of the bondholders' committees were paid honoraria upon the completion of a settlement.

OTHER EUROPEAN BODIES

50. A number of other national bodies for the protection of bondholders' interests were modeled on the British Corporation of Foreign Bondholders. In 1898 the Paris Stock Exchange, at the request of the French Minister of Finance, established the Association Nationales des Porteurs Français de Valeurs Mobilières. It also had an executive organ, a number of bondholders' committees, and a small permanent staff. The institutional structure, powers and process of selection were almost identical to that of the British Corporation. Under French law, however, all of the members of the committees had to be bondholders. The Association was financed partly through annual contributions (by members, the stock exchange, and the state) and mainly from fees paid by the debtors upon settlement.

Similar bodies were established in:

- ***Belgium***—the Association pour la Défense des Détenteurs de Fonds Publics of 1898—which was a non-profit entity working closely with the Antwerp Stock Exchange and coordinating the work of its *ad hoc* subcommittees;

- ***Germany***—the Permanent Commission of 1927 sponsored by bankers, chambers of commerce and the stock exchange;

- ***The Netherlands***—a committee with the Amsterdam Stock Exchange whose functions were to decide on the acceptance for listing of bonds of defaulting sovereigns and advising bondholders on the steps to be taken in the course of renegotiations.

THE FOREIGN BONDHOLDERS PROTECTIVE COUNCIL, INC.

51. With the express backing of the U.S. government and upon the invitation of the Secretary of State, Secretary of the Treasury and Chairman of the Federal Trade Commission, the Foreign Bondholders Protective Council, Inc. (the "FBPC") was incorporated in December 1933 as a private, non-profit corporation. The FBPC effectively replaced a long series of *ad hoc* and sometimes competing private committees that had been established to represent holders of defaulted foreign government obligations.

52. The original proposals for the FBPC contemplated that it would either affiliate itself with existing protective committees (which had been formed by issuing banking houses or private entrepreneurs) or establish special negotiating committees to deal with governments in default. Actual practice evolved very differently, however, as the FBPC negotiated the settlement of foreign bond defaults directly and in its own name, rather than through committees. The FBPC conducted negotiations with defaulting foreign governments either at its own initiative or after being approached by the government, and it did so after obtaining information from the relevant houses of issue and/or fiscal agents. Negotiations were carried

out by the officers of the FBPC (mainly the president and executive vice president) in consultation with the executive committee.

53. The FBPC did not accept deposits of outstanding bonds and consequently did not act as the legal representative of bondholders. When negotiations resulted in an acceptable readjustment proposal, the FBPC would merely recommend the offer to bondholders. As in the case of the London Corporation of Foreign Bondholders, recommendations were normally accepted because of the absence of legal remedies.

54. Until the early 1970s, the FBPC never negotiated any settlement that did not give bondholders the eventual opportunity of receiving 100% of the principal amount of their bonds and did not include some payment on arrears of interest. In 1973, however, it changed its policy to recommending discounted lump sum payments of principal where this was deemed to be in the best interests of bondholders.

55. The FBPC's record of success would seem to be mixed. On the one hand, by the mid-1970s, it had identified with 44 restructuring plans and had negotiated settlements involving all defaulted foreign sovereign dollar bonds other than those issued by a few eastern European and other communist governments. On the other hand, some empirical surveys have indicated that certain categories of American bondholders fared worse than their British counterparts (although even these American investors succeeded in recovering their principal and ultimately reaped a higher rate of return on foreign national bonds than they would have gotten on U.S. Treasury securities).

56. The FBPC operated at all times in full cooperation with, and with the informal backing of, the U.S. government and the State Department in particular, and had a general policy of deferring to the State Department's views on larger matters of policy.[16] Consequently, the council on at least one occasion refrained from negotiating on behalf of bondholders, in response to State Department wishes. In return, the State Department reportedly referred bondholders to the FBPC, frequently used its good offices on behalf of the FBPC, and provided it with confidential and other information on economic and political conditions in countries with which the FBPC was negotiating. Key members of the FBPC's leadership had close ties to the State Department, including one of its earliest presidents (who was a former Ambassador to Mexico, Solicitor of the State Department, and Under Secretary of State), and its first executive vice president (who was a former Assistant Secretary of State).

57. Most of the council's initial funding came from "dues" and advances paid by the commercial and investment banks that had distributed defaulted foreign bonds. Individual bondholders contributed only a minute potion of the initial funds, but subsequently made contributions at the request of the FBPC upon the conclusion of some readjustment

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[16] The FBPC also reported in later periods that it received assistance from the World Bank in its negotiations.

negotiations. The FBPC also occasionally obtained payments from the foreign governments with which it concluded debt settlements; these payments were the results of negotiation with the government, and were generally requested to be made after the readjustment was concluded.

58. The FBPC was active until at least the early- to mid-1970s, when it recommended offers of settlement by Poland, Hungary and Romania and additionally engaged in negotiations with Bulgaria. In addition, although now inactive, the FBPC still appears to be incorporated as a nonprofit corporation in the state of Maryland.