Towards a code of conduct for Sovereign Debt Restructuring

By Robert Gray, Chairman, International Primary Market Association

The international debate on sovereign debt restructuring has focused on two diametrically opposed approaches: (1) a market-based contractual approach, based on the widespread inclusion of Collective Action Clauses (CACs) in debt contracts, and (2) a statutory approach embodied in the International Monetary Fund's proposal for a Sovereign Debt Restructuring Mechanism (SDRM). At its April meeting, the International Monetary Financial Committee (IMFC) concluded that it was not feasible at this stage to move forward to establish the SDRM.

However, the IMFC recognised that work should continue on issues of general relevance to creating a more orderly and predictable framework for sovereign debt crisis resolution. But the battle between these two approaches, portrayed by some as complementary but in reality conflicting, is not over.

The SDRM concept was first mooted by the International Monetary Fund in November 2001, since when it has encountered stiff and sustained opposition from private sector participants. The original proposal was modified in early 2002 to lessen the IMF's role in connection with the proposed regime, although the premise remained that it would be by amending the IMF Articles of Agreement that the SDRM would be implemented, enacting sovereign bankruptcy into the domestic laws of member states (see *"Chapter 11 for Sovereign Debtors?"* Andrew Yianni, LMA News, December 2002). In April 2002, the US Treasury called for a more voluntary, decentralised approach to the general challenge of making the resolution of sovereign financial crises more orderly. Under a proposal made by John Taylor, Deputy Secretary for International Affairs at the US Treasury, the private sector was strongly encouraged to develop the types of CAC that might be suitable for inclusion in sovereign contracts. The International Primary Market Association (IPMA), together with five other trade associations (the "Group of Six"), took the lead in developing marketable CACs. The Group of Six's marketable CAC package provided specific language covering majority actions, engagement acceleration and transparency (visit the web site - www.ipma.org.uk – for a more detailed discussion).

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A parallel initiative was undertaken by the official sector with the formation of a G10 working group to draft its own set of model clauses, which proved to be broadly in line with those developed by the Group of Six. The IMF responded to these initiatives by arguing that the SDRM and CACs were complementary, a "two track" approach, and not competing initiatives; based on the logic that a sovereign debtor would only invoke the SDRM if it had been unable to achieve a voluntary restructuring with its creditors.

In fact, the IMF argued that the core of the SDRM approach was to provide a legal framework under which a debtor and its creditors could act as if common CACs were included in all relevant debt instruments. The private sector disagreed, arguing that investors and issuers would regard the creation of an SDRM as overriding CACs, thus rendering any initiative to implement CACs ineffective. Responding to these concerns, the IMF sought to further modify its proposal by strengthening the provisions for collective representation, and providing greater transparency in relation to the proposed terms of any restructuring of official or domestic debt outside of, but in parallel with, the restructuring taking place under the SDRM.

However, the SDRM retained two key factors that remained contentious with the private sector. First, the SDRM would apply to debt instruments issued before its creation. Second, the SDRM could co-ordinate a restructuring across different instruments through providing for the aggregation of voting rights across different debt instruments, including bank loans.

Why did such an apparently emasculated SDRM concept continue to attract such a high degree of opposition from the private sector? The core of the market's objection was that the SDRM would be both unnecessary and counter-productive. In particular, the Group of Six argued that the SDRM rested on the false premise, for which indeed the IMF had produced no empirical evidence, that there is an inherent collective action problem among private sector creditors in sovereign debt restructuring that precludes agreement.

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The case for stating that any restructuring had been prevented from moving ahead by the actions of recalcitrant or rogue creditors still remains unproven. The Group of Six also argued that the IMF's attempt to draw an analogy between an SDRM and

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private sector bankruptcy legislation was fundamentally flawed because private companies are subject to the jurisdiction of a bankruptcy tribunal. Finally, the selective coverage of the debt covered by the SDRM effectively was deemed to potentially create subordinated classes of debt, thereby increasing funding costs for borrowers, and jeopardising their access to private capital markets.

Prior to the IMFC meetings in April, the level of discomfort with the SDRM among emerging market issuers became increasingly apparent. The alternative of CACs started to appear distinctly attractive by comparison. However, a degree of uncertainty remained over whether US investors would demand a higher spread for a CAC bond in view of the limitations on the unbridled freedom of individual creditor action traditionally incorporated in New York law bonds. In this environment, which sovereign issuer would be the "first mover"? Mexico answered the question by launching the first New York law, SEC-registered bond to include CACs in February 2003 (US$1 billion 6.625% global notes due 2015).

Mexico's initiative took the market by surprise because it had previously expressed scepticism about the possibility of adopting CACs, suggesting that its move was indeed a measure of its concern with the threat of the SDRM alternative to its access to capital, and perhaps also a measure of Mexico's concern that another less well-regarded issuer would launch a bond with CAC language that it would not itself regard as acceptable, thereby establishing an unattractive market norm.

Although Mexico did not adopt CACs in the form proposed by either the Group of Six or the G10 working group, it did adopt the key majority action and acceleration clauses. Particular attention was focused on the selection of the threshold for amendment of key terms, also known as reserved matters. Although the voting level (75%) selected by Mexico was lower than that recommended by the Group of Six, Mexico introduced three key changes favourable to creditors to the traditional majority action clauses:

- the threshold would apply to aggregate principal amounts outstanding. By comparison, English law bonds have traditionally counted votes cast at a meeting, where typically 75% of a quorum as low as 25% may amend key terms;
- bonds directly or indirectly controlled by the government and its instrumentalities would not be considered "outstanding" for voting purposes; and
- governing law, jurisdiction and waiver of immunity were added as reserved matters.

The favourable reaction to Mexico's bond reflected in large part the market judgement that Mexico, and its advisers, had achieved an equitable balance between its interests and those of the bondholder community. Mexico's initiative has been followed in rapid order with CAC bonds from Brazil, South Africa, Korea and, of greatest interest, Uruguay. Uruguay's

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US$3.7 billion SEC-registered exchange offer has been notable for a number of reasons:

- Uruguay adopted Mexico's approach to majority action, but added additional safeguards for its bondholders: a limit on future exit consents (a technique adopted in Ecuador's 1998 Brady restructuring) to amend reserved matters, limitations on the issuance of new debt to dilute a restructuring vote, and tighter non-reserved matter amendment rules;
- Uruguay issued its new bonds under a trust indenture (IPMA is a supporter of the use of trustees since trustees can provide a useful channel of communication between a debtor and its bondholders, and also act as the focus of litigation on behalf of all the bondholders thereby rendering sharing, a standard feature of the loan market, feasible); and
- perhaps of greatest interest, Uruguay incorporated provisions allowing for the aggregation of voting rights across different bonds. In essence, several bonds can be amended by one vote with the support of 85% of the aggregate principal amount of the relevant bonds, and 66⅔% of each relevant bond.

These recent examples provide further evidence of the private sector's capacity to provide innovative solutions in the sphere of sovereign debt restructuring. Although only a few months have passed since Mexico's bold initiative, it is safe to assume that any emerging market issuer that does not adopt CACs will be the exception rather than the norm. It is also safe to assume that the market will question the motivation of any issuer that does not adopt CACs. And yet this is not a time for complacency in respect of crisis prevention and resolution.

The Group of Six (now the Group of Seven, supplemented by the addition of ISMA), believes that the CAC initiative should be reinforced by a process for early consultation to strengthen crisis prevention, sustained by the framework of a broader Code of Conduct. A Code of Conduct would outline the respective roles that all parties, including bank lenders, could be expected to play in emerging markets finance, particularly during times of crisis. The Code should be developed as a joint initiative of the private and official sectors, including the IMF. The LMA could play an important role in any consultation process that leads to the formulation of a Code of Conduct.

Nor is this a time for complacency in relation to the SDRM. The SDRM attracted a high degree of support from the membership of the IMF: in a recent speech, Jack Boorman, Special Advisor to the IMF Managing Director, indicated that support for the SDRM included over 70% of the Fund's membership. The IMF continues to argue that an approach based on a combination of CACs and a Code of Conduct is not sufficiently powerful to provide what is needed for the more complex and potentially damaging crises that may occur in the future. The onus remains on the private sector to prove the robustness of a market-based approach to sovereign debt restructuring. The core of the disagreement with the IMF is whether sovereign debt restructurings have in the past, and/or will be in the future, characterised by collective action failure. The bond market has demonstrated its commitment to the principle of collective action through the adoption of CACs, notably majority action provisions.

The IPMA welcomes the willingness of the LMA to support the principle of including

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majority action provisions in sovereign loan contracts (at the higher level of 90%) and the IPMA looks forward to engaging with the global loans community in the initiative of a Code of Conduct for emerging markets.