FOR AGENDA



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March 7, 2000

To: Members of the Executive Board

From: The Secretary

Subject: **Involving the Private Sector in Resolving Financial Crises—Experience and Principles**

Attached for consideration by the Executive Directors is a paper on involving the private sector in resolving financial crises—experience and principles. Issues for discussion appear on pages 37 and 38. This subject is tentatively scheduled for discussion on Monday, March 13, 2000.

Mr. Allen (ext. 38786), Mr. Fisher (ext. 38755), and Mr. Hagan (ext. 37715) 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 Resolving Financial Crises—Experience and Principles

Prepared by the Policy Development and Review and Legal Departments

In consultation with other Departments

Approved by Jack Boorman and François Gianviti

March 7, 2000

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Attachment

## EXECUTIVE SUMMARY

This paper is intended to help carry forward the Executive Board's consideration of involving the private sector in the resolution of financial crises and in assisting countries to return to medium-term balance of payments viability. It seeks to distill some lessons from recent experience, and provides a preliminary discussion of a framework that could help guide decisions on issues associated with private sector involvement.

Over the past two years, the Fund has encouraged Brazil, Ecuador, Indonesia, Korea, Pakistan, Romania, and Ukraine to take steps to secure the concerted involvement of the private sector in the financing of adjustment programs. The approach followed in these cases has not been well understood in financial markets or in the international community more generally and has been criticized as ad hoc and lacking the underpinning of a coherent policy framework. This in turn, has led to calls for a rule-based system, which would seek to identify ex ante when and how concerted private sector involvement would be sought. However, in previous discussions, most Executive Directors have doubted the feasibility of formulating rules that are likely to be robust across a range of cases.

This paper first outlines recent developments in the above cases and draws some tentative lessons. It then suggests some general propositions which, while short of a rule-based system, could be part of a framework for deciding when concerted private sector involvement might be required, with the aim of countering the criticisms mentioned above. A starting point for the framework is provided by the principles, considerations, and tools suggested by the G-7 Finance Ministers in their Report to the Köln Economic Summit.

The proposed framework takes as its starting point that members will, to the extent possible, seek cooperative solutions to emerging debt difficulties. For international support, and in particular the support of the Fund, to be effective, adjustment programs must be fully financed and obstacles to medium-term viability removed. Solutions should take into account the limited availability of official finance and should not undermine the stability of the international monetary system in the short or long run. The framework also recognizes that the approach taken in individual cases will need to reflect their specific circumstances, including the composition of outstanding debt instruments.

### The suggested framework

The suggested framework for handling members in financial crisis is based on five propositions:

- **Proposition 1**. If the sheer size of the program-financing requirements exceeds the availability of financing from official sources, concerted private sector involvement will be needed.

- **Proposition 2**. If program-financing requirements are large, but there are good prospects for the rapid resumption of substantial spontaneous private capital flows in appropriate forms, concerted private sector involvement would not be required, provided that the official community is willing to provide financing on an adequate scale.

- **Proposition 3**. If program-financing requirements are large and the prospects for regaining market access in a reasonable time period are poor, concerted private sector involvement would be required.

- **Proposition 4**. If the program-financing requirements can be covered with moderate amounts of official financing, concerted private sector involvement would not be required.

- **Proposition 5**. If analysis shows that the member has an unsustainable debt burden, concerted private sector involvement to restructure or reduce that debt would be required.

Thus, the Fund would continue to rely on its traditional catalytic role if the financing requirements are moderate or if the financing requirements are large but the member has good prospects of regaining market access rapidly. By contrast, concerted private sector involvement would be required if the financing requirement is exceptionally large, if the financing requirement is large and the member has poor prospects of regaining market access in the near future, or if the member has an unsustainable debt burden. Application of this framework, however, raises a number of issues.

- Relying on the catalytic approach under proposition 2 runs the risk that market sentiment will not stabilize quickly and the financing situation will worsen. If the catalytic approach seems to be failing, action may have to be taken to move to some form of concerted private sector involvement. Members in this situation need to adopt and sustain particularly strong policies to build market confidence. To protect Fund and other official resources, it may be necessary to interrupt Fund support until concerted private sector involvement can be organized and stronger policies are implemented.

- However, the threat of switching to concerted private sector involvement if the catalytic approach does not work may in itself make private creditors less willing to maintain exposure and thus undermine the catalytic approach. This dilemma is not easily resolved.

- Requiring concerted private sector involvement under proposition 3 serves notice that the official sector is not prepared to bail out excessive inappropriate lending to countries.

- Estimation of financing requirements and of the prospects for market access involves uncertainties. If it turns out that financing requirements have been overstated, or spontaneous market access has been understated, there may be a need to reassess the program targets for net international reserves in light of the reserve position.

- If the member has an unsustainable debt burden, concerted private sector involvement to restructure or reduce that debt will be required, regardless of the size of current financing requirements.

- If it takes time for the private sector to agree on the diagnosis of the need for comprehensive debt restructuring, where it is judged necessary, the Fund and the official sector should be prepared to lend into arrears to support the member's program.

- Creditors may be more willing to go along with debt reduction if they are offered value-recovery or "clawback" instruments.

- To ensure the acceptability to creditors of concerted private sector involvement, there will need to be broad comparability of treatment among private sector creditors. This does not necessarily mean identical treatment of all debt instruments.

**Form of private sector involvement**

The form of private sector involvement needs to be decided on a case-by-case basis, taking full account of the circumstances of the member concerned. In general, initial efforts to secure private sector involvement should focus on the immediate balance of payments financing problem, and not necessarily be comprehensive *across all classes of instruments*. At the same time, efforts to secure private sector involvement should generally be comprehensive *within asset classes*, because of intercreditor equity considerations and the risk of shifting pressures to other instruments (e.g., from interbank lines to trade credit for the corporate sector). While recent individual cases of private sector involvement have generally involved few asset classes, in some future cases—in view of financing requirements and burden-sharing considerations—more comprehensive approaches may be needed, possibly also extending to domestic instruments, as done in the recent case of Pakistan.

In cases in which the resolution of crises involves the concerted involvement of different groups of private creditors, it will be necessary to find a means of achieving broad comparability of treatment that results in a burden sharing that is acceptable to all parties. This is likely to entail ensuring that no one category of private creditor is regarded as inherently privileged. In practice, however, there are likely to be marked differences in the debt structures of individual cases, as well as the positions of individual creditors in a single case, thereby making it difficult to formulate a set of principles that could guide burden sharing in a way that is likely to be robust across most cases. Thus, these issues are likely to be resolved by negotiation.

Fund staff and management do not participate in negotiations between a debtor and its creditors, although there are inevitable pressures to involve them in the discussions. If requested to do so by the member concerned, it would seem appropriate for staff to participate in discussions with creditors concerning the design of adjustment programs and the member's medium-term prospects—and the associated capacity to service external debt. Staff may also be requested by the member or creditors to give views regarding the consistency of terms offered for a restructuring with the financing needs of the program.

**Institutional issues**

The paper considers certain institutional arrangements which might facilitate speedy agreement between a member and its creditors. One is the need for temporary arrangements to arrest the outflow of capital during program negotiations. In some cases, voluntary standstill arrangements by creditors may be feasible, but if they are not, then the authorities may have no choice other than to declare a moratorium on sovereign debt and impose exchange controls on the servicing of private debt, even though currently they would have no protection from litigation. The inclusion of collective action clauses in bond contracts would strengthen the ability of debtors to reach rapid agreement with creditors, without inappropriately abridging the rights of the latter. The paper discusses recent developments in the use of collective action clauses in industrial countries and also issues related to creditor committees.

The paper ends with a discussion of how the proposed framework might have been applied in the four recent cases where concerted private sector involvement focused on sovereign bonds.

## I. INTRODUCTION

1. This paper is intended to help carry forward the Executive Board's consideration of private sector involvement in the resolution of financial crises. Specifically, it seeks to distill lessons from recent experience and provides a preliminary discussion of a general framework for thinking through questions relating to private sector involvement.

2. The paper is organized as follows. Section II provides a brief discussion of the experience with efforts to secure concerted private sector involvement in the resolution of financial crises. Section III sketches a possible framework for deciding whether to take measures to secure concerted private sector involvement in the financing of Fund-supported adjustment programs. For cases in which it is decided to seek some form of concerted private sector involvement, Section IV provides a brief discussion of some principles governing the selection of instruments to be included in a concerted refinancing or restructuring. The paper then discusses the institutional limitations on the ability of debtors to secure timely agreement on an orderly refinancing or restructuring (Section V). The paper concludes with a review of the four cases in which international sovereign bonds were an issue (Ecuador, Pakistan, Romania, and Ukraine) and considers how these cases might have been handled in the context of the framework sketched in Section III.

## II. EXPERIENCE WITH SECURING PRIVATE SECTOR INVOLVEMENT

3. As discussed in previous papers, prevention remains the first line of defense against financial crises. Recent experience confirms that consistent macroeconomic and exchange rate policies, debt management, and prudential supervision of financial systems are all critical elements of a policy framework designed to manage vulnerabilities and thereby to reduce the frequency and mitigate the severity of crises. At the same time, policies designed to improve the environment for private sector decision-making can also be expected to contribute to reducing buildups of vulnerability. Improvements in the transparency of both the public and private sectors, as well as efforts to promote the adoption of and adherence to standards, should facilitate risk management on the part of investors. It is also hoped that the costs at which the public and private sectors alike are able to mobilize resources from domestic and international capital markets will reflect countries' efforts in these areas and reinforce incentives for the adoption of transparency and standards and for strengthening balance sheets. Nevertheless, on occasion, prevention will prove to be insufficient, and crises will occur. In such circumstances, members are likely to request financial resources from the Fund in support of measures intended to address the crisis and restore macroeconomic stability.

4. The guiding principles concerning the use of Fund resources and the design of financing packages involve two critical and related elements. First, they must allow the Fund to support effective balance of payments adjustment, thereby paving the way for a resumption of sustainable growth and a restoration of medium-term viability. A second critical element regards safeguards for the use of Fund resources so as to maintain their revolving character.

Clearly, a restoration of medium-term viability within the repurchase period of Fund credit offers the best prospect that a member will be able to meet its financial obligations to the Fund without undue strain. In practice, in the context of the above two Fund-specific desiderata, burden sharing may also be an important element of the design of financing packages. As discussed below, the reluctance of official creditors to provide financing without a corresponding contribution from private creditors may, as a practical matter, require the Fund to insist on the involvement of the latter so as to ensure that programs are fully financed.

5. Ensuring that programs with emerging market members are fully financed typically requires the continued involvement of the private sector. In most circumstances, it is expected that the Fund will be able to continue to rely on its catalytic role to mobilize spontaneous private financing (i.e., as policies take hold and confidence builds, in combination with financial support from the Fund and other official sources, private investors will gain the confidence needed to maintain or increase their exposure). However, in circumstances in which a member's financing requirements cannot be covered by available official financing and spontaneous private financing, it will be necessary to find some way to restructure debt or otherwise secure financing from the private sector.

6. There have been several cases in the past two years in which the Fund has encouraged members to take steps to secure the concerted involvement of the private sector in the financing of Fund-supported adjustment programs. Three cases (Brazil, Indonesia, and Korea) involved short-term interbank credits,[1] and four cases (Ecuador, Pakistan, Romania, and Ukraine) involved international sovereign bonds. Efforts to involve the private sector have had to address new and complex issues under the pressure of crises. Members and the Fund have had to feel their way through unfamiliar and difficult terrain (Box 1). In each case, these efforts focused on the need to secure adequate financing during the program period, while helping the member concerned pave the way toward a return to medium-term viability. At the same time, considerable attention has been given to ensuring that efforts to help one member's financing difficulties do not have adverse effects on other members or the efficient operation of capital markets more generally.

7. It is worth emphasizing that decisions concerning private sector involvement have been taken in the face of considerable uncertainty regarding both the member's balance of payments prospects and global developments in capital markets. Moreover, efforts to secure private sector involvement—particularly in the cases involving the restructuring of bonds—were initially greeted with stiff opposition from private capital markets. Investors and underwriters had a vested interest in avoiding a reduction in the perceived seniority of sovereign bonds. It should also be recalled that decisions concerning the involvement of the private sector have been taken against the background of limitations of the existing tool box,

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[1] Involving the Private Sector in Forestalling and Resolving Financial Crises—Further Considerations, EBS/99/21, Revision 1 (03/09/99).

**Box 1. Recent Experience with Private Sector Involvement**

Some degree of success has been achieved in stabilizing short-term bank lines in periods of crisis. In the case of Brazil (1999), after an initial attempt at relying upon the catalytic role proved unsuccessful, the voluntary agreement with commercial banks to maintain exposure on interbank and all short-term trade related credits was successful in resolving the collective action problem. In the case of Korea (1998) moral suasion, assisted by the dissemination of data to help resolve collective action problems, was successful in stabilizing a critical situation and paving the way for a restructuring. But it must be recognized that such operations should only be used with great care—on the one hand, they may tend to export balance of payments pressures to other markets, to the extent that banks operate regional or country-category exposure limits. On the other hand, they could also have a destabilizing effect, encouraging banks to cut lines whenever country authorities initiate discussions with the Fund. In this way, market reactions to current or possible future operations could result in early Fund involvement having a negative catalytic effect (see EBS/99/21 Revision 1, 3/9/99).

The experience in securing the continued involvement of bondholders has been uneven. So far, experience is limited to four principal cases: Pakistan, Ukraine, Romania, and Ecuador. As discussed below, efforts to secure private sector involvement were made within the existing institutional structures in response to immediate crises. That is to say, the focus was on resolving problems relating to the existing debt instruments (and the associated contractual provisions) within the existing legal framework. Clearly, to the extent that, over time, there are improvements in the institutional or legal setting (for example, through the widespread inclusion of collective action clauses in debt contracts), the difficulty of securing private sector involvement could diminish. In brief:

- The recent case of **Pakistan** appears to have been successful in terms of reaching a comprehensive restructuring of bonded debt on terms consistent with a return to medium-term viability. In December 1999, over 94 percent of bondholders exchanged their existing instruments for a new six-year amortizing bond with a three-year grace period and a coupon of 10 percent. Due to the relatively straightforward nature of the restructuring, Pakistan chose not to rely directly on the collective action provisions of its U.K. Trust Deed bonds—it was confident that a reasonable unilateral offer would be well understood by its bondholders, and thus the risk of calling a bondholders' meeting (primarily the opportunity created for dissident creditors to coordinate opposition to a restructuring) was not warranted. Instead, the authorities and their legal and financial advisors made informal contacts with bondholders which helped formulate the terms of an exchange offer that proved to be acceptable to most bondholders.

- This stands in contrast to the earlier experience with **Ukraine**, in which piecemeal restructurings in 1998–99 featured large up-front costs (with cash payments of at least 20 percent); short maturities (no more than 2 years) and high yields (up to 21 percent p.a.) which placed an undue strain on the balance of payments and failed to provide exit instruments and any assurance of a return to medium-term viability. Against this background, and in the face of substantial maturities on bonds in the period through February 2001, the authorities have announced their intention to seek a

**Box 1 (concluded). Recent Experience with Private Sector Involvement**

comprehensive restructuring of sovereign debt owed to private creditors, as well as to request a comparable rescheduling from Paris Club and other official bilateral creditors. To this end, the authorities have mandated a syndicate of investment banks to manage an exchange offer. After extensive informal contacts with investors, on February 4, 2000, the authorities announced an exchange offer under which bondholders were invited to exchange their existing instruments for new seven-year amortizing bonds. The new instruments feature a one-year grace period, a step-up amortization schedule, and coupons of 10 percent per annum (Euro-denominated bond) and 11 percent per annum (dollar-denominated bond).

- **Romania** was unable to mobilize new money from the bond market after its bonds had been repaid in May–June 1999, despite earlier indications to the contrary from reputable financial institutions. At the start of the stand-by arrangement, the authorities indicated that they would be able to make bond placements in the second half of 1999, notwithstanding investors' perception that Romania was not creditworthy.[1] Accordingly, numerical targets for mobilizing private financing were included as conditions under the stand-by arrangement. In the event, it proved impossible to obtain sufficient new financing with reasonable interest rates. It has been argued that setting numerical targets as prior actions impeded market access in that investors may have been reluctant to commit resources in the absence of a firm assurance that the Fund would make disbursements. The effort to secure private sector involvement as earlier sought was progressively relaxed and subsequently abandoned against the background of Romania's inability to make bond placements and the much stronger than programmed developments in the external accounts.

- In the case of **Ecuador**, the authorities' repeated delays in formulating and implementing an adjustment program and evident political problems have precluded rapid progress toward a comprehensive restructuring. Their initial plans to launch an exchange offer during the 30-day grace period following the coupon payments scheduled for August 25, 1999, were abandoned. Instead, the authorities paid the coupon on the (uncollateralized) PDI bond, and asked creditors holding the discount bond to vote to release the interest collateral, which would have cured the default on that instrument. In this case, there was insufficient support to release the interest collateral, and creditors voted instead to accelerate the discount bond. Subsequently, Ecuador also defaulted on its other international bonds. Ecuador has initiated contacts with its bondholders through a number of meetings of a so-called consultative group. Participation in the group has been decided by the authorities on the basis of investors' exposure. To date, however, progress with discussions within the group has been hampered by the continued economic and political uncertainties.

[1] Moody's sovereign credit rating, B3, and Standard and Poors and Fitch IBCA, B-, are only one notch above default grade. Other countries with similar ratings at that time—Ecuador, Indonesia, Russia, and Ukraine—also had no market access.

which does not contain instruments to permit a debtor always to secure timely agreement on needed debt refinancing or restructuring (Section V). Nevertheless, a number of lessons have emerged from this experience (Box 2). These have been helpful in beginning to develop the tools needed to respond to the diverse circumstances facing individual members in crises and in providing some guidance as to which approaches are likely to be more successful than others.

8. In some cases, an important factor motivating efforts to secure private involvement was the need to secure adequate burden sharing. Specifically, official creditors indicated that they would not be willing to provide official resources to allow private investors to exit in the midst of crises. To a large extent, this reflected concerns regarding moral hazard—the danger that the provision of official resources that serves to protect investors from the consequences of risks is likely to diminish their incentives to assess and manage risks, thereby potentially increasing both the frequency and severity of crises.

9. The case-by-case approach followed in the recent period has not been well understood by financial markets or the international community more generally. It has been criticized as being ad hoc and lacking the underpinning of a coherent policy framework. This, in turn, has led to calls for a rule-based system, which would seek to identify ex ante the circumstances in which concerted efforts would be made to secure private sector involvement and how that would be done.

10. In a previous discussion,[2] most Directors noted that the diversity of individual country circumstances—in terms of the size and composition of their debt stocks, soundness of their banking systems, their fiscal situations, their prospects for regaining medium-term viability, etc.—makes it difficult to formulate hard and fast rules that are likely to be robust across most cases. In addition, to the extent that the rules became widely known, capital markets would be likely to react in two ways. On the one hand, markets are likely to adjust the pattern of capital flows to take better account of changes in debtors' vulnerabilities. Limitations on the availability of inappropriate market financing could provide important incentives for debtors to take early corrective action and would serve to reinforce the rules. On the other hand, markets would also be likely to try to adopt financial engineering designed to circumvent such rules in an effort to escape any future bail in. To the extent that such circumvention became widespread, the rules would need to be modified in the face of a crisis.

11. Nevertheless, as has been recognized by both the official community and the private sector, there would be considerable merit in developing a general framework for private sector involvement that, while short of a rule-based system, would provide a set of broad principles used to decide whether private sector involvement should be secured, and if so, how. Such a

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[2] EBM/99/100 (9/8/99). Summing Up by the Acting Chairman, circulated as BUFF/99/122 (9/22/99).

## Box 2. Tentative Conclusions from Recent Experience

While the cases of Ecuador and Ukraine have yet to reach a conclusion, it may be helpful to attempt to draw some tentative conclusions regarding the necessary conditions for a successful bond restructuring. It is important to note that the ability to draw firm conclusions is complicated by the intensity of creditors' reaction, motivated, in part, by a desire to avoid any action by the official community to tarnish the halo surrounding international bonds.

In early 1999, following the Paris Club's announcement that the comparability of treatment provision of the Club's Agreed Minute would apply to Pakistan's international sovereign bonds, widespread concerns were expressed in financial markets that this would close the bond market to a wide range of emerging market borrowers, thereby forcing such countries to look to the official community for future external financing. In both Ukraine and Pakistan, creditors have argued that they should receive at least partial cash payments and have warned of dire consequences of restructuring in terms of the debtor's loss of market access for an extended period. While creditors' interest in being paid—rather than receiving new instruments—is clear, it remains to be seen whether any dire consequences will materialize. More recently, sentiment in financial markets appears to have shifted. Despite this early negative outlook, the ability of Pakistan to reach a satisfactory restructuring supported by an overwhelming majority of its creditors is encouraging. On another front, a number of well-known international investment banks signaled their interest in joining a syndicate of banks organizing Ukraine's latest exchange offer.

In view of the experience to date, the following points regarding the conditions for a successful bond restructuring may be noted:

*The debtor needs substantial leverage*. This, in turn, implies a credible threat of default, as well as the support of the international community. A comprehensive approach can help provide leverage and help avoid arguments relating to debtors' capacity to pay a very high price for restructuring a small fraction of the debt (Ukraine in 1998–99). By the same token, the combination of a comprehensive restructuring and a weak balance of payments helped to provide the leverage necessary to secure agreement on Pakistan's bond restructuring.

*Addressing intercreditor equity issues will be important*. In part, this doubtless reflects a negotiating position. Nevertheless, it appears that creditors will not be willing to grant concessions if they believe that their forbearance will be used to allow other investors to exit. This too suggests the need to avoid piecemeal solutions and seek comprehensive restructurings.

*Creditors will want to be satisfied that their forbearance is being used to provide breathing room for the implementation of corrective policies—and not financing to postpone adjustment*. It is worth noting that this argument, while compelling, has been used by creditors to delay agreement with Ecuador on a stabilization of interbank lines, thereby allowing banks to continue to unwind their exposure prior to an agreement on policies that could be supported by a stand-by arrangement.

*Finally, to date, the experience with the default by Ecuador on Brady bonds and Eurobonds suggests that creditor litigation may be less likely than the staff previously thought*. It remains to be seen, however, whether litigation will play a role in shaping progress toward a settlement.

framework would be intended to provide a clear and better articulated basis for decisions on private sector involvement. Its application would still have to rely on judgments concerning complex analytic questions on such matters as a member's medium-term prospects, its likelihood of regaining or deepening access to capital markets, and its ability to garner the political consensus required to sustain policy implementation. However, the adoption of a framework for securing private sector involvement is likely to be seen by financial markets as signaling that the policy of bailing-in private creditors is here to stay, and this will over time be reflected in market assessments of risks and pricing of international debt instruments.

12. A starting point for such a framework is provided by the principles, considerations, and tools suggested by the G-7 Finance Ministers in their Report to the Köln Economic Summit (Attachment I). The next section of this paper suggests ways in which these principles and considerations could be made operational in the context of the Fund's support for members' adjustment efforts. The discussion focuses on ways in which the private sector can be involved in the resolution of crises in a fashion that both helps to ensure that the immediate financing needs of adjustment programs are fully covered and that such financing is consistent with the member's return to medium-term viability. The discussion takes as its starting point that:

- members will, to the extent possible, seek cooperative solutions to emerging debt difficulties. This is important from the perspective both of maintaining discipline in financial markets and minimizing adverse longer-term effects on that member's access to capital markets, as well as the efficient operation of markets more generally;
- no one category of private debt should be regarded as inherently privileged relative to others, and
- the approach taken in individual cases will need to reflect the members' specific circumstances, including the composition of outstanding debt instruments.

## III. A Suggested Framework for Deciding Whether to Take Measures to Secure Private Sector Involvement in a Fund-Supported Program

13. This section lays out a framework to guide the Fund in deciding whether or not actively to seek private sector involvement. It makes five general propositions, which lay down the general principles. The section discusses the implications of each proposition and the problems in its application. The suggested framework cannot capture the full diversity of individual cases and would need to be amplified and applied flexibly in practice. It will also be important to take account of the views of the private sector in deciding how individual cases should be handled, and how the approach should be adapted in the light of experience.

14. The guiding principles underlying the following propositions are that the member's program should be fully financed and that obstacles to the restoration of medium-term viability should be removed. In addition, the demand for official financing must be limited to that which is available and appropriate, and solutions should not damage the stability of the international monetary system in the short or in the long run.

15. These propositions are designed to cover the Fund's support of a member in the midst of a financial crisis. The member will have lost spontaneous access to international capital markets, and, as a result, mobilizing spontaneous new money from private sources on terms consistent with medium-term viability is not immediately feasible. At the same time, there may be a substantial runoff of short-term credits. It is also assumed that understandings have been reached concerning macroeconomic and structural policies that could be supported under a possible Fund arrangement and that the remaining issues relate to the design of the financing package.

- **Proposition 1**. If the sheer size of the program-financing requirements exceeds the availability of financing from official sources, concerted private sector involvement will be needed.

- **Proposition 2**. If program-financing requirements are large, but there are good prospects for the rapid resumption of substantial spontaneous private capital flows in appropriate forms, concerted private sector involvement would not be required, provided the official community is willing to provide financing on the necessary scale.

- **Proposition 3**. If program-financing requirements are large and the prospects for regaining market access in a reasonable time period are poor, concerted private sector involvement would be required.

- **Proposition 4**. If the program-financing requirements can be covered with moderate amounts of official financing, concerted private sector involvement would not be required.

- **Proposition 5**. If analysis shows that the member has an unsustainable debt burden, private sector involvement to restructure or reduce that debt would be required.

16. The rest of this section comments on and discusses the limitations of these propositions.

### A. Excessive Financing Requirements

17. **Proposition 1**. If the sheer size of the program-financing requirements exceeds the availability of financing from official sources, concerted private sector involvement will be needed.

18. This proposition applies to those cases where the sheer size of the financing gap overwhelms the official sector's readiness or ability to provide resources, and where the uncertainties regarding the pace and scale of a return of spontaneous private market access raise substantial concerns regarding the adequacy of financing assurances for the Fund and other official creditors. Those cases where the financing requirements could be covered by the official sector are dealt with in Propositions 2 and 3.

19. In reality, the amount of support that the official sector is prepared to make available may depend on the systemic implications of the case.[3] Thus the official sector may be willing to extend larger amounts of assistance to a country where a crisis has systemic ramifications than to a relatively minor market borrower. Nevertheless, it is important to avoid giving the impression that some members are systemically so significant that they will never be candidates for private sector involvement. Not only could such a perception undermine market discipline and promote moral hazard in the case of the largest borrowers, but these are likely to be the very cases where the financing needs could exceed the amounts the official sector can make available.

### B. Large Financing Requirements, Good Market Access Prospects

20. **Proposition 2**. If program financing requirements are large, but there are good prospects for the rapid resumption of substantial spontaneous private capital flows in appropriate forms, concerted private sector involvement would not be required, provided the official community is willing to provide financing on the necessary scale. For most emerging market countries with an established presence in capital markets, a return to medium-term viability and the attainment of medium-term growth prospects would require the member to regain access to international capital markets.[4] The appropriate form of capital market access

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[3] While financial assistance from the Fund is governed by the principle of uniformity of treatment, this is not necessarily the case for other forms of official international support.

[4] The extent to which capital market access is required for viability will clearly depend on the circumstances of individual members. In cases in which scheduled amortization obligations are moderate, and potential opportunities for productive investment can be financed largely from domestic savings, capital market access limited to a combination of inward direct investment and normal short-term trade credit may be sufficient to allow a country to regain medium-term viability and realize its growth potential. By the same token, however, in cases in which a member has significant scheduled amortization payments over the medium term, or cases in which productive investment opportunities exceed domestic savings by a significant margin, medium-term viability—in the context of realizing the country's medium-term growth potential—would require access to international capital markets (whether through the extension of credit, or the purchase of equity and other portfolio assets by nonresidents) over and above inward direct investment and normal trade credit. If access to portfolio inflows

(continued...)

could include access to cross-border credits, inward direct investment, as well as privatization that could allow for the refinancing of debt through the proceeds of asset sales. Since viability requires the restoration of market access, the approach to program financing would be designed to minimize the damage to the prospects for such access.

21. The approach in this proposition is based on the Fund's catalytic role in mobilizing private sector financing. It requires good prospects for the curtailment of outflows and the resumption of spontaneous flows within a reasonable period, say 6 to 12 months at the outside. It is essential that the authorities be firmly committed to sustain policies which will build market confidence and to strengthen their policies if necessary. Nevertheless, there is a serious risk that flows will not stabilize and that continued reductions in private sector exposure will vitiate the program's financing assumptions. Such an event will undermine the adjustment program, thus putting the Fund's resources at risk, and may even create a financing need so large that the conditions of Proposition 1 would apply.

22. If the purely catalytic approach is taken, but financial conditions do not stabilize in a reasonable period, the question arises of whether there can be a quick shift to some form of concerted private sector involvement. This was done in the cases of Korea 1997 and Brazil 1998, where additional policy measures were combined with specific actions to raise the rollover rate of external bank credit, thus securing private sector involvement. While this worked relatively smoothly in these two cases, it is conceivable that a case might arise where it would be necessary to interrupt disbursements under a Fund arrangement until actions were taken to strengthen policies and to secure private sector involvement.

23. However, by this point, the financing requirement may already be much larger, as much money will have left the country. In addition, knowledge that the arrangement may have to be interrupted and private sector involvement required could itself unsettle the markets and precipitate the capital outflow. Thus an approach designed to minimize damage to the prospects for market access would in fact have worsened them. This analysis casts doubt on the possibility of having a general policy of cutting off assistance and requiring more rigorous private sector involvement measures should the catalytic approach not be working. This points in turn to the need for caution in eschewing concerted private sector involvement even when there are reasonable prospects for renewed market access in the medium term. Thus, the decision whether to rely solely on the Fund's catalytic role to secure private sector involvement remains a very difficult one, with both alternatives fraught with risks.

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were not adequate in such circumstances, medium-term viability would be associated with economic growth below the long-run potential rate.

### C. Large Financing Requirements, Poor Market Access Prospects

24. **Proposition 3**. If program-financing requirements are large and the prospects for regaining market access in a reasonable time period are poor, concerted private sector involvement would be required.

25. In contrast to the cases covered in Proposition 2, medium-term viability in these cases would not depend on near-term restoration of general access to international capital markets. While the normal servicing of certain obligations, such as trade credits, normal banking credits, and official assistance, as well as establishing conditions for foreign direct investment, would be essential to the rapid restoration of balance of payments viability, access to the international capital markets would be a lower priority because the member was not in a position to take on substantial debt in that form.

26. Members covered by this proposition might have accessed capital markets inappropriately in the past or the members' circumstances might have deteriorated substantially. The requirement of private sector involvement in such cases would signal to markets that the official sector was not prepared to provide resources to bail them out when their lending was inappropriate. Proposition 4 below also treats cases where there may have been inappropriate lending, but in those cases the problem had not reached the point where private creditors could avoid debt and debt-service reduction without exceptional official support. The need to send a signal to markets would be less pressing in the latter case.

27. Experience with cases over the past three years has underscored the substantial uncertainties with program estimates of financing requirements (Box 3). In cases such as those considered here, where the financing of the program is initially based upon securing concerted private involvement, if financing requirements prove to be smaller than programmed, it may be appropriate to reconsider the targets for net international reserves in light of the reserve position.

**Box 3. Uncertainties Regarding Program Financing Requirements**

Decisions concerning whether or not to seek concerted private sector involvement will necessarily be taken against the background of substantial uncertainty regarding both the immediate financing requirements during the program period and the prospects for a return to medium-term viability. Accordingly, it is important that the Fund's policy for securing private sector involvement should reflect this uncertainty and avoid premature moves to restructure debt.

In contrast to the experience with the 1980s debt crisis, where external imbalances were generally associated with weak fiscal positions and interruptions in medium- and long-term bank lending, to an increasing extent, more recent acute liquidity crises have been associated with abrupt movements in short-term capital, including, for example, capital flight by residents, an unwinding of portfolio positions by nonresident investors, and a cutting of interbank and other short-term credit lines. Such abrupt movements have occurred in a number of countries, including some with relatively sound fiscal positions and only modest imbalances in net movements of medium- and long-term capital. This has increased the difficulty of estimating financing requirements as compared to cases in which balance of payments crises are dominated by flows associated with current transactions and long-term capital movements. In particular, it is difficult to predict with any certainty how short-term capital movements are likely to respond to the combination of the adoption of a comprehensive adjustment program and the provision of official financing. It is thus difficult at the start of an arrangement to estimate the financing requirements during the program period or the adequacy of the Fund's financing assurances. A rapid return of confidence could lead to an abrupt reversal of capital outflows, while a more measured return of confidence could entail substantial continued outflows following the approval of an arrangement.

It is also worth noting that projections of the external accounts underpinning Fund-supported adjustment programs are subject to wide margins of uncertainty beyond those associated with the behavior of short-term portfolio flows and interbank credit lines. Arrangements with Romania and Ukraine in 1999, for example, both witnessed better-than-programmed developments in the external accounts. In the case of **Romania**, this was partly associated with a larger decline in domestic demand than programmed and a somewhat larger exchange rate depreciation that led to a strengthening of the trade balance. The latest balance of payments data indicated that the current account adjustment was about $900 million (2.7 percent of GDP) better than programmed in 1999. In the case of **Ukraine**, in contrast, the stronger reserve position appears to have reflected higher demand for money than programmed. While these developments were clearly welcome, forecasting errors of the same magnitude, but with the opposite sign, could have posed severe difficulties.

28. A particular difficulty may arise in cases where the Fund and country authorities disagree about prospects for regaining capital market access. The analytic basis for judging future market access is not strong, and sentiments in capital markets can change abruptly and unpredictably. But there is also a danger of missing opportunities to secure agreement on a restructuring at the time when a member has leverage over its creditors. In such circumstances, if the Fund does proceed without requiring concerted private sector involvement, it will be particularly important for the member to show through its policy actions that it is doing everything possible to vindicate its judgment that it has good prospects for capital market access and to reduce the risk to the Fund's resources. This will normally require an ambitious structural adjustment program, with particular focus on measures aimed at strengthening creditworthiness and creating an attractive environment for sustainable foreign investment. This would help to ensure that the member could meet its obligations to the Fund without undue strain.

## D. Moderate Financing Requirements

29. **Proposition 4**. If the program-financing requirements can be covered with moderate amounts of official financing, concerted private sector involvement would not be required.

30. This proposition covers the traditional case where the Fund provides its support to a member without requiring it to incur the costs of negotiating with its creditors. While Fund support is intended to catalyze inflows, this is not a program requirement in such cases; instead, the emphasis is on overcoming the current problem with a view to returning to a sustainable balance of payments path as soon as possible. This proposition would cover cases both where medium-term viability is consistent with likely capital market access in the near future and those where such access is only a distant prospect.

31. The issue may arise of how to treat a member which makes exceptional efforts to reduce its financing gap to a moderate level in order to eliminate the need for private sector involvement, although at a considerable cost in terms of economic activity. In essence, such a member would be judging that the costs to it of requiring some form of private sector involvement exceed the costs of the additional domestic adjustment. While the member may have its reasons for making this assessment, the Fund will also have to make a judgment on whether it is justified in making its resources available in support of a program that may involve drastic adjustment (Box 4).

**Box 4. Use of Fund Resources in Support of Programs with Large Reductions in Domestic Absorption**

This box highlights a number of factors that would need to be considered in the context of the possible use of Fund resources in support of arrangements that aim to engineer large external adjustments through a severe compression of domestic absorption.

- There is a question of a whether use the of Fund resources would be consistent with the objectives of Fund financial assistance, which include: "To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with *the opportunity to correct maladjustments in the balance of payments without resorting to measures destructive of national or international prosperity.*" (Emphasis added.) Severe compression of domestic absorption is likely to be associated with sharp increases in unemployment, with the associated impact on the prosperity of the affected segments of the population.

- To the extent that a relatively severe economic recession may call into question the political sustainability of the reform program, there could also be concerns relating to the adequacy of safeguards.

More broadly, the Executive Board may consider that making available Fund resources for programs that entail pushing countries into deep recessions is inappropriate and have adverse effects on the willingness of members facing balance of payments difficulties to seek early support from the Fund. It could also run counter to the increased emphasis on the alleviation of poverty and protecting the most vulnerable segments of the population.

## E. Unsustainable Debt Burden

32. **Proposition 5**. If analysis shows that the member has an unsustainable debt burden, concerted private sector involvement to restructure or reduce that debt would be required.

33. The previous propositions focused on the size of the financing gap facing the member; this proposition overrides the others. Since the objective of Fund support is to restore balance of payments viability, if viability requires debt restructuring or, in the limit, debt reduction, such action should be required for Fund support, regardless of the size of the financing gap in the program period.[5] In practice, once it is clear that a member has an unsustainable burden of debt, the market is likely to be closed to it for borrowings on reasonable terms, thus making a restructuring or a debt and debt-service reduction (DDSR) operation more feasible than a refinancing.

34. Determining the extent to which a member has become excessively indebted requires that medium-term scenarios point to substantial debt burdens stretching over the medium term that threaten to place undue strain on the external, and possibly fiscal, accounts. However, medium-term scenarios are highly judgmental exercises, and their analytical basis may be subject to wide margins of error. This is likely to be particularly the case at the peak of a crisis, when uncertainties regarding the timing and pace of an eventual recovery of output are likely to be particularly acute, and the possible fiscal cost associated with the resolution of a banking system crisis is hard to predict.

35. As a result, it may take time to reach a consensus that the results of medium-term scenario analysis demonstrate robustly the need for action on the debt stock. In particular, creditors are likely to be reluctant to grant DDSR promptly, and may insist on extended negotiations and careful analysis to be convinced that their best interests are served by agreeing to a restructuring that reduces the contractual value of their claims. Once the Fund and the official community are convinced that substantial debt restructuring is needed, it may not be appropriate to wait until the private sector comes into line to give their support to the member. If the member is following an appropriate adjustment program and is seeking constructive engagement with its creditors, the Fund should be prepared to lend into arrears to private creditors, securing private sector involvement by this route. One device to bridge

[5] In cases of a debt overhang, scheduled debt obligations may act as a substantial impediment to new investment financed from domestic and imported savings alike, thereby having a chilling effect on the prospects for resumed economic growth and a restoration of viability.

differences in view concerning the medium-term outlook is to encourage members to offer creditors "clawback" or "value recovery" instruments.[6]

36. In a case where there is an unsustainable debt burden, broad comparability of treatment among private creditors would address concerns relating to intercreditor equity and could help to facilitate early agreement on a restructuring. However, such comparability does not necessarily mean identical treatment of debt instruments.

## IV. Form of Private Sector Involvement

37. Previous papers have provided a brief discussion of the range of instruments that could be considered as private sector involvement (Box 5). This section, in contrast, first provides a brief discussion of issues associated with efforts to secure private sector involvement through the restructuring or refinancing of existing instruments and, specifically, issues concerning the selection of such instruments in individual cases.[7] After a brief discussion of considerations relating to burden sharing, the section provides a discussion of the role of the Fund in creditor/debtor negotiations. It then discusses an approach to securing private sector involvement in cases in which leverage has been lost through the repayment of external debts owed to private creditors. Finally, there is a short discussion of standstill arrangements during program negotiations.

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[6] See the discussion in EBS/99/29, Involving the Private Sector in Forestalling and Resolving Financial Crises—Further Considerations—Background Paper (3/5/99), paragraph 27.

[7] A discussion of the circumstances in which it may be appropriate for the government to offer comprehensive guarantees of specified private sector obligations (such as guarantees of banks' liabilities) in order to help restore confidence is beyond the scope of this paper.

**Box 5. Form of Private Sector Involvement**

As discussed in previous papers,[1] in seeking to implement the strategy, the involvement of the private sector has been defined in terms of the cross-border extension (or maintenance) of credit and exposure to counterparty risk. Accordingly, types of financial engineering that include the extension of credit, but not exposure to counterparty risk (such as gold-backed loans and loans collateralized on export receivables), would generally not be considered to represent private sector involvement.

As private sector involvement is intended to help forestall or facilitate the resolution of liquidity crises, the focus has mainly been on financial credits, as these are most relevant from the perspective of their impact on official reserves. Attention has also been given to the need to maintain access to short-term trade credit so as to limit the degree of economic dislocation during crises.

A question arises, however, concerning the treatment of inward direct investment in the assessment of private sector involvement. A comprehensive treatment of this issue is beyond the scope of this paper. However, inward direct investment covers a heterogeneous range of capital account transactions including: (i) the acquisition of equity by nonresidents;[2] (ii) long-term trade credit extended by foreign equity partners (typically used to finance imports associated with fixed investments); and (iii) a range of other capital transactions between companies and foreign equity partners. In general, while inward direct investment would be expected to be beneficial from the perspective of promoting sustainable growth, the immediate net impact on the balance of payments would relate only to the cross-border investment of capital by nonresidents used to acquire equity.

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[1]See Statement by the Staff on Involving the Private Sector in Resolving Financial Crises—Update on Ukraine FO/DIS/99/77 (6/8/99), paragraph 5, Involving the Private Sector in Forestalling and Resolving Financial Crises—Additional Considerations, EBS/99/152 (10/10/99), paragraph 56, and Involving the Private Sector in the Resolution of Financial Crises—Further Considerations, EBS/99/194 (10/19/99), paragraph 7.

[2]Typically defined to consist of acquisition of equity, which may involve cash transactions, as well as noncash transactions, such as debt equity conversions and acquisitions associated with the transfer of technology and access to foreign markets.

## A. Choice of Instruments to be Restructured or Refinanced

38. The form of private sector involvement would need to be decided on a case-by-case basis, taking full account of the circumstances of the member concerned.

- *In general, initial efforts to secure private sector involvement would be focused on the immediate external financing problem and would generally not be comprehensive* ***across all classes of instruments*** *(unless warranted by specific circumstances).* By way of example, in the case of **Brazil**, the immediate source of outflows in early 1999 related to the unwinding of interbank lines and other short-term trade related credits. Efforts to secure continued private sector involvement focused on such lines, and did

not need to address other less pressing channels for private outflows, such as international bonds.[8] Clearly, had efforts to secure agreement with commercial banks been unsuccessful, or had outflows through other channels accelerated, consideration would need to have been given to a somewhat broader coverage of a subsequent restructuring.

- *At the same time, efforts to secure private sector involvement should generally be comprehensive* ***within asset classes***. By way of illustration, an agreement for the maintenance of exposure limited to interbank lines would likely export pressures to the corporate sector unless accompanied by understandings regarding the maintenance of exposure on trade-related bank credits extended directly to corporations. Also as noted above (Box 1), the piecemeal approach to bond restructuring used by **Ukraine** in 1998–99 limited its leverage in negotiations and raised concerns about intercreditor equity. This resulted in agreement on refinancings over short periods that did not provide durable resolutions of the payments difficulties, as well as large up-front payments and high yields that placed strain on the external and fiscal accounts. The comprehensive approach followed by **Pakistan**, in contrast, helped to facilitate an orderly resolution on terms consistent with a return to medium-term viability. By the same token, the decision in early February 2000 by **Ukraine** to launch a comprehensive exchange offer is expected to facilitate reaching an orderly agreement with creditors on terms consistent with a return to medium-term viability.

39. While some cases to date have involved only a single asset class (short-term interbank and trade-related credit—**Brazil** and **Korea** and sovereign bonds—**Romania** and **Ukraine**), it is possible that future cases will be more complex and cover both sovereign and nonsovereign borrowers and both international and domestic instruments. In the case of **Pakistan**, for example, private sector involvement included restructuring of nonsovereign foreign currency deposit liabilities of commercial banks owed to resident and nonresident investors; sovereign obligations to foreign commercial banks; and international sovereign bonds. And, while the details have yet to be finalized, it is clear that the scope of the private sector's involvement in the case of **Ecuador** will need to extend well beyond international sovereign bonds and may have to encompass domestic debt.

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[8] By early 1999, in the wake of the LTCM crisis, nonresident investors had unwound large leveraged positions in Brazilian instruments, thereby reducing the scope for further outflows. Had such positions not already been unwound, it is unlikely that the agreement with commercial banks would have been sufficient to stabilize short-term capital movements.

## B. Comparable Treatment

40. In cases in which the resolution of crises involves the concerted involvement of different groups of private creditors, it will be necessary to find a means of achieving broad comparability of treatment that results in a burden sharing that is acceptable to all parties. This is likely to entail ensuring that no one category of private creditors is regarded as inherently privileged. In practice, however, there are likely to be marked differences in the debt structures of individual cases, as well as the positions of individual creditors in a single case, thereby making it difficult to formulate a set of principles that could guide burden sharing in a way that is likely to be robust across most cases.[9]

41. By way of example, in some cases it may be sufficient for the resolution of financial crises to secure the involvement of only private (and possibly official bilateral) creditors holding international debt instruments (e.g., Brazil, Indonesia, and Korea), while in other cases it could be necessary to cover a range of domestic instruments, possibly including government debt instruments and/or selected liabilities of the banking system (e.g., Ecuador, Pakistan, and Ukraine). At the same time different groups of creditors may have claims with markedly different payment profiles. At the extreme, one group may hold claims that are predominantly in arrears, while others may hold claims that have yet to mature. The Paris Club generally requires as a condition for extending debt relief that other creditors should provide comparable relief. The difficulty of formulating a broad definition of adequate burden sharing that is likely to be applicable to all cases has led the Paris Club to reserve some element of discretion in the application to individual cases of the comparability of treatment provision of its Agreed Minutes. Recently, voices in the private sector have called for restructurings of private creditors' claims to be matched by comparable restructurings by official bilateral creditors.

## C. Role of the Fund in Creditor-Debtor Negotiations

42. Questions are likely to arise concerning the role of the Fund in debt negotiations. It is important to maintain the principle that Fund staff and management are not a party to the negotiations between a debtor and its creditors and therefore cannot participate in the negotiations. Nevertheless, there has been an inevitable tendency for Fund staff and management to be drawn into discussions between debtors and creditor. During recent episodes, the staff has worked closely with members to develop understandings regarding the magnitude of the financing needs during program periods, the medium-term capacity to service restructured or refinanced debt, and issues associated with the design of new instruments.

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[9] It is worth noting that in the context of nonsovereign workouts, intercreditor equity issues among various groups of private investors are typically resolved through negotiation.

43. It is likely that debtors will continue to seek the views of Fund staff and management regarding the consistency of various possible financing packages with regard to both the immediate financing needs of the program and a return to medium-term viability. At the same time, in refining negotiating strategies, debtors are likely to want a signal as to whether—in the event it is not possible to reach agreement on a proposed package and to avoid the emergence of arrears—Fund management would be willing to recommend that the Executive Board approve continued support for the member's adjustment efforts by lending into arrears. Since the discussions between the Fund staff and the member are material to the outcome of negotiations between the member and its creditors, it is inevitable that the latter will want to discuss with Fund staff issues arising from debt negotiations. Typically, the creditors may wish the Fund staff to confirm the member's description of the state of negotiations between the Fund and the member or they may wish to gain a better understanding of the member's adjustment program or payments capacity. If requested to do so by the member concerned, it would seem appropriate for staff to participate in discussions with creditors concerning the design of adjustment programs and the member's medium-term prospects—and the associated capacity to service external debt. Finally, it should be noted that the Fund can play an important role in resolving collective action difficulties that may arise in creditor-debtor relations through the dissemination of data. This could be particularly important for members with substantial short-term obligations.

### D. Approach to Securing Private Sector Involvement in Cases in which Debts have been Repaid

44. In some cases, there may be no feasible means of securing private sector involvement in the financing during the immediate program period. This is most likely to be the case where large obligations fall due at or before the start of the program. In the case of **Romania**, for example, with capital markets essentially closed to the country, and, by late June 1999, the sovereign bonds repaid, there was no means of mobilizing private sector involvement in the financing of Romania's adjustment program. With the benefit of hindsight, establishing numerical targets for market borrowings as prior actions did not serve the intended purpose. In such cases, a better approach may be to complement the stabilization program with a structural reform agenda focused on tackling the critical impediments to market access, so as to provide a basis for the eventual return of spontaneous market access. Such a reform agenda could be built on the analysis prepared in the context of Fund surveillance and World Bank economic and sector work and could also draw upon market commentaries—including the detailed reports of the principal credit rating agencies. Such commentaries typically provide a detailed description of a country and its economic prospects, as well as a discussion of the principal impediments to a return to spontaneous market access.

## V. Institutional Limitations on the Ability of Debtors to Secure Timely Agreement on an Orderly Refinancing/Restructuring

45. The discussion of the suggested decision-making framework sketched above has abstracted from institutional limitations on the ability of debtors—with the support of the international community—to reach timely agreement on debt restructurings or other means of securing private sector involvement. This section discusses areas in which progress might be made in lifting institutional constraints. It first discusses the question of standstill arrangements during program negotiations. It goes on to consider mechanisms for coordination among creditors, including recent developments in the use of collective action clauses and the role of creditor committees.

### A. Standstill Arrangements During Program Negotiations

46. Concerted private sector involvement should be used to finance adjustment, rather than allow corrective measures to be postponed. Nevertheless, it may be appropriate in some cases to consider temporary arrangements to arrest outflows of private capital for relatively brief periods to provide a breathing space while country authorities formulate comprehensive programs of macroeconomic stabilization and structural reform and mobilize the necessary political consensus to support them. Such arrangements would be intended to moderate exchange rate pressures and the depletion of reserves. This could limit the potential scale of economic dislocation and the associated impairment of the member's medium-term debt-servicing capacity while enhancing the ability of the Fund to obtain the financing assurances necessary for the support of a member's adjustment efforts. To the extent possible, it would be desirable for temporary arrangements to be voluntary and market based. Such arrangements could include agreements with foreign commercial banks to maintain exposure with respect to interbank and trade-related credits extended directly to corporations, or standstill agreements with creditors holding medium- and long-term claims covering payments of principal, interest, or both. This approach would be the least damaging from the perspectives of regaining market access over the medium term and of the efficient operation of global capital markets. In extreme circumstances, however, if it is not possible to reach voluntary agreements and the process of elaborating and adopting corrective measures is protracted, it may be difficult for the authorities to avoid a default on sovereign obligations or the imposition of exchange controls limiting the ability of nonsovereign debtors to service their debts. However, within the framework of the Fund's existing Articles of Agreement, the Fund would not be able to sanction such a standstill with respect to sovereign obligations in a fashion that provided temporary protection from creditors seeking to enforce their claims through litigation.

## B. Creditor Coordination Mechanisms

47. The experience with agreements concerning the rollover of interbank claims for Brazil, Indonesia, and Korea has demonstrated that informal mechanisms for coordination within the banking community developed during the 1980s debt crisis continue to be effective. Contacts among commercial banks provide an effective channel for exercising peer pressure to participate in rollover agreements and for disseminating information to help resolve collective action problems. Moreover, in the case of Korea, central monetary authorities were effective in applying moral suasion to creditor banks under their supervision to pursuade them to agree to roll over their exposure and to tender their claims for conversion into medium-term bonds. As the rollover agreement was reached only at a late stage, it was relatively straightforward to obtain the agreement of banks that something had to be done to prevent a default. These informal mechanisms served to resolve the collective action problem that had become apparent. (One of the lessons from the rollover exercises has been the importance of establishing efficient monitoring systems to allow country authorities to monitor short-term capital movements associated with interbank transactions and to provide early warning of emerging pressures. Experience has pointed to the desirability of establishing such systems in good times, as their introduction in periods of stress may risk spooking international banks, thereby triggering an acceleration of outflows.)

48. Similar mechanisms do not exist for investors holding international sovereign bonds (Box 6). As a result, there is substantial uncertainty surrounding the prospects for obtaining timely agreement on an orderly restructuring/refinancing of sovereign bonds, even in cases in which the restructuring is being sought in the context of a Fund arrangement and with the support of the official community.

49. Despite the absence of formal mechanisms to bring a restructuring of securities to closure, the ability of Pakistan to reach agreement with its bondholders is encouraging. Similarly, there are signs that Ukraine's current negotiations with its bondholders may result in broad acceptance by creditors of a satisfactory restructuring. In neither case has there been resort to litigation by creditors. The reasons for the successful outcome in the Pakistan case include a recognition by creditors that, in light of the country's situation, little value is likely to be extracted by litigation. Also important has been the recognition that the comprehensive nature of the restructuring, by improving the debtor's creditworthiness, resulted in an increase in the market value of the aggregate claims. Thus, at least in the case of Pakistan, a sufficiently large group of creditors saw benefit in accepting the restructuring offer for it to succeed. In this case, the fact that the bonds contained collective action clauses providing for the modification of the terms and the enforcement of creditor rights by qualified majorities may have convinced disaffected creditors of the futility of rejecting the deal and resorting to litigation. The active market soundings made by the debtor and its advisors were probably also instrumental in achieving this result.

## Box 6. Differences Between International Sovereign Bonds and Syndicated Commercial Bank Loans Relevant to an Orderly Restructuring

There are a number of differences between international sovereign bonds and syndicated bank loans that have a bearing on the ability of debtors to secure rapid agreement on an orderly restructuring.

- ***It may be difficult to establish the identity of individual bondholders, and as a result it may be difficult to conduct informal market soundings regarding the acceptability of restructuring proposals within a brief period.*** Most international sovereign bonds are issued in the form of global notes held by the large clearinghouses (Euroclear and Cedel Bank, in Europe, and DTC in the U.S.). However, neither Euroclear nor Cedel Bank is permitted to reveal the identity of individual investors. Moreover, while DTC will provide debtors with information relating to the holders of record, such holders may not be the owners of the beneficial interest. Such difficulties may be compounded by the widespread use of derivatives under which certain risks may be borne by writers of derivative contracts rather than bondholders. However, recent experiences with Pakistan have shown that with adequate time it is possible to make informal contacts with bondholders.

- ***Bondholders are more likely to accelerate their instruments and demand full payment of principal and accrued interest upon the occurrence of an event of default.*** Acceleration can provide an avenue for creditors to apply pressure for a settlement by making litigation potentially more profitable. Banks participating in syndicated loans rarely accelerated. This was due to various reasons, including the generally cooperative nature of most syndicated loan negotiations, the absence of significant creditors outside of syndicates, and relatively high acceleration thresholds of 50 percent of principal. Because one or more of these factors may not apply with respect to a bond event of default, acceleration may become more likely. Ecuador is one example.

- ***In contrast to syndicated bank loans, relatively few sovereign bonds include sharing clauses.*** Sharing clauses, which require that any recoveries received by one creditor be shared with other members of the syndicate (or holders of the instrument), provide powerful incentives for creditors to seek collective solutions to debt difficulties, and to eschew litigation. Only English law trustee-type bonds, a relatively small minority of all international sovereign bonds, include de facto sharing clauses. The presence of these clauses in Pakistan's bonds may, however, have facilitated the restructuring process.

Moreover, bondholders may form a diverse group, including long-term investors (such as insurance and pension companies), commercial banks, a wide range of investment companies (including mutual funds, hedge funds, and vulture funds).[1] This diversity introduces a number of complicating factors to a potential workout process, including:

- ***Moral suasion.*** As a group, bondholders are not subject to moral suasion of regulatory authorities. While some investors may be susceptible to official pressures, other investors (that may have become particularly important in the run-up to crises as a result of secondary market trading, such as some hedge funds) are less so. Moreover, while some investors may be concerned about the affect of aggressive negotiation tactics (including litigation) on their reputations and future ability to develop their businesses, others may specialize in recovering value in difficult circumstances.

- ***Regulatory requirements.*** Some investors are required to mark to market, and thereby reflect the secondary market value of their claims promptly in their balance sheets. Other investors, in contrast, are able to continue to show their claims at the full face value. While investors who have already recognized losses in the market value of their claims may be willing to participate in a restructuring or

**Box 6 (concluded). Differences Between International Sovereign Bonds and Syndicated Commercial Bank Loans Relevant to an Orderly Restructuring**

refinancing that allows them to realize a capital gain, investors who continue to record claims at face value may be reluctant to participate in deals that would force them to recognize a loss.

- ***Fiduciary responsibilities***. Investment funds that are the lender of record may manage their investments on behalf of clients who own the beneficial or economic interest. The managers who operate such funds have fiduciary responsibilities that may limit their scope for maneuver and authority to tending instruments for a restructuring or refinancing. This is likely to be a particular problem in cases in which the beneficial interest is held by relatively unsophisticated investors (such as the household sector), rather than large and sophisticated financial institutions.

- ***Vulture funds***. Distressed debt may be held by vulture funds that specialize in extracting salvage value. Such investors may have little interest in participating in an orderly exchange, and may be motivated, instead by trying to use aggressive litigation to obtain settlement on favorable terms.

- ***Complicated decision-making structures***. Bonds may be held by special purpose vehicles or investment funds that have decision-making structures that severely complicate the task of reaching agreement on a restructuring.

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[1] Recent press reports suggest that the importance of household sector investors in emerging market debt instruments may tend to increase over time as companies that now offer to trade equities over the Internet expand to include a range of emerging market sovereign and nonsovereign bonds.

50. Nevertheless, there remains fear that there may be protracted delays in reaching agreement on a restructuring—accompanied by the accumulation of payments arrears and the threat of litigation—which would exacerbate the member's situation.[10] The scale of economic dislocation resulting from such a delay is well illustrated by the experience of Indonesia. Against this background, members may delay approaching their bondholders for a

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[10] The case of Ecuador provides an interesting illustration of the way in which the potential threat of litigation (as opposed to actual litigation) can have an adverse effect on a member's ability to borrow. Following the default on the Brady bonds in 1999, Ecuador lost the opportunity to mobilize resources through an oil-backed facility. Investment bankers noted that the normal due diligence process would show that the security package supporting the envisaged financing (whether through the forward sale of oil or a lien on export receivables) could be vulnerable to litigation. As such vulnerability cannot be priced and traded, banks would be unwilling to enter into new arrangements that exposed their capital to the associated risks.

restructuring until the last possible moment, by which time the economy may already be in deep crisis and official reserves substantially depleted.

51. There would thus be merit in examining proposals to strengthen the capacity of debtors to secure rapid agreement on such restructuring/refinancing arrangements. Clearly, in seeking to strengthen this capacity it is important to strike an appropriate balance between the legitimate interests of creditors and debtors. As noted in a previous paper,[11] although there has been a great deal of emphasis in discussion of the recent crises on the need to find ways of allowing debtors to delay or not make scheduled payments at times of crisis, it is important for the efficient operation of markets that contracts be honored. This principle—that contracts be honored—should be maintained in order to help underpin the integrity of financial markets. Accordingly, there is a need is to find ways of modifying contracts and the operation of the international monetary system in a way that increases its efficiency while ensuring that both lenders and borrowers understand the rules of the system and abide by them—not to find ways to allow borrowers to abrogate contracts at their convenience or to permit creditors to force adherence to contracts in situations of extreme stress.

52. Previous papers have discussed various proposals for ways in which institutional arrangements could be modified so as to facilitate orderly restructurings of bonds and other external debts. The two most far reaching proposals—the establishment of a formal international debt adjustment mechanism (which would act as a sovereign bankruptcy mechanism) and a modification to Article VIII, Section 2(b) (so as to allow the Fund to sanction a temporary stay on creditor litigation as mentioned above)—would require the approval of new (or amendment of existing) international treaties and the associated enabling legislation in member countries. Some other suggestions for involving the private sector in the resolution of financial crises (including call options in interbank lines) have also been discussed in previous papers. On balance, however, seeking such changes—if they are deemed desirable—could take time, and they are not pursued here.

**Collective action clauses**

53. The inclusion of collective action provisions in international bonds can assist in promoting an orderly and equitable sovereign restructuring process by addressing the free rider problems that arise when a minority of creditors seek to take advantage of the forbearance of those who are more willing to reach an agreement with a sovereign debtor. These provisions were analyzed in a recent staff paper[12] and are described briefly in Box 7.

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[11] Involving the Private Sector in Forestalling and Resolving Financial Crises—Further Considerations, EBS/99/21, Revision 1 (3/9/99), Paragraph 4.

[12] Involving the Private Sector in Forestalling and Resolving Financial Crises—Collective Action Provisions in International Sovereign Bonds, SM/99/207 (8/11/99).

**Box 7. Collective Action Provisions in International Sovereign Bonds**

Collective action clauses help a qualified majority of creditors prevent minority creditors from derailing the restructuring process. As such, they serve to facilitate an orderly and equitable restructuring process. Collection action clauses consist of two types:

- ***Majority restructuring provisions***, which enable a qualified majority of bondholders to bind all bondholders to a modification of the key terms of a bond both before and after a default, provide a particularly effective means of promoting an orderly restructuring process.

- In addition, inclusion of ***majority enforcement provisions,*** which enable a qualified majority of bondholders to limit the ability of other bondholders to enforce claims, provides a useful brake on any disorderly behavior while the sovereign is negotiating a restructuring in good faith. Following a method that is used in connection with some international sovereign bonds governed by English law, this could be most easily achieved through the reliance on bonds issued under trust deeds that give the trustee—rather than individual bondholders—the authority to initiate acceleration and legal proceedings on behalf of all bondholders once requested to do so by the requisite proportion of bondholders. Moreover, by relying on the trustee to enforce claims on behalf of all bondholders, the terms of the trust deed ensure that ***the proceeds of any litigation initiated by the trustee will be shared among all bondholders***.

While there are considerable variations among outstanding international sovereign bonds regarding the inclusion or exclusion of the above provisions, these variations are due, in most cases, to practice rather than the requirements of any national law. In particular, these provisions could be incorporated into all international sovereign bonds governed by the laws of New York or England.

The statement by the German government of February 14, 2000 on the validity of collective action clauses in bonds of foreign issuers subject to German law notes that majority restructuring clauses in such bonds are not governed by the German Bondholders Act and that they would be valid under the German Standard Contracts Act if they were modeled on the principles of the Bondholders Act. The statement adds that clauses which do not ensure the same protection for minority bondholders as the Bondholders Act (e.g., majority decisions on the partial reduction of principal) might be permissible in bonds of foreign issuers if they are included for the purpose of safeguarding the interests of all bondholders (see Appendix III).

With respect to Samurai bonds, it is unclear whether a clause limiting individual bondholders' rights to initiate legal proceedings would be valid under Japanese law.

54. During the recent Board discussion, 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. Directors also discussed the pros and cons of a demonstration strategy under which industrial countries would include such terms in their own bond issues.

55. With a view to setting an example for emerging markets, the U.K., on January 28, 2000, auctioned the first U.K. Treasury Euro Notes containing majority action provisions.[13] Aside from the outstanding stock of Euro debt, the U.K. now has collective action clauses in all its foreign currency debt.

56. Also, in response to questions raised on the validity of collective action clauses in bonds of foreign issuers (including sovereign issuers) that are subject to German law, and in the absence of court rulings on this matter, the German government issued a statement on February 14, 2000 to the effect that collective action clauses in such bonds are valid under German law if they comply with certain requirements (see Box 7 and Appendix I).

**Creditor committees**

57. As a complement to measures that seek to promote orderly restructuring by constraining disruptive action by individual creditors, consideration could be given to promoting a collective framework for negotiations between creditors and sovereign debtors through creditors' committees and other bodies acting in the common interests of creditors. Creditors recognize that such committees—which are established on a regular basis in the context of both nonsovereign and, on a broader level, sovereign debt restructuring—create efficiencies during the negotiating process that serve to enhance the value of their claims. If requested to do so by the member concerned, Fund staff could work with committees to develop a common understanding of the developments and medium-term prospects of the fiscal and external accounts.

58. At the same time, the operation of creditors' committees and the collective framework generally is becoming more difficult, as a result of the increasing diversity of creditors and complexity of financial instruments. The private sector, under the leadership of the International Federation of Insolvency Practitioners (INSOL), is seeking to establish principles and procedures to guide and enhance the framework for nonsovereign debt restructurings. Its work could serve as a starting point for the development of similar principles and procedures in the sovereign context (recognizing the important differences between the two types of debt).

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[13] Under the terms of these notes, a meeting can be called at which noteholders representing more than two-thirds of the outstanding principal can vote by a 75 percent majority to change key financial terms of the instrument.

59. The current and historical roles of creditors' committees and other bodies acting in the common interests of creditors, and possible ways in which their roles could be enhanced in light of recent difficulties with the existing framework, were discussed in detail in a recent staff paper.[14]

## VI. Review of Recent Cases in Which Bonds Were an Issue in Light of the Suggested Framework

60. This section provides a brief discussion of how the four cases in which international sovereign bonds were an issue might have been handled under the suggested framework sketched in Section III, above, and contrasts this with what actually occurred. The cases are discussed in chronological order.

### A. Ukraine

61. In the aftermath of the Russian crisis in 1998, Ukraine faced a severe liquidity crisis in the context of a loss of access to international capital markets. When the authorities continued to be unable to raise capital from private investors following the approval of a Fund arrangement, they sought to close the financing gap through the rescheduling/refinancing of obligations to foreign investors falling due in September and October 1998. This was followed by a partial refinancing of a further instrument maturing in June 1999. With the prospect of substantial scheduled redemptions on sovereign debt in 2000-01, on February 4, 2000, the authorities announced a comprehensive restructuring of bonds owed to private creditors maturing in the period through end-2001 and, at the same time, indicated that they would seek comparable relief from Paris Club and other official bilateral creditors.

62. How would the suggested framework sketched above suggest that this case should have been handled? In this case, the financing requirements were large (it would have been very difficult for Ukraine to make the scheduled payments in the fall of 1998—in the absence of additional financing—without drawing reserves down to unacceptable levels). Also, Ukraine had lost access to capital markets and appeared to have little prospect of regaining spontaneous access within a reasonable period. Against this background, the suggested framework would have pointed to the need for efforts to secure concerted private sector involvement.

63. The one respect in which the suggested framework points to a different approach from that followed in this case concerns the form of private sector involvement and, specifically, the use of a comprehensive approach to bondholders, rather than the piecemeal approach actually

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[14] Involving the Private Sector in Forestalling and Resolving Financial Crises—The Role of Creditors' Committees—Preliminary Considerations, SM/99/206 (8/11/99).

adopted. There is little doubt that the piecemeal approach—and associated limited leverage and difficulties associated with intercreditor equity—contributed to restructurings that did not provide credible exit instruments and imposed an undue strain on the external and fiscal accounts (as a result of large up-front cash payments and high yields on the restructured instruments). In part, the initial approach to rescheduling reflected the early and evolving experience of the Fund and the international community on these issues. Nevertheless, it should be recognized that the authorities' rationale for adopting a piecemeal approach was the optimistic anticipation of a large-scale privatization program, which could have allowed Ukraine to meet obligations maturing in 2000–01 without resorting to further restructurings. In the event, the authorities considered that it was not politically feasible to mobilize the consensus needed to support such a privatization program and decided instead to seek comprehensive debt restructuring.

## B. Pakistan

64. In late 1998, as a result of vulnerabilities associated with an excessive build-up of short-term liabilities and a reduction in official inflows that was associated with the testing of nuclear devices, Pakistan experienced an acute liquidity crisis. The restructuring of obligations owed to private creditors was a key element of the financing package supported by the Fund arrangement. (Other elements of the financing package included a Paris Club restructuring and assistance from MDBs.) The restructuring of obligations to private investors covered both nonsovereign and sovereign claims: (i) the foreign currency deposit liabilities of Pakistani banks and other financial institutions;[15] (ii) short- and medium-term obligations of the Republic and of selected state-owned enterprises to commercial banks; and (iii) Pakistan's international sovereign bonds.[16]

65. Under the suggested framework sketched above, the substantial size of the financing requirements and the limited prospects for a return to spontaneous capital market access, would have pointed to the need to secure concerted private sector involvement. In view of the complexity of the balance of payments situation and associated sources of capital account

[15] These liabilities were supported by forward cover arrangements between the financial institutions concerned and the central bank.

[16] It will be recalled that the internationally placed note secured on the international receivables of the majority state-owned Pakistani telecommunications company was excluded from the scope of a restructuring on account of the difficulty of restructuring a claim supported by liens on receivables.

pressures, the form of private sector involvement—a comprehensive restructuring across sovereign and (selected) nonsovereign obligations—was appropriate. The following points are of relevance:

- It seems appropriate to have excluded from the scope of the restructuring trade-related and other credits extended directly to privately-owned Pakistani corporations so as to preserve such borrowers' access to trade credit and working capital, thereby avoiding unnecessary economic dislocation.

- Excluding international sovereign bonds from the scope of a refinancing/restructuring would not have been feasible. A bond restructuring was required by official bilateral creditors as a condition for their own restructuring on grounds of equitable burden sharing.

### C. Romania

66. Romania is among the most difficult and controversial of the cases in which the Fund has recommended measures to secure concerted private sector involvement. Against the background of a weak reserve position and prospects for the balance of payments, the negative sentiment in capital markets, and Romania's uneven track record under previous Fund arrangements, Fund staff initially recommended that Romania seek to restructure its international sovereign bonds maturing in May-June 1999 as a means of helping to resolve the liquidity crisis. The authorities were firmly opposed to this recommendation. In light of the advice from major investment banks, they considered that Romania would have strong prospects for mobilizing spontaneous new money after they had demonstrated their commitment to honor debt obligations by avoiding a restructuring. They were also concerned that any restructuring would impede their return to market access and their ability to continue to attract inward direct investment and trade credit, and might even trigger a domestic financial crisis. Staff, in contrast, considered that Romania did not have realistic prospects for being able to mobilize new money from the bond market. Nevertheless, in April 1999, staff and management accepted the authorities' position. As noted in Box 1, the authorities redeemed the bonds, but were unable to make further placements. In the only new money they were able to mobilize came from a Club loan from a syndicate of foreign commercial banks active in Romania. Initially, the approval of the Fund arrangement and completion of program reviews were conditioned on the mobilization of specified amounts of financing from the private sector. With the passage of time, however, it became clear that Romania would not be able to meet these targets, and against the background of more favorable than programmed developments in the external accounts, the conditions regarding private financing for Board approval of the arrangement and completion of program reviews were progressively relaxed and then abandoned. This experience suggests that establishing numerical targets for market access as a condition for the use of Fund resources in cases in which leverage has been lost through the repayment of debt does not provide an effective tool for securing private sector involvement, and should probably not be repeated in other cases.

67. How would the suggested framework sketched above suggest that this case should have been handled? On balance, the low level of reserves and the size of the financing requirement (estimated in mid-1999) coupled with the limited prospects for a spontaneous resumption of capital market access, suggest that it was appropriate to seek concerted private sector involvement in this case. It is recognized, however, that the relative magnitude of the financing requirements and bond redemptions make this case less clear cut than either Ukraine or Pakistan.

68. Three features of the case warrant particular mention.

- It is worth recalling that a decision regarding whether to seek concerted private sector involvement had to be taken at an early stage, as the bunching of obligations to private investors ahead of the approval of a Fund arrangement did not allow the luxury of delaying a decision until the prospects for the external accounts had been clarified.

- There was a sharp divergence of views between Fund staff and the Romanian authorities regarding the prospects for spontaneous capital market access.

- There were concerns that efforts to restructure international sovereign bonds could have had a chilling effect on Romania's ability to attract inward direct investment and normal trade credit during and immediately after the program period. These concerns were reinforced by the legal structure of the sovereign bonds, which were issued by the National Bank and included comprehensive waivers of immunities over the official reserves. Had efforts to reach agreement on a voluntary bond exchange failed, and Romania had fallen into arrears, the reserves could have been exposed to the risk of attachment through creditor litigation. (The limited experience to date with sovereign bond restructuring offers little evidence one way or the other regarding the possible impact of such restructurings on access to such capital. It seems likely, however, that the credibility of a member's commitment to sustain policies that hold the prospect of avoiding future payments difficulties is a more important determinant of capital market access than previous restructurings.)

69. Against this background, the suggested framework points to the following approach. In the face of a divergence of views between the staff and country authorities regarding the prospects for market access, it was appropriate for the Fund not to require the refinancing/restructuring of the maturing bonds as a condition for the use of Fund resources. Nevertheless, it would have been appropriate to consider modifying the program, instead of conditioning the approval of a Fund arrangement and program reviews on numerical targets for private financing. The structural reform program could have been strengthened—with a focus on measures aimed at improving Romania's creditworthiness in order to lay the basis for a subsequent enhancement of the Fund's catalytic role.

### D. Ecuador

70. The Fund has maintained a close dialogue with the Ecuadoran authorities since early 1999 regarding a possible program that could warrant financial support. During this period, Ecuador's external financing prospects deteriorated dramatically, as a result of which hopes of arranging a market-friendly financing package faded. Spontaneous market access has been lost, arrears emerged on interbank lines extended to intervened banks, and there have been large short-term capital outflows associated with both the scaling back of interbank lines and the flight of residents' capital fuelled by the unfreezing of bank deposits. Moreover, in September, Ecuador defaulted on Brady bonds. This was followed by the default on sovereign Eurobonds in November of that year.

71. In this case, the suggested framework sketched above suggests that it was appropriate for the Fund to focus on helping the authorities elaborate policies that could be supported by the Fund. At the same time, staff had extensive discussions regarding the design of possible financing programs, including issues associated with securing the continued involvement of private creditors. Nevertheless, the staff was not involved in the authorities' efforts to secure private sector involvement until understandings on policies had been reached. By the same token, in the absence of agreement on appropriate economic and structural reform policies (and in the interests of limiting moral hazard), it was appropriate to withhold Fund financial support that might have allowed the bond default to be avoided. Nevertheless, one issue that needs further consideration is whether additional efforts should have been made to secure agreement on a standstill on short-term lines during the period of protracted program negotiations.

72. It is premature to assess the appropriate form of private sector involvement in this case. It is now clear, however, that the financing requirements are very large, and the coverage of any refinancing/restructuring will need to be broad. One key issue to be resolved in the design of a financing package will relate to intercreditor equity, given the complexity of Ecuador's debt structure. Until understandings have been reached on policies that could be supported by the use of Fund resources and the associated medium-term projections for the external and fiscal accounts, it is premature to assess whether, and if so to what extent, a return to medium-term viability will require some degree of debt and debt-service reduction.

## VII. Issues for Discussion

This paper has:

- Drawn tentative conclusions from recent experience with efforts to secure concerted private sector involvement (Section II and Box 2).

- Suggested ways in which the principles and considerations put forward by the G-7 Finance Ministers could be made operational in the context of the Fund's support for members' adjustment efforts (Section III).

- Discussed some operational issues in determining concerted private sector involvement (Section IV).

- Discussed some institutional impediments to the rapid conclusion of negotiations between a debtor and its creditors (Section V).

- Considered how the proposed framework might have been applied in recent cases (Section VI).

73. Directors might wish to address the following points:

- Do Directors draw similar conclusions from recent experience to those of the staff?

- Do Directors consider that the proposed framework is a useful way of thinking through and deciding questions relating to private sector involvement?

- Under what circumstances do Directors consider it would be appropriate to enter a Fund arrangement on the basis of the Fund's catalytic role, but with the understanding that the Fund would shift gears and seek concerted involvement in the event that the catalytic role proves to be ineffective?

- Do Directors find the broad considerations suggested for the choice of instruments to be restructured or refinanced to be appropriate (Section IV, A)?

- Do Directors agree that it will be difficult to formulate a set of principles for broad comparability of treatment that could serve as a robust guide to burden sharing?

- Do Directors have views on how to secure concerted private sector involvement in cases in which leverage has been lost through the repayment of debts to private creditors?

- Do Directors agree with the line taken on the appropriate role of the Fund in creditor-debtor negotiations?

- How do Directors judge the desirability and feasibility of temporary debt standstills during program negotiations?

- What are Directors' views on the development of collective action clauses and on the possibility creditor committees covering sovereign instruments?

74. Section VI has provided a brief discussion of the ways in which the suggested framework sketched in Section III might have been applied to the four recent cases in which bonds were an issue. Directors may wish to comment.

**Bundesministerium der Finanzen**

Berlin, February 14, 2000

**Statement by the German Federal Government on the admissibility of including collective action clauses in foreign sovereign bond issues subject to German law**

1. With a view to enhancing the international financial system's functionality, the IMF, the Group of Seven and the Group of Ten all strongly advocate that the terms and conditions of sovereign bond issues include clauses that, in the event, would enable a bondholder majority to modify bond contracts. On various occasions the view has been expressed that the German law would be at odds with such clauses in foreign bonds issues. The Federal Government and the Deutsche Bundesbank, however, maintain that German law does not preclude the use of collective action clauses in foreign bond issues.

2. German law, as set out in the Act on the Joint Rights of Bondholders (Bondholders Act) of December 4, 1899, provides for amendment to the terms of bond issues by stipulating, under certain conditions, binding majority decisions. The Bondholders Act contains the technical provisions for convening bondholders' meetings and appointing a joint representative. It also sets out specific requirements for majority decisions which authorise a three-quarter majority at a bondholders' meeting, convened for this purpose, to temporarily waive or restrict bondholders' rights, particularly by reducing interest rates or granting respites in debt service, in order to avert payment terminations or insolvency proceedings and thereby to safeguard the bondholders' joint interests. Only the right to waive principal is reserved to regular insolvency proceedings.

   The Bondholders Act applies to private domestic debtors (but to that extent applies to bond issues denominated in either Deutsche Mark and euro or to foreign currency bonds). The Bondholders Act, by virtue of its designated purpose of preventing debtors' insolvency, does not apply to public entities as these are not subject to insolvency proceedings in Germany.

3. Since the Bondholders Act does not apply to bonds of foreign issuers, bonds issued under German law by foreign debtors are subject to the general principle of freedom of contract, which equally applies to private and sovereign foreign bonds. Since German statute law contains only a few basic principles concerning bonds, the contracting parties are basically at liberty to determine among themselves the terms and conditions under which bonds are issued and consequently may also agree to include collective action clauses.

4. As no doubt is the case in all legal systems, the principle of freedom of contract is not limitless in Germany. The judicial benchmark for the terms of bond issues is the German Standard Contracts Act (*Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen*) of December 9, 1976, according to which a clause is void if it places one contracting partner (i.e., the bondholder) at an undue disadvantage to such an extent as to be incompatible with the principle of good faith. Owing to the suspected legal uncertainties, bond issues by non-residents under German law have hitherto, as a rule, not been furnished with collective action clauses. Hence there are no court rulings on the question whether such clauses might lead to an undue disadvantage within the scope of the Standard Contracts Act. In legal writings , however, it is acknowledged that no undue disadvantage would exist if collective action clauses were modelled on the principles of the Bondholders Act. That would require observance of the following rules:

- The bondholders' meeting has to be convened by the debtor. It is summoned on the motion of a 20% quorum or by a joint representative appointed by the bondholders. The meeting can only be convened after it was twice publicly announced . At least two weeks' notice must be given after the second announcement.

- A majority of at least 75 % is required for decisions that restrict or waive the rights of bondholders.

- This majority is calculated according to the outstanding principal of the bonds. A minimum of one-half of the par value of the outstanding bonds must be achieved. The debtor is not entitled to vote with respect to the bonds he owns himself.

- Majority decisions are binding for all bondholders provided they were passed with the intention to safeguard the joint interests of bondholders (this prevents decisions to the detriment of individual bondholders).

5. Regarding the contents of majority decisions, it is permissible, without more, that bonds issued under German law by non-residents incorporate clauses which match the Bondholders Act's provisions for bonds of domestic private issuers (without requiring any contractual arrangement to this effect). This applies to clauses which permit majority action with respect to a temporary reduction of interest payments or a respite in debt service payments. Beyond the scope of the Bondholders Act, it also might indeed be permissible to provide bonds of foreign issuers with clauses which, for the purpose of safeguarding the interests of the bondholders, permit majority decisions on partial reduction of principal. In the case of German domestic bonds, the rationale of the law is that decisions to waive principal should be exclusive to standard insolvency proceedings. Since foreign debtors are not subject to German insolvency law, there is no reason to curtail freedom of contract with regard to domestic insolvency proceedings. On the contrary, in cases of imminent or actual insolvency, the joint interests of bondholders may be best served if bondholders participate, in an overall effort to resolve crises, in debt restructurings on the basis of majority decisions that include, as events warrant, a partial debt cancellation.

6. In summing up, according to the Federal Government's judgment no legal impediments exist to incorporate collective action clauses into the bonds of foreign issuers issued under German law, provided that the debt restructuring serves to safeguard the joint interests of all bondholders.

**A Framework for Private Sector Involvement in Crisis Resolution**[1]

1. In addition to crisis prevention measures addressed above, we are agreed that the international financial community needs to set out in advance a broad framework of principles and tools for involving the private sector in the resolution of crises. The following framework should help to promote more orderly crisis resolution and therefore be of mutual benefit to debtors and creditors in finding cooperative solutions. It should also help to promote cooperative solutions between borrowing countries and the private sector and to shape expectations in a way which reduces the risk that investors believe they will be protected from adverse outcomes. Developing a framework of this kind which facilitates debtor/creditor cooperation should minimise the incidence and intensity of crises and also minimise the time before debtor countries can expect to regain market access.

***Principles***

2. We agree that this framework should comprise the following key principles:

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

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

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

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

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[1] Extract from the Report of G-7 Finance Ministers to the Köln Economic Summit; Cologne, Germany, 18-20 June, 1999 (www.library.utoronto.ca/g7/finance/fm061999.htm).

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

*Considerations*

3. The principles outlined above, and the tools we propose below, should help establish a broad framework for making judgements about the policy response appropriate to a given case. The appropriate role for private creditors, if any, and the policy approaches needed to induce private creditors to play this role will vary depending on the circumstances of the particular case. There are advantages to making clear in advance the basic considerations that will guide our actions and specific approaches we will employ. The principles and tools we propose should help provide a degree of predictability for investors, without sacrificing the flexibility required to address effectively each particular financial crisis.

4. There is a variety of circumstances where countries might face external financing pressures There are circumstances where we believe emphasis might best be placed on market-based, voluntary solutions to resolve the country's financial difficulties. There are also cases where more comprehensive approaches may be appropriate to provide a more sustainable future payments path. In practice, there will be a spectrum of cases between these two extremes. Where a country falls on this spectrum, will help to determine the policy approach best suited to its particular circumstances. Relevant considerations include the country's underlying capacity to pay and its access to the markets.

5. In addition, the feasibility of different policy approaches will depend on the nature of outstanding debt instruments. These will influence assessments of which claims need to be addressed to resolve the country's financing difficulties, the magnitude of possible concerns about equitable treatment among various categories of creditors, and the scope for voluntary versus more coercive solutions. The nature of the relevant debt obligations can differ along many axes, including whether the debt obligations are principally private or public; foreign or local currency; short-term or long-term; payment of principal or interest; offshore or onshore; secured or unsecured; held narrowly or held by a diffuse group of creditors.

6. It is important to put into place incentives that would encourage a country to take strong steps at the early stages of its financial difficulties to prevent a deepening crisis.

*Tools*

7. To address effectively a wide range of potential cases, the international community needs to have a broader range of tools available to promote appropriate private sector involvement. The tools available to the international community should comprise the following:

a. Linking the provision of official support to efforts by the country to initiate discussions with its creditors to explain its policy program.

b. Linking the provision of official support to efforts by the country to seek voluntary commitments of support, as appropriate, and/or to commit to raise new funds from private markets.

c. Linking the provision of official support to the country's efforts to seek specific commitments by private creditors to maintain exposure levels.

d. Linking the provision of official support to the country's efforts to restructure or refinance outstanding obligations.

e. In cases where a country's official debt needs to be restructured in the Paris Club, the Paris Club principle of comparability of treatment applies to all categories of creditors other than the international financial institutions. The Paris Club should adopt a flexible approach to comparability, taking into account factors including the relative size and importance of different categories of claims.

f. Imposing a reserve floor that effectively ensures that the private sector makes an adequate contribution, such as through debt restructuring, alongside official resources in the resolution of crises.

g. In exceptional cases, it may not be possible for the country to avoid the accumulation of arrears. IMF lending into arrears may be appropriate if the country is seeking a cooperative solution to its payment difficulties with its creditors.

h. In exceptional cases, countries may impose capital or exchange controls as part of payments suspensions or standstills, in conjunction with IMF support for their policies and programmes, to provide time for an orderly debt restructuring.

8. We call on the IMF further to develop and define the legal and technical questions involved in implementing the specific approaches identified in the framework agreed here. We look forward to its conclusions by the autumn Annual Meetings.

9. In order to guide expectations more effectively, we agree that we will seek to provide a clear and timely explanation of the policy approaches, adopted in individual cases, in relation to the principles and considerations that we have laid out above.