A Better Framework for Crisis Resolution

While crisis prevention has been the main focus of the IMF's reform agenda, the Fund has also been working to improve the management and resolution of the financial crises that do occur, where it also has a central role. Indeed, a stronger and clearer framework for crisis resolution should make an important contribution to crisis prevention in addition to lessening the number and severity of crises. Evolving reforms of the framework for crisis resolution have been designed to reinforce incentives for countries and their creditors to reach voluntary, market-oriented solutions to their financing problems. To this end, the IMF has sought to combine a clearer policy on access to Fund resources and greater selectivity in its lending with an examination of possible approaches to strengthening the mechanisms for the restructuring of sovereign debt. This chapter describes progress made in these areas during the past financial year.

Access Policy in Capital Account Crises

Increasing international integration of financial markets in recent decades has facilitated the financing of investment and economic activity in emerging market countries but has also exposed these countries to the risk of crises caused by rapid reversals of capital flows. In some cases, the IMF has supported members' efforts to resolve such crises by providing large amounts of financing. Beginning with Mexico in 1995, during the Asian crises of 1997–98, and subsequently, the IMF has in several cases provided financing in amounts that have been well above the access limits normally applying to Stand-By Arrangements and arrangements under the Extended Fund Facility (EFF).

The Executive Board held discussions on access policy in the context of capital account crises in September 2002 and January/February 2003. Most of the programs supported by exceptional access have been quite successful in helping the member achieve external viability, resume growth with limited vulnerability, and regain access to private markets, Directors noted, although in some cases more slowly than at first expected. But in a few cases, the combination of adjustment and exceptional access in the context of the associated political and external environment was insufficient to avoid a restructuring of obligations. However, in all cases, the borrowing members have remained current on their repayment obligations to the IMF. From a broader perspective, Directors also observed that, while some moral hazard is bound to be present in IMF lending, there is little empirical evidence that the use of exceptional access in general has had large moral hazard effects by increasing investor or country risk taking.

During the Board discussion in September 2002, Directors agreed that more clearly defined criteria for exceptional access in capital account crises were needed to help shape the expectations of members and markets, set up benchmarks for difficult decisions about program design and access, safeguard IMF resources, and ensure uniform treatment of members. Directors generally considered that (at a minimum) the following criteria would need to be met to justify exceptional access for members facing a capital account crisis:

- The member is experiencing exceptional balance of payments pressures on the capital account, resulting in a need for IMF financing that cannot be met within the normal limits.
- A rigorous and systematic analysis indicates there is a high probability that debt will remain sustainable.
- The member has good prospects of regaining access to private capital markets within the time IMF resources would be outstanding, so that the Fund's financing would provide a bridge.
- The policy program of the member country provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment.

During the January/February 2003 discussions, Directors agreed on stronger procedures for decision making on all exceptional access proposals. These procedures include a higher burden of proof in program documentation, early consultations with the Board on program negotiations in exceptional access cases based on a concise staff note outlining the considerations, and ex post evaluation of programs with exceptional access within a year of the end of the associated arrangement. The ways in which these criteria and procedures are applied in practice in reaching judgments about access will, however, be decisive, and an assessment of implementation is planned by early 2004.

Policy on Lending into Arrears to Private Creditors

When a member is experiencing difficulties in servicing its debt obligations to its external private creditors, discussions on the restructuring of its debt may be a difficult and protracted process, and an agreement may not be reached before the emergence of arrears. The IMF stands ready to provide resources to members that are in arrears to private creditors when prompt support is essential for the success of the member's adjustment policies and the member is making a good-faith effort to reach a collaborative agreement with its creditors.

In September 2002, the Board reviewed recent experience gained with the restructuring of sovereign bonds and the application of the good-faith criterion under the policy on lending into arrears. Greater clarity about the good-faith dialogue between a debtor and its creditors during the restructuring process, Directors agreed, could better guide the application of the lending into arrears policy and, more generally, promote a better framework for the engagement of debtors and creditors in the restructuring of sovereign debt.

Greater clarity on the framework for possible debt restructuring would strengthen the capacity of investors to assess recovery values under alternative scenarios, thereby facilitating the pricing of risk and improving the functioning of the capital markets. At the same time, however, Directors stressed the need for continued flexibility in applying the good-faith criterion to accommodate the characteristics of each specific case; to avoid putting debtors at a disadvantage in the negotiations with creditors; and to avoid prolonged negotiations that could hamper the ability of the IMF to provide timely assistance. Indeed, any clarification of the good-faith criterion should serve primarily to support the difficult judgments that will continue to have to be made in each case, and should be made operational in a manner that does not impair market discipline.

The following principles would strike an appropriate balance, Directors considered, between clarity and flexibility in guiding the dialogue between debtors and their private external creditors:

- When a member has reached a judgment that a restructuring of its debt is necessary, it should engage in an early dialogue with its creditors, which should continue until the restructuring is complete.
- The member should share relevant, nonconfidential information with all creditors on a timely basis.
- The member should provide creditors with an early opportunity to give input on the design of restructuring strategies and the design of individual instruments.

Although, as a general premise, the form of the dialogue would be left to the debtor and its creditors, Directors expected that a member in arrears would initiate a dialogue with its creditors before agreeing on an IMF-supported program, consistent with the above principles. In cases in which an organized negotiating framework is warranted by the complexity of the case and by the fact that creditors have been able to form a representative committee on a timely basis, there would be an expectation that the member would enter into good-faith negotiations with this committee, though the unique characteristics of each case would also be considered. By the same token, in less complex cases, where creditors have not organized a representative committee within a reasonable period, or where for other reasons a formal negotiation framework would not be effective, the member would be expected to engage creditors through a less structured dialogue.

In assessing whether the member is making good-faith efforts to negotiate, judgments would continue to be required in a number of important areas. These include a consideration of the complexity of the restructuring case, the extent to which a creditor committee is sufficiently representative, and whether a reasonable period has elapsed to allow for the formation of a representative committee. Directors also noted that, to the extent that negotiations become stalled because creditors are requesting terms that are inconsistent with the adjustment and financing parameters that have been established under an IMF-supported program, the Fund should retain the flexibility to continue to support members notwithstanding the lack of progress in negotiations with creditors.

Finally, all loans made while a member has outstanding arrears to private creditors will continue to be subject to financing reviews, which will provide an opportunity for the IMF to monitor relations between a debtor and its creditors, and for the Board to be kept informed about developments in this area at an early stage.

Dealing with Unsustainable Sovereign Debt

The IMF has also been engaged in an active debate on how best to deal with the relatively rare cases in which sovereign debts have become unsustainable. The challenges to a successful restructuring are several. Sound macroeconomic and structural policies are clearly critical. Transparency and predictability in the restructuring process are also important, to permit better-informed due diligence and decision making, and ease the task of achieving adequate intercreditor equity. Another challenge is effective collective action by creditors. In particular, there is a danger that individual creditors will decline to participate in a voluntary restructuring in the hope of recovering payment on the original contractual terms, even though creditors as a group would be best served by agreeing to a restructuring.

The IMF has been working with its members and other representatives of the international financial community on possible approaches to improving the framework for the resolution of sovereign restructuring cases, and in particular on:

- The inclusion of *collective action clauses* (CACs) in sovereign bond contracts; and
- The establishment of a statutory framework through a *sovereign debt restructuring mechanism* (SDRM).

These approaches could be complemented through the development of a *voluntary code of conduct*—a set of standards for transparency and best practices—that could help guide the conduct of debtors and their creditors across a broad spectrum of circumstances, ranging from relative tranquility to acute stress. The IMF welcomes the private and public sector initiatives in this area and supports their development. It is clear, in this context, that a code could be effective only to the extent that it is able to attract broad support among debtors and their creditors.

Collective Action Clauses

CACs in international sovereign bond instruments are designed to facilitate more orderly and rapid debt restructuring in the rare cases when a sovereign needs to restructure its debt. CACs are provisions in bond contracts that enable the sovereign and a qualified majority of its bondholders to make decisions that become binding on all bondholders within the same issuance.

The IMF has long recognized the role of CACs in helping to resolve the collective action problem. This financial year, the Board held two discussions on CACs. In June 2002, Directors discussed two staff papers focusing on the design and effectiveness of CACs and ways to encourage their greater use. The discussion was advanced during April 2003, when Directors considered a staff paper reviewing issues and developments in promoting the use of CACs more actively.

The IMF's most effective strategy, Directors reiterated, is to promote the more widespread use of those types of provisions that already exist in many international sovereign bond contracts. Perhaps the most important provision is the *majority restructuring provision*, which enables a qualified majority of bondholders within the same issuance to bind all bondholders to the terms of a restructuring agreement, either before or after default. In addition, *majority enforcement provisions* enable a qualified majority of bondholders to prevent individual creditors from taking disruptive legal action before a restructuring agreement is reached. While majority restructuring provisions currently exist in sovereign bonds that are governed by English law, bonds governed by New York law (which represent the largest portion of the emerging market sovereign bond market) have not traditionally included these provisions.

Developments over the past year were encouraging, Directors noted, with respect to both the design of majority restructuring and majority enforcement clauses, and the incorporation of such clauses into bonds governed by New York law, which represents an important breakthrough in this area (see Box 3.1). However, given the outstanding stock of bonds that do not include CACs, Directors acknowledged that it will take some time before CACs are included in most international bonds. Moreover, because of the contractual nature of CACs, any decision as to the inclusion and design of CACs will ultimately be made by the debtor and its creditors.

The IMF should more actively promote the use of CACs through its bilateral and multilateral surveillance, Directors emphasized, and all member countries, both advanced and developing, should be encouraged to include CACs in their international bond instruments. Directors welcomed the proposals to continue several forms of outreach to encourage the use of CACs. They strongly encouraged the staff to hold a more active dialogue with emerging market issuers, with a view to encouraging the use of CACs in the New York market as well as in other markets, such as Germany, where CACs are not yet the norm. Progress by mature market economies in the use of CACs in international bond issuance, such as with recent issuance by Italy and the United Kingdom, would further strengthen these efforts. In addition, as part of a more concerted effort to encourage the use of CACs, Directors encouraged the staff to hold workshops with key issuers and legal practitioners later in 2003 on ways to promote CACs.

Sovereign Debt Restructuring Mechanism

The second approach pursued by the IMF for resolving unsustainable sovereign debt situations—a proposal for a sovereign debt restructuring mechanism (SDRM)—differed from the CAC approach in two key ways. First, an SDRM would create a legal framework that allows for collective action for all instruments, including those that required unanimity to restructure the financial terms. The adoption of such a legal framework would require an amendment of the Fund's Articles of Agreement. Second, the votes of similarly situated creditors holding participating debt instruments would be aggregated, allowing a single vote to restructure *multiple debt instruments*.

The period after the 2002 Annual Meetings witnessed a vigorous debate regarding the need for, and design of, an SDRM. A Board discussion in December

Box 3.1
Collective Action Clauses: Latest Developments

Collective action clauses (CACs) in debt instruments allow a qualified majority of lenders to amend key financial terms of the debt contract and bind a minority to these new terms. Incorporating CACs in bonds, as is the norm under English law, contributes to more orderly and rapid agreement on restructuring terms, ensures that the rights of the majority are respected, and prevents a minority of dissident creditors from pursuing disruptive litigation.

There have been several important developments in the design and use of CACs in the past financial year.

Proposals on the Design of Model Clauses

In June 2002, the official community through a G-10 working group consulted with market participants, issuers, and legal experts to recommend improvements to the debt-restructuring process. In its September 2002 report, the working group proposed a set of clauses based on existing practices with respect to bonds governed by English law that reflect the principles of fostering early dialogue, ensuring effective recontracting, and minimizing litigation by minority creditors. In early 2003 the group published its work on a set of model clauses that are designed to illustrate that these recommendations could be implemented. A group of private sector capital trading associations also published proposals for developing model clauses.

CACs and Recent International Sovereign Bond Issuance

A number of mature market countries have taken steps to introduce CACs in their international sovereign bonds. In September 2002, European Union (EU) finance ministers stated that their member countries intended to include CACs in new sovereign bonds issued under a foreign jurisdiction. Although such bonds represent a small part of the overall bonds issued by EU countries, the EU represents a sizable portion of the global bond market and, thus, could influence market practice in the jurisdictions of New York and Germany, which traditionally have not included majority restructuring provisions.

At the end of 2002, international sovereign bonds with CACs issued by emerging markets amounted to about 30 percent of total sovereign bonds issued by these markets. In March and April 2003, amid much discussion within the official and capital markets communities about the use of CACs, Mexico twice issued bonds governed by New York law that included both majority restructuring provisions and majority enforcement provisions. (Lebanon (2000), Qatar (2000), and Egypt (2001) had preceded Mexico in issuing bonds with majority restructuring provisions governed by New York law, but at the time the inclusion of these clauses went unnoticed by the markets.) Mexico's issuances were successful in that they were oversubscribed, and an analysis of the Mexican sovereign yield curve provided no evidence that the price, either at the launch or in secondary market trading, reflected a yield premium for the inclusion of CACs.

Also in April 2003, a global bond issuance by Brazil—governed by New York law and including CACs—was heavily oversubscribed and again showed no evidence that there was a cost associated with the use of CACs. Shortly after the end of the financial year, South Africa, Korea, Belize, and again Brazil followed with new international bond instruments that were governed by New York law and included CACs. In addition, CACs were included in Uruguay's new bonds following its debt exchange operation.

2002 reviewed issues associated with a possible design of an SDRM. In January 2003, the Board discussed a broad range of economic policy issues that might arise in connection with a member's decision to restructure its unsustainable sovereign debt obligations. A Board discussion in March 2003 further advanced the issue, in particular by considering a first draft of the Proposed Features of an SDRM that the International Monetary and Financial Committee had requested in September 2002 for consideration at its April 2003 meeting. The formulation of this proposal involved an extensive dialogue with private market participants, debt-restructuring practitioners and other workout specialists, academics, and members of the official community, and benefited from inputs received during a workshop and conference organized at the IMF in January 2003 (see Box 3.2). In addition to contributing to the design of an SDRM, this debate provided fresh impetus to efforts to promote the adoption of CACs in sovereign bonds, as well as proposals for a voluntary Code of Good Conduct.

While most Directors supported the establishment of an SDRM, not all were convinced of the need for, or the desirability of, such a mechanism. Moreover, views among Directors that supported an SDRM continued to differ on a number of design issues.

Directors who expressed support for an SDRM agreed that its objective should be to provide a framework that strengthens incentives for a sovereign and its creditors to reach a rapid and collaborative agreement on a restructuring of unsustainable debt in a manner that preserves the economic value of assets and facilitates a return to medium-term viability, thereby reducing the costs of the restructuring process. To achieve this objective, the SDRM must not only address collective action problems among creditors, but also catalyze an early and effective dialogue and exchange of information between the debtor and its creditors. By creating greater predictability in the restructuring process, the SDRM should also be expected to improve the working of international capital markets. Although a number of issues remained

Box 3.2

Sovereign Debt Restructuring Mechanism Conference

The IMF hosted a conference in January 2003 on its Sovereign Debt Restructuring Mechanism (SDRM) proposal to exchange views with country officials, representatives of the private sector, nongovernmental organizations, legal experts, and academics. In his opening remarks, Managing Director Horst Köhler stated the conference objectives as (1) to "remind ourselves" of the problem that a sovereign debt restructuring mechanism is trying to address; (2) clarify the state of the discussion, and the nature of the proposals that have been made; and (3) bring that work to a provisional close embodied in a single, clear, and understandable design.

The main topics discussed were the IMF proposal for sovereign debt restructuring; the context and content of the SDRM; the role of creditors and the IMF under the SDRM as well as its implications for the impact on capital markets; and ensuring integrity in the process.

Most speakers agreed that the sheer diversity of creditors and debt instruments had made the negotiation process between the sovereign and its creditors more complex, leading to delays in restructuring. However, they differed on the extent of the collective action problem and the design of the solution. Anne Krueger, IMF First Deputy Managing Director, underscored the need to establish a system that would promote a transparent, orderly, and expeditious debt restructuring. Some speakers thought that holdout creditors were only a minor problem, and called for more voluntary approaches to reaching a solution.

IMF staff argued that the scope of debt brought under the SDRM would generally be broad enough to ensure the future sustainability of debt and intercreditor equity, but that some carve-outs would be required to avoid undermining domestic insolvency procedures and protect secured financing. Other participants argued for wider coverage of debt under the SDRM, in order to better ensure economic viability of the sovereign following debt restructuring as well as fairer treatment of all creditors.

IMF staff also argued that the use of a stay on creditor litigation was not proportionate to the relatively low risks of such litigation. Moreover, an automatic stay would not be appropriate in the absence of a general cessation of payments. Staff maintained that other aspects of the SDRM—including the "hotchpot" rule to neutralize any benefits received by a litigating creditor following activation—would effectively discourage disruptive litigation. While some participants supported this view, others noted that the specter of early litigation could arise in response to changes in capital markets, and some feared that debtors would be forced to use up scarce resources in fighting litigation.

open, Directors expressing support for an SDRM viewed the Proposed Features as providing a balanced response to key questions. The main elements of the proposal included:

- A qualified majority of creditors across aggregated claims could vote to accept new terms under a restructuring agreement, thereby binding all affected creditors.
- The mechanism would contain provisions that would prevent creditor enforcement actions from disrupting the negotiating process, or delaying agreement on a restructuring that could be acceptable to a broad majority of creditors.
- An independent dispute resolution forum would be established to verify claims, ensure the integrity of the voting process, and adjudicate disputes that might arise following activation of the SDRM.

The International Monetary and Financial Committee considered a Report by the Managing Director on a Statutory SDRM at its April 2003 meeting. The IMFC emphasized in its Communiqué that the extensive analysis and consultation undertaken in developing the SDRM proposal have served to promote better understanding of the issues to be addressed in bringing about orderly resolution of crises. While recognizing that it was not feasible at that time to move forward to establish the SDRM, the Committee agreed that work should continue on issues raised in its development that are of general relevance to the orderly resolution of financial crises. These issues include intercreditor equity considerations, enhancing transparency and disclosure, and aggregation issues. The Managing Director will report on progress at the Committee's meeting in September 2003.

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