GROUP OF TEN

THE RESOLUTION OF SOVEREIGN LIQUIDITY CRISES

A report to the Ministers and Governors
prepared under the auspices of the Deputies

May 1996

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EXECUTIVE SUMMARY

1. Following an invitation to the Ministers and Governors of the Group of Ten by the Heads of State and Government of the Group of Seven in Halifax in June 1995, the Deputies of the Group of Ten established a Working Party to consider the complex set of issues arising with respect to the orderly resolution of sovereign liquidity crises. While taking a comprehensive view of the problem, the Working Party focused its attention on those forms of debt to private creditors, such as internationally traded securities, that have increased in importance in the new financial environment but that in the past have usually been shielded from payments suspensions or restructurings. In carrying out its work, the Working Party recognised that the highest priority needs to be given to measures that will help prevent crises from occurring and endorsed efforts underway in other forums to improve market discipline and strengthen the surveillance of sovereign borrowers' economic performance. It attached particular importance to the need for sovereign borrowers to make timely changes in their economic policies if conditions change in ways that may lead to reductions in capital inflows.

2. After careful review of analyses of the full range of questions involved, and taking into consideration surveys of the views of market participants and of legal practices relating to collective representation of debt holders that were conducted by its members for this purpose, the Working Party reached the following broad conclusions.

- First, it is essential to maintain the basic principles that the terms and conditions of all debt contracts are to be met in full and that market discipline must be preserved. However, in exceptional cases, a temporary suspension of debt payments by the debtor may be unavoidable as part of the process of crisis resolution and as a way of gaining time to put in place a credible adjustment programme.

- Second, neither debtor countries nor their creditors should expect to be insulated from adverse financial consequences by the provision of large-scale official financing in the event of a crisis. Markets are equipped, or should be equipped, to assess the risks involved in lending to sovereign borrowers and to set the prices and other terms of the instruments accordingly. There should be no presumption that any type of debt will be exempt from payments suspensions or restructurings in the event of a future sovereign liquidity crisis.

- Third, current flexible, case-by-case practices and procedures, as they have evolved over the years, are an appropriate starting point for approaches to sovereign liquidity crises. They emphasise the importance of adjustment efforts of the debtor country and place principal responsibility for workouts on the debtors and creditors, with the debtor country having primary responsibility for setting the process on a cooperative footing. Improvements in practices and procedures should continue to be evolutionary.

- Fourth, international bankruptcy procedures and other formal arrangements do not appear to provide, in current circumstances or in the foreseeable future, a feasible or appropriate way of dealing with sovereign liquidity crises. However, further study by private sector entities may be warranted.

- Fifth, further consideration should be given in appropriate forums to ways in which financial systems in emerging market economies could be strengthened in order to reduce the risks they might pose in the event of a sovereign liquidity crisis.

- Sixth, a market-led process to develop for inclusion in sovereign debt instruments contractual provisions that facilitate consultation and cooperation between debtors and their private creditors, as well as within the creditor community, in the event of crisis would be desirable. Market initiatives would deserve official support as appropriate.

- And seventh, note was taken of current policies of the IMF that provide, under exceptional circumstances, for lending in support of effective adjustment programmes

prior to full and final resolution of a sovereign borrower's arrears to private creditors. It would be advisable for the IMF Executive Board to review existing policy in this area and to consider whether the scope of its application should be extended to other forms of debt not now covered, while remaining mindful of the need for prudence and the maintenance of strict conditionality.

3. The thinking of the Working Party was influenced by three basic changes in the financial environment bearing on the character of potential future sovereign liquidity crises. First, the broader and stronger linkages among domestic and international financial markets mean that crises can erupt much more quickly in today's markets and can be far larger in scope than in the past. Second, flows of capital to emerging market economies in the form of purchases of securities have increased greatly in size over the years and have substituted for other types of private capital. Third, when a crisis occurs new finance is unlikely to be forthcoming from those who undertook the original lending. These changes mean that financing available from official sources is less likely to be sufficient to enable a sovereign debtor experiencing a crisis to meet fully its external financing obligations. In any event, the Working Party stressed that provision of official funds to limit private losses raises serious moral hazard risks and could interfere with market discipline.

4. In considering means to deal with future sovereign liquidity crises, the Working Party was of the view that no single pre-set procedure can be suitable in all cases. However, it identified a broad set of desirable principles and features that provide a framework for the development of procedures for handling sovereign liquidity crises in a flexible, case-by-case approach in light of the conditions prevailing at the time, the nature and the intensity of the crises, and the circumstances of the debtor. Any such procedure should have the following features.

- It should foster sound economic policies by all debtors.
- It should minimise moral hazard for both creditors and debtors.
- It should rely on market forces and not interfere with the efficient operation of secondary markets in relevant debt instruments.
- It should limit contagion from one debtor's problems to other countries.
- It should support credible and sustainable actions and, to this end, not impose excessive social, political, or economic costs on the debtor.
- It should seek to ensure that burdens associated with the provision of exceptional financing are allocated fairly within and across different classes of creditors.
- It should strengthen the ability of governments to resist pressures to assume responsibility for the external liabilities of their private sectors.
- It should be suitable for quick and flexible use in a variety of different cases.
- It should be cooperative and non-confrontational, and promote the adoption by debtors and creditors of arrangements to facilitate resolution of liquidity crises should they occur.
- It should build on existing contractual or other arrangements that facilitate the resolution of crises.
- It should make use of existing practices and institutions.

5. The Working Party concluded that the establishment of a formal international bankruptcy procedure would not be feasible or appropriate under present circumstances or in the foreseeable future. Sovereign debtors have not in the past had a strong need for legal protection against their creditors, nor could they be obligated to submit to the jurisdiction of a bankruptcy forum. However, the Working Party noted that interested private parties might wish to continue to study the merits of bankruptcy or other formal procedures. At the same time, the Working Party concluded that it is not possible or desirable to preclude official involvement altogether in the event of a serious crisis. The

official community's interest in containing systemic risk and its role as a lender to sovereign borrowers mean that it is has a stake, and therefore a role to play, in fostering cooperative efforts by debtors and creditors to contend with unexpected payments problems.

6. In considering specific ways to facilitate resolution of sovereign liquidity crises, the Working Party took the view that current practices are an appropriate starting point. Current practices were developed over the course of the past few decades to contend with real world problems in a pragmatic and flexible manner. They are voluntary and make use of market information and market forces. The practices recognise the distinct perspectives of the three main actors involved in a crisis - the official community, private creditors, and the sovereign debtor - as well as their common interest in the orderly resolution of the crisis. They involve national authorities and multilateral institutions but place principal responsibility on the individual debtor and its creditors. The practices are based on the implementation of an IMF-supported sustainable adjustment programme as a major precondition for the cooperative resolution of a crisis.

7. The Working Party recognised that structural weaknesses in the banking systems of debtor countries could seriously aggravate liquidity crises and might pose difficulties for financial systems in lender countries. The Working Party concluded that further work should be undertaken in appropriate international forums to promote the strengthening of financial systems in emerging market economies and thus help to reduce such risks.

8. The Working Party took the view that certain contractual or statutory provisions governing debt contracts can facilitate the resolution of a crisis by fostering dialogue and consultation between the sovereign debtor and its creditors and among creditors, and by reducing the incentive for, or ability of, a small number of dissident creditors to disrupt, delay or prevent arrangements to support a credible adjustment programme that is acceptable to the vast majority of concerned parties. Among such provisions are those that (a) provide for the collective representation of debt holders in the event of crisis, (b) allow for qualified majority voting to alter the terms and conditions of debt contracts, and (c) require the sharing among creditors of assets received from the debtor. Such clauses have been employed in a limited set of debt contracts. The Working Party emphasised that evolution of contractual arrangements between sovereign borrowers and their creditors needs to be a market-led process if it is to be successful. Such efforts should receive official support as appropriate.

9. The Working Party strongly endorsed the fundamental principle that the terms and conditions of all debt contracts are to be met in full and on time. At the same time, it recognised that in certain exceptional cases the suspension of debt payments may be a necessary part of the crisis resolution process. Such payment suspensions should be non-confrontational and implemented in a way that does not hamper the operation of secondary markets. The Working Party did not consider that it would be feasible to operate any formal mechanism for signalling the official community's approval of a suspension of payments by the debtor. Although the Working Party rejected any formal international approval of a suspension of debt payments, it concluded that it would be advisable for the IMF Executive Board to consider extending the scope of its current policy of lending, in exceptional circumstances, to a country that faces the prospect of continuing to accumulate arrears on some of its contractual debt-service obligations to private sector creditors, in cases where the country is undertaking a strong adjustment programme and making reasonable efforts to negotiate with its creditors. Such lending can both signal confidence in the debtor country's policies and longer-term prospects and indicate to unpaid creditors that their interests would best be served by quickly reaching an agreement with the debtor.

10. The Working Party reached the overall conclusion that there is no need to change current procedures for official bilateral credits and long-term bank claims. However, there is a need for the principles and procedures for handling sovereign liquidity crises to take into account the new importance of debt in the form of securities and the growing likelihood that some such debt may have to be subject to renegotiation in the future. While the official community may be able to facilitate dialogue and assist in data collection, market participants should make the decisions regarding any innovations in contractual provisions. The official community's primary role in the resolution of

sovereign liquidity crises should remain centred on the promotion of strong and effective adjustment by debtor countries in the context of IMF-supported programmes, which would need to take into account any recourse to temporary suspensions of payments.

INTRODUCTION

1. At their meeting in Halifax on 15th-17th June 1995 the Heads of State and Government of the Group of Seven countries, "... recognising the complex legal and other issues posed in debt crisis situations by the wide variety of sources of international finance involved . . . encourage[d] further review by G-10 Ministers and Governors of other procedures that might also usefully be considered for their orderly resolution". Following this invitation, the Deputies of the Group of Ten established a Working Party consisting of representatives of the ministries of finance and central banks of the G-10 countries, with the participation of experts from key international organisations, to examine the complex range of issues arising in this area. In October 1995 the Deputies were asked by Ministers and Governors to continue this work and to report to them in April 1996.

2. This undertaking is complementary to other work under way to improve the ability of the official community to deal with threats to the stability of the international financial system. In response to a separate but related Halifax initiative, the Group of Ten has been exploring whether its members and other countries with the capacity to support the system would be prepared to double the resources currently available under the General Arrangements to Borrow (GAB) for responding to financial emergencies. In addition, at its meeting in autumn 1995 the Interim Committee endorsed the establishment of a new standing "Emergency Financing Mechanism" which on the basis of strong conditionality would, when warranted, provide borrowers with faster access to IMF arrangements and larger up-front disbursements.

3. The rapid changes observed in the financial system and the increasing size and diversity of financial flows to emerging market economies have given rise to questions whether existing procedures for resolving sovereign liquidity crises would be adequate for dealing with future crises, should preventive measures fail. As noted in the Halifax Communiqué and discussed later in this report, the Mexican crisis provided the backdrop against which consideration of these issues occurred. However, the Working Party did not focus on that particular case and took a broader view of its mandate.

4. The Working Party considered alternative approaches for dealing with sovereign liquidity crises. While not wishing to discourage further exploration of other specific alternatives by interested parties, the Working Party concluded that it should focus its attention on those approaches that build on existing practices and institutions (e.g. those of the Paris and London Clubs) and are designed to work to the greatest possible extent with the grain of the market.

5. In most cases, three classes of actors are involved when a sovereign liquidity crisis erupts: the government of the debtor country, its private creditors and the official community (comprising multilateral institutions and national authorities, both of which may be involved also in their capacity as creditors). The balance of actions undertaken, and the burdens assumed, by each class of actors in this trilateral process are of the utmost significance for containing moral hazard. Moral hazard in this context refers to distorted incentive structures that induce borrowers and/or lenders to engage in risky financial behaviour, or inadequately monitor the risks they assume, in the expectation that they will be insulated from the adverse consequences of their activities by the public authorities. The official community has several objectives in this respect, including:

(i) promoting adjustment by the debtor country, generally in the context of an IMF-supported adjustment programme;

(ii) minimising collective action problems, that is, problems which arise when individual agents do not have sufficient incentive to cooperate but instead pursue their own narrow objectives to the detriment of the common good;

(iii) catalysing finance in support of adjustment efforts, when the latter are credible; and,

(iv) discouraging expectations that large-scale official financing packages will be available to meet debt service obligations to the private sector. The Working Party has kept in mind the need to balance these considerations.

6. The Working Party is of the view that no single preset procedure can be suitable for dealing with every sovereign liquidity crisis. The appropriate course of action will depend on the nature and intensity of the crisis, the circumstances of the debtor and the type of creditor. Therefore, procedures should allow for flexible, case-by-case treatment. Nevertheless, arrangements for handling sovereign liquidity crises should have a number of desirable features. After delineating a broad set of such features, the report seeks to set out and widen the range of approaches available to the three classes of actors.

7. With the benefit of work done in the first half of 1995 by representatives of G-10 central banks under the auspices of the BIS, the Working Party set out to collect from national authorities and international organisations a range of factual and analytical material relevant to the issues at hand. It also carried out a survey of the views of market participants on many of these issues and compiled information on legal practices relating to the collective representation of debt holders. Summaries of these surveys are annexed to the report. The Working Party used the information gathered to consider whether changes in current practices and procedures might be warranted and to what extent they might be feasible.

8. The Working Party's findings are presented below. The first section sets out the basic framework for the analysis. The second considers various approaches for handling a crisis. The third section discusses how the economic, legal and institutional environment for dealing with crises can be improved. The fourth examines the management of a crisis.

I. FRAMEWORK

9. This section outlines the basic framework for the report. It begins by describing the substantial changes in the international economic environment which have taken place over the past decade under the impact of financial and technological innovation and the liberalisation of cross-border capital flows and then assesses the implications of these changes for the nature and severity of future sovereign liquidity crises and for the manner in which they could be handled. It then goes on to list a few features that workout procedures should ideally possess if they are to facilitate the orderly resolution of liquidity crises. It concludes with a discussion of the types of crisis and types of debt that might have to be covered.

A. The changing environment

10. The considerable changes that have occurred in the international financial environment in the past decade will have a major bearing on the speed, intensity and nature of any international liquidity crisis that might occur in the future. Liberalisation of capital markets and financial and technological innovation have greatly increased the size and volatility of cross-border positions. They have been associated with a corresponding expansion of capital flows and massive growth in the volume of transactions, reflecting in part greater market breadth and depth.

11. While foreign direct investment flows to developing countries have surged over the past decade, the most dramatic development has been the growing importance of bonds and other securities, especially in the financing of emerging market economies. Net portfolio investment flows to all developing countries increased from an average of US$ 6.5 billion per year in 1983-89 to over US$ 43 billion in 1990-94 (Table 1). The increase in net flows of portfolio investment to the emerging economies of Asia and the western hemisphere has been even more pronounced, as both governments and private entities in these economies have made heavy use of securities to raise funds in the international capital market.

Table 1

Capital flows to developing countries

(annual averages, in billions of US dollars)

	1977-82	1983-89	1990-94
Total net capital inflows	30.5	8.8	104.9
Net foreign direct investment	11.2	13.3	39.1
Net portfolio investment	-10.5	6.5	43.6
Other	29.8	-11.0	22.2

Source: IMF World Economic Outlook database.

12. The changes in the nature and size of capital flows to developing countries have been accompanied by significant changes in the composition of the investor community. Institutional investors, including so-called emerging markets mutual funds, have become a notable source of funds for borrowers in emerging market economies though their claims on these countries still account for only a small proportion of their total assets. By contrast, commercial bank loans to developing countries and emerging market economies, which were a main source of finance in the 1970s, have increased only slowly during the early 1990s. Relative to their capital, commercial banks' exposure to these countries is considerably lower than in the 1980s. This reduces the likelihood that the type of approach to debt problems that was followed in the 1980s could be adopted again in the event of financial distress in an emerging market country.

13. The Mexican crisis of 1994/95 illustrated the potential size, speed and severity of sovereign liquidity crises in these new circumstances. The Mexican Government had a large stock of short-term liabilities in the form of securities indexed to the US dollar (tesobonos), and Mexican banks had extensive foreign-currency denominated international interbank lines as well as large comparable liabilities to foreign non-banks. Rolling these liabilities over or refinancing them in the market was very problematic.

14. The increase in the importance of debt in the form of securities raises the question of whether the liquidity problems of a troubled debtor can be resolved without including such liabilities in workout procedures providing temporary relief for the debtor in support of its adjustment efforts. It is worth noting that the risk premium on some emerging market debt suggests that market participants realise that there is a non-negligible probability of debt service payments being interrupted in some cases.

15. On balance, the change in the environment has had several significant consequences. The shift of sovereign borrowers away from commercial bank loans and towards increased reliance on bond financing means that holdings are more dispersed and that a liquidity crisis is less likely to threaten the international financial system. At the same time, however, it means that new finance is unlikely to be forthcoming from those who undertook the original lending. Bondholders are in general probably less likely than commercial banks to see any advantage in forming a long-term relationship with the countries to which they lend, and many are likely to sell their holdings in reaction to perceived payments difficulties. Securities can be traded more easily than bank loans. The increasing integration of capital markets also means that crises may erupt quickly and can be far larger in scope than they were in the past. In addition, they can be transmitted from the original problem debtor to countries with stronger underlying economic fundamentals.

16. In light of these developments the Working Party drew two main policy conclusions. Firstly, approaches which stress prevention and enhance market discipline should be given the greatest priority. Secondly, given the limitations on the availability of official finance, the need to contain moral hazard and the desirability of equitable burden sharing, there can be no presumption

that any form of debt will be excluded from workout arrangements in the future. While the provision of some official funds may be warranted in the case of a pure liquidity crisis, repeated reliance on emergency finance would encourage imprudent behaviour by debtors and creditors alike.

B. Objectives and desirable features of orderly workout procedures

17. After considering current and past arrangements, and taking into account the underlying objectives of action to prevent, handle and resolve sovereign liquidity crises, the Working Party concluded that any crisis management procedure should have certain basic features:

(a) It should foster the pursuit of sound economic policies by all sovereign debtors. In this context appropriate conditionality is essential for promoting economic adjustment by debtors so as to enhance their capacity to repay their creditors and regain the confidence of the markets.

(b) It should minimise moral hazard for both creditors and debtors. This entails taking full account of the risk of moral hazard for debtor behaviour implicit in any official action and ensuring that creditors are not insulated from the effects of their own lending decisions. Official financial support, if necessary, should be limited in amount.

(c) It should work with the grain of the market and avoid measures that interfere with the efficient operation of secondary debt markets. The smooth functioning of these markets can foster the continued exercise of market discipline, the accurate pricing of risk and the renewed flow of finance to emerging markets.

(d) It should limit contagion effects, whereby a crisis in one country leads creditors to shift funds out of other countries perceived to be in similar circumstances.

(e) It should support credible and sustainable action, and to this end not impose excessive social, political or economic costs on the debtor. Accordingly, some amount of financing may be required for a successful economic adjustment programme.

(f) It should seek to ensure that the burdens associated with the provision of exceptional financing are shared fairly within and across different classes of creditors, with due account being taken of de minimis[1] and other considerations.

(g) It should strengthen the ability of governments to resist pressures to assume responsibility for external liabilities of their private sectors.

(h) It should be flexible enough to be applied quickly and suitable for use in a variety of different cases.

(i) It should be cooperative and non-confrontational, and promote the adoption by debtors and creditors of arrangements to facilitate the resolution of liquidity crises should they occur.

(j) It should build upon contractual or other arrangements that facilitate the resolution of international liquidity crises should they occur.

(k) It should make use of existing practices and institutions, modified, if necessary, to make them effective and quick to respond in new circumstances.

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[1] The de minimis criterion provides for the exclusion of certain creditors on the grounds that their claims are so small as not to be of material concern for either the debtor or other creditors.

C. Coverage

18. One reason for seeking to develop procedures for handling sovereign liquidity crises is to contend with threats to the international financial system. However, a range of views exists on precisely what constitutes a systemic crisis, and it may often be difficult to tell early in the course of a major crisis whether the crisis will remain contained or grow through contagion and other effects. Moreover, there is good reason to reduce the cost of crises even when they do not have systemic implications. Just as existing procedures provide for action in a variety of cases, so should new procedures. Accordingly, the report considers procedures which could be used to contend with sovereign liquidity crises irrespective of whether they are systemic.

19. Multilateral institutions enjoy effective preferred status because of the seniority of their claims. The Paris Club procedures for the resolution of sovereign debt problems cover bilateral claims of the official sector. The more diffuse London Club process has been applied primarily to long-term claims of the commercial banks. For a large and increasing class of debt instruments such as bonds and other securities issued by sovereign borrowers, there are, however, no established procedures for the use of payment suspensions or reschedulings for dealing with a debtor's liquidity problems. Accordingly, these types of instruments were the main focus of the Working Party's attention.

20. Decisions on the items to be covered by the workout process must be made in light of the size and composition of a country's liabilities and the prospective impact on its balance of payments. For this reason, the Working Party's attention could not be restricted exclusively to sovereign debt. Private sector debts might in extremis have to be considered in a sovereign workout arrangement in order to ensure that it is successful in stabilising conditions. Also, the distinction between external and internal debts may become progressively less meaningful as debt instruments are increasingly tradable across national borders. International interbank lines constitute a sizable portion of some emerging economies' total debt, and banks in these countries fund long-term domestic claims in the international interbank market. However, since trade credits and interbank lines are essential for retaining commercial and economic links with the world economy, they have so far been excluded from most sovereign workout arrangements.

21. Altogether, the liabilities not covered by existing arrangements for dealing with impaired payment capacity amount on average to over half of the external claims on middle-income countries. To the extent that particular forms of debt are shielded from any restructuring arrangement, an incentive arises in favour of such financing channels (as may have been the case with bonds and other securities in the 1980s and 1990s). To avoid this distortion, it is useful to make it clear to market participants that:

(i) no firm lines can be drawn ex ante between types of debt to be covered by orderly workout arrangements;

(ii) each crisis must be treated on a case-by-case basis;

(iii) depending on the circumstances of the debtor, there will be a ranking of debts with respect to servicing on their original terms; and

(iv) the commitment to ongoing provision of new credits could be one factor determining which debts are serviced on time.

22. The liabilities of the private sector are not always immune from the effects of government action. There may be pressure to "socialise" (i.e. for the public sector to take over) some liabilities originally incurred by private sector entities. The Working Party is of the view that such pressures should be resisted wherever possible because socialisation complicates the resolution of sovereign liquidity problems and hampers the efficient operation of the market. However, it also recognises that the banking system is one domain where the domestic authorities may not always be able to avoid some responsibility for private debts if they are to avert a domestic banking crisis.

II. CONCEPTUAL METHODS FOR DEALING WITH SOVEREIGN LIQUIDITY CRISES

23. As noted above, the Working Party expressed a distinct preference for an incremental approach building on existing procedures and practices. Such a conclusion is the result of a thorough review of some alternative conceptual approaches, to which the present section is devoted. The Working Party agreed that the provision of large-scale official financial support for sovereign debtors was warranted only in exceptional circumstances. Such an approach may involve the use of official funds to enable the debtor country to service its debt to private creditors. This result would obviously be inconsistent with the principle of equitable burden sharing and the general aim of limiting demands on official resources. In addition, it would give rise to moral hazard on the part of both debtors and creditors since official funds would be used to insulate them from the consequences of deficient debt management or inadequate risk assessment. Therefore, this section looks at other possible approaches. It begins with a brief discussion of bankruptcy procedures and other formal arrangements and whether it would be appropriate and feasible to apply them to sovereign debt in an international context. It then considers the option of minimal official involvement, the so-called market solution. The section concludes with an examination of the main features of existing arrangements.

A. Bankruptcy and other formal arrangements

24. There is no international bankruptcy code for private or public sector borrowers. In order to consider whether such a code would help to contend with the liquidity problems of sovereign borrowers, it is useful to examine the economic aims and operation of existing corporate insolvency procedures. In a national context, bankruptcy arrangements provide court assistance for the orderly treatment of the debts of insolvent private or, in some cases, local government entities.

25. Although differing from one jurisdiction to another, notably in the balance of rights and obligations of debtors and creditors, bankruptcy procedures can be said to have two basic economic purposes. Firstly, by specifying ex ante rules for the distribution of partial or delayed payments on impaired debt claims among different classes of creditor, they reduce uncertainty and make it easier for markets to price risk. Bankruptcy procedures do not in this respect substantially increase moral hazard on the part of the debtor if they do not significantly alleviate the pain for the debtor that is associated with insolvency. Secondly, by providing the debtor with temporary protection from its creditors and access to interim finance with some form of de facto seniority, bankruptcy procedures enable an enterprise whose value as a going concern exceeds its break-up value to continue to operate. To this end, it may be necessary to provide the debtor enterprise with protection from creditors who wish to invoke remedies available to them individually as a result of the non-performance of the debt contract, and at the same time to enable creditors to influence the management of the company - or even replace the management. This latter threat helps to reduce problems of moral hazard on the part of the debtor.

26. Despite their advantages in a national context and some theoretical appeal by analogy in an international context, formal insolvency procedures do not appear to be either appropriate or feasible now or in the foreseeable future as a means of dealing with sovereign debt problems, for the following main reasons:

- The analogy does not apply in some crucial respects, as it would be neither appropriate nor possible to replace the authorities responsible for the economic policies of a sovereign state with a "new management", or to take possession of a state's non-commercial property.
- The need for additional protection from creditors has not in the past been a serious problem for sovereign debtors. Such debtors have few assets to seize and some of these benefit from sovereign immunities.

- Any international insolvency convention would inevitably involve a long and cumbersome negotiation process as it would be necessary to narrow the gap between the currently diverse objectives and philosophies of individual countries' bankruptcy legislation and practices and to reach agreement on matters affecting countries' sovereign rights.
- Many of the same results could in principle be achieved in more informal ways that would not require such fundamental institutional reform.

27. It has been suggested that existing international arbitration procedures, which can be used as an alternative to court proceedings, might also provide some insight into how analogous procedures could be developed for sovereign debtors. However, this approach does not seem viable for workouts involving debt in the form of securities even though there is nothing in principle to prevent arbitration being used by interested parties. Arbitration is a method of dispute resolution which, unlike court proceedings, depends upon the consent of all the parties involved. Unless arbitration is provided for in the original contract or is unanimously agreed to by all interested parties after a dispute arises, the large, diffuse and changing community of creditors poses serious practical difficulties for gaining unanimous consent, particularly when what is meant in law by "consent" varies from one jurisdiction to another. Moreover, international arbitration procedures were essentially devised for use in connection with bilateral contractual arrangements and could not be easily adapted to resolve disputes that may arise from multi-party contract renegotiations such as international debt offerings. However, no obstacles to the use of mutually agreed upon arbitration by interested parties should be imposed.

28. It has also been suggested that mediation and/or conciliation procedures might be used in resolving sovereign liquidity crises. Although such procedures can be less confrontational than arbitration or court proceedings, they do not result in binding or enforceable rewards. Accordingly, existing mediation and conciliation procedural rules, which are in any case not widely used, could not easily be applied to a dispute of the sort likely to result from a sovereign liquidity crisis. Binding provisions requiring parties to a dispute to go through mediation and conciliation sometimes also delay the resolution process.

29. On balance, formal procedures suitable in a national context or those developed for dealing with private international commercial disputes would not at present be a feasible way to resolve the problems arising in connection with a sovereign liquidity crisis. While it was pointed out that bankruptcy procedures may warrant further study by other interested parties, the Working Party recognises that such procedures do not in current circumstances or in the foreseeable future provide a feasible way of dealing with sovereign liquidity crises. In addition, as is discussed below, formal mechanisms intended to provide explicit official approval of the suspension of debt payments are not needed in the present circumstances. The Working Party therefore focused its attention on procedures that do not require fundamental changes in international laws and conventions and could be implemented more quickly.

B. Relying on market solutions

30. An alternative to large-scale institutional reform would be to let debtors and creditors work out problems on their own, without any official involvement whatsoever. Clearly a major attraction of this approach is its potential to deal effectively with the moral hazard problem. Many of the market participants surveyed in the course of this work broadly supported this approach and expressed a strong preference for it (see Annex III).

31. Even though some respondents expressed the belief that certain large institutions would have incurred sizable losses if the official sector had not provided support for Mexico, many market participants saw no major or generalised risk to the creditor countries' financial systems arising from losses that some institutions might suffer during a typical sovereign liquidity crisis. This is because the re-emergence of bonds and other securities has increased the dispersion of debt holdings, thus

spreading the impact of the losses in the event of a crisis, compared with the past when syndicated loans were concentrated in a smaller number of institutions.

32. A separate concern expressed by market participants was that some of the proposed innovations would interfere with their ability to sell freely the securities they hold. This concern related in particular to the introduction of clauses in bond contracts that would provide more explicitly for renegotiation in the event of default and the ex ante establishment of bondholders' associations. The investor community, and especially those that favour a more arm's-length relationship with the borrower, interpreted such innovations as implying that they would not be able to transfer their holdings freely during any renegotiation period. However, none of the options considered viable by the Working Party is expected to impede the transfer of creditors' claims.

33. Against a background characterised by the absence of serious losses on bonds and other securities during their professional lives, the interviewees were on balance broadly satisfied with the status quo and in general did not favour major innovations, although some expressed an interest in a clear statement of the "rules of the game" by the official community. In the view of many market participants, bonds represent an arm's-length source of finance, and the obligation to repay should be considered almost as "sacred" by the debtor. Private investors' aversion to official sector intervention in the formation of a workout process appears to be rooted in the suspicion that this intervention may tilt the balance too much in favour of the debtor. The arguments against official sponsoring of new arrangements were that such arrangements would be invoked too early, would be less favourable to creditors, would raise the cost of funds to borrowers, would narrow the investor base and could potentially heighten the risks of contagion compared with the status quo. Market participants were confident that the market is capable of devising any feasible value-enhancing innovation on its own.

34. The reactions of the market participants - as suggested by the explicit indications provided by some - may have been influenced by their expectation that the official sector would in fact continue to play a very significant role in the management and resolution of a liquidity crisis. In particular, given that voluntary private provision of fresh money to the debtor facing repayment difficulties was considered unlikely, it may have been assumed that the necessary liquidity would be provided by the official sector, especially in the most severe cases. However, other respondents indicated that the awareness that official support would not be forthcoming in the event of a crisis would tend to make market participants pay greater heed to risk assessment.

35. The Working Party felt that, while there is much to say in favour of minimising interference in the market process, the extent of public concerns likely to be at stake when a liquidity crisis occurs provides sufficient justification for the authorities to look for ways to foster cooperative efforts by debtors and creditors to contend with unexpected payments problems.

C. Existing practices and procedures

36. Current practices for handling sovereign liquidity crises were developed over the course of the past few decades to contend with real-world problems in a pragmatic and flexible manner. They involve national authorities and multilateral institutions, but are informal and take account of conditions prevailing in the market. They allow the case-by-case application of a few broadly accepted general principles and lend themselves to evolutionary development. However, the changing financial and economic environment poses new challenges to the capacity of these procedures to deal expeditiously with liquidity crises, as the coverage of various types of debt is incomplete for countries with access to international capital markets.

37. An articulated set of procedures and principles for dealing with bilateral official debt problems has been developed within the context of the Paris Club. These procedures provide for the rescheduling of payments due on long-term and medium-term credits granted or guaranteed by national governments. In exceptional cases they are used for short-term debts. At present they are used primarily in the case of sovereign debtors which do not have regular access to the international

capital market. Debt rescheduling alleviates liquidity problems that threaten to lead to default, and the Paris Club has been largely successful in regularising the payments situation of sovereign borrowers.

38. The decision to seek a rescheduling rests with the debtor country. Since such a step has consequences for the debtor's credit standing and for the cost and availability of finance from the market in the future, it is exceptional and is not taken without exploring the alternatives. Before an initiative is taken, estimates of both the financing gap and the need for the adjustment of the terms on existing debt are made with the assistance of the IMF. In making such projections, considerable thought is given to economic adjustment even before the negotiations are formally started. An IMF programme must be in place before a rescheduling is agreed.

39. Paris Club procedures are informal and based on consensus embodied in the agreed Minute. In other words, there is no international statutory law which governs the procedures. The official creditor community is small and cohesive. This has been a key factor in making these procedures function.

40. A second factor which has contributed to the success of the process has been the use of a set of general principles which are broadly accepted by creditors and debtors alike. One principle is that rescheduling should enhance the value of existing claims by promoting the pursuit of sustainable economic policies and thereby fostering new money flows. Conditionality and continued monitoring are therefore integral components of the process, with the IMF serving as the key institution in this context. Because the circumstances in different countries vary, the terms and conditions need to be agreed case by case. One feature characteristic of Paris Club rescheduling is the use of a cut-off date, which provides some assurance that new credits will have seniority.

41. Another broadly accepted principle is comparability of treatment with respect to both creditors and other debtors. This takes a variety of forms. One is equal burden sharing among participating creditor countries, with the burden being allocated according to exposure. In addition, comparable treatment clauses enjoin the debtor country not to grant preferential treatment to creditors which are not represented in the Paris Club. The use of various formulas, such as those promulgated at Houston, Toronto, London and Naples, helps to ensure comparable treatment of different classes of debtors based on their objective economic and financial situation.

42. The London Club process for rescheduling sovereign debt owed to commercial banks is considerably more diffuse than the Paris Club process, partly because the community of creditors is both larger and more heterogeneous. Only a small proportion of the banks participate directly in the negotiations by sitting on the ad hoc bank advisory or steering committees which are generally set up after a debtor has suspended payments.

43. Nevertheless, in its reliance on convention rather than statute and the use of various contractual devices to foster equitable treatment and reduce free riding, the London Club resembles the Paris Club. Under the bank advisory committee approach, a borrower reaches an agreement with key creditors to endorse a set of terms that are then presented to the entire community of bank creditors for their acceptance or rejection. One common set of terms (or menu of options) is presented to all bank creditors simultaneously.

44. The terms incorporated into some London Club agreements have been influenced by those agreed upon in Paris Club reschedulings because the agreed Minute of the Paris Club contains comparable treatment clauses obliging debtors to seek similar terms with other creditors. It has often taken considerable time to obtain the final agreement of the hundreds of creditor banks not represented on the steering committee. In some cases, sales of debt by small creditor banks have helped reduce the number of creditors and eased the process of reaching agreement.

45. At present there are no permanent forums for other types of creditors or for groupings based on the type of obligation. In the period prior to the Second World War, national groupings of bondholders were formed, sometimes with the endorsement or support of the national authorities. More recently, ad hoc groupings of other creditors, such as uninsured suppliers with substantial claims on Russia, have eventually sprung up when it has been in their interest. The problems of

communication and coordination are greater for non-bank creditors than for banks both because this community is larger and more diffuse and because its membership is more likely to change since some of the debt is negotiable. This issue is considered later in the report.

III. IMPROVING THE ENVIRONMENT FOR HANDLING CRISES

46. Prevention is far better than ex post resolution. Since efforts are under way in other forums to strengthen preventive mechanisms, the Working Party decided not to consider this matter in any detail. It limited its analysis to the potential advantages, as well as costs, of certain specific precautionary measures that could prove useful in the event of a crisis. Such measures include the collection of more detailed statistics on international (sovereign) debt, the strengthening of the financial systems in debtor countries and the possible incorporation into debt contracts of standard clauses aimed at improving debt holder representation and reducing the scope for disruptive debt holder behaviour in the event of a crisis. Rapid and effective crisis management will also require cooperation and communication among the authorities with a stake in the process, and will be facilitated if the debtor takes early action to deal with the problem.

A. Prevention

47. Prevention is the first and most fundamental element in crisis management, and the best preventive measure is the pursuit of sound economic policies. In today's highly integrated markets, reliable and comprehensive information about policies and economic conditions are particularly important.

48. At present, the IMF is seeking to refine its methods of surveillance, through which governments can encourage one another to adopt sound macroeconomic, structural and debt management policies. Greater detail is now available in press releases on IMF programmes and in other published forms, and detailed factual information derived from Article IV reviews is frequently released; these steps may help to enhance market discipline. In autumn 1995 the Interim Committee endorsed the establishment of standards for the provision to the public of economic and financial data that will permit the effective monitoring of countries' macroeconomic policies. An agreement on the establishment of a voluntary set of standards for countries that attract significant private external credit is expected shortly. Various committees and groupings meeting under the umbrella of the BIS and other international organisations are developing procedures for promoting the soundness of banks and other financial institutions and for strengthening financial markets so that the inevitable shocks and disruptions are not amplified and their systemic repercussions are contained. In order to avoid unnecessary duplication of this work, the Working Party welcomed such efforts but did not dwell on these dimensions of crisis prevention.

B. Improving external debt data

49. There is close complementarity between the information needed for the prevention of crises and that needed for their handling and resolution. For both purposes it is desirable to have accurate, timely and comprehensive information on economic conditions in the borrowing country. Market participants were unanimous in their view that it would be desirable to have more and better information, particularly with respect to the expected cashflows of the debtor government and the currency, maturity and instrument composition of the debtor's obligations. Many investors also mentioned that sufficient information should be available about the foreign assets and liabilities of the domestic banking system, with particular attention paid to short-term liabilities. Although

understandable, market participants' views on their information needs may be unrealistic, given the cost of collecting such data. Moreover, it also appears that some market participants are not aware of all the information that is currently available and do not use the available information adequately in their investment analysis.

50. Some of the data that market participants desire could be collected from them, although at some cost, and from debtor-supplied information, which will be increasingly available under the voluntary standards referred to earlier. In some cases it may be more feasible to collect data on debtors' external liabilities from information on the size and composition of creditors' claims. Any increase in the coverage, timeliness or frequency of data compiled from the creditor side would add to creditors' reporting burdens, but the creditors would also be the principal beneficiaries. The Working Party endorses efforts under way to improve data on external indebtedness.

C. Strengthening the financial system in debtor countries

51. Structural weakness in the banking systems of debtor countries could seriously aggravate sovereign liquidity crises. This is particularly the case when banks fund a sizable amount of longer-term domestic lending by borrowing in the wholesale interbank markets of the main international financial centres. The decision by these banks' creditors not to roll over such funding could generate a severe domestic banking crisis. If the debtor country government provided extensive support for the banking sector in such circumstances, its own financial position could deteriorate significantly. If the foreign offices of such banks were affected, this could have supervisory and regulatory implications in the host countries.

52. Recognising the potential vulnerability of banking systems in many indebted countries, and its implications for approaches to sovereign liquidity crises, the Working Party concluded that further work should be undertaken on these issues in the appropriate international forums. This work could consider (i) what further steps could be taken to strengthen financial systems in emerging market countries, in particular banking systems, for example by devising and enforcing strict prudential standards, including those relating to foreign borrowing, particularly when this entails maturity mismatches and exchange rate risk, and (ii) how best to deal with potential liquidity crises in the banking system arising from the loss of short-term funding.

D. Developing contractual underpinnings: model clauses in international bond issues

53. Certain contractual provisions, if broadly contained in international debt contracts, could help to facilitate debt holders' decision-making and hence the resolution of a sovereign liquidity crisis as well as have other benefits in fostering dialogue and consultation between a debtor and its creditors. In addition they may promote cohesion among creditors and reduce the incentive for, or ability of, a small number of dissident creditors to disrupt, delay or prevent arrangements supporting a credible adjustment programme that are acceptable to the vast majority of the interested parties. There is a wide range of such clauses. Some are already included in many syndicated loan agreements and some bond contracts. Three clauses that might prove useful regardless of whether they are explicitly linked to the resolution of sovereign liquidity crises provide for (i) the collective representation of debt holders, (ii) qualified majority voting to alter the terms and conditions of the debt contract, and (iii) the sharing of proceeds among creditors. Other clauses with similar aims could be drafted by market participants as a substitute for or complement to these clauses and incorporated into debt contracts in the light of the specific needs of the parties to the contract.

54. There appears to be very little experience with such clauses in workouts involving international bond issues, and consequently no solid information is available on precisely how they would operate. Most of the market participants surveyed expressed some scepticism about the

usefulness of including this type of clause. However, some indicated that they were in favour of the use of contractual clauses that would give them some assurance about how a crisis would be resolved. There is no way of knowing, a priori, whether clauses facilitating the resolution of sovereign liquidity crises would noticeably affect the cost of borrowing if they were to become more prevalent and actually be invoked in workout situations. However, it is worth noting that there are two potential effects on the cost of borrowing that work in opposite directions: (i) such clauses might lead markets to expect that debt service interruptions and modifications would be more likely; but (ii) they might also reduce the uncertainty surrounding the debt workout process and increase the value of the obligations in a crisis situation. To the extent that the inclusion of such clauses raised the cost of borrowing because the risks were more apparent, this could be seen as a benefit rather than a drawback, although issuers are unlikely to share this view.

1. Collective representation

55. Providing holders of international securities with effective arrangements for communicating with other holders and with debtors and, if desired, appointing representatives would be beneficial. The existence of such arrangements could be expected to make international debt restructurings proceed more quickly and smoothly in the event of a liquidity crisis. Where collective "representation" clauses are incorporated in bond contracts, they typically provide procedures for the organisation of bondholders and the designation of a representative. In general, debtors and creditors are free, subject to statutory restrictions in certain jurisdictions, to include in their contracts whatever provisions they choose concerning the representation of debt holders and the coordination of debt holder action. Practices in this regard vary widely according to national traditions and the particular circumstances of individual contracts. International bond issues rarely provide for extensive forms of collective organisation or representation of debt holders. In many cases they only make provision for an agent (such as a fiscal agent, which is not a representative of the bondholders) authorised to call meetings and to issue notices. Where collective representation of bondholders is provided for in advance by contract, the powers of the representative vary. However, the representative rarely has the power to make significant decisions for the holders.

56. Ad hoc arrangements for coordinating action by debt holders or appointing a representative for them may also arise in response to a crisis. Indeed, this has happened on a number of occasions. Such ad hoc arrangements may, however, take time to put in place.

2. Qualified majority voting clauses

57. Qualified majority voting clauses enable changes to be made in the terms of a bond contract without the unanimous consent of the holders. Decisions made according to these arrangements are binding on all holders of the debt. Such clauses could be expected to facilitate the workout process in the event of a sovereign liquidity crisis, since they limit the scope for a small minority of creditors to stall or block the process.

58. Some bonds already have qualified majority voting clauses, such as some of the eurobonds governed by English law, which allows issuers and originators to include such provisions. There is no quantitative evidence that bonds with such clauses are priced much differently by the market. Many investors may not even be aware that the debt instruments they hold contain these clauses.

59. The resistance to qualified majority voting clauses expressed by market participants in some countries may be attributed to a lack of familiarity with such clauses in their national context. Increased public awareness of the extent to which qualified majority voting clauses are already used in some bonds, and official support for efforts by the private sector to make greater use of such

clauses, should, over time, allow market participants to become more familiar and comfortable with the clauses both in principle and in practice.

3. Sharing and similar clauses

60. Sharing, non-discrimination and comparable treatment clauses could facilitate the market process by discouraging dissident creditors from engaging in disruptive action and by obliging debtors to treat creditors in a fair and equitable manner. However, there is little experience with the effects of such clauses when the community of creditors is large and dispersed, as in the case of bonds. Sharing clauses are covenants among lenders and debtors for the lenders to "share" payments received from a debtor on an issue-by-issue basis. Although the practice in drafting sharing clauses varies across jurisdictions, the clauses may reduce the incentive for individual creditors to take independent legal action against the debtor, as any successful creditor would have to share any assets or payments received from the debtor with the other creditors. Limiting the application of such clauses to the holders of a particular bond issue, rather than applying them to the totality of creditors, would help to promote cohesion among creditors without unnecessarily increasing the cumbersomeness of debt restructuring negotiations.

61. Non-discrimination and comparable treatment clauses help to ensure equitable treatment of creditors and, indirectly, to reduce free rider problems. A non-discrimination clause enjoins the debtor not to grant more favourable treatment to other creditors which are party to the agreement. If the debtor does so, the participating creditors can usually, inter alia, demand the acceleration of the payments due to them. These clauses do not prevent the debtor from seeking better treatment from creditors which are not party to the agreement. The comparable treatment condition requires the debtor to seek comparable concessions from other creditors.

4. Design and introduction

62. Market participants are in the best position to assess which contract clauses would most effectively promote speedy decision-making by bondholders without unnecessarily raising the cost of capital for sovereign borrowers. More extensive use of such provisions should therefore be based on a market-led process, with the initiative being taken and further developed by the private sector, rather than enforced through a process of harmonisation of national legislation or the negotiation and ratification of an international treaty. However, encouragement and support from the authorities can be helpful, as was demonstrated in the development of standardised documentation for swaps and other derivatives.

63. Because new clauses would be included only in newly issued debt, it would take some years before the bulk of any country's debt contracts would contain such provisions. Nonetheless, general acceptance by the market of the desirability of such clauses could create a climate conducive to cooperation between debt holders beyond the legal provisions presently incorporated in contracts.

64. New clauses designed to facilitate decision-making by bondholders would be most suitable for contracts with borrowers whose access to capital markets is less well established. Individual issuers might be reluctant to be the first to adopt new provisions because of the fear that this would raise funding costs, although this reluctance might be less if the clauses were seen as providing for general contingencies and not just for debt service interruptions. In addition, many countries with well-established borrowing records will no doubt also be reluctant to adopt such clauses, thus weakening their attraction for other borrowers. Use of the clauses could facilitate a workout process, and it can be argued that these provisions should be potentially attractive to investors in the case of issues of countries whose access to capital markets is less well established.

65. The Working Party is of the view that it would be both natural and appropriate for the private sector to take the lead in the development of new clauses and that such efforts should receive official support as appropriate.

E. Improved coordination and communication

66. Rapid concerted action may be required, particularly at the time of a major crisis, in order to limit adverse consequences for debtors, creditors or other parties. The Working Party stressed the importance of quick and informal consultation among key public authorities. However, it refrained from proposing institutional changes or detailed procedures, which might not be in line with the need for a case-by-case handling of specific liquidity crises.

F. Early action by debtors

67. The willingness of debtors to provide information, to engage in dialogue with creditors and with the official community and to make timely adjustments in their macroeconomic policies is essential at the time of a crisis and for its ultimate resolution. Debtors must adopt sound macroeconomic policies and remove structural distortions which have arisen. Avoiding the build-up of too much short-term debt is important in this context. Decisions regarding exchange rates are crucial. There is the risk that the maintenance of an inappropriate exchange rate would convert any entity's liquid domestic currency claims into a call on the foreign exchange assets of the country.

IV. CRISIS HANDLING

68. When a country encounters difficulties in meeting its debt payments, challenges arise for all parties involved, namely the debtor country itself, its private creditors and the official community of creditor governments and multilateral organisations, particularly the IMF. These three sets of actors involved in a crisis have partially, but not always totally, different objectives and responsibilities. All of them will gain from a smooth and cooperative crisis resolution process.

69. Each party has a range of options, whose desirability and feasibility depend on the circumstances prevailing. This section considers what steps might be taken that would accord with the interests of the individual parties and foster compromises conducive to a speedy resolution of the crisis. The relevant issues are discussed in the following order:

(i) the combination of adjustment and financing;

(ii) the objectives and possible courses of action open to the debtors, creditors and the official community;

(iii) a possible suspension of payments;

(iv) the possibility for the IMF to approve an economic adjustment programme in cases where the debtor has not yet restructured its debts to other creditors; and

(v) the implementation of a cooperative strategy involving all the parties concerned.

A. The combination of adjustment and financing

70. Typically, a country's inability to service its debt is associated with protracted balance-of-payments difficulties and the virtual exhaustion of its reserves. In such situations some countries will already have consulted the IMF on an appropriate economic adjustment programme,

which is crucial for the resolution of the problems. They will probably also have approached existing and potential new creditors to ask about rolling over loans or obtaining additional finance. In these cases many of the contacts essential for handling the crisis will have been established, though it may be necessary to put them on a different footing. However, countries relying on international financial markets for capital but suddenly affected by a sharp change in market sentiment may not have been in close consultation with the IMF. Moreover, in some cases there may be a period before the crisis when the country is unwilling to discuss its problems with the IMF for fear of precipitating the very crisis whose imminence it is denying and when the financial markets and the international official community fail to recognise the seriousness of the situation. In such cases, the crisis is likely to be more abrupt and severe.

71. At the time of a crisis the interested parties will each have to make judgements on the appropriate combination of adjustment and finance and in what form and from which source finance is likely to be available. At this time the debtor will have to determine whether and to what extent a suspension of debt service payments may be unavoidable, in full awareness of the high costs involved. Eventually the decisions will need to converge into a consistent set of actions conducive to the speedy resolution of the crisis and allow any temporary initiatives to be replaced by longer-term arrangements.

72. In all cases economic adjustment programmes must be the pivot of the process. The stronger such programmes are, the less will be the danger of moral hazard and the sooner the debtor country will be likely to be able to regain access to capital markets. Such programmes will typically include an immediate tightening of monetary policy, a credible fiscal package and possibly some exchange rate action, which may have to be weighed against other considerations if the exchange rate has been used as an anchor in the debtor's stabilisation efforts. Microeconomic measures also have a role to play in restoring equilibrium to the balance of payments. In combination these actions will help to stem capital flight and encourage lenders to keep normal lines of credit open.

B. The role of the debtor, creditors and the official community

73. The aim of the debtor is to promote the long-term economic development of the country. This will entail minimising the impact of a crisis on the cost of capital and regaining access to the international capital market, if interrupted. To do so it will have to adopt a set of policies which will remedy the problems that gave rise to the liquidity crisis in the first place. However, since excessively rapid adjustment may have unacceptably high economic, social and political costs or may simply not be feasible, some appropriate combination of financing and rescheduling may be needed to allow the debtor country to follow a sustainable adjustment path.

74. The aim of the private creditor is to maximise the value of its portfolio of assets. For creditors which have a long-term interest in the country, this may entail the provision of new money and/or the adjustment of the terms on existing debt, as appropriate. For creditors with no such commitment or substantial financial interests, it may involve readjustment of the composition of investment portfolios through the sale of impaired assets. However, even those investors with no long-term commitment may be able to increase the value of their claims by not rushing for the exit but instead accepting the adjustment of terms, thereby counteracting the tendency for secondary markets to overreact and unduly to discount the claims on the debtor country.

75. The aims of the official sector (governments of creditor countries and multilateral institutions) are to minimise systemic risk, to contain contagion, to address market failures and to restore prosperity to the debtor countries. As creditors, the official sector also seeks to restore the payment capacity of the debtor while minimising reliance on official funds so as to reduce moral hazard.

76. Apart from having somewhat different goals, the three sets of actors have different instruments and courses of action available to them. The debtor's instruments are the speed and nature

of the adjustment programme and the options of instituting capital controls and/or suspending payments on its debt obligations. For banks and other private creditors, the main instrument is the option to provide or withhold new loans, but creditors can also sell their claims, seek legal recourse, decide to accept a suspension of payments declared by the debtor, or agree to alter the terms of existing credit. The main instruments of the official sector are signalling confidence in the good faith of the debtor and the economic soundness of its adjustment programme and providing the prospect of limited finance, subject to conditionality, to foster the resumption of spontaneous inflows.

77. Because their objectives and responsibilities differ to some extent, the three sets of actors may face collective action problems which can arise within as well as across the different groupings. In these cases independent actions taken by individual actors for their short-term self-interest could result in a reduction in overall economic welfare. Even if all three parties act in ways that are appropriate to their own long-term best interests, there may remain a balance-of-payments financing gap that requires exceptional financing. In such a case tripartite cooperation is essential. There are difficult trade-offs between self-interest and burden sharing for the common good. The moral hazard entailed in providing such financing creates future problems beyond the case at hand.

78. In dealing with a crisis, it is important for all parties concerned to recognise that a non-cooperative and confrontational approach, characterised by a prolonged stalemate, would not only exacerbate the adjustment costs to be borne by the debtor country. In some circumstances it could also pose a risk of disruption to world financial stability and jeopardise the ability of official and private creditors to protect their claims. By contrast, a cooperative procedure would produce an orderly and more expeditious resolution of the crisis and help contain any contagion and systemic effects and minimise the costs of the crisis to all the principal parties involved. While the specific measures implied by this cooperative approach, which underlies current procedures, will be determined on a case-by-case basis, some basic principles are crucial and should also apply if the approach is extended to new classes of debt.

79. The debtor country has the primary responsibility for setting the process on a cooperative footing, by informing the other parties of emerging difficulties, involving the IMF actively and very early on in the resolution of its problems, and adopting strong domestic measures to deal with the crisis ahead of any other action. The treatment of a debtor country by creditors should be influenced by the debtor's economic record and past history of cooperation and consultation, by its willingness to provide information and engage in dialogue at the time of a crisis and by its readiness to accept an appropriate degree of conditionality ex post. Adjustment on the part of the debtor is the central ingredient of any solution. Still, in the absence of new financing, the degree of adjustment required to meet international obligations may impose such high costs that it is not in the interest of either the debtor or the international community as a whole.

80. Because private creditors are numerous and dispersed, the question arises as to how they can be most effectively involved in the resolution of a crisis. Representative groupings may spring up when a crisis occurs even if there are no ex ante provisions for collective representation, but the process may be quicker and more orderly if there are provisions allowing for the appointment of a debt holders' representative and the assignment, as appropriate, of powers and obligations to such a representative. Private creditors can also contribute to an orderly process by voluntarily refraining from exercising contractual or statutory rights whose primary purpose is to dissuade liquid and solvent borrowers from delaying payment, but they will only do so if this improves the long-term prospects that they will be repaid. Creditors must therefore be convinced both that the debtor is genuinely unable to pay and that the likelihood of receiving payment will be increased by voluntary restraint. If most of creditors are so convinced, they may wish to persuade dissident creditors to refrain from disruptive behaviour without restricting individual creditors' legitimate rights. Since some creditors may have no interest in a workout process, obstacles should not be placed in the way of sales of distressed debt. In this way the creditor community may become more homogeneous or at least more inclined to participate in debt restructurings and other aspects of debt workouts.

81. The role of the official community is complicated by the fact that it often has an existing or prospective credit exposure to the debtor. National authorities may wish to pursue their interests as creditors of the distressed country. Their aim will be to maximise the long-run value of their claims on the debtor. But they also have a wider interest in ensuring that problems in one country are contained and that threats to the stability of the world financial system are minimised. In some, perhaps many, cases it may be advisable for the official sector to be restrained in its approach and allow debtors and creditors to work out their differences on their own.

82. The IMF has a special role to play in this context, acting both as adviser to the debtor and to the creditor countries, and as the body best placed to make an informed assessment of the debtor's capacity to pay. Agreement with the IMF on an adjustment programme as a precondition for debt reorganisation is a way of containing the debtor's moral hazard. The IMF provides information to the Paris and London Clubs, and could also offer to facilitate discussion with representatives of bondholders, and other private creditors. An IMF-supported programme will generally entail the extension of official finance and perhaps also presume some relief on outstanding debts to private creditors. In exceptional circumstances as discussed later in this report, the IMF may decide to lend to a debtor making strong adjustment efforts even when that debtor is likely to remain in arrears on its debt obligations to certain private creditors.

C. Temporary suspension of payments

83. A fundamental principle underlying all contracts is that the terms and conditions are to be met in full and on time. The Working Party strongly endorses this principle. At the same time it recognises that in certain exceptional cases the suspension of debt payments may be part of the crisis resolution process. Temporary payment suspensions are a way of gaining time when a crisis occurs. Given the costs of such action, it will not normally be undertaken until all reasonable alternatives have been explored.

84. A distinction is sometimes made between payment suspensions occurring as a result of unilateral action by debtors ("moratoria") and those undertaken with the explicit or implicit agreement of the creditors ("standstills"). This distinction is, however, not hard and fast since an initial moratorium may soon be accorded tacit agreement by the creditors. The more relevant distinction, for the purpose of achieving an orderly workout, is that between payment suspensions which are part of a process of cooperative and non-confrontational debt renegotiation, and those which are of a more adversarial nature. The latter are more likely than the former to generate antagonistic reactions by creditors such as uncooperative confrontations, obstructive and disruptive tactics, withdrawals of funding, and resort to legal remedies and attempts to seize assets.

85. However, as discussed above, a suspension of payments, whatever form it takes, carries risks for the debtor country itself and also raises a number of practical issues:

(i) What range of claims should be covered by the suspension?

(ii) Can there be some formal or informal method of signalling that the debtor is acting in good faith and making every effort to solve the underlying problems?

(iii) Assuming a non-confrontational process, should ways be devised to protect the debtor against the behaviour of dissident creditors which are unwilling to refrain from obstructive and disruptive tactics such as seeking legal remedies in spite of an agreed standstill?

86. On the question of the spectrum of claims to be covered, a suspension of payments will in general be applied uniformly to all claims in a particular class but will differ in scope depending on the severity of the liquidity problem, the composition of the country's obligations, the prospective contribution of a particular creditor class to the restoration of balance-of-payments equilibrium and other considerations. In the case of obligations to multilateral institutions, which enjoy de facto preferred creditor status, debt service payments are to be continued with the limited resources

available. It may no longer be possible to exempt bonds and other claims because of their increased importance. Each case will have to be considered on its merits, taking account of the fact that trade credits and interbank lines are crucial for maintaining links with the world economy.

87. A distinction should be made between the suspension of scheduled interest payments and principal payments. Ordinarily, missed interest payments are viewed more negatively by the market than are missed principal payments.

88. It must also be recognised that if the suspension of payments is extended to obligations of the private sector, this may require the use of formal or informal exchange controls. However, the resort to such controls, even temporarily, can have long-lasting adverse effects on a country's access to international capital markets and may not be practicable once a country has completely liberalised external payments and dismantled the machinery for imposing controls. Debtors may nonetheless be tempted to resort to such controls to slow a "rush for the exit" by holders of claims, including domestic holders, which have come to believe that a suspension of payments on their claims can occur soon.[2] In the case of marketable claims, however, sales may be discouraged by sharp falls in prices caused by the expectation that controls will be imposed; this effect can be reinforced by a depreciation of the domestic currency. When appropriate, a degree of exchange rate flexibility could help to conserve the country's remaining foreign exchange reserves and may even obviate the need to obstruct the servicing of the private sector's obligations.

89. On the question of signalling that the debtor is making every effort to resolve its problems, the Working Party observed that there are no formal means for explicitly approving decisions by sovereign debtors to suspend payments. National legislation in the main jurisdictions where sovereign debt contracts are issued does not provide for such procedures. The question has been raised whether one could contemplate the use of the Articles of Agreement of the IMF, most notably Article VIII 2(b), for this purpose. National courts interpret this article in widely diverging ways, and a harmonisation of interpretations on the basis of a formal IMF interpretation is not to be expected. For instance, the Article could not easily be construed as covering the case in which a sovereign debtor interrupts its own payments. The Working Party is of the view that it is not feasible to operate a formal international instrument of this kind.

90. It is important that the measures taken by the authorities do not interfere with the liquidity of the market for debt instruments. Investment fund managers and other similar agents may have a fiduciary obligation to alter the composition of their portfolios when a sovereign liquidity crisis arises, and need well-functioning markets in which to operate. Moreover, the transfer of claims to those with specialised skills in the workout of impaired claims may facilitate the resolution of the crisis. Authorities should also not be unduly concerned about sharp swings in the prices of debt instruments of countries facing payments difficulties. Admittedly, market reactions are sometimes excessive. Concern about the possible imposition of exchange controls may induce market participants to "rush for the exit", which exacerbates price movements. However, overshooting does ultimately lead to natural subsequent price corrections.

91. On the question of the pursuit of individual legal remedies by dissident creditors, the Working Party reached the conclusion that the seizure of assets has not been a serious problem in the past. This is partly because sovereign debtors have few assets located outside their own territories, and some of these benefit from sovereign immunity. In addition, uncertainty about what decisions the courts will make and about how long it will take and how much it will cost to obtain a final judgement discourages casual recourse to legal remedies. On the broader question of obstructive or disruptive behaviour on the part of dissident creditors, the Working Party believes that the resolution of sovereign debt problems would be facilitated if such behaviour was kept to a minimum. Clauses

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[2] Restrictions on current payments are subject to IMF approval under Article VIII 2(a). The IMF's definition of current payments encompasses some capital transactions, including "all payments due in connection with foreign trade" and "payments for a moderate amount of amortisation of loans" as well as standard current account transactions.

developed by market participants to promote cohesiveness among creditors might be helpful in this respect.

D. IMF lending policies

92. In normal conditions the IMF extends official finance only in the context of a fully funded adjustment programme and typically requires the clearance of arrears before disbursement or according to a predefined schedule. In the case of arrears on debt due to official creditors, the IMF considers that imminent agreement in the Paris Club in line with the programme's assumptions amounts to the clearance of arrears. Similarly, for arrears to commercial banks, the IMF in principle awaits actual or imminent agreement on the clearance of arrears before approving an arrangement. In exceptional circumstances, however, the IMF may lend in advance of an agreement with commercial bank creditors, while the debtor continues to accumulate new arrears to such creditors, but only if it deems prompt support to be essential for programme implementation, negotiations have begun with bank creditors and an agreement with these creditors is expected within a reasonable period of time. In such cases, the financing of the programme is subject to periodic reviews by the IMF.

93. These cases should remain rare. They expose the official sector to the risk that the debtor will not be able to implement its adjustment programme, and they thus increase the risks associated with the extension of official assistance. Lending into arrears should therefore always be conditioned on very strong adjustment efforts on the part of the debtor country and limited to cases where the debtor country is making reasonable efforts to negotiate with its creditors.

94. In the future, and subject to similar conditions, the IMF might be well advised to extend this practice to debt owed to other groups of private creditors. Lending in such circumstances could signal that the adjustment efforts of the debtor country are strong enough to warrant the support both of the official community, through an IMF arrangement, and of private creditors through an effective restructuring of payments on existing obligations. Such a policy is intended to prevent failure to reach agreement with creditors from holding up implementation of an adjustment programme. The provision of financial support by the IMF can improve the bargaining position of the debtor substantially. Combined with the adjustment programme, this action can signal to the unpaid creditors that their interests are best served by quickly reaching an agreement with the debtor. Thus, a policy of IMF lending in such circumstances needs to be seen as part of a package to give the debtor support in its efforts to implement a comprehensive and credible adjustment programme and to increase the likelihood of agreement with creditors.

95. A policy of lending into arrears potentially provides the IMF and the official community with the opportunity to manage a crisis by signalling confidence in the debtor country's policies and longer-term prospects. The Working Party feels that it would be advisable for the IMF Executive Board to review existing IMF policy in this area and to consider whether the scope of its application should be extended, while remaining mindful of the need for prudence and the maintenance of strict conditionality.

E. The cooperative strategy

96. The conclusion and implementation of an economic programme benefiting from IMF support, irrespective of whether it involves lending into arrears, is part of the resolution of the crisis, not merely part of the efforts to stem the effects of the crisis as it erupts.

97. Indeed, success in reaching agreement on an IMF arrangement can be seen as the beginning of a continuing partnership for the restoration of macroeconomic balance in the country concerned, for the preservation or reopening of its access to capital markets, and more generally for the return of confidence in its growth prospects.

98. Depending on the circumstances, and particularly the size and nature of the financing gap, the successful conclusion of an IMF arrangement in support of an economic adjustment programme will, when relevant, open the way for meetings of creditor representatives such as the Paris Club or the London Club. The Working Party sees no reason to suggest changes in this flexible and cooperative approach, which deals in appropriate ways with official bilateral and commercial bank debt and debt service.

99. However, the principles and procedures that have been developed must take into account the shift towards bonds and other securities, which has resulted in considerable amounts of debt in instruments outside the scope of traditional restructurings. Markets are largely equipped to assess the risks involved in such investments and to price them accordingly. However, the wide dispersion and changing composition of the set of holders of these claims make it difficult to establish mechanisms to serve their collective interests in a debt workout and to endow them with effective means of upholding these interests.

100. The official community has a strong interest in avoiding disruptive adjustment of debtor economies and unnecessary losses to creditors, while minimising recourse to official finance. Accordingly, it should strive to encourage a timely resolution of any payment suspensions on debts to private creditors that may arise, without interfering in the exercise of contractual rights. The Working Party believes that this encouragement should extend to issues of primary concern to debtors and private creditors such as the timely exchange of information and the development of contractual provisions that reflect the growing likelihood that some of the debt in the form of securities may be the subject of renegotiation in the future. While the official community might be able to play a significant role in facilitating dialogue and assisting in data collection, it should leave to market participants decisions regarding contractual provisions. Its primary role should remain centred on the promotion of strong and effective adjustment by debtor economies in the context of IMF programmes, which would need to take into account any recourse to temporary suspensions of payments.

ANNEX I

LIST OF DEPUTIES

Chairman: Mario Draghi

Belgium:	G. Brouhns	Ministry of Finance
	J.-J. Rey	National Bank of Belgium
Canada:	T. Bernes	Department of Finance
	P. Jenkins	Bank of Canada
France:	J. Lemierre	Ministry of Finance and Economy
	H. Hannoun	Bank of France
Germany:	J. Stark	Ministry of Finance
	H. Schieber	Deutsche Bundesbank
Italy:	A. Zodda	Ministry of the Treasury
	T. Padoa-Schioppa	Bank of Italy
Japan:	T. Kato	Ministry of Finance
	A. Nagashima	Bank of Japan
Netherlands:	H. Brouwer	Ministry of Finance
	A. Wellink	Netherlands Bank
Sweden:	S. Öberg	Ministry of Finance
	S. Ingves	Bank of Sweden
Switzerland:	J. Zwahlen	Swiss National Bank
	G. Colombo	Federal Department of Finance
United Kingdom:	N. Wicks	HM Treasury
	M.A. King	Bank of England
United States:	L. Summers	Department of the Treasury
	E. Kelley	Board of Governors of the Federal Reserve

Observers:

International Monetary Fund:	Deputy Managing Directors
Organisation for Economic Cooperation and Development:	K. Shigehara
European Commission, Brussels:	G. Ravasio
Bank for International Settlements:	W.R. White

Secretaries:	T.R.G. Bingham
	C. Pigott
	H. Vittas

ANNEX II

MEMBERS OF THE WORKING PARTY ON THE RESOLUTION OF SOVEREIGN LIQUIDITY CRISES

Chairman: Jean-Jacques Rey

Belgium:	P. Lemaire	Ministry of Finance
	J. Mont	National Bank of Belgium
	D. Ooms	National Bank of Belgium
Canada:	M. Kelly	Department of Finance
	J. Murray	Bank of Canada
France:	J. Haas	Ministry of Finance and Economy
	P.-M. Fremann	Bank of France
	T. Francq	Ministry of Finance and Economy
Germany:	G. M. Röskau	Ministry of Finance
	W. Fritsch	Deutsche Bundesbank
	R. Wölfinger	Ministry of Finance
Italy:	G. Vigliotti	Ministry of the Treasury
	C. Giannini	Bank of Italy
	F. Costa	Ministry of the Treasury
Japan:	T. Kitamura	Ministry of Finance
	M. Takeda	Bank of Japan
	T. Yasui	Ministry of Finance
Netherlands:	A. Deckers	Ministry of Finance
	G. Frankena	Netherlands Bank
Sweden:	S.-O. Johansson	Ministry of Finance
	W. van der Hoeven	Bank of Sweden
	A. Sahlén	Ministry of Finance
Switzerland:	U. Schwarz	Swiss National Bank
	F. Zurbrügg	Federal Department of Finance
United Kingdom:	J. Rutter	HM Treasury
	C. Atkinson	Bank of England
	D. Lawton	HM Treasury
United States:	J. Shafer	Department of the Treasury
	E.M. Truman	Board of Governors of the Federal Reserve
	J. Lister	Department of the Treasury
	D. Howard	Board of Governors of the Federal Reserve

International Monetary Fund:	J. Boorman F. Gianviti D. Williams M. Allen J. Ferrán
Organisation for Economic Cooperation and Development:	R. Pecchioli C. Lluch M. Kennedy
European Commission, Brussels:	M. Neilson
Bank for International Settlements:	W.R. White M. Giovanoli K. Tsatsaronis M. Milford
Secretaries:	T.R.G. Bingham C. Pigott H. Vittas

ANNEX III

SUMMARY REPORT ON THE SURVEY OF MARKET PARTICIPANTS

This report summarises the responses of a range of market participants in the main financial centres in the Group of Ten (G-10) countries to an inquiry into market practices and attitudes towards sovereign liquidity crises. The surveys were conducted by officials from the G-10 countries in the way each country considered most appropriate. The questionnaire on which the survey was based is annexed to this document together with a list of the institutions surveyed in each country. This summary of the national write-ups follows the sequence of questions in the survey questionnaire and groups together the responses to questions of similar nature in order to facilitate the exposition.

1. Pre-crisis conditions and market practices

This set of questions relates to ex ante arrangements and market practices which have a bearing on the likelihood of a crisis and on how it unfolds when it occurs.

Questions 1-3: Nature of interviewees' involvement in the market for international debt and their past experience with liquidity crises.

The market participants interviewed covered a large array of institutions involved in the market for emerging market debt either as market-making traders, originators and underwriters or as managers of clients' investments in the form of mutual and hedge funds. Only the commercial banks among them had a well-defined institutional memory of the debt workouts in the 1980s. However, many participants have been involved in the trading and handling of defaulted sovereign debt, and some had personal experience of debt workouts in previous positions they held with commercial banks.

The interviewees were active participants in many types of securities traded in the markets of their speciality. While there was a certain tendency for each country's institutions to focus on international bonds denominated in their respective domestic currency, Brady bond issues were a very popular instrument for all types of participants and many references were made to these instruments. Also, most of the European institutions seemed to focus more generally on London-traded eurobonds.

In terms of the types of securities they prefer to hold, many of the participants expressed a slight preference for transferable bearer instruments. It was pointed out, however, that the differences between bearer and registered instruments were becoming less and less important. Institutional investors were in general more inclined than other types of investor to look into equity investments in emerging markets. There was also a differentiation between bank and non-bank institutions in terms of attitudes towards the emerging market clientele. Some suggested that bankers were more likely to take the long view as they have an interest in maintaining business relationships with the borrower, while other types of investors had a more short-term portfolio investment view of their emerging market holdings and valued market liquidity greatly.

Questions 4-6: Risk management, information and credit ratings. Sovereigns vs. non-sovereigns and the pricing of resolution uncertainty.

Although information furnished by the originators and underwriters as well as credit rating agencies provides a valuable input, almost all the market participants relied heavily on in-house analysis generated by their specialised teams. The need for more and better information that would help improve the accuracy of this analysis was mentioned by nearly all the interviewees. The participants place a premium on the availability of accurate and comparable data on the external financial position of the emerging markets' private and public sectors that will enable them to perform a cash-flow analysis. Some market participants felt that more information should be available on the maturity, instrument and currency composition of the public debt and that some emphasis should also be put on the external position of domestic financial institutions.

It is noteworthy that, without minimising the importance of broader coverage, many respondents felt that at the moment greater gains could be made by improving the quality and timeliness of the information that is already provided by the emerging market official sector and the international financial institutions (IFIs). This information should be made available on a comparable basis, be published regularly and reflect the latest developments. Some interviewees also mentioned that in certain cases the failure on the part of some investors to foresee an upcoming crisis could be attributed to inadequate analysis of the information that is already widely available.

Despite the fact that all the respondents said that they were using the credit ratings of emerging market debt issues as an input for their analysis, many expressed doubts about the timeliness with which ratings reflected changes in the riskiness of these assets. Their usefulness was therefore mainly of a supplementary nature.

The participants noted a direct link between the perceived risk of sovereign and private sector obligations in emerging markets. The majority subscribed to the view that no private issuer could be perceived as being of lower risk than the corresponding sovereign (the only possible exception being the local branches of multinationals), and some made the point that the financial obligations of certain private entities (banks in particular) could easily be translated into government liabilities if the authorities rushed to their assistance in the event of a crisis. In addition, as some respondents mentioned, the suspension of payments by the sovereign will have severe repercussions for the market access by the private sector.

Most participants were of the view that the uncertainty surrounding the renegotiation process and the difficulty of attaining a resolution in the event of a liquidity crisis, serves as a disciplinary device for borrowers. Consequently, any arrangements that would make the resolution less painful might increase the price of capital because of moral hazard effects. A few of the participants conceded that reduced uncertainty might actually have some dampening effect on risk premia for emerging market debt.

Questions 7-9: The role of the ex ante provisions in present contracts: credit enhancements, clauses regarding default and renegotiation (negative pledge, arbitration etc.).

The respondents noted that the scope for increased use of collateralisation in sovereign debt contracts is quite limited. They attributed this phenomenon to two factors. The first has to do with the limited availability of collateralisable assets and the high legal costs that such provisions entail for both the borrower who pledges the asset and the lender who will take possession of it. An additional factor that further constrains its use is that collateral provisions in a contract are often interpreted as a sign of the borrower's lack of confidence in its ability to pay in full.

Unlike collateral provisions, negative pledge and pari passu clauses in sovereign debt contracts are common. Indeed, as some participants mentioned, even though sovereigns are in certain cases exempt from the requirement to include such clauses in the bond they issue, they usually waive

their prerogative so as to avoid giving a bad signal to the market. However, a number of participants expressed some concern regarding the enforceability of such clauses.

The majority of the respondents noted that sovereign bond contracts generally do not allow for non-unanimous decisions by the bondholders to change the schedule of debt payments. A few European participants noted that some eurobond issues include provisions for a qualified bondholders' majority to agree to such a rescheduling. Even among those participants, however, there was some degree of uncertainty regarding the typical size of the majority required. A large proportion of the interviewees seemed not to favour such clauses because, in their view, they represent serious infringements of their creditor rights. Another reason cited was the perceived moral hazard effects of such provisions on the borrowers, who may be more likely to suspend payments if the renegotiation process is less uncertain and drawn out. There were certain types of market participant who were only interested in trading emerging market debt as part of a global portfolio strategy. These portfolio investors were indifferent to such ex ante arrangements as they are not interested in holding these securities and they expected to sell them well before the issue of renegotiation became topical. Some participants noted that a successful renegotiation process required the equality of treatment of all creditors and the standardisation of the process itself.

Questions 10-12: Possible improvements in ex ante arrangements: collective representation of bondholders, majority action clauses, and a "model contract".

Market participants opposed any attempt to change the present structure of bond contracts. The general view among the respondents was that bonds represent a simple promise by the borrower to pay, and their attractiveness as an investment vehicle reflects their character as easily transferable, unencumbered and difficult-to-restructure securities. The respondents were particularly opposed to any innovations in bond contracts that might interfere with their ability to sell the securities they hold at any time they choose to do so.

In the market participants' view the essential difference between a loan and a bond is that the latter represents an arm's-length financial relationship between the borrower and the lender, and the respondents wanted this characteristic to be preserved. Bonds are perceived as representing an almost "sacred" (in the words of some interviewees) obligation by the borrower to pay and as such should be very difficult to restructure. The uncertainty and the costs associated with the renegotiation of bond provisions serve as a disciplinary mechanism for both parties that make defaults less likely. Attempts to incorporate in bond contracts ex ante provisions that might facilitate this workout process would alter the character of the security, and it was feared by many participants that would increase moral hazard on the part of the borrower and consequently reduce the security's attractiveness for the investor community.

Because of the perceived negative effects of such bond clauses on the borrower-lender incentive structure and the liquidity of the instruments, the respondents argued that investors would demand a higher premium as compensation for their inclusion in bond contracts. Some participants also expressed the fear that this might discourage certain types of investor from participating in the market altogether. Some interviewees were of the opinion that such clauses might well be resisted by the debtor countries themselves because of the higher cost of capital that they might entail. Such a reaction from the borrowers would effectively block their introduction.

With respect to the idea that contract formats could be proposed by the official community, the market participants did not feel that model contracts could be imposed upon the market and that such innovations could only be introduced if market players chose voluntarily to use them. Some respondents mentioned that assuring the sponsorship of the main trade associations would be instrumental in persuading the market to adopt them. Even if "model contracts" were to be used henceforth, the conversion of old bonds was considered not to be feasible as the costs would be prohibitive.

2. When a crisis emerges

This section deals with the events precipitated by the outbreak of a crisis: the potential of market overshooting, the externalities in the form of contagion effects on other debtors and the issue of systemic disturbance. Market participants were also asked to comment on the worth of suggested alternative methods for instituting a "sanctioned" standstill.

Questions 1-2: The factors influencing the behaviour of investors when a crisis emerges.

In the market participants' view, as expressed in their responses to questions 4-6 in the previous section, up-to-date quantitative information, which is necessary in order to perform cash-flow analysis of the debtor's external position, should be available at all times. In this sense, the respondents felt that there is no need for additional information of this type at the outbreak of a liquidity crisis. The secondary market price of the securities is the only other piece of quantitative information that investors require in order to make their assessment of the situation and plan their actions.

The market participants did, however, stress the important role that information of a more qualitative type plays in shaping investors' attitudes in the event of a crisis. This information concerns the nature of the response by the borrower's authorities to the situation at hand, and the plans of action, if any, of the official sector and the IFIs.

A very important factor that determines the behaviour of private investors in the event of a liquidity crisis is the credibility that the borrower's authorities enjoy in the market and the perceived willingness of these officials to be frank and cooperative. A number of interviewees cited examples from the past in which the local authorities' attitude was instrumental in either stopping a crisis from generalising or, on the contrary, worsened the impact of a crisis that was already developing. One sign of such a cooperative and frank attitude, in the judgement of many participants, is the early communication by the authorities to the investor community of adverse news regarding the country's economic and financial prospects.

With regard to the official sector's announcements during a crisis, the market participants favoured a clear statement of the nature and the extent of their intended response and the amount of any support that might be provided by the international financial community. They noted that such a statement would play a major role in reducing the unnecessary uncertainty that surrounds the resolution of a crisis, and that it should be issued at a very early stage. Some participants also mentioned that high-level channels of communication among officials of the major creditor countries and the IFIs with the key private creditors and intermediaries should be established before a crisis materialises.

It was the view of market participants that securities have to change hands in the event of a crisis. It is the normal and natural way for the market to reallocate risk to the participants who are better equipped and/or more willing to bear it. One factor that determines investors' decision to hold or to sell is the expected magnitude of the price decline. Another factor, which seems to be of greater importance to fund managers than to other types of actor, is the risk that liquidity might evaporate in certain segments of the market. Investors may sell liquid assets of less risky sectors to cover losses they sustain in the sectors that have been harder hit by the crisis. Institutional constraints may lead to sales of certain securities by certain types of investor when this paper's rating falls below some predetermined threshold. In general, fund managers seem to be the least likely among the investor community to hold on to their portfolio, and can be expected to sell at virtually any price.

Questions 3-6: The externalities associated with the market's reaction (overshooting, contagion, systemic problems).

Overshooting is something that market participants very often observed in the market, but it was their opinion that there is no scope for direct intervention by the official sector to reduce its impact without at the same time distorting the market's equilibrium. They tended to treat this phenomenon as the result of a quasi-natural behaviour of market players which helps the reallocation of risk. According to most respondents price overshooting is a reflection of reduced liquidity in the particular market, but it was not obvious how official action could counteract this tendency in a way that would enhance the performance of the market mechanism. It was conjectured by some participants that, as the market for emerging country debt matures, such phenomena will tend to be less and less pervasive. Another factor that in the opinion of some participants might help reduce market overreactions would be a frank and credible assessment of the situation by the official sector at a very early stage of the crisis.

The "contagion effect" of a crisis of one sovereign debtor on others was thought to be a very common occurrence by almost all the market participants interviewed. It was attributed by many either to demonstration effects arising from the reassessment of the value of the totality of emerging market paper in light of the information highlighted by the particular characteristics of the crisis in one country, or to technicalities of the portfolio management methods used by many investors or fund managers (rebalancing of the portfolio, closing-out of speculative positions, increased liquidity needs in view of expected withdrawals, etc.). Again, the market participants were of the opinion that direct official intervention to contain contagion would be of very limited effectiveness. In fact, some respondents suggested that official intervention might actually have the opposite result if it reduced the disciplinary effect of market pressures on the debtor country's economic policy, postponing the time when bold corrective economic measures are taken. Another danger pointed out by many market participants was that a workout procedure which made the liquidation of a position difficult could exacerbate these contagion effects as investors might try to get out of many markets at once, fearing that they will be locked in by other countries resorting to similar procedures.

In the event of a crisis, different types of participant react in different ways, depending on their institutional characteristics. In recent episodes retail investors tended to show confidence in their fund manager's ability to manage their investments and did not react with mass withdrawals from funds that specialise in emerging markets. In contrast, proprietary traders are more inclined to sell immediately and indiscriminately, disposing not only of the paper of the sovereign in distress but also that of all others thought to be in the same category - one respondent characterised this behaviour as "sell now and look for bargains later". The interviewees also gave conflicting responses with regard to the treatment of different classes of borrower within a country. Some said that the fate of the private borrowers could not be disentangled from that of the government, but a few said that they could be treated independently.

The risks to creditor country financial institutions arising from the recent Mexican crisis (had the official action not been what it was) were generally thought to have been relatively limited. However, some participants advanced the view that a few large institutions (not necessarily banks) did face severe difficulties because of their exposure in emerging country debt. Some participants noted in connection with this type of market externality, that official financial packages designed to protect "innocent bystanders" - i.e. countries which experience an adverse effect because of a liquidity crisis in another country - might help in containing contagion and systemic risks. A few participants mentioned that regulations aimed at curbing the practice of short-selling and highly leveraged position-taking by some market players might also contribute to the reduction of the risk of systemic disruption.

Questions 7-10: Standstills and stop-crisis measures, availability of fresh money.

Market participants contemplated the possibility of the institution of some form of a payments standstill with feelings that ranged from indifferent to very negative. There was strong, almost unanimous, opposition to the idea of a formalised standstill arrangement whereby the debtor was in some way legally excused from continuing debt repayment until negotiations produced a workout agreement. Such an arrangement was perceived as a major infringement of creditors' legal rights. The alternative proposal that a payments standstill could be "sanctioned" by the official community but this characterisation would have no legal standing met with somewhat less negative reactions from some of the market participants. These respondents were inclined to interpret such a declaration, accompanied by an IMF programme, as a signal that some steps were being taken by the debtor to correct the imbalances that brought about the crisis. Many other respondents, however, had serious reservations as to whether such a declaration would positively affect creditors' attitudes towards cooperating in a workout with the debtor. Some participants also expressed the concern that a standstill, in any form, might exacerbate the "rush for the exits" and contagion effects, as many investors would attempt to liquidate their holdings in order to avoid being "trapped" by a standstill.

The role of the IMF in a standstill arrangement was viewed with considerable suspicion because of the perception that it would favour debtor governments (and especially those with particular ties to major shareholders) over private sector creditors. They asserted that the Fund's preferred creditor status leads to a conflict of interest if the IMF is also in charge of announcing a standstill. Some general concern was also voiced by the interviewees regarding the ability of the IMF to enforce strict conditionality - a necessary complement to any standstill arrangement - if the same institution is also responsible for declaring the standstill. Since market participants saw very little scope for the voluntary provision of fresh private money to the troubled debtor as part of a workout after the crisis, some proposed that the most useful role for the Fund would be to provide liquidity finance to qualified debtors when this was judged beneficial to an orderly resolution of the crisis situation. In fact, the only cases where the idea of a standstill was not dismissed out of hand were those in which a "reasonable financial involvement" by the IMF was also contemplated.

Market participants did not seem to be too concerned about the consequences that legal action by the old creditors might have on the market's ability to extend fresh money after the crisis. A major impediment to the voluntary provision of new private finance to the troubled country seemed to be that market participants doubted the ability and/or willingness of the debtor to credibly accord them preferential treatment over old debts. The announcement of a standstill, whether "formal" or "informal", would not have a positive influence on participants' decisions to lend new money.

3. The resolution process

This section refers to issues related to the complications of the renegotiation of the original contract terms and the conclusion of a new agreement.

Questions 1-3: The experience with present renegotiation schemes (Paris and London Clubs).

Equitable treatment of all creditors and negotiating flexibility were viewed as the two fundamental characteristics of a successful resolution process. The role that the official community played in facilitating discussion and ensuring the circulation of information was generally viewed as positive in the negotiations that followed the debt crisis of the 1980s, although the process itself had tended to be rather long and drawn out. Some pointed out that the involvement of non-bank creditors in such negotiations might have a negative effect on the speed with which an agreement could be reached as these participants do not have established business relationships either with the debtors or with each other. It was suggested that these investors might be well advised to build structures similar to those that currently exist for the bankers. Not much was said regarding the Paris Club process as

the participants had no direct experience. Some participants mentioned, however, that the Paris Club principle of comparable treatment should not be viewed as implying strict equality.

Questions 4-6: Economic characteristics of the current workout process (multiplicity of creditors, free riders and institutional constraints).

There was a range of views among the interviewees regarding the severity and likely consequences of the problem posed by the diffused holding of securitised debt for the timely resolution of a liquidity crisis. Some thought that the holders of the paper would naturally and voluntarily step out and negotiate if this would be to their benefit, or just stay in the background and either hold or sell the paper. Some others asserted that the identity of the major holders was known (or could be discovered with relative ease) and that there were existing channels of communication among the investors that could be used in the event of a crisis. There was considerable resistance on the part of certain groups of participants, particularly fund managers, to becoming involved in the negotiation process. Some originators felt that the market might look to them as the natural candidates to coordinate the creditor community, but several of them expressed serious reservations as to whether they were adequately equipped to perform this task. The importance of registered securities was downplayed by all participants.

The existence of free riders was viewed as an unavoidable nuisance by most market participants. A few viewed free-riding as a feature of the 1980s crisis that would tend to be less of a problem in the era of securitised debt. Free riders can be most damaging when they form a blocking coalition that demands to be bought out before agreeing to any amendment to the terms of the original contract and especially to the provision of fresh money. But at the same time concern was expressed that any amendment to the present legal framework aimed at minimising the power of minority holders would provoke strong legal challenges and would raise the cost of funds to borrowers. Some participants mentioned that gentle arm-twisting by the IFIs and the respective national regulatory bodies could be helpful in persuading free riders to adopt a more collaborative strategy.

The respondents mentioned two examples of institutional constraints that might impede the ability of certain types of market player to participate in a workout process. The first was the case of rules, often self-imposed, that prevents institutional investors from holding securities rated below a certain minimum grade. The second was that open-ended mutual funds which face liquidity demands from their customers will need to maintain a liquid portfolio of assets and thus will be unwilling to hold on to bonds that are being renegotiated. There are no general official restrictions that forbid institutions to buy, hold and trade securities in default, other than higher capital regulatory requirements. However, certain types of loan require the consent of the borrower in order to be transferred when in default.

Questions 7-8: Bondholder associations.

The market participants were not sympathetic to the establishment of bondholder associations, but various groups gave different reasons to justify their position on this issue. Some were very sceptical that such associations would expedite the workout process because the diversity in the characteristics of the relationships between the debtor and different types of investor would tend to complicate the renegotiation process. Some viewed the establishment of such associations as an infringement of their right to sell the paper when a liquidity crisis occurred. In particular, fund managers were strongly opposed to the notion that they would have no option but to participate in a workout procedure since they do not consider this to be part of their business and do not have the management resources to devote to these procedures. They prefer to use their discretion and either sell and get out or "free ride" on the efforts of others and accept the negotiated workout agreement. Only some large market-makers felt that their extensive holdings carried an implication that they had some

additional responsibility to maintain an orderly market (some drew parallels with the establishment of the Emerging Markets Trade Association (EMTA).

Most participants saw no scope (or possibility) for discriminating among different types of holder of debt instruments and mentioned that the evolving nature of the market and the particularities of each case made it very difficult to establish general procedures to deal with liquidity crises. Many stressed that local investors' flight had been instrumental in bringing about a liquidity crisis that more often than not was triggered by problems in rolling over short-term debt. It was in this connection that some suggested that it would be helpful if domestic investors as well as holders of short-term trade credit were represented in analogous forums.

Question 9: International bankruptcy court.

This idea was almost unanimously rejected by the market participants as not being feasible and maybe even counterproductive. They noted that, because of the vast differences in national legislation in this area, a very broad political consensus would be necessary for any such entity to come into existence. Even if legal judgements were legally binding, there was a general problem of enforceability in the case of sovereign debtors. They were also concerned that such a court might be inappropriately biased towards the debtors compared with present arrangements. A very small number of respondents noted, however, that such an innovation might bring some uncertainty-reducing "order" into the liquidity crisis situation, but they also did not think that it would be a feasible proposal.

Question 10: Access to capital markets after the crisis.

There was a significant divergence of opinion among the participants in the survey regarding the time that it takes for a debtor in default to return to the markets, and the respondents generally avoided offering precise conjectures. Some said a generation, but others commented that the length of time that represents a generation in the market is getting shorter and shorter. The few speculative estimates offered ranged from ten years to no time at all. Several participants noted that the circumstances of default and the behaviour of the borrower before and after the crisis were crucial, but these factors were more likely to influence the behaviour of the institutional investors and banks with longer-term investment horizons than the shorter-horizon investors who now make up a significant share of the market. In any case, a borrower that defaults cannot expect to regain full access to the markets before all issues regarding the old debts have been completely resolved.

APPENDIX

Survey of market participants

Questionnaire

Interviews with participants in the market for international debt are being undertaken to understand how they behave in the face of sovereign liquidity crises and to survey market views about how current procedures could or should be improved.

The questionnaire is broken down into three sections. The first section deals with the operation of the market prior to the occurrence of a crisis and the ex ante conditions shaping the unfolding of a crisis. The second considers what happens when a crisis occurs. The third looks at procedures for resolving the crisis. Both current practices and possible new procedures are considered in each of the three sections.

I. Pre-crisis conditions and market practices

This set of questions relates to ex ante arrangements and market practices which have a bearing on the likelihood of a crisis and on how it unfolds when it occurs.

1. How would you characterise your firm's involvement in the market for international debt? Do you usually trade on your own account or do you represent other market participants?
2. When you invest directly in the international debt market do you have a preference for holding bearer securities as opposed to registered securities?
3. What has been your firm's experience with emerging market debt default?
4. When making investment decisions, what methods do investors use to assess and manage the risk that a sovereign borrower may encounter debt-servicing difficulties? To what extent does the existence of uncertainty about how such difficulties will be resolved influence both investment and pricing decisions?
5. To what extent is there a connection between the investor's assessment of the attractiveness of investments in the country in general and the investor's assessment of the sovereign borrower itself? How helpful are the professional credit ratings in assessing country risk?
6. What information would be needed that is not at present available to improve investment decision making and risk management?
7. What is role of credit enhancements, such as collateral and guarantees, in a typical credit contract to a sovereign borrower? Are these different between sovereign and non-sovereign debtors? Would increased use of these mechanisms be desirable? If yes, what are the reasons that they are not used more frequently?
8. What is the practice regarding negative pledge and other clauses that prevent the borrower from contracting future debt in more favourable terms? How often are they used and how effective are they?
9. What is the current practice with respect to ex-ante provisions dealing with the potential problem of re-negotiation of the original contract terms in cases of multiple lenders (e.g. arbitration, provisions for protection from legal recourse by creditors in certain well-defined circumstances, minimisation of the disruptive effect of hold-outs etc.)?

10. Would new clauses in debt contracts clearly stipulating procedures to be followed in the event of debt-service interruptions (e.g. providing for a qualified majority of bondholders to be able to approve a change in terms applying to the entire group of bondholders) be helpful?

11. Would it be constructive for the official community to encourage the formulation of a "model contract" that includes such new clauses? Would such an initiative make these provisions more easily acceptable?

12. Even if such contract innovations become standard, they would only apply to new debt agreements while the bulk of the existing debt would be under the old style contract. Is there a case for converting these "old" debts? If yes, how could this be accomplished?

II. When a crisis emerges

This section deals with the events precipitated by the outbreak of a crisis and the issues of potential market overshooting, and externalities in the form of contagion effects on other debtors and systemic disturbances. Market participants are also asked to comment on the worth of suggested alternative methods for instituting a "sanctioned" standstill.

1. What types of information are most crucial for the investor community at the time a crisis breaks? Could you identify any informational deficiencies which have been evident in recent crises?

2. What considerations go into an investor's decision to liquidate claims on a troubled sovereign debtor and other debtors in the country? In particular, is it just the natural reaction to a price change, or is it exacerbated by fears that market liquidity would dry up fast because of large scale retreat from market making and/or fear of imposition of exchange controls? What impact, if any, do legal and regulatory considerations have on the decision whether to liquidate claims or to participate in the re-negotiation with the debtor?

3. Do investors believe that the market value of claims on sovereign debtors always constitute an accurate measure of the troubled borrower's ability to pay back or does excessive pessimism unduly depress prices after the emergence of crisis? If the latter is the case, is this of concern?

4. It has been observed that sell-offs of emerging market debt obligations often occur in waves and that countries with seemingly very different profiles are all affected at the same time. How do market participants explain this phenomenon? Is this "contagion" something that could or should be mitigated?

5. In the event that a crisis occurs in one country, how do investors differentiate between different borrowers? Are differences in instruments important? If so which ones and why? Do retail and wholesale investors react differently?

6. In general, how do private market participants view the risks that the debt-servicing difficulties of a key sovereign borrower might have a severe, adverse impact on major creditors, and/or international financial markets? What could be done to lower such systemic implications?

7. Would international approval, for example, by the IMF, of a suspension of payments by a sovereign borrower under certain strict conditions, but with ***no*** legal standing, affect the private market's attitudes towards the debtor and the price of the claims? What conditionality should be attached to such an approval?

8. How would such a declaration influence the willingness of creditors to cooperate with the borrower in a workout type of setting and the readiness with which private investors would resume lending to the sovereign borrower?

9. Assuming for the moment that some mechanism existed for legally sanctioning temporary payments standstills for sovereign debtors that met certain conditions, how would investor behaviour change? How would debtor behaviour change? What would be the broader implications of having such a mechanism?

10. Under what terms and conditions would market participants extend to a sovereign debtor for a short period to enable it to carry out essential activities until the process of resolving the crisis could be initiated (if the crisis did not resolve itself)? What difference would it make if a standstill which enjoyed some form of official blessing was in place? What difference would it make if the debtor benefited from protection from certain legal action by existing creditors for the period of the standstill?

III. The resolution process

This group of issues relates to the complications of the renegotiation of the original contract terms and the conclusion of a new agreement.

1. What has been the experience with existing arbitration schemes and conciliation procedures (speed, equitable treatment of creditors, cost)? In what way has intervention by the official community proved helpful to a speedy settlement? In what way has it been an obstacle?

2. How do market participants view the London Club process, and what are the lessons of the London Club experience for the general question of workout arrangements? What arrangements would be suitable in the case of debt owed to non-bank creditors?

3. How do market participants view the Paris Club process, and what are the lessons from this experience for the general question of workout arrangements? In particular, in what way does the comparability of treatment emphasised by the Paris Club influence other creditors?

4. To what extent is the process of resolving a crisis complicated by the difficulty of knowing who are the other creditors in the same (implicit) seniority class, particularly when the claim is in bearer form and traded in the secondary market?

5. To what extent is there concern about free riders in the current arrangements? Do they present a serious obstacle to expedient voluntary workouts? If yes, then what could be done to contain their disruptive influence?

6. What limitations or rules (legal, supervisory or self-imposed) apply to the acquisition, holding and trading of debt which is in default or otherwise impaired?

7. To what extent would the formation of bondholder associations, to negotiate with troubled debtors on behalf of individual bondholders and to agree on restructuring as necessary, be helpful? Should these associations be formed on an ad hoc basis, or should they be standing committees? Would it be desirable to have many such associations each representing a more homogeneous class of claim holders? Would there be difficulties in defining the covered "bonds" with sufficient precision? What could or should the authorities do to facilitate the voluntary formation of such associations? Would such associations help speed up the negotiation process to a degree that could contain spillovers and other externalities?

8. If bondholder associations, along with the Paris and London Clubs, were in place, would there be concern about other types of assets not covered by these arrangements? Could the bondholder association model be used in the case of other debt instruments, such as those of shorter maturity and perhaps those held by domestic residents of the borrowing country as well as international investors?

9. Some have gone as far as to advocate an international bankruptcy court, empowered in some way to impose debt workout solutions, including debt restructuring and perhaps debt forgiveness, on both debtors and creditors. What is the private sector's opinion of such an arrangement?

10. When a sovereign borrower interrupts debt servicing, what are the consequences for the borrower's access to capital markets, and over what period of time? Do different classes of creditors and potential creditors respond differently? To what extent do the circumstances under which the borrower was forced to interrupt debt servicing affect the market consequences of the action?

ANNEX IV

REPORT ON EXISTING FORMS OF COLLECTIVE REPRESENTATION APPLICABLE TO DEBT INSTRUMENTS

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SCOPE AND STRUCTURE OF THE REPORT

This report summarises general views on the law and practice relating to collective representation of holders of debt instruments or claims generally (in particular, indebtedness taking the form of securities) in Group of Ten countries, as those views were expressed by national authorities in reports prepared for the Working Party.[1]

Part I of this report provides an overview of certain aspects of the rules or practices relating to collective representation of debt holders as described by national authorities, highlights certain potential weaknesses of existing arrangements as far as helping to control sovereign liquidity crises and suggests some potential improvements to those existing arrangements. Part II summarises selected aspects of the various national reports, with particular emphasis on collective representation as it is used in international debt offerings.

Even though the national reports were prepared from materials believed to be accurate, this report in no way purports to be an exhaustive or authoritative discussion of the relevant law or practice. No representation is made concerning the accuracy or completeness of any statement contained in this report. This report is in no way to be viewed as an official interpretation or as a restatement of law or practice relating to collective representation.

PART I GENERAL FINDINGS

1. Purpose and sources of existing forms of collective representation

There is no clear definition of what a collective representative is or does: according to national reports, the term "collective representation" can be understood to refer to various sorts of "representatives", of either the debt holders or the debt issuer, although most of the representatives described were permanent, as opposed to *ad hoc*, representatives. The forms of collective representation described in national reports can, however, be classified, notably according to their (a) purpose or (b) source, as described below.

(a) Purpose of existing forms of collective representation

The purposes for which existing forms of collective representation are used can differ considerably, ranging from: a representative of the debt issuer, such as a fiscal agent, which is appointed to fulfil limited, administrative, debt-servicing functions on behalf of the debt issuer;[2] to a trustee which represents debt holders and can, in certain circumstances, sue on behalf of the debt holders;[3] to a representative appointed by a debt holders' assembly in response to a crisis, with exceptional powers to represent the debt holders for the duration of the crisis. In addition, in bankruptcy situations, a debt holders' representative will often be granted, by operation of domestic statute law, exceptional powers to take action binding on all debt holders.

The purpose for which any collective representation is used can, to a large extent, be chosen by the market participants, even though particular tasks sometimes are required by statute to be accomplished by particular forms of collective representative. Thus, although some statutorily

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[1] This report has been drafted with the support of the BIS Legal Service.

[2] See, in particular, Part II, sections 10(b) and 11(b) below. Although fiscal agents under US or English law do not represent debtholders, fiscal agency agreements often contain administrative provisions which could facilitate collective action and decision making.

[3] See, in particular, Part II, sections 10(a) and 11(a) below.

required representatives, such as certain trustees in the US, may have an obligation to provide information to debt holders, other functions or powers of the trustees can largely be determined by market participants.

In general, however, it appears that any permanent collective "representative", whether appointed by the debt holders or otherwise, may be in a privileged position to facilitate communication between debt holders and debt issuers in the event of a crisis, notably by securing a channel for information between the debt issuers and the debt holders.

(b) Sources of existing forms of collective representation

The forms of collective representation described in national reports broadly fit into three categories according to their source, as follows:

(i) Statutory forms of permanent collective representation;
(ii) Optional use of statutory forms of permanent collective representation; and
(iii) Contractual forms of collective representation.

The main features of these three categories are as follows:

(i) Statutory forms of permanent collective representation

Certain legal systems require, by statute, the use of particular forms of permanent collective representation in connection with particular types of domestic debt offerings. This includes, among others, trustees when required under the US Trust Indenture Act, 1939 (*"**TIA**"*), as well as the "*masse des créanciers*" under French law, "*kanri gaisha*" under Japanese law, the "*communauté des créanciers*" under Swiss law and bondholders' assemblies under German law.

Although the details relating to these forms of collective representation are specific to the legislation of particular countries, some general features are common to a number of legal systems. Thus, appointments, by statute law, of collective representatives typically are permanent appointments which last for the entire duration of the debt instrument. One of the main statutory purposes or functions of these representatives generally appears to be to make information available to the debt holders, although some may also actively represent the debt holders with respect to the debt issuer.

In most cases, the parties involved in debt offerings for which a statutory form of collective representation is required can, at least at the time of the debt offering, adapt to their specific needs certain aspects of the powers or duties of the collective representative they are required to use. One general limit on a statutory representative's powers is that it is rarely, if ever, entitled to waive the rights of the debt holders to receive timely payment of the full amount due under the debt instrument.

There are also limits as to the scope of application of a statute and therefore as to when statutory forms of collective representation are required: in particular, statutes do not apply beyond the jurisdiction for which they were enacted and many do not apply to debt instruments issued by sovereign debtors. In fact, many statutory forms of collective representation only apply to debt offerings by private issuers domiciled within the country for which they were enacted and therefore are not generally applicable in connection with international debt offerings.

(ii) Optional use of statutory forms of permanent collective representation

Even though not required by statute, many, if not all, of the forms of permanent collective representation which are sometimes required by statute are also used, by choice, by the parties involved in debt offerings, with the powers and duties of the representative adapted, by agreement, to suit the parties' needs.[4]

In order to be valid under German consumer-protection legislation, any contractual provision restricting or limiting debt holders' rights would probably have to comply with the basic provisions of fairness and justice contained in the German Debenture Act, 1899, which sets out the mandatory provisions on collective representation applicable to debt instruments issued in Germany by certain German domiciled debt issuers.[5]

(iii) Purely contractual forms of collective representation

Financial market participants also choose to use certain forms of collective representation which do not resemble any statutory form and might be either:

(a) Permanent representatives provided for in the debt instrument and to last for the entire duration of the debt instrument, such as collective representatives for debt issued, guaranteed or otherwise available in the UK, where there is no statutory form of collective representation. This category also includes fiscal agents used under US law in connection with Eurobonds and Brady bonds.[6] Or,

(b) *Ad hoc* collective representatives which are set up and used only to respond to a crisis, whether or not provision is made for the *ad hoc* representation in the underlying debt instrument. These *ad hoc* representatives, which often have exceptional powers, may be necessary to supplement permanent representatives in the event of a crisis. Thus, for instance, under English law, bondholders' meetings will frequently appoint a "representative" with the extended powers which are needed to respond to a crisis, even though the bond documentation provides for a trustee with certain limited powers to act for the bondholders over the entire duration of the bond.

In addition, *ad hoc* groupings of debt holders often arise as and when problems occur with the performance of obligations in connection with a debt instrument. Many of these groupings do not have a formal legal structure and do not provide much more than an *ad hoc* forum for negotiation and a conduit for information. Nevertheless, during the debt crises of the 1980s, groupings such as so-called Bank Advisory Committees ("BACs"), which advised the debtor, played a leading role in re-negotiations of sovereign debt: members of the BACs (normally, major bank creditors) would assist the sovereign debtor in putting together a restructuring proposal and, typically, they would then endorse the proposal before it was sent to all of the creditors.[7]

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[4] It is not the practice in Germany to make optional use of statutory provisions, although there is nothing to prevent market participants from doing so.

[5] This German legislation will shortly be supplemented by the entry into effect of an EU Directive on unfair terms in consumer contracts.

[6] Agents, whether fiscal agents under US law or facility agents under English law, provide essentially administrative debt-servicing services to the issuer; they do not "represent" the debt holders, but act on behalf of the debt issuer.

[7] Although BACs purported to be representative of the broader creditor community, they were not, from a legal point of view, "representatives" of it.

2. Flexibility of current arrangements

The national reports indicate that there is considerable flexibility in the collective representation arrangements used in connection with international debt offerings. Many of the statutes described in the national reports do not apply to foreign domiciled debt issuers, or to any sovereign debt issuer. Furthermore, market participants can often select the governing law for an international debt offering and therefore can opt for a legal system which allows them to adapt the form and powers (and therefore purpose) of any collective representative used in debt offerings, provided all applicable mandatory provisions of statute law and "*ordre public*" are respected.[8] The use of collective representation in international debt offerings is therefore largely market driven and the applicable rules result principally from the contractual arrangements agreed among the debt issuer and the initial debt holders (or trustee or agent, as applicable).

The flexibility which allows market participants (i.e. issuers and the financial institutions arranging the issues) to choose how, if at all, to use collective representatives in connection with international debt offerings, however, also allows market participants to circumvent, to a certain extent, statutory provisions which are felt to be inappropriate or too oppressive or cumbersome: market participants can notably select a governing law which will not prevent them from doing what they would like to do.

In practice, most international debt offerings, particularly Eurobonds and Brady bonds, as well as various other forms of sovereign debt issues, are subject to either English or US law, both of which afford participants considerable freedom of contract.[9] In debt instruments governed by English or US law, the two most prevalent forms of collective "representation" are trustee and agent.[10] The choice, according to the US national report, between using a trustee or an agent (for bond issuances governed by US law and exempted from the TIA) is largely driven by convenience, cost and various marketing factors, but may also depend upon the type of debt instrument, such that, for instance, it might be more appropriate to use a trustee, which can hold and deal with collateral, in the case of collateralised bonds.[11]

3. Potential weaknesses affecting how current collective representation practices might help control a sovereign liquidity crisis

The national reports suggest that there are certain potential weaknesses in how current arrangements for collective representation may contribute to controlling a sovereign liquidity crisis, including as follows:

(a) Even where some form of permanent, debt holder, collective representation is provided for in debt instrument documentation, the representatives appointed are rarely, if ever, accorded the powers needed to cope with a supervening crisis.

(b) For most securitised debt, there is no established forum (similar to the London or Paris Clubs) for discussion, coordinated action and decision making by debt holders in the event of a liquidity crisis of the issuer.

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[8] Although market participants have considerable flexibility to determine whether to provide for any form of collective representation and, if so, to adapt it to suit their specific needs, the proposed EU Directive on unfair terms in consumer contracts may affect the market participants' freedom of contract in this regard.

[9] New York governing law is specified for the majority of debt issues arranged or lead-managed by US commercial and investment banks and is often chosen for offerings aimed primarily at the US market (particularly in US public debt offerings, where New York law is invariably selected).

[10] See Part II, sections 10 and 11.

[11] Brady bonds have both a fiscal agent and a collateral agent, which is not a trustee.

(c) *Ad hoc* representatives with exceptional powers are frequently appointed under contractual arrangements among debt holders when a crisis develops, even though some form of permanent collective "representation" is provided for in the debt instrument documentation. Before any *ad hoc* "representative" can operate effectively, however, time needs to be spent determining essentially procedural matters, such as how that "representative" is to be appointed and how it is to function.

4. Potential generalisation of certain existing collective representation practices

It appears from the national reports that certain existing collective debt holder representation arrangements could facilitate the resolution of a sovereign liquidity crisis. Market participants might therefore consider developing and generalising the use of certain existing practices which apply to collective debt holder representation in the event of a crisis, particularly in connection with debt instruments lacking arrangements for collective representation or where arrangements for collective representation do not foster rapid and efficient workouts.

A possible focus for developing existing practices might be to provide the procedural framework necessary, for example, for:

(i) Constituting promptly an assembly[12] of all holders of a particular debt instrument when a crisis arises or, if appropriate, before a crisis develops (the "trigger" would need to be carefully defined);

(ii) The designation by the assembly of debt holders of one or more collective representatives, of the debt holders, to respond to a crisis; and

(iii) Forming, through the assembly, a forum for discussion and decision making among debt holders and, if appropriate, among debt holders and debt issuers.

Market participants could effectively research what existing market practices could be developed and harmonised, perhaps in coordination with the admission boards of stock exchanges and the organisations which approve debt-offering documentation: these bodies could encourage the generalised use of certain practices by the market. This process may ultimately lead to developing a set of uniform international standards on collective debt holder representation.

[12] In certain jurisdictions, e.g. the US, it may not be appropriate to form an "assembly" of debt holders, but effective arrangements for these purposes may perhaps be achieved otherwise.

PART II SUMMARIES OF COLLECTIVE REPRESENTATION AS DESCRIBED IN NATIONAL REPORTS

The following sections summarise the features of the forms of collective representation described in the national reports which are most relevant to international debt offerings.

1. Belgium

Belgian statute law does not contain specific provisions regulating collective representation of holders of debt instruments issued on an international level.

The Commercial Companies Law, however, contains provisions relating to the organisation and functioning of a "General Assembly of Bondholders" ("*assemblée générale des créanciers obligataires*") for bonds issued by companies established under Belgian law. Under certain conditions, a qualified majority of this Assembly has the right, for example, to agree with the bond issuer to a reduction of the interest rate or to a postponement of interest payments. The Assembly can appoint a representative for executing its decisions.

2. Canada

Trustees are typically appointed, under the terms of a trust indenture, to represent bondholders with respect to the bond issuer in large corporate bond issues. Trustees represent the holders of the debt instruments in respect of which the trust indenture was created and perform obligations defined in the trust indenture according to the general law applicable to trustees. Unless otherwise specified in the trust indenture, the trustee owes duties to the debt holders, who are the beneficiaries of the trust.

3. France

The French Companies Act[13] requires the formation of a grouping or "*masse des obligataires*" of the holders of every bond from the same bond issuance, whether public or private, by commercial companies, if governed by French law.[14] The same "*masse*" may be used to represent the bondholders in successive debt issues, if this is provided for in the debt instruments for each issue and all debt instruments provide that all bondholders enjoy the same rights.

Although French law does not require certain public sector issuers to use a "*masse*" in connection with their debt instruments, public sector issuers frequently chose to do so, particularly public entities in respect of domestic French issues.[15] Similarly foreign issued debt, including foreign issued eurocurrency debt sold in France, is not subject to the statutory requirement for there to be a "*masse*". However, these debt instruments often provide for a "*masse*" to be constituted, even though this is purely optional.[16]

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[13] Law number 66/537 dated 24th July, 1966 *sur les sociétés commerciales*, articles 293 through 339.

[14] As collective representation is mandatory for all commercial companies issuing bonds, whether publicly or privately, the rating of the issuer has no influence upon the form of collective representation to be used.

[15] French debt issued with a public guarantee by State or local authorities, or by public enterprises ("*établissements publics*") do not need to have a "*masse*".

[16] The existence of a "*masse*" can facilitate an issuers' discussions with bond holders, including on amendments to the terms of the debt instruments.

Upon issuance of the relevant debt instrument, the creditors form, by law, a "*masse des obligataires*", which is in itself a legal entity with legal personality which only ceases to exist upon full satisfaction of the bondholders' rights under the debt instrument.[17] This group, or "*masse*", of creditors has two organs: a general assembly made up of all the debt holders of the relevant bond issuances; and a committee of between one and three "*représentants*" or representatives elected by the general assembly. The chairman of the general assembly is automatically one of the representatives. If the bond issue is floated in a public offering ("*appel public à l'épargne*"), the representative(s) of the general assembly of debt holders is/are sometimes designated in the bond issue documentation. The appointment or designation of the representatives is published in a legal notice which appears, for instance, in the BALO.

The representatives of the debt holders may either be individuals or other legal entities. They must be domiciled, or at least registered, in French territory. There is no statutory requirement for the representatives to be bondholders.[18] However, the issuer and persons with managerial responsibilities within the issuer, or in companies with an interest in the capital or in the management of the issuer and persons who are banned from exercising banking activities or from taking on managerial responsibilities, cannot be appointed as a representative.

The "*masse*" and its organs represent solely and exclusively the interests of the bondholders: once the "*masse*" exists, the bondholders have no individual right to supervise the issuers' operations and management and cannot individually request communication of the issuer's accounts and documentation. This supervision and communication of these items to the bondholders is solely the responsibility of the representatives and debt holders are only entitled to request documentation from the representatives.[19]

The general assembly of bondholders will deliberate on every proposed measure involved in the representation of the bondholders and related to the execution of the debt contract, including any proposed modification in connection with the debt instrument and proposals on the following issues:[20]

(a) the modification of the memorandum of association of the issuer such as will affect the object or form of the issuer;

(b) to settle any dispute or litigation;

(c) to merge or to break up the issuer;

(d) relating to a new issue of bonds benefiting from a guarantee or security making that new issues rank above the rights of the bondholders already in the "*masse*";

(e) relating to any waiver or amendment of the guarantees or securities granted to the bondholders;

(f) relating to the extension of the due date of interest instalments or modifications of the redemption terms or the interest rate.

There are important limits on the powers of the general assembly, including that it cannot increase the debt holders' expenses or treat debt holders of the same "*masse*" unequally. The

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[17] Article 293, Companies Act.

[18] One of the representatives (who need not be bondholders) is the president of the general assembly.

[19] The bondholders can take no individual action other than in connection with the to exercise of their voting rights. See Article 319, Companies Act.

[20] Article 313, Companies Act.

Companies Act contains a number of provisions relating to meetings of the general assembly, including quorum requirements.[21]

The representatives of the general assembly are empowered to do anything necessary for the administration of the "*masse*" and in the common interests of the bondholders. The general assembly can restrict certain of the powers granted to the representatives by statute. The representatives can, if expressly authorised by the general assembly, commence legal proceedings on behalf of the bondholders. The representatives can supervise the issuer, but may not intervene in its management (the representatives will receive the same information as the shareholders of the issuer and can attend general assemblies of the issuer, although they have no right to vote).

Furthermore, the representatives are responsible for supervising any guarantees and securities connected to the debt instrument and for taking any necessary action in this regard. They can receive all guarantees and securities which are regularly attached to the debt instrument after its issue. They can waive partially, or in full, security clauses, when authorised to do so by the general assembly, or when the debt instrument is reimbursed.

The representatives are potentially liable to the general assembly of bondholders in the same way as agents in accordance with the agency provisions of the French Civil Code. The functions of the representatives therefore end in the same way as for any agent. However, the general assembly has the power to terminate the functions of the representatives. If a representative resigns, it will be liable for any harm caused to bondholders by its resignation. Pending replacement by a new representative, no-one can act in its stead. However, pending the designation of a new representative, or in an emergency, any person who has a valid interest can request the president of the appropriate court of first instance to designate a representative on an emergency basis.

4. Germany

Under German law, a special act provides for an assembly of the holders of certain domestic bonds having the same rights. The assembly has to be convened at the bondholders' request (when holders of at least 5% of the nominal bond capital demand such convening) and the assembly may, if the need arises, be represented by one or more representatives. These statutory provisions apply to all domestic issues with two exceptions: issues below a specific threshold in terms of amount and denomination are exempt from the act, as are issues by sovereign borrowers (such as federal authorities, Länder governments and municipalities). However, the act may be made applicable to municipal authorities through Länder legislation. Moreover, similar rules may be implemented by contract for domestic issues not covered by statutory law and for foreign issues of private or sovereign entities.

Where required by statute, the collective representation is governed by the German Debenture Act of 1899 (***"Debenture Act"***).[22] In contrast, where collective representation is optional, the relevant source of any obligation will be the terms and conditions of the bonds issued.[23] Provided that any such contractual provisions complied with the basic requirements of fairness and justice (as is

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[21] On first convening, the bondholders present or represented must have title representing at least one quarter of the voting rights; on the second convening of the assembly there is no quorum. Each bond gives the right to at least one vote and each bondholder has voting rights proportional to the value of the loan its bonds amount to. The general assembly's resolutions are adopted by a majority of the votes present or represented.

[22] Gesetz über die gemeinsamen Rechte der Besitzer von Schuldverschreibungen dated 4th December, 1899, as amended by the Registrierverfahrensbeschleunigungsgesetz dated 20th December, 1993.

[23] For collective representation to be available, the terms and conditions of a bond issued by a foreign sovereign issuer would either have to refer explicitly to the Debenture Act or include particular provisions for bondholders' collective representation.

the case with the provisions of the Debenture Act), they would be valid under the German Standard Contracts Act (AGB-Gesetz), which protects consumers.

Where the Debenture Act applies, representatives are elected by the general assembly of bondholders, subject to respecting certain statutory criteria relating to their eligibility, including that they must not be members of the issuer's or his creditors' executive or supervisory boards or creditors of the issuer or otherwise able to exercise significant influence upon the issuer. The representative acts as the bondholders' agent and has to safeguard the bondholders' interests. In principle, a representative elected or appointed pursuant to the terms of the bond would be subject to the same rules; however, other contractual arrangements might apply instead, e.g. endowing the representative with the powers of a "trustee".

The Debenture Act contains detailed provisions specifying certain extraordinary powers and functions which can be attributed to a representative, by a qualified majority vote of the general assembly of bondholders, in the following areas: enforcing the bondholders' rights against the issuer and thus preventing individual bondholders from commencing litigation, negotiating on and agreeing to defer principal or interest payments or even to waive interest payments. However, the representative cannot be authorised to waive the bondholders' rights to receive principal, unless formal insolvency proceedings have been opened. Furthermore, the representative is obliged to treat bondholders equally.

Contractual representation clauses can, by concentrating powers with the general assembly of bondholders, generally limit what a representative is entitled to do. Similarly, where the Debenture Act applies, the general assembly might further limit the representatives' powers by requiring the representative to consult, or obtain approval from, the general assembly before taking any action.

Under the Debenture Act, the representative may be removed by the assembly at any time by a qualified majority vote, but otherwise its functions will cease upon the completion of its duties.

5. Italy

By Articles 2415/2418 of the Civil Code there is collective representation of the holders of corporate debentures issued by joint stock companies, including public and state sector companies, but excluding banks. The collective representation involves a permanent assembly of the debt holders and a representative elected by the debt holders.

The assembly of the debt holders, as well as designating the representative, adopts resolutions on: (a) changes to the terms of the loan; (b) motions for administration under supervision and for composition; (c) establishment of a fund for the expenses necessary for the protection of common interests and related statements of account; (d) other issues of common interest to bondholders, e.g. plans to merge the issuer with another company. Validly determined resolutions of the assembly are binding, even upon absent or dissenting bondholders. However, the power of the assembly of bondholders to introduce substantial changes to the terms of the debt issue is not always recognised in legal doctrine. It is generally thought that any total or partial waiver of the principal of a debt must receive the consent of all individual creditors, and that therefore a majority decision in this regard by the assembly is not binding on all bondholders.

The representative does not need to be a debt holder. If he is not elected by the assembly, he is appointed by the president of the tribunal with jurisdiction upon request by one or more bondholders or of the directors of the company. He remains in office for a period of up to three years and can be re-elected. The representative implements the decisions of the assembly, protects the common interests of bondholders in relation to the company and attends the drawing of lots for the repayment of bonds (certain issues in Italy involve bonds which are redeemed on a lottery basis). He is entitled to attend meetings of the shareholders. He also represents the bondholders in bankruptcy proceedings; however, the assembly has to vote on any proposal of composition or administration

under supervision; such resolutions are binding for all holders of bonds. Legal doctrine tends to regard the representative as an agent of the debt holders, who is therefore subject to the Civil Code provisions regarding agency.

There are no limits on what individual debt holders can do pending designation of the representative. Debt holders can initiate individual actions even after the designation, provided that such actions do not contradict resolutions validly adopted by the bondholders' assembly.

6. Japan[24]

The two forms of collective bondholder representation most used in Japanese law are "kanri gaisha" (bond management companies or commissioned companies) and bondholders' meetings, both of which are explicitly provided for in the Japanese Commercial Code.

The collective representation provisions of the Japanese Commercial Code automatically apply to all bonds issued in Japan by Japanese "corporate" type entities. In contrast, these provisions do not automatically apply when non-Japanese sovereigns, quasi governmental and corporate type entities issue yen-denominated bonds (so-called "Samurai bonds") or other bonds in Japan. However, most foreign issuers of bonds in Japan provide for kanri gaisha and bondholders' meetings by making specific reference, in the transaction documents, to the relevant provisions of the Japanese Commercial Code.[25]

Where a foreign issuer provides for kanri gaisha and bondholders' meetings in debt offerings under Japanese law, two situations need to be distinguished: when a corporate-type foreign issuer chooses Japanese law as the governing law, it is generally believed that the statutory provisions of the Japanese Commercial Code on kanri gaisha and bondholders' meeting apply. However, where foreign sovereigns and non-corporate governmental entities choose to provide for kanri gaisha and bondholders' meetings, the issuers would not generally be bound by, or subject to, all of the provisions of the Commercial Code regarding kanri gaisha and bondholders' meetings. Instead, in this latter situation, the arrangements for the kanri gaisha and bondholders' meetings are purely contractual and accordingly the kanri gaisha's powers with respect to the bonds may differ from those of a kanri gaisha appointed pursuant to the Japanese Commercial Code, or by a foreign "corporate" issuer.[26]

As a matter of practice, both domestic and international bond issuers tend to utilise kanri gaisha and bondholders' meetings as the forms of collective representation for holders of bonds issued in Japan. Even though foreign issuers are not, as a matter of law, obliged to appoint kanri gaisha, one reason why they might choose to do so is that it enhances the marketability of the bonds in Japan since the bonds will provide similar mechanisms to those applied, by law, to domestic Japanese bonds.[27]

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[24] This summary is entirely based upon the analysis and views of the Bank of Japan and does not necessarily represent the views of the Japanese Government.

[25] Foreign issuers frequently select Japanese law as the governing law for issues in Japan.

[26] Where a "Samurai bond" issue in Japan is governed by a law other than Japanese law, the prevailing view is that the specific provisions of the Commercial Code concerning kanri gaisha and bondholders meetings would not generally apply. Therefore the foreign issuer would be free to provide for any type of collective bondholder representation mechanism, provided that the mechanism was not contrary to Japanese public policy (e.g., if the law chosen by the foreign issuer for the bond agreement did not provide for any type of protection of the bondholders, it might be deemed to be contrary to Japanese public policy and, consequently, Japanese courts might not consider themselves to be bound by the provisions of the relevant bond agreements).

[27] Foreign issuers may thus appoint kanri gaisha to receive payments under the bonds, preserve the rights of the bond holders and to handle certain administrative duties in relation to the bonds.

Statutory kanri gaisha are standing representatives (banks, trust companies or companies specifically licensed by the MOF) appointed by the issuer at the time of the initial invitation for subscription of the bonds. Where the Japanese Commercial Code does not apply, contractual arrangements for the appointment of the kanri gaisha tend to follow the statutory scheme.

A statutory kanri gaisha has duties and powers which it can exercise directly, without obtaining prior approval from the bondholders' meeting or a court, as well as powers which it can only exercise if authorised by the bondholders' meeting and by a court and also any additional powers accorded by contract which are not inconsistent with its statutory powers. The powers and duties of a kanri gaisha appointed by contract will be set out in the bond documentation and are usually the same as the powers described in the Japanese Commercial Code for statutory kanri gaisha. Many acts can be performed directly by the kanri gaisha, although declaring an event of default, accelerating bonds and acting on any matters "material to the interest of the bondholders" are deemed to be beyond the kanri gaisha's discretion and therefore need the prior approval of the bondholders.

As a general rule, the existence of a kanri gaisha theoretically does not affect individual bondholders' rights: an individual bondholder is entitled to take any action at any time in respect of its own bonds, including commencing litigation against the issuer to recover the payment of principal or interest in the event of a default. However, if a kanri gaisha sues the issuer for payment of the bonds in respect of which it has been appointed, an individual bondholder would probably be precluded from suing the issuer concurrently to obtain payments in respect of its own bonds. Furthermore, if the issuer pays or compromises a claim by an individual bondholder in a way which is "markedly unfair", the kanri gaisha has a statutory power to seek to avoid the payment or action.

Although a kanri gaisha cannot, in principle, generally restrict bondholders' rights, a majority at a bondholders' meeting can pass a resolution which, if approved by a court as required by the Japanese Commercial Code, will bind all bondholders, even those who voted against it. (The Japanese Commercial Code does not apply to Samurai bonds issued by foreign States and therefore it is generally believed that court approval is unnecessary for bondholder resolutions in respect of them.) By obtaining a resolution from a bondholders' meeting authorising it, for instance, to approve a standstill, a kanri gaisha can be involved in restricting bondholders' rights. This said, strict procedural rules apply for convening bondholders' meetings and obtaining court approval, both of which could take time.

7. The Netherlands

The Dutch practice with regard to the collective representation of institutional creditors in large syndicated financial transactions is based upon the UK market practice of using an agent.[28] Accordingly, by one of the transaction documents, the lenders will generally appoint an agent who will act on their behalf as their exclusive representative. In the case of publicly placed bonds, it was customary to appoint a trustee, but this is no longer the practice.

Whether a trustee or agent is used as a representative,[29] it is usually designated in the transaction documents, which will typically also set out the powers of the representative, as well as the duration of its function. Transaction documents normally specify that the representative must consult the debt holders it represents on any "important" issue. However, in "emergencies", a

[28] Since 1st July, 1994, it has been possible to take collective action under Article 305 a of Book 3 of the Netherlands Civil Code. For recent case law on this Article, see, for instance, Supreme Court, 2nd September, 1994, NJ 1995 no. 369 and 2nd December , 1994, RvdW 1994 no. 263 (ABN AMRO Bank v. Association of Holders Coopag).

[29] An agent (which is normally part of the leader of a syndicate of debt holders) will generally act on behalf of the debt holders in all circumstances. A trustee will normally only act in case of payment default or failure to provide security when required by contract.

representative may act to bind the debt holders, even if provisions in the transaction documents require consultation of the debt holders.

Transaction documents also usually restrict when debt holders can take individual action, although in an "emergency" situation an individual debt holder could conceivably act in the place and on behalf of the representative, thereby binding itself, the representative and also the other debt holders.[30]

A representative from a foreign country will be recognised in the Netherlands, provided that its appointment and powers conform with the law governing its appointment and do not contravene "*ordre public*" in the Netherlands.

8. Sweden

Swedish law does not contain any specific provisions on collective representation applicable to debt instruments. The Swedish market practice in this regard is, however, for companies, mortgage institutions or local authorities issuing debt instruments (including all kinds of long-term loans traded on regulated markets, as well as commercial paper) sometimes to include, in the transaction documents, provisions for the collective representation of the debt holders. The collective representation used in Sweden is therefore contractual. Swedish issuers using the Euromarkets generally provide for English law to apply to the debt instrument.

Generally, debt instruments will provide that the banks or investment firms acting as dealers of the debt will act as the representatives of the holders of that debt in accordance with the powers and duties specified in the transaction documents. These powers may include agreeing with the debt issuer to a standstill or, in certain circumstances, agreeing to amendments of terms and conditions of the debt instrument, except in respect of the repayment of principal and the payment of interest. The representatives act for the debt holders, but do not owe them any fiduciary duty.

9. Switzerland

The Swiss Code of Obligations contains, in articles 1157 *et seq*., detailed provisions relating to collective representation in connection with debt instruments governed by Swiss law. Two main situations must be distinguished in connection with whether and, if so, how these articles of the Swiss Code of Obligations apply: the articles apply, by law, in connection with any public offering of bonds by an issuer who has its domicile or a business establishment in Switzerland.[31]

In contrast, for private offerings of debt instruments or public offerings by issuers not domiciled in Switzerland, some, or all, of the provisions of these articles may apply, in whole or in part, by agreement among the issuer and the creditors. In practice, however, this rarely occurs. Where a debt instrument is not, by law, subject to the provisions of the Swiss Code of Obligations, the rules governing the form of collective representation are therefore essentially contractual and market driven.

Upon issuance of a debt instrument which is subject to the provisions of the Swiss Code of Obligations, the holders of each specific issue of debt instruments constitute a "*communauté des créanciers*", or group, which can have one or more representatives, although it is unusual to designate several representatives. The representatives may be designated by the issuer in the debt instrument documentation (and therefore accepted by the debt holders when they subscribe the debt instruments),

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[30] Under the "Zaakwaarneming" concept of Netherlands law, a person can validly bind a third party, in an emergency, even without the knowledge of that third party.

[31] The place of issue of a debt instrument is not considered to be relevant to the application of these provisions of the Swiss Code of Obligations.

or elected by the general assembly of the group of debt holders at any time after the debt has been subscribed.[32]

Where the representative is designated in the debt instrument documentation, it may, in the absence of stipulations to the contrary, represent both the debt holders and the issuer. According to prevailing legal theory, this does not mean that the representative has to safeguard the interests of both the issuer and the debt holders; it merely means that the representative cannot be unilaterally dismissed by the general assembly of debt holders and that its powers cannot be changed without the consent of the issuer.

The market practice for issuers domiciled outside Switzerland (who are not subject, by law, to the collective representation provisions of the Swiss Code of Obligations) is for the lead-managing bank to be designated as the creditors' representative in the debt instrument documentation.

Subject to respecting Swiss applicable legislation which may not be modified by contract, *ordre public*, *bonae mores*, or basic personal rights,[33] the powers accorded to the representative may vary for different debt issues. As stated above, where there is a foreign domiciled issuer, the lead-managing bank usually acts as the creditors' representative and its rights and obligations to both the issuer and the debt holders are as set out in the debt instrument documentation. In practice, the representative usually has considerable discretionary powers to exercise on behalf of the debt holders, including certain special powers not available to a creditors' representative appointed by law. The special powers typically granted to a creditors' representative where the Swiss Code of Obligations does not apply might include: the power to accelerate debt repayment upon the occurrence of an event of default (including the dissolution, sale, merger or reorganisation of the issuer) and the power to agree with the issuer on minor, formal or technical amendments to the terms of the debt instrument.[34]

It would, however, be "unusual" to delegate to the representative more far-reaching powers, such as agreeing to substantive changes in the terms of the issue, without a resolution of the general assembly of creditors; "unusual" terms might not be enforced by Swiss courts.[35] It is not common for debt instruments to contain clauses empowering the representative to commence court or arbitration proceedings.

Debt instruments issued by debtors domiciled outside Switzerland generally do not contain more than rudimentary procedural rules applicable to the measures or decisions taken by the representative. Thus, the representative will usually be obliged to allow the issuer a certain amount of time in which to cure any default, before the representative can call in the debt. Debt instruments, however, generally contain procedural rules relating to the holding of debt holders' meetings, in particular, rules for quorum.

Whether and, if so, to what extent, the existence of a representative can restrict or limit the rights of individual creditors depends on the terms of the debt instrument. Accordingly, it appears that where the terms of a debt instrument empower a representative to take certain actions upon the occurrence of an event of default, the implication is that those actions are open to the representative

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[32] A court can also, in certain circumstances, appoint a representative, where necessary.

[33] Furthermore, in accordance with Swiss agency law principles, the representative is generally obliged to exercise due care in comprehensively protecting the debt holders' interests.

[34] In addition, the representative will be responsible for passing onto the debt holders indemnification, received from the issuer, for any taxes introduced after the debt issue. The representative might also be responsible for verifying whether any conditions for a change in the debtor are respected, if necessary.

[35] The terms contained in any debt instrument will be interpreted in the same way as general business conditions and therefore a court might refuse to allow the application of "unusual" terms which would operate to the detriment of investors, including institutional investors.

alone, unless the debt instrument expressly states that debt holders are entitled individually to take such actions. The market practice, however, is that the representative is not granted, in the debt instrument, the right to agree, for instance, to a moratorium with the issuer; instead, the general assembly of debt holders may resolve to take this sort of measure, or any other measure "encroaching" on the individual debt holders' rights and modifying any of the substantive terms of the issue.

In principle the representative's mandate lapses when the debt instrument (including all interest) is repaid. Although debt instruments usually do not contain any provision allowing for the termination of the representative's mandate, it appears likely that the general assembly of debt holders could resolve to terminate the representative's mandate, provided the issuer consented, because the representative's mandate is based on a contract among the debt holders and the debt issuer. Similarly, the general assembly of debt holders could probably, if necessary, appoint a replacement representative, with the consent of the issuer.[36]

Swiss law is chosen as the governing law of the vast majority of Swiss franc bonds issued in Switzerland by foreign issuers, principally because the rules governing the listing of securities on Swiss stock exchanges only permit the selection of a foreign law as the governing law of a debt instrument in "exceptional cases".[37] Furthermore, the courts at the domicile of the lead-managing bank are usually given non-exclusive jurisdiction over any disputes.[38] In contrast, non--Swiss franc denominated eurocurrency bonds offered in Switzerland are usually issued and traded outside Switzerland and governed by a law other than Swiss law.

10. United Kingdom

English statute law does not require any specific form of collective creditors' representation to be used in connection with debt instruments. However, in various debt offerings governed by English law, the debt issuer and debt holders frequently agree upon some sort of formal collective representation, notably the use of trustees or agents, as described below.

Holders of debt instruments (regardless of whether they provide for trustees or agents) frequently resort to informal or *ad hoc* arrangements for collective representation as and when problems arise with performance of obligations under the debt instruments.[39] Thus, bond documentation may provide for collective decisions to be made by bondholders' assemblies. In the event of a default by the issuer, the bondholders' assembly typically has the power to appoint a representative with wide powers, including negotiating on behalf of the debt holders. The debt holders' assembly can usually delegate to this representative any powers which the assembly could have exercised by "Extraordinary Resolution" (as described in the debt documentation). Extraordinary Resolutions by debt holders' assemblies are typically binding on all debt holders. Instruments such as Brady bonds, which do not provide for debt holders' assemblies, do not permit any bondholders' rights to be altered without their consent.[40]

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[36] Pending appointment of any replacement representative, individual debt holders could probably petition the appropriate courts in order to obtain an order for performance of any contractual right which would normally have been exercised by the representative.

[37] The Admission Board for Swiss Stock Exchanges allows exceptions for foreign sovereign issuers, provided, *inter alia*, that the securities are deemed marketable from the Swiss perspective and the issuer waives its rights of sovereign immunity from jurisdiction and enforcement.

[38] Debt instrument terms often permit the debt holders to have recourse to the courts of the issuer's country of origin.

[39] This solution is typically used also when problems arise with short-term instruments (which usually do not contain provisions for collective representation) and commercial paper (which does not usually provide for meetings of note holders, unless it is issued under a medium-term note programme).

[40] Powers conferred upon a representative by a debt holders' assembly typically end by decision of the debt holders' assembly.

(a) Trustees

Where a trustee is used, the debt offering is structured around the trustee and the bonds (or other debt instruments) are constituted pursuant to a trust deed entered into between the trustee and the debt issuer. The trustee is to function from the date of execution of the trust deed, which provides that there must be one or more trustees during the life of the issue. Pursuant to the trust deed, the issuer covenants with the trustee that it will comply with its obligations in respect of the bonds and the trustee holds the benefit of this and the other covenants on trust (i.e. as a fiduciary) for the debt holders: the trustee is legally an agent of the debt holders. The trust deed is binding on the debt holders. The legal source for any arrangement using a trustee is contractual.

Trustees, if any, are standing permanent representatives appointed on signature of the trust deed and are usually selected by the issuer. UK market participants stressed the caution exercised in the appointment, such that trustees are usually selected from only among approximately half a dozen recognised specialists (e.g. trust corporations or financial institutions) active in a particular bond market. Furthermore, since the appointment of trustees is consensual, in that the debtholders agree to accept the trustee selected by the issuer, it usually cannot be challenged by the debt-holders. The involvement of a trustee is usually extinguished upon repayment of the issue.

Where a debt offering makes provision for a trustee, the precise powers and obligations of the trustee vary depending upon the terms agreed upon and contained in the relevant bond issue documentation. However, the trustee typically has certain powers to act on behalf of the debtholders. Furthermore, the debtholders are typically restrained from taking certain courses of action independently of the trustee. Thus, for instance, upon an event of default, typically only the trustee is able to exercise the debtholders' rights of acceleration. Typically, the trustee can do so at its discretion, but will usually be obliged to accelerate if instructed to do so by one or more bondholders representing a specified percentage (typically 20%) of the principal value of the outstanding debt issue.[41] An individual debtholder holding less than that specified percentage does not usually have any right to accelerate a claim where the debt has been issued with a trustee. However, a debt holder would be permitted to accelerate the amount outstanding in respect of the debt it is holding if he can prove that the trustee has omitted to accelerate upon instructions from the requisite percentage of debt holders.

Rather than accelerate against a sovereign debt issuer, a trustee is often more likely to exercise its right to call a meeting of debt holders before any possibility of a default becomes an issue. Thus the trustee would pass responsibility for dealing with the act of default onto the debt holders, who would get advance warning of problems before a crisis emerged. Furthermore, the issuer might be able to avoid a disorderly default.

Similarly, the trustee's intervention might be needed if an amendment or waiver is sought by the debt issuer, or the trustee may have to enforce a collateralised debt, provided any pre-determined majority of debt holders required the trustee to take action.

Even where a debt instrument has been issued with a trustee, in the event of a default by the debt issuer, debt holders will sometimes appoint a representative, with more powers than the trustee, to negotiate on their behalf with the issuer. Thus, a debt holders' meeting may appoint a representative by passing an "Extraordinary Resolution" on a "Reserved Matter". This representative (or committee of representatives) can have any powers delegated to it which the debt holders themselves could exercise by Extraordinary Resolution.

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[41] The use of a trustee in connection with a debt issue will usually restrict the rights of individual bondholders to accelerate their claims, if any: a bondholder will usually have no right to accelerate unless he or she can prove that the trustee has been requested to accelerate by the required percentage of bondholders and has not done so.

(b) Fiscal agents

Most eurobonds are either governed by English law or by US law. Whereas US eurobond issues tend almost exclusively to use fiscal agents, UK eurobonds are fairly evenly divided between using either a trustee or a fiscal agent.[42]

Fiscal agents, if any, are usually designated in the fiscal agency agreement and selected by the issuer. UK market participants stressed the caution exercised in the appointment such that (as with trustees) names of fiscal agents are selected from among approximately half a dozen recognised specialists. The fiscal agent has an administrative role in respect of the debt instrument and is legally an agent of the issuer, with no or limited responsibility to the debt holders. However, the fiscal agent's position at the centre of the debt holder's group can mean that fiscal agents find themselves playing a role in coordinating action in any crisis.

Where a debt instrument has been issued with a fiscal agent and a crisis develops, the debt holders might decide to appoint a "representative" or "committee of representatives" in much the same way as a representative might be appointed to supplement the powers of a trustee. If a representative is appointed, it might be the original lead manager or alternatively one of the larger bondholders.[43] The process of acceleration seems to be less orderly in the case of debt issued with a fiscal agent. An individual debt holder may be permitted to accelerate its own debt and, subject to the terms of the issue documentation, could be able to accelerate the entire debt.

The involvement of a fiscal agent is extinguished with the repayment of the debt, although the fiscal agent may still have some residual responsibilities, for instance where bearer coupons have not been honoured. In practice, although a fiscal agency agreement usually provides for the replacement of a fiscal agent during the life of the issue, this occurs only rarely.

(c) Facility agents

Most syndicated loans governed by English law call for a "facility agent" to represent syndicate members for the duration of the loan.

The facility agent is a permanent representative, chosen by the borrower initially and named in a facility agreement. The facility agent has a chiefly administrative role (e.g. it is the conduit for payments and notices), but is an agent of the members of the syndicate rather than of the borrower. Facility agents may have some discretion to act on behalf of the syndicate members on certain minor issues and also a discretion to accelerate or to enforce repayment of a loan in the event of a default, but rarely exercise these powers: most decisions on matters such as acceleration are usually taken by a specified majority vote among the syndicate members (usually 66% or 75%). Syndicate members are usually allowed independently to enforce their debt, when due and owing.

When problems arise, syndicates often set up on an *ad hoc* basis "advisory committees" or "steering committees" which have similar functions to the debt holders' representatives described above in connection with trustees. The steering committees have limited authority to act on behalf of the syndicate during the period of default and may attempt to negotiate a rescheduling or compromise with the borrower on behalf of the syndicate. Steering committees of banks have in the past had considerable freedom of action and significant, although informal, powers to make decisions on behalf of the rest of the syndicate.

Syndicated loan agreements in which financing is provided to sovereigns in emerging markets tend not to provide for collective action by creditors. Each creditor can therefore independently accelerate its own claims upon the occurrence of an event of default and can then sue

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[42] There is never a statutory obligation to use a fiscal agent.

[43] It is difficult to appoint the fiscal agent as the representative without creating a conflict of interest as the fiscal agent is an agent of the debt issuer.

once payment is due and owing. Furthermore, no creditors can have their rights changed without their express consent.

11. United States

Under US law, there are three main forms of collective "representation" of debt holders: trustees, fiscal agents and syndicate agents, all three of which are discussed separately below. However, when a crisis arises, creditors often resort to various informal or *ad hoc* forms of collective representation, regardless of whether any formal collective representation is already in place.[44]

(a) Trustees

Under the TIA, independent trustees with specific rights and duties must be appointed to serve as debt holders' representatives in connection with certain debt offerings in the US market which are subject to the registration requirements of the US Securities and Exchange Commission ("**SEC**"). These debt instruments generally include bonds, debentures and notes of foreign private issuers.[45] However, bonds of (or guaranteed by) foreign official issuers, as well as bonds issued in private placements or offshore (including bonds of foreign private issuers) even though governed by US law, are exempt from the application of the TIA; although exempt, these bonds may also be issued with a trustee.

Bonds issued with a trustee are issued under a contract known as an indenture, between the debt issuer and the trustee, which sets out the terms under which the trustee is to operate and function. A trustee used in connection with a US issued debt instrument is therefore a permanent representative which is named in the transaction documents and is to function immediately from signature of the transaction documents in accordance with the terms of the indenture. The TIA sets out certain criteria which apply to the identity of the trustee, including that there must always be one or more trustees, at least one of which is an entity organised and doing business under the laws of the United States, or a state of the United States or which is specifically authorised to act as a trustee by the SEC.[46]

A trustee represents[47] the holders of the debt instruments issued under an indenture, which may include bonds issued in more than one series. The trustee owes various duties, including fiduciary duties, to the holders of the debt instruments covered by the indenture. When a trustee is appointed as a result of the TIA, the TIA imposes certain mandatory powers and duties upon the trustee.[48] Where the trustee is not appointed as a result of the TIA, the powers and duties of the trustee will reflect the agreement negotiated by the parties, or the market practice and no terms will be implied by operation of the TIA.[49] This said, debt instrument provisions concerning bondholders' collective representation tend to follow a pattern, even where the TIA does not apply and there is consequently no obligation to appoint a trustee.

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[44] Bankruptcy is not considered for present purposes.

[45] The TIA applies to every note, bond, debenture, or evidence of indebtedness issued in the United States, whether or not secured, which does not fall within a specific exemption.

[46] The institutional trustee must have a combined capital and surplus in excess of US$ 150,000. No obligor upon the indenture securities, nor any person controlling or controlled by the obligor is permitted to act as trustee.

[47] The trustee's powers to "represent" the bondholders are limited.

[48] The TIA also imposes certain duties upon the obligor.

[49] In these circumstances, "bondholder rights and collective representation arrangements are determined exclusively by market practice and contract".

The trustee is generally responsible for disseminating information to the debt holders. Thus, at least every 12 months, a trustee appointed under the TIA must provide the debt holders with any information it has regarding the following matters:[50]

(a) any change in its eligibility to be trustee;

(b) the amount, interest rate and maturity date of all indebtedness owed to it, in its individual capacity, by the obligor;

(c) any change in the property and funds physically in its possession as trustee;

(d) any change to any property subject to the lien of the indenture;

(e) any additional issue of indenture securities which it has not previously reported;

(f) any action taken by it in the performance of its duties under the indenture which it has not previously reported and which materially affects the indenture securities or the trust estate.

In addition, the trustee must, within 90 days, transmit to the debt holders a brief report with respect to:[51]

(a) the release of property subject to the lien of the indenture; or

(b) the character and amount of any advances made by it since the date of the last report where the trustee itself claims a lien or charge, if such advances remaining unpaid at any time aggregate to more than 10% of the principal amount of the indenture securities outstanding.

Regardless of whether there is a trustee (either as a result of the TIA or otherwise), it is the market practice in the United States for creditors to communicate on an informal and *ad hoc* basis if the obligor encounters payment difficulties. In the event of a default, the trustee under an indenture governed by the TIA must give notice of the default to the debt holders within 90 days.[52] The trustee may also take certain actions upon the occurrence of an event of default: the trustee can accelerate debt repayment in certain circumstances.[53] Furthermore, if a payment of principal or interest is overdue, the TIA provides that the trustee may, in its own name, sue the issuer for the whole amount of the principal or interest remaining unpaid; a trustee will usually also have this right even where the TIA does not apply.

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[50] Furthermore, under the TIA, the trustee is obliged to keep a list of the holders of debt. Three or more holders of the debt may request the trustee to supply them with a copy of this list so that they can communicate with the other holders and discuss their rights under the indenture. If the trustee refuses to make the list available, which it may do if it believes that disclosure "would be contrary to the best interests of the indenture security holders or would be a violation of applicable law", the holders may request an order from the SEC to compel the trustee to allow access to the list.

[51] The trustee's reports must also be filed with the SEC and the stock exchange on which the indenture securities are listed.

[52] However, if there has been a default in the payment of interest, principal or a sinking fund instalment, the trustee is protected in withholding such notice if and so long as the board of directors, the executive committee, or a trust committee of directors and/or responsible officers, or the trustee in good faith determine that withholding of such notice is in the interests of the indenture security holders.

[53] Typically, either the trustee, or the holders of a fixed percentage of the debt (perhaps 25%), may accelerate, although indentures generally provide that acceleration can be rescinded by a majority of debt holders.

Even though the trustee is entitled to sue on behalf of the debt holders, the holders of a majority of the debt will usually direct the trustee as to the time, method and place for conducting any proceeding for obtaining any remedy. Furthermore, in practice, a trustee is likely to consult individual debt holders before taking any action, as it can shield itself from potential liability to the debt holders for its actions or inactions by acting with the approval of at least 50% of the debt holders.

The existence of a trustee does little to restrict or limit the rights of individual debt holders: the right of individual debt holders to sue for overdue principal or interest is nearly absolute[54] and, under the TIA, the consent of each debt holder must be obtained in order to allow the trustee to alter the rights of that holder to receive principal and interest in the amounts originally agreed upon on the stated due date.[55] This consent is almost always needed in practice for all debt instruments governed by US law, even when the TIA does not apply. As a result, the trustee cannot, without the consent of each affected holder, agree to a standstill or rescheduling, as this would result in payments of interest or principal being made at times or in amounts other than those originally agreed. Furthermore, a trustee cannot waive or amend significant indenture covenants, including negative pledge clauses, without obtaining the consent of at least a majority of the debt holders by value.[56]

Few formal, procedural rules apply to the actions of a trustee, whether appointed under the TIA or otherwise. Generally, the trustee will seek guidance from the majority of debt holders on any significant procedural matters, as it would arguably be imprudent for the trustee not to follow the wishes of the debt holders which the trustee purports to represent.[57]

There is generally no possibility of appealing against decisions taken by the trustee, even though indenture contracts often provide that a stated percentage of the debt holders may rescind a trustee's decision to accelerate. In addition, decisions taken by a majority of the debt holders can reverse or effectively dictate the actions to be taken by a trustee, as the trustee can shield itself from potential liability to the other debt holders if it acts in accordance with the majority, by principal amount, of the holders.

A trustee appointed under the TIA may be disqualified from function if it has, or acquires, a conflicting interest and does not either resign or eliminate the conflicting interest within 90 days. Any debt holder who has been a *bona fide* holder of debt instruments issued under an indenture for at least six months may, on behalf of himself and all other similarly situated debt holders, petition any court of competent jurisdiction for the removal of the trustee and the appointment of a successor, unless the trustee's duty to resign has been stayed. Furthermore, indentures generally provide that the holders of a majority in principal amount of the outstanding debt issued under an indenture may replace the trustee.

(b) Fiscal agents

When a trustee is not required by the TIA, debt instruments, including bonds, debentures and notes issued or guaranteed by foreign sovereigns and other official entities, which are offered in the US market, are often issued with a fiscal agent.[58]

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[54] There are some statutory exceptions.

[55] The fact that a trustee is able to sue on behalf of the other holders may influence an individual debt holder's decision over whether to sue, even though each individual holder retains its right to sue.

[56] The power of a trustee to act on behalf of bondholders outside of the United States is not subject to any specific limit, except as might arise under any applicable non-US law.

[57] The TIA generally allows the holders of at least a majority by principal amount of the debt to direct the actions of the trustee. Furthermore, the trustee may be required to take certain actions upon the direction of a specified percentage of bondholders by amount.

[58] This also applies, inter alia, to debt instruments of foreign private issuers offered under an exemption from the registration and disclosure requirements of the SEC.

There is never a statutory requirement to use a fiscal agent. The decision to use a fiscal agent, as opposed to a trustee (in situations where there is no statutory requirement to use a trustee), is largely driven by convenience, cost and marketing factors.[59]

Fiscal agents are usually standing or permanent representatives selected by the borrower and named in a fiscal agency agreement entered into between the debt issuer and the fiscal agent, which also usually sets out the powers and duties of the fiscal agent. Fiscal agency agreements sometimes also contain provisions requiring notice to bondholders and providing for bondholders' meetings which may facilitate collective decision making by bondholders. The fiscal agent is typically a commercial bank, trust company or an affiliate thereof (although there is no formal requirement in this regard) and will usually have to meet minimum size requirements in terms of its capital and surplus. As the issuer usually appoints the fiscal agent, it is generally also free to remove the fiscal agent, at any time, with or without cause and to replace it with a new agent of its choice.[60]

The fiscal agent performs limited, administrative, debt-servicing duties on behalf of the issuer: unlike trustees, fiscal agents do not represent the debt holders, even if they can facilitate coordination of the debt holders.[61] Thus a fiscal agent receives payments of principal and interest from the issuer and disperses those payments to the debt holders in the manner specified in the fiscal agency agreement. When payment of the full principal amount is made, the fiscal agent often has to cancel, retire or destroy the bonds and to certify to the issuer that it has done so or to request a depository e.g. Euroclear or Cedel to cancel the instruments.[62]

In addition, the fiscal agent generally has various duties for receiving and disseminating information. For instance, if the issuer is contemplating not making a payment on time, it is generally obliged to notify the fiscal agent who will in turn have to notify the debt holders. Similarly, the fiscal agent may be designated to receive notice from a debt holder that an event of default has occurred and that the debt holder wishes to accelerate; in this situation, the fiscal agent must notify the issuer. However, the fiscal agent generally has no duty to the debt holders in the event of default, other than giving notice of the event of default.[63]

As the fiscal agent is the agent of the issuer and not of the debt holders, the fiscal agent has no authority to take any action on behalf of the debt holders upon an event of default by the issuer. The individual debt holders retain exclusive power to take action in response to an event of

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[59] Several US practitioners claimed that the choice between a trustee and a fiscal agent makes little practical difference in workouts of foreign debt governed by US law: trustees have no financial incentive to take independent action and, as they are potentially liable to debt holders for any breach of their fiduciary duties, they are generally not inclined to take any substantive decision concerning a bond workout without instruction from a large majority of debt holders. Consequently, the major debt holders usually need to be at the table, or at least directly consulted, regardless of whether there is a trustee. There may also be certain market preferences for using a trustee as opposed to a fiscal agent, even where there is no statutory obligation to use a trustee. Thus, in the case of collateralised bonds, it may be seen as advantageous to have a trustee hold and deal with the collateral.

[60] The fiscal agency agreement sometimes provides that any new fiscal agent must comply with certain eligibility requirements and also that a stated percentage of the debt holders must not object to the new fiscal agent. Fiscal agents generally can resign at any time upon giving written notice to the issuer. Otherwise, the functions of a fiscal agent will normally cease when the fiscal agency agreement expires, which typically will occur when the issuer discharges the whole debt, or all of the debt is extinguished after exchange for other instruments not covered by the fiscal agency agreement.

[61] As fiscal agents do not have a representational role, there is only rarely a challenge or appeal by debt holders against any action or decision of a fiscal agent. However, the agents can be sued by debt-holders.

[62] The fiscal agent is generally required to maintain the sums for making such payments in accounts separate from its own monies.

[63] In addition, the fiscal agent may have duties to maintain records of the outstanding debt instruments and to make these records available to the issuer as well as also notifying the issuer of any changes in relevant law (especially tax law) which might be to the detriment of the issuer.

default, including suing the issuer. However, in a typical fiscal agency agreement, when a specified percentage of the debt holders has determined to accelerate, the agent is required to so inform the issuer and all the other debt holders.

Some fiscal agency agreements contain provisions which require the fiscal agent to convene a meeting of the debt holders upon being requested to do so by a specified percentage of the debt holders. When such a meeting has been validly called and a quorum is present, a majority of the debt holders in attendance can, for instance, resolve to take action to bind the others, except that changes in the basic economic terms of the debt instruments (including changes in the stated date of maturity of principal or interest, or accepting a reduction of the principal or interest payments) require the agreement of all debt holders.[64]

(c) Syndicate agents

Syndicated bank loans, in favour of foreign private or foreign sovereign borrowers, which are arranged or syndicated by US banks or offered on the US markets often feature a so-called "syndicate agent" or "agent bank".[65]

A syndicate agent is a standing or permanent representative who is usually named in a syndicate agreement among the debt issuer, the syndicate (of all the creditors under the syndicated loan) and the syndicate agent itself and will generally have been selected as the result of informal consultation among members of the syndicate. The syndicate agent will typically be a commercial bank of at least a minimum size, which is usually specified in the syndicate agreement (as with fiscal agents) and is often itself a member of the syndicate and therefore a creditor under the syndicated loan.

Syndicate agents do not represent the syndicate or the holders of the syndicated debt.[66] Syndicate agents perform limited, debt-servicing administrative duties, similar to those performed by a fiscal agent, in respect of the debt covered by the agreement which appoints them. Thus, among other things, the syndicate agent receives, from the borrower, funds and documents and disperses or distributes them to members of the syndicate.[67]

A syndicate agent generally does not have an active duty to collect information on behalf of the syndicate or to provide the syndicate members with any information it receives with respect to the borrower and/or guarantor, if any, whether any such information comes into its possession before or after the disbursement of the loan. Nor does the typical syndicate agent have any duty to enquire into whether the borrower or guarantor has performed any of its obligations under the loan agreement, guarantee or any other agreement. However, the typical syndicate agent must give prompt notice to each member of the syndicate as soon as the agent itself receives notice of an event of default.

The typical syndicate agent has no power or obligation to sue in its own name on behalf of the syndicate members (or to take any other action to protect the syndicate members' interests) upon the occurrence of an event of default. However, as the syndicate agent is generally one of the syndicate members, it may carry out, or consent to, any action in its capacity as a syndicate member.

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[64] This is common for fiscal agency agreements governed by US law which are entered into in connection with Brady bonds.

[65] There is never a statutory requirement to use a syndicate agent.

[66] Given the duties it has to perform, a typical syndicate agent is held to a low standard of care and will generally be liable to the syndicate members only for gross negligence or wilful misconduct. Moreover, the syndicate agent is allowed to rely on any document signed by the proper person and believed by it to be genuine. In the absence of bad faith, the agent generally has no affirmative duty to make further enquiries about any information it receives.

[67] However, unlike a fiscal agent, the syndicate agent performs its duties for the syndicate of lenders and not for the borrower.

Upon the occurrence of an event of default, each individual syndicate member will normally be entitled to sue the debtor for any overdue amounts or other breaches of the terms of the loan agreement, even though it is unlikely to do so without at least consulting other members of the syndicate.

Most syndicate agreements specify that, upon occurrence of an event of default, the syndicate agent must accelerate a loan, if it is requested to do so by a specified percentage of syndicate members. However, although the terms of many syndicate agreements restrain individual syndicate members from accelerating the loan, syndicate members can usually commence a lawsuit upon any payment default or other event of default, thereby provoking acceleration. Although commencement of a lawsuit may provoke creditors to accelerate the loan, this is not automatic. Furthermore, unanimity of the syndicate members is generally required for changing any of the basic economic terms of the debt, although lesser majorities, typically two-thirds, might be sufficient to amend or waive other covenants, including negative pledge covenants.[68]

The functions of a syndicate agent typically cease when the debt obligations are fully discharged by the borrower. A typical syndicate agent can usually be replaced, with or without cause, by a fixed percentage of the syndicate members (often a majority by principal amount). A syndicate agent may also resign at any time by giving written notice to the obligor and also to the syndicate members. Upon either instance, the syndicate members may appoint a successor agent. If they do not do so within a specified time, the former agent may be entitled to appoint a successor agent.

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[68] Most syndicate agreements do not contain any significant procedural rules specifying the way syndicate agents have to operate, as agents generally cannot take independent action to alter the terms of the debt or control lawsuits with respect to the debt, or to amend or waive any of the debt provisions.