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SOVEREIGN DEBT CRISES: AN INTEGRATED APPROACH TO CRISIS PREVENTION, MITIGATION AND RESOLUTION

Sponsored by the Securities Industry Association

excerpt from
"Moving From Words to Action
With the Monterrey Consensus"
Statement by Frank Fernandez
for the Business Interlocutors,
The General Assembly Dialogue, The United Nations
October 28-30th, 2003

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Sovereign Debt Crises:
An Integrated Approach to Crisis Prevention, Mitigation and Resolution

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> The private financial community continues to participate in efforts to strengthen crisis prevention, promote early crisis containment and hence mitigate the cost associated with financial crises in emerging markets and to provide a flexible, market-based approach to sovereign debt restructuring operations when a payments interruption becomes unavoidable. These efforts have broadened and intensified in the past year and tangible results are visible in initiatives already being implemented, while new proposals have been brought forward and are under consideration. In this area, the private sector has addressed the Monterrey challenges and has moved from words to action.

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The private financial community continues to participate in efforts to strengthen crisis prevention, promote early crisis containment and hence mitigate the cost associated with financial crises in emerging markets and to provide a flexible, market-based approach to sovereign debt restructuring operations when a payments interruption becomes unavoidable. These efforts have broadened and intensified in the past year and tangible results are visible in initiatives already being implemented, while new proposals have been brought forward and are under consideration. In this area, the private sector has addressed the Monterrey challenges and has moved from words to action.

Collective Action Clauses

As part of a market-based approach, new contract clauses have been developed by the private financial community in consultation with issuers that will facilitate orderly restructurings of debt contracts while reinforcing essential creditor rights. The new documentation is designed to modify the traditional New York law unanimity requirement for amending core provisions, including payments; require debtors to adhere to higher transparency standards and provide early warning of possible creditor deterioration and /or excess borrowings; facilitate the formation of creditor groups and their ability to engage in early consultation with issuers facing legitimate financial crises; strengthen creditor protections generally; and strengthen acceleration and de-acceleration provisions in order to prevent precipitate legal action, without prejudice to individual creditor's rights. This documentation would also harmonize differences between English and New York law governed bonds.

In the first half of this year, Mexico, Uruguay and Brazil issued bonds containing supermajority requirements. Contrary to the expectations of critics of this approach, the inclusion of collective action clauses (CACs) had no discernible impact on the pricing of these bonds. CACs will help create a more transparent, organized approach to debt restructuring. This in turn reduces uncertainty and risk inherent in this market while providing for faster resolution of defaults. This, along with other initiatives, may well reduce the probability of defaults.

Substantial work in this area remains. CACs will be important to future issuances of sovereign debt, but broad-based inclusion of these clauses is required before they have a measurable impact on risk-reduction. In addition, further refinement of these clauses is required. The official sector successfully catalyzed a viable private sector initiative to develop marketable CACs: this initiative should now be supported by the official sector. One recommendation to speed broad-based inclusion of these clauses would be to make their inclusion a condition precedent to initiation of new IMF programs.

Code of Conduct

The private financial community, specifically the "Gang of Seven"[1], have continued efforts toward developing the elements of a voluntary Code of Conduct and substantial progress has been achieved.[2] A high level group of principals convened in Paris for discussions this summer, followed by additional consultations in Dubai and London. A "rendezvous" with G-20 deputies is planned for end-October to discuss the most recently completed draft.

There is broad-based consensus that the Code should be voluntary, flexible and balanced in providing standards of behavior and responsibilities for the main participants in emerging markets finance and that it would complement broad-based inclusion of marketable CACs. It rests on the premise that all parties share a common interest in strengthening the international financial system and promoting private capital flows.

The Code reaffirms a commitment to strengthened crisis prevention and sustaining market access for emerging market borrowers through the pursuit of sound policies, structural reforms, enhanced risk management practices, and continued IMF surveillance. The Code also promotes early crisis containment through debtor-creditor consultations and policy adjustments before situations become critical. It also identifies signs of eroding market confidence and proposes how borrowers should respond to these early warning signs. In these regards, the Code goes well beyond efforts to address problems associated with sovereign debt restructurings, but complements and advances those efforts. Specifically, it provides guidelines for crisis resolution through debt restructuring for both pre-default and post-default cases.

While substantial progress has been made, significant work remains. Recommendations for the most innovative part of the Code, early crisis containment, have met some resistance and further modifications will be necessary to correct the misperception that the Code represents a form of Best Practices. Further, the disruptions created by developments in Argentina have eroded support for the Code. Worse yet, it has even led some to suggest reconsideration be given to the IMF's proposal for a Sovereign Debt Restructuring Mechanism (SDRM). We believe this would prove to be unproductive given that the proposal has been repeatedly rejected by the private financial community as well as by a broad range of official sector representatives. Private/public sector consultations need to continue to finalize the Code and official endorsements by issuers needs to be actively pursued.

[1] The "Gang of Seven" includes my own association, the Securities Industry Association, along with The Bond Market Association, the Institute for International Finance, the International Primary Market Association, the International Securities Market Association, the Emerging Markets Creditors Association, the Emerging Markets Traders Association.

[2] The latest draft of Proposed Elements of a Voluntary Code of Conduct is attached as Appendix A.

The SDRM

The SDRM is described by the official sector as a complement to the use of collective action clauses and as having the objective of facilitating the orderly, predictable, and rapid restructuring of unsustainable sovereign debt. However, prominent features of the SDRM include the early use of stays, a legal priority on payment of official sector debt, and the creation of a Sovereign Debt Dispute Resolution Forum with "judges" appointed by IMF member states and rules drafted by those appointed judges. Since sovereign debtors will have the exclusive authority to activate the SDRM, it is viewed by many as increasing the probability of future debt restructurings while failing to honor basic creditor rights. These characteristics have significantly raised investor anxieties, particularly since one of the key issues apparently sought to be addressed by the SDRM – litigation by rogue creditors – has in fact caused little practical disruption in the vast majority of previous debt restructuring exercises. At the same time, while the SDRM contains extensive mechanisms for imposing stays on debt repayment, it does not propose any official counterbalancing mechanisms for constraining debtor behavior (as, for example, would be seen in a typical domestic bankruptcy regime in exchange for freezing payments to creditors).

For the foregoing and following reasons, the SDRM has significant drawbacks that not only make it unnecessary, but also could be counterproductive to the debt restructuring process:

- Creates an inherent conflict of interest for the official sector;
- Imposes a lengthy and time consuming restructuring process;
- Excludes official sector debt thus subordinating private credit;
- Advances the timing of the rundown in exposure;
- Increases the likelihood and frequency of restructurings going forward;
- Fails to address aggregation issues, or investor concerns about transparency; and
- Requires significant time to amend IMF articles.

More detailed views of the SDRM are attached as Appendix B.

Next Steps

In addition, to the actions proposed above to move forward on CACs, the Code and the Global Clearinghouse,[3] the private financial community is placing substantial resources in accelerating development of advanced risk management systems (partly to advance efforts towards Basel II) that will also help to deal with efforts related to emerging markets financial crisis. New initiatives should also be promoted. Consideration should be given to proposals for: the issuance of global development bonds with embedded credit derivatives for infrastructure financing[4]; formation of a consultative body of "wise persons"; expansion of investor relations programs, and; continuation and greater coordination of recent research efforts, by both academia and the private financial community, into the causes and consequences of recurrent financial crises in emerging markets, with particular focus given to practical applications for their prevention, mitigation and resolution.

[3] For more information on the The Global Clearinghouse Information Portal contact Dr. Barbara Samuels II at barbara.samuels@globalclearinghouse.org (phone 845-868-7639) or visit the portal itself.

[4] For a brief discussion of this concept see Appendix C.

Appendix A

Proposed Elements of a Voluntary Code of Conduct
Draft, September 11, 2003

A Code of Conduct rests on the premise that all parties share a common interest in strengthening the international framework in order to promote private capital flows in the context of growth and financial stability. It outlines standards of behaviors and responsibilities for the main parties in emerging markets finance and its guidelines will apply flexibly and on a case-by-case basis. None of the provisions should be given any legal effect as a matter of contract, comity, or otherwise. The Code would complement a broad-based inclusion of marketable collective action clauses (CACs) in sovereign bond contracts.

Unlike mechanisms that concentrate exclusively on debt restructuring and become relevant only following a financial crisis, when severe losses in output and growth have already occurred, this approach is pro-active and growth-oriented. It explicitly recognizes that market participants accept full responsibility for their investment and lending decisions in emerging markets and that they do not expect "bail outs" from the official sector. The Code would, of course, recognize the role of the IMF and endorse firm access limits with provisions for exceptional circumstances. At the same time, the IMF could support and encourage policies and actions by sovereign debtors that are consistent with the Code.

The Code reaffirms a commitment to strengthened crisis prevention and promotes early crisis containment through debtor-creditor consultations and course correction before problems become unmanageable. In connection with a preliminary determination by the debtor that comprehensive debt restructuring may be needed, consultations between debtors and creditors would form the basis for market-based approaches to debt restructuring that allow debt sustainability to be restored while all efforts are being made to maintain debt service payments in the interim. In cases where the debtor can no longer fulfil its payment obligations, negotiations between the debtor and its creditors would be based on shared information, conducted in good faith, and aim to achieve a fair outcome for all parties that restores as soon as possible market access under sustainable macroeconomic conditions.

A. Sustained Market Access

Sound policies, structural reforms, sound risk management, and IMF surveillance are essential components of an effective approach to crisis prevention and have been widely endorsed by all parties. A few particular responsibilities of debtors, private creditors and investors, and official creditors are worth highlighting.

Debtors should be guided by a commitment to rule of law, the sanctity of contracts, and transparency about key economic variables as well as policy performance and intentions. In particular, they should:

- Pursue robust investor relations programs (IRPs). Minimum guidelines for IRPs should include accurate and timely dissemination of data/information; formal channels of communication between policymakers and investors; investor teleconferences, videoconferences, or interactive road shows; a comprehensive list of contact information of relevant market participants; a regularly updated, comprehensive website; and qualified core staff of investor relations professionals.
- Subscribe to and strive to comply with international standards and codes.

- Include in a voluntary manner collective action clauses in international bond documentation.

Creditors and investors should make investment and lending decisions on their own merit, accept full responsibility for these decisions, and not expect "bail-outs" from the official sector. In addition, they should:

- Perform thorough analysis and apply sound risk management that can minimize the risks of contagion, especially when coupled with robust investor relations programs by debtors
- Participate in debtor's investor relations efforts and provide feedback
- Take into account debtor's efforts on standards and codes
- Support efforts by debtors to voluntarily include CACs in international bond documentation.

The *IMF* should

- Carry out its surveillance function in order to promote sound policies and transparency.

A comprehensive approach to strengthening crisis prevention is an integral part of this Code of Conduct. The essential elements of such an approach are set forth in the Appendix.

B. Early Crisis Containment

Despite efforts by all to strengthen crisis prevention, from time to time, countries will face performance challenges and difficulties without being on the verge of a financial or economic crisis. It is important that potential crises be addressed at an early stage. Experience has shown that early corrective action based in part on consultations between the debtor and its creditors and investors can avert a full-blown crisis, preserve the debtor's financial situation, and reduce the number of cases requiring debt restructuring.

More specifically:

Debtors should:

- Engage in an early dialogue with key investors and creditors to restore confidence. As a first line of defense, all countries with market access should have effective IRPs. Depending on the experience with and track record of the IRP as well as the circumstances of the specific case at hand, the debtor could choose from a menu of options for such consultations:

    1. Upgraded investor relations ("IR Plus")
        - Involvement of senior policymakers in ongoing dialogue with broad investor base, including through conference calls and briefings
        - Focus briefings on key areas of investor concern
        - Increase frequency of conference calls/briefings as necessary
        - Involvement of senior policymakers in consultations with senior investors and creditors
            - On a bilateral basis
            - In small groups

    2. Ad hoc advisory panel
        - Debtor could initiate policy consultations with several members of such a panel.

3. Standing committee of experienced bankers and investors (a group of "wise men") such as a Private Sector Advisory Group
    - o Debtor could seek advice and feedback on basic economic framework and key policy issues
    - o Consultations could focus on approaches that are most likely to rebuild market confidence
    - o Debtor could explain policies more fully, clarify misunderstandings about policy intentions, and gain insights about private sector attitudes, leading to more informed policy action
    - o Consultations could provide an informal forum for cooperative action as outlined below.

- Initiate such a dialogue prior to agreement with the IMF on a Fund-supported program if such support is sought.
- Take strong measures aimed at stabilization of the macro situation and rebuilding of confidence.
- Avoid measures that would violate the rights of foreign or domestic investors, preserving an open investment environment that respects investment rights.
- Work with the IMF to strengthen policies as part of the process of restoring confidence and consolidating market access.

Creditors and investors should:

- Engage in an early dialogue with the debtor to help identify measures that would halt the slippage in confidence and provide advice and feedback against the background of the global environment for emerging markets finance
- Focus discussions on policies not on specific financial transactions
- Help catalyze early corrective actions before market access is impaired
- Recognize that IMF decisions on lending to debtor countries should be consistent with IMF access policies determined by its members that involve firm limits on access
- If necessary and as part of an effort to avoid a broader restructuring of sovereign debt:
    - o Commercial banks and investment houses should consider participation in a voluntary, industry-wide, temporary maintenance of trade and inter-bank advances in the context of continued debt service and strong performance under a convincing policy framework supported by an IMF program; consider requests to roll over short-term claims on public and private sector borrowers in the same context
    - o Holders of marketable instruments such as bonds can help minimize undue contagion and support the sovereign's reform efforts and economic performance by consistently evaluating investments on their merits; and consider requests to roll over short-term maturities in the same context as above.

At the request of the debtor, the *IMF* should

- Provide policy advice
- Provide temporary balance of payments financing consistent with access policy that can help support a strengthened policy framework needed to rebuild market confidence.

C. Debt Restructuring (Pre-default)

In connection with a preliminary determination by the debtor that comprehensive debt restructuring may be needed, consultations between debtors and creditors can form the basis for market-based approaches to debt restructuring that allow debt sustainability to be restored while all efforts are being made to maintain debt service payments in the interim.

The *debtor* should

- Take strong measures aimed at stabilizing the macroeconomic environment, revitalizing structural reform, and laying the basis for renewed growth. It is vital that political support for these measures be developed.
- Retain international financial and legal advisors.
- Consult with key creditors before any payments are missed in order to explore alternative market-based approaches to addressing debt-service problems.
- Disclose to all creditors details regarding all outstanding financial obligations, including proposed treatment thereof.
- Disclose fully all bonds and loans owned or controlled, directly or indirectly, by the sovereign.
- Disclose fully to its investors/creditors central aspects of its economic policies and programs, including all assumptions, commitments, and targets involved in any IMF-supported program.
- Avoid discriminating among creditors based on domicile, currency, maturity, or type of entity.
- Negotiate promptly and in good faith with creditors the terms of a restructuring through:

    1. A creditor committee. This approach may be especially useful if there are several different types of creditors and if the creditor base is diffuse.
    2. A negotiated debt exchange.

- Ensure that creditors are in a position to make informed assessment of the economic and financial situation of the debtor. Such disclosure is not only important if the debtor deems its debt unsustainable but also in order to establish a common understanding of the intellectual foundation of the IMF's assessment of the country's balance of payments outlook.
- In connection with any such restructuring discussions, the reasonable costs of such creditor group's financial and legal advisors should be borne by the sovereign debtor.
- Before announcing the final terms of any such debt restructuring (whether by amendment, exchange offer, or otherwise), engage in constructive negotiations with bondholders and other key creditors; and avoid any coercion of creditors by impairing existing bond and loan provisions.
- Ensure that contractual rights remain fully enforceable throughout the negotiating and restructuring process.
- Seek rescheduling from all official bilateral creditors.
- Avoid exchange controls except for temporary periods in exceptional circumstances. In this connection, authorities should acknowledge the deleterious effect of resident capital outflows and work toward making domestic investment more attractive.

Creditors and investors should

- Engage in regular consultations with the debtor in order to exchange information and to consider the best means of promptly restoring market access
- If a creditor committee is formed, creditors should
    - Adopt internal rules and practices to guide their activities, including appropriate firewalls to protect sensitive information

- Coordinate across instruments and with other creditor classes with a view to from a single committee
- Initiate contact with official creditors (the IMF and, if appropriate the Paris Club)
- Be a forum for the debtor to present its economic program and financing proposals
- Collect and analyze economic data
- Evaluate, disseminate and gather creditor input with respect to financing proposals
- Negotiate and disseminate a definitive term sheet
- Administer a voting process.
- Recognize that any agreement with the debtor that as part of a broader adjustment program would not restore medium-term debt sustainability is not viable
- Recognize that IMF decisions on lending to debtor countries should be consistent with IMF access policies determined by its members that involve firm limits on access
- Consider the appropriate time to engage legal and financial advisors.

The *IMF* should:

- Vigorously support all efforts to avoid default and assiduously avoid any appearance of encouraging a debtor to default
- Engage in meaningful consultations with key private creditors regarding the best means of preserving and protecting asset values and contract rights during the restructuring process
- Suspend any disbursements to a country that has violated the basic rights of foreign investors or creditors
- Approve exchange controls only on a temporary, exceptional basis and as part of an initial phase of a bold reform program
- Support restructuring of the full range of bilateral credit.

D. Debt Restructuring (Post-Default)

In the rare circumstance where the debtor aims to resolve its financial difficulties by declaring a unilateral suspension of debt service payments, all efforts by debtors, creditors, and the IMF should be geared foremost to establish a framework for engagement that facilitates constructive debt negotiations and the restoration of macroeconomic sustainability.

The *debtor* should

- Take strong measures aimed at stabilizing the macroeconomic environment, revitalizing structural reform, and laying the basis for renewed growth. It is vital that political support for these measures be developed.
- Retain international financial and legal advisors.
- Identify officials responsible for consulting with creditors and engage in a constructive process of regular dialogue and meetings with creditors.
- Avoid discriminating among creditors based on domicile, currency, maturity, or type of entity.
- Disclose debt details and economic program as under section C.
- Negotiate promptly, in good faith, and directly with creditors the terms of any proposed restructuring.
- Bear the reasonable costs of the creditor group's financial and legal advisors

- Ensure that creditors are in a position to make informed assessment of the economic and financial situation of the debtor. Such disclosure is not only important if the debtor deems its debt unsustainable but also in order to establish a common understanding of the intellectual foundation of the IMF's assessment of the country's balance of payments outlook.
- Seek to resume partial debt service during negotiations as a sign of good faith and, to the extent necessary, resume full payment of all principal and interest as soon as possible.
- Ensure that all bonds and loans owned or controlled, directly or indirectly, by the sovereign are not voted in respect of a restructuring.
- Seek rescheduling from all official bilateral creditors.
- Take into account – if needed – appropriate steps to address corporate debt.

Creditors and investors should

- Recognize that any agreement that as part of a broader adjustment program would not restore medium-term debt sustainability is not viable
- Engage in good faith negotiations with the debtor over the terms of a restructuring
- Form a creditor committee that carries out the task as described in section C
- Endeavor that enforcement action against the debtor or its assets (such as declaring cross-defaults and accelerating principal, as well as bringing law suits and foreclosing on collateral) is taken only as deemed necessary to preserve and protect asset values and contract rights.

The *IMF* should:

- Engage in meaningful consultations with key private creditors regarding the best means of preserving and protecting asset values and contract rights during the restructuring process.
- Disburse financing to the debtor during an event of default only if following consultations with creditors it determines that the country is negotiating in good faith directly with its external creditors. Implementation of the Code should be taken into account when assessing the good faith criterion.
- Support restructuring of the full range of bilateral credit.

Once agreement on a Code has been reached, consideration could be given to the possible need for an informal monitoring arrangement to facilitate implementation.

Essential Ingredients of a Comprehensive Approach for Strengthening Crisis Prevention

Since the Mexican crisis in 1995, numerous measures have been put in place to strengthen the global financial system, mitigate the probability of financial crises in emerging markets and limit their impact as they arise. The private and the officials sectors have worked both in parallel and collaboratively to identify key principles as well as specific measures that would reduce vulnerabilities while building market access. Moreover, approaches have been outlined for how emerging market authorities should respond to signs of eroding market confidence.

Pursuit of sound macroeconomic policies, including appropriate exchange rate policies and prudent liability management, as well as persistent implementation of structural reforms remain the keystones of crisis prevention. In this connection, it is crucial that the government secures political support for its policy program and commits to apply the "rule of law" in order to provide investors and creditors both domestic and foreign with a favorable investment climate.

The Financial Stability Forum (FSF) has developed a Compendium of Standards, which in the area of macroeconomic policy calls on emerging market economies to comply with:

- Monetary and Financial Policy Transparency: guided by the Code of Good Practices on Transparency in Monetary and Financial Policies issued by the IMF. The code identifies desirable transparency practices for central banks in their conduct of monetary policy and for central banks and other financial agencies in their conduct of financial policies.

- Fiscal Policy Transparency: guided by the Code of Good Practices on Fiscal Transparency issued by the IMF. The code contains transparency requirements to provide assurances to the public and to capital markets that a sufficiently complete picture of the structure and finances of government is available so as to allow the soundness of fiscal policy to be reliably assessed.

- Provision of comprehensive, frequent, timely, and accurate data to market participants is crucial for sound risk management. While significant progress has been made in recent years, gaps remain in the timely availability of meaningful data. In their newly developed model bond clauses, the private sector calls on countries with access to international capital markets to implement the IMF data standard (SDDS) in its "encouraged" version, which is nearly identical to stricter IIF data standards. The latter has in particular established more rigorous dissemination on data for international reserves and external debt and debt service.

Weak financial systems have too often been at the center of broader economic crises. Although some progress has been made, emerging market policy makers and
market participants should give priority to developing domestic capital markets, building credit cultures, improving risk management systems, advancing consolidation, and forcing corporate restructuring. To strengthen the ability of market participants to assess financial sectors, the IMF or country authorities should announce on their web sites in a timely manner when a country has decided to participate in the IMF/World Bank Financial Sector Assessment Program (FSAP). Moreover, all countries should publish the results shortly after completion.

In support of stronger financial systems, the FSF Compendium calls on emerging market to upgrade financial regulation and supervision. Adherence to these standards is reviewed as part of the FSAP exercise. All emerging market economies should aim toward their timely implementation:

- Banking Supervision: guided by the Basel Committee on Banking Supervision's (BCBS) Core Principles for Effective Banking Supervision.

- Securities Regulation: guided by the Objectives and Principles of Securities Regulation, issued by the International Organization of Securities Commissions (IOSCO), upon which the regulation of securities markets is based.

- Insurance Supervision: guided by Insurance Core Principles, issued by the International Association of Insurance Supervisors (IAIS), which comprise essential principles that need to be in place for an insurance supervisory system to be effective.

To advance the implementation of structural reforms while reducing vulnerabilities, both private and official sectors have established best practice guidelines in a number of areas. It is important that countries commit to implementing these standards and work with the official community as well as market participants to ensure compliance as soon as possible. To ensure greater transparency, mechanisms to measure the implementation of these standards should be encouraged.

- Insolvency: The World Bank is coordinating a broad-based effort to develop a set of principles and guidelines on insolvency regimes. The United Nations Commission on International Trade Law (UNCITRAL), which adopted the Model Law on Cross-Border Insolvency in 1997, will help facilitate implementation.

- Accounting: 41 International Accounting Standards (IAS) have been issued to-date by the International Accounting Standards Board (IASB) and approved by the Board of the International Accounting Standards Committee (IASC Board.)

- Auditing: International Standards on Auditing (ISAs) issued by the International Federation of Accountants (IFAC) contain basic principles and essential procedures together with related guidance in the form of explanatory and other material.

- Payment and Settlement: guided by the Core Principles for Systemically Important Payment Systems issued by the Committee on Payment and Settlement Systems (CPSS) and the Recommendations for Securities Settlement Systems issued by the CPSS-IOSCO Joint Task Force on Securities Settlement Systems.

- Market Integrity: guided by the Financial Action Task Force (FATF) Forty Recommendations on Money Laundering combined with its 8 Special Recommendations on Terrorist Financing.

The IIF's Code of corporate governance formulates best practice principles from an investor's perspective that provides practical guidelines for governments, regulators, stock exchanges and companies. The aim of the Code is to help reinvigorate portfolio investment flows to emerging markets while also contributing to financial market depth, performance and stability. The OECD has developed more comprehensive Principles of Corporate Governance aimed at improving the legal, institutional, and regulatory framework for corporate governance in OECD and non-OECD countries. All emerging market economies should make improvements in corporate governance a top priority and work closely with market participants toward that goal.

Sustained investor relations programs can help build market access at attractive terms during good times and sustain vital support at times of market volatility. All countries with access to international capital markets should have effective investor relations programs. Information and possibly evaluation of investor relations programs should be included in bond prospectuses and rating comments, based on minimum standards and "best practices" for such programs. In addition, IMF programs should include performance on investor relations by member countries.

The IMF's contingent credit lines (CCL) could be a useful crisis prevention tool if means are considered to make it more user-friendly through, for example, the inclusion of ex ante approval of a small group of eligible countries (perhaps in the context of Article IV consultations) and assurance of automatic access for countries when needed.

Appendix B

EMCA • EMTA • IIF • IPMA • ISMA • SIA • TBMA *

DISCUSSION DRAFT
12/6/02

Sovereign Debt Restructuring

Executive Summary

Financial crises in emerging markets have often been characterized by sharp breaks in confidence, financial volatility, and severe losses of output and market access. Concerns about such upheavals, reinforced more recently by the collapse of the policy framework in Argentina, have provided impetus for a search for more orderly approaches to crisis management.

The private financial community is actively engaged in this effort. The goal of its market-based approach is to avoid debt restructuring where still possible, to facilitate it where necessary, and to restore early market access. This approach would include a framework for early consultations between debtors and key creditors, making use of an advisory group comprised of leading private sector emerging market participants that would give way to a country-specific creditor group in cases where restructuring cannot be avoided. It would also feature the implementation of newly designed collective action and related bond clauses in order to minimize such free-rider problems as may, from time to time, arise. In fact, considerable progress has been made by the private sector in developing such clauses. This market-based approach would be designed with input from both the private and official sectors, and framed within a Code of Conduct to help guide the behavior of all parties involved. In an environment where emerging market investors and creditors face heightened global uncertainty and increasingly seek to minimize risk – and where flows to emerging markets have fallen back to levels last seen a decade ago – financial crises can only be managed effectively with a market-based approach. (See the Attachment for an outline of such an approach).

In contrast, most of the official sector's efforts over the past year have focused on the formulation of a statutory approach, the so-called Sovereign Debt Restructuring Mechanism (SDRM). The SDRM is an attempt to "create some of the features of a bankruptcy regime without creating a bankruptcy court." The stated objective of the SDRM is "to facilitate the orderly, predictable, and rapid restructuring of unsustainable sovereign debt, while protecting asset values and creditor rights." In some official quarters, the SDRM is also seen as key to limit the size of official financing packages in the future as well as an instrument to force burden sharing. However, it remains unclear how the presence of an SDRM would constrain political decisions in favor of or against official funding in any given case. As suggested in the recent G30 report, IMF access policies should be dealt with as a separate matter.

Market participants from emerging markets and financial centers alike agree that the SDRM is both unnecessary and counterproductive. While we note that the IMF is still revising the SDRM proposal, no changes in its specifics will alter our serious concerns about the SDRM's inherent problems:

- The SDRM rests on the false premise that there is an inherent collective action problem among private sector creditors in sovereign debt restructuring that precludes agreement. In fact, not

* Emerging Markets Creditors Association (EMCA), Emerging Markets Traders Association (EMTA), The Institute of International Finance (IIF), International Primary Market Association (IPMA), International Securities Market Association (ISMA), Securities Industry Association (SIA), and The Bond Market Association (TBMA)

one restructuring has been prevented from moving ahead by the actions of holdout creditors. Moreover, creditors have been willing to act early and constructively as evidenced by the spontaneous formation of bondholder committees in the cases of Argentina, Ecuador, Ivory Coast, and Russia.

- Implementation of an SDRM would render collective action clauses meaningless by overriding, in advance, the clauses' intended operation with a statutory mechanism. Moreover, its very pursuit has made implementation of clauses more difficult; the shadow of the SDRM may have already had an adverse effect on private sector flows.

- An SDRM and associated exchange controls that could affect international credit lines, create incentives that could themselves precipitate a crisis as creditors act defensively at the first sign of a problem and advance the rundown of short-term exposures and even accelerating long-term exposure. As a result, this would increase the risk that a crisis occurs, as well as intensifying it.

- The analogy between an SDRM and private sector bankruptcy legislation is fundamentally flawed: private companies are subject to jurisdiction of the bankruptcy tribunal. Even under an SDRM, the sovereign debtor would inherently not be subject to the appropriate checks and balances that legitimize and make a bankruptcy regime fair and effective.

- The selective coverage of debt under the SDRM effectively creates subordinated classes of debt, thereby increasing funding costs to borrowers and possibly restraining them from obtaining investment grade ratings. Moreover, the proposed coverage will leave the mechanism applicable only to a small number of cases since most recent crises were triggered by external debt of the private sector or domestic debt of the sovereign (such as Korea and Russia, respectively).

- The SDRM would force cases that may appear unsustainable, such as Brazil in 1999, toward long, costly, comprehensive restructurings, when informal, more surgical solutions might restore market access and growth at a much earlier stage. Paradoxically, the SDRM could shift more of a country's financing requirements to the official sector.

- Using debt sustainability as a trigger for the SDRM is fundamentally flawed. While the IMF has a useful role to play as an agent of adjustment, its role as de facto judge of debt sustainability presents major problems due to the acknowledged complexity of the task and the Fund's vested interest as a creditor.

- Despite its complex voting arrangements, the SDRM does not in fact resolve the problem of aggregation across different classes of debt, which is one of its principal goals. The private sector believes the issue of aggregation can be better – and more simply – addressed through greater transparency during the restructuring process.

Capital markets are built on the fundamental principle of enforceability of contracts. By making "structured" default – without the appropriate checks and balances such a regime normally includes – an alternative to policy adjustment, an SDRM represents a radical departure from this fundamental principle. It would appeal to those political forces in emerging markets that look for easy alternatives to policy discipline making it more difficult for finance officials to convince others of the need for adjustment. The resulting shift in expectations is also likely to have a highly adverse effect on private sector flows.

Background: Past Experiences with Market-Based Restructuring

The premise of this paper is that market-based solutions are the only viable means of addressing international financial crises. Moreover, a brief background illustrates that the purported "free rider" or "holdout" problem described by the official sector as requiring a supra-market, statutory solution is neither a relevant justification for the SDRM nor a circumstance that the market is unable to address. First, there have always been a small number of free riders or holdout creditors, only some of which have pursued legal action. During the 1980s, banks' incentives to minimize write-offs coupled with occasional pressure from the banks' home regulators and the long-term commercial interests and reputation of banks themselves largely overcame the impact of free riders.

- In the Brady exchanges of the late 1980s and early 1990s, the "menu-of-options" approach was created together with the collateral structure underlying the Bradybonds to respond to differences in commercial bank interests and to increase bank participation. The menus were also tailored to individual country circumstances and adapted to the developing secondary market for emerging market debt.

Second, the success of this "menu-of-options" approach has been replicated in recent debt exchanges where legal and financial measures have been used to make the offers more attractive to creditors with different time horizons, risk appetites, and investment constraints. While some of these measures have been viewed as unfair by some investors, the technique of a debt exchange has been used to avoid cumbersome voting provisions often requiring unanimity. Partly as a result, the influence of free riders on debt restructurings has not increased despite the proliferation of creditors and instruments during the course of the last 10 years:

- The outcome of three high-profile debt exchanges – albeit not the result of debtorcreditor negotiations – showed participation rates of 99 percent in the case of Pakistan, 97 percent in Ecuador, and 99 percent in Ukraine.

- Even in the long and drawn-out restructurings with Russia, the participation rate was 96 percent in the first exchange in December 1997 and over 99 percent in the second in August 2000.

- We also disagree with the assertion by many in the official sector that the Brussels Court of Appeals' decision in the Elliott vs. Peru case – is a prime example of rogue creditor behavior that justifies creation of an SDRM. There, the Court ordered Peru to pay Elliott at the same time it paid its other creditors through Euroclear; but at no stage did Elliott prevent Peru's Brady restructuring from moving ahead. Moreover, Peru itself had been in default for 18 years; yet Peru was both able to, and did, pay its Brady creditors as well as Elliott.

The private financial community therefore considers the SDRM proposal a disproportionate and potentially counterproductive response to the nature and size of any collective action problem that could arise during the process of restructuring sovereign debt.

Drawbacks of the SDRM

While free riders have not been an obstacle to reaching comprehensive debt restructuring agreements, it may be useful to consider means of limiting the potential for disruption in the future. However, the SDRM provides an unnecessarily heavy-handed apparatus for introducing what the official sector believes will be greater orderliness to the process. The proposal has undergone a number of modifications since its launch one year ago and the current version has reduced the role that was originally assigned to the Fund as the de jure arbiter between debtors and creditors. Nevertheless, the Fund remains the de facto judge on debt sustainability and as such the linchpin for authorities to be able to trigger the mechanism. The proposal has multiple additional drawbacks and runs the risk of causing unintended adverse consequences.

1. *Jeopardizing Private Sector Initiative on Clauses*. The work by the private sector groups has proceeded on the assumption that the G-7 Ministers and Governors share the view that this initiative to develop marketable bond clauses is the preferred approach for making sovereign debt workouts more orderly. However, this assumption has been undermined by the reinforced support for the SDRM by the IMFC in late September. Thus, it may now become prudent and necessary for the private sector to review financing terms in the context of a possible overriding SDRM. Such a review would cover inter alia:

- Revisiting the move away from unanimity requirement for a change in payment terms;
- Introducing earlier or automatic rights of acceleration (with the attendant risk of precipitating a "race to the court house");
- Formulating more stringent rules of engagement that could make it more difficult to get bondholders agree to a restructuring;
- Requiring tougher substantive covenants and events of default; and
- Introducing a possible bias against unsecured and longer-term credits in favor of collateralized and more highly structured financings and shorter tenors.

The result of such a review will inevitably be to delay the implementation of the clauses and possibly jeopardize their viability altogether.

2. *Precipitation of a Crisis*. With the SDRM at its disposal and access to Debtor in Possession (DIP) funding, a country would be in a position to act quickly on a decision to declare its debt to be unsustainable and to suspend its payments. In such an environment, creditors are likely to react defensively at the first signs of potential financial trouble. As in today's markets, those lenders who have an ability to react on short notice – providers of trade credit, interbank funding, off-balance sheet transactions and other short-term lenders – would be able to bring down their exposures as conditions in the country worsen and risks rise. In a world of an SDRM, this tendency would be exacerbated, since private creditors with claims on private sector borrowers, which are excluded from an SDRM targeted at sovereign debt, would have to fear the imposition of exchange controls.

The SDRM and associated exchange controls, therefore, would simply advance the timing of the rundown in exposure and do nothing to impede it. As a result, the "capital preserving" feature of the SDRM stemming from the sovereign's ability to initiate a stay at its own discretion would be undone through market anticipation of the potential early move by the sovereign. Moreover, the development of a crisis may become even more unpredictable as debtor and creditor actions interface in a dynamic setting under an SDRM, an outcome at variance with the stated goal of the IMF.

Perhaps even more importantly, the potential application of exchange controls could drastically disrupt trade flows that are the fundamental conduit for economic growth. Moreover, the sheer confusion that can be created as regulations are issued – and likely to be modified on a daily basis as loopholes are discovered and repaired just to create new ones – to enforce such controls would complicate the restoration of normal financial arrangements as demonstrated during the Russian GKO restructuring process.

3. *Subordination Raises Funding Costs*. The selective inclusion of certain private sector claims and exclusion of others will effectively subordinate the former to the latter. This de jure subordination of private sector debt – as compared with the de facto subordination that now occurs but has not been conceded – would restrict private sector flows further, increase funding costs, and jeopardize future investment grade ratings. In fact, there are already signs that the market place anticipates some of these effects.

4. *Exclusion of Claims*. The official sector has argued that reducing uncertainty about the restructuring process is the raison d'être for the SDRM. At the same time, Management and the Board of the Fund have left the issue of coverage of debt open for now. A case-by-case determination of coverage would create high uncertainty that runs in conflict with the purpose of the SDRM. Perhaps more importantly, if debt is judged unsustainable, all debt should be considered eligible for restructuring. If a significant portion of the debt is excluded a priori – or will be treated more favorably – there is likely to be strong resistance to the proposed restructuring from those being asked to accept its terms. Of course, whenever possible, short-term trade credit should not be restructured because it is the foundation for international trade and medium-term credit flows.

The proposal to exclude Paris Club debt from the SDRM suggests that the official community believes that the Paris Club restructuring process has worked satisfactorily. The Fund has also argued that special treatment of Paris Club creditors is required due to their ability to provide early financial support. This reflects a selective view of the record of Paris Club negotiations, which have not always proceeded quickly as evidenced by such cases as Poland and Russia. This blatant inequity in the treatment of private and official bilateral claims allows bilateral creditors to continue to operate in a system that at times afforded them more favorable terms.

A number of important cases involved the controversial use of IMF resources, a feature that the SDRM has been targeted to cure. The examples of Russia in 1998 and Mexico in 1994-95 perhaps stand out in this regard. At the same time, these two cases would have not been addressed by the SDRM since they were primarily related to domestic debt problems. Efforts to exclude domestic debt from the SDRM appear to be driven by the recognition that politicians in industrial countries would not support the SDRM treaty if domestic debt were subject to treatment under the mechanism.

5. *Delay of Market Access*. The SDRM is seen by many in the official sector as a way for achieving a comprehensive restructuring at lower economic costs than those associated with the prevailing informal case-by-case approaches. However, the SDRM could lead to the unwarranted initiation of a time-consuming debt restructuring process when a temporary, voluntary standstill might suffice. The result of this would likely be an extended period during which renewed access by a country to capital markets is delayed, therefore paradoxically shifting more of a country's financing requirements to the official sector. By contrast, more surgical, informal, and voluntary solutions are likely to lead to a rapid shift in investor confidence and early-renewed market access.

- After a period of extreme uncertainty in early 1999 which could have argued for activation of the SDRM, Brazil's arrangements with commercial banks in March 1999 to maintain short-term credit lines in the context of a strong IMF-supported adjustment program contributed to renewed confidence that enabled Brazil to place a $2 billion Eurobond issue in May.

6. *Judging Debt Sustainability is Inherently Complex*. The analysis of debt sustainability is extremely sensitive to assumptions on key macroeconomic variables, which in turn are a function of both the financial support provided to the country – official and private – and the degree to which the government is willing and able to implement needed adjustment measures. The private financial community recognizes the useful role the IMF has played in program design, as agent of adjustment, and as catalyst for private flows. However, investors are concerned about the IMF's role in determining sustainability in the context of an SDRM due to the lack of any provision for a market input into that judgment and the IMF's status as an interested party. With regard to the latter, investors see a conflict because the IMF may well be overexposed vis-à-vis a given country but its exposure would not be covered by the SDRM. Moreover, the Fund's prospects of receiving repayments may be enhanced in some cases.

In a recent paper entitled Assessing Sustainability, the IMF stated that the application of its tools for determining debt sustainability "has not been sufficiently consistent and disciplined to always ensure the credibility of the Fund's overall assessment of sustainability."

- The Mexican crisis in 1994-95 represents a case where several traditional indicators, including the current account balance and short-term debt signaled trouble but did not trigger warnings from the IMF about debt sustainability.

- At the same time, the resolution of the crisis without debt restructuring facilitated the quick reflow of private capital ($12 billion net in 1996 compared with net repayments to official creditors of nearly $11 billion) and the resumption of growth, which averaged 5.5 percent per year in 1996-2000. By contrast, a comprehensive restructuring that could have occurred under an SDRM would have delayed renewed market access and adversely impacted growth prospects.

Recognizing its own weak performance, the IMF has undertaken to develop a new framework that incorporates calibrated sensitivity tests to determine the implicit likelihood of default. This approach, however, does not explicitly link the external, fiscal and financial sectors and does not take into account the views and sentiment of private sector creditors. At the same time, the Fund's sustainability assessment assumes a certain profile of private sector flows but such projections are not discussed with market participants.

7. No Complete Solution for Aggregation. Although one of the key rationales for the SDRM has been that it would solve the aggregation problem, the most recent IMF staff paper acknowledges that the SDRM is not likely to accomplish that result. In fact, its proponents have argued that an SDRM could accomplish what collective action clauses could not, including limiting the risk for a minority of creditors with a certain type of claim being unfairly treated by a qualified majority of creditors holding different claims. Under the SDRM, support by a qualified majority of creditors in each class would be required to approve the restructuring terms offered to all classes. However, since all classes would be required to approve the overall restructuring, each creditor class would have de facto veto power over the terms offered to other classes of creditors. As a result, this approach per se does not guarantee quick success in reaching a comprehensive agreement.

Under a market-based approach, greater transparency on the part of the debtor regarding proposed restructuring terms for various claimant groups would be an essential ingredient in order to overcome the aggregation problem by permitting creditor classes to better understand and negotiate restructuring terms. It should also be noted that lack of formal aggregation has not posed a problem for debt restructurings in the past.

8. Abrogating Creditor Rights. In previous versions of the SDRM proposal, a stay of litigation was seen as being either unilaterally imposed by the debtor or endorsed by the IMF. In its current form, a stay is to be agreed by a (unspecified) super-majority of creditors. However, it seems unlikely that even a relatively low super-majority of creditors would be willing to enter into such an agreement with the possibility that they would have no recourse to react in a situation where the debtor would not act in good faith. Political turmoil such as has occurred in Argentina could result in a situation where the debtor would be unable to move forward in a restructuring process.

In this connection, the recent attempt to strengthen the "good-faith" criterion under the IMF's policy of lending into arrears has not resonated with investors. According to the revised policy, the "formal negotiating framework would include, inter alia, the sharing of confidential information needed to enable creditors to make decisions on the terms of a restructuring and the agreement to a standstill on litigation during the restructuring process." The implication of this statement is that "confidential" information sharing is contingent on an agreement to a stay. This further adds to the distinct impression that once the IMF determines that debt is unsustainable, the circumstances would be biased toward a stay, increasing the probability that this will lead to a broad-based default and restructuring.

While investors and creditors need to avoid unnecessary litigation, its potential can be addressed without an SDRM that overrides contractual arrangements and deprives creditors of the right for a judicial review.

9. No Quick Implementation. The SDRM also foresees the possible need for exchange controls and the creation of a Sovereign Debt Dispute Resolution Forum (SDDRF). In order to accommodate these features, there would be a need to amend the IMF Articles of Agreement. This whole process is likely to take a minimum of two to three years. The main reason for this is that any amendment to the IMF Articles of Agreement needs legislative approval by 85 percent of the IMF's voting power and by 60 percent of the IMF's membership. Since its inception, there have been three successful attempts to amend the articles. The average time for approval once the amendments were received by the membership was 22 months. These amendments dealt exclusively with how the IMF itself operates. However, the SDRM proposal would be using the Articles as a surrogate for changing international law. In this circumstance, it seems likely that the length of time required for approval would exceed the average. Moreover, if implemented, it is likely that the first application of an SDRM would be challenged in court, possibly taking years to sort out, thus creating a new type of market uncertainty unknown to date.

Moreover, one key issue arises as to the ability of the official sector to create a body that is independent from the Fund such as the SDDRF by amending the IMF Articles. By definition, anything accomplished through the Articles needs to have some relationship to the Fund itself. To create a truly independent body, it would be necessary to establish a new legal framework. Such an endeavor would require even more time to implement.

10. Enhancing Debtor Moral Hazard. Concerns have risen among investors and creditors that the adoption of the SDRM will increase the likelihood and frequency of restructurings going forward partly because political pressure could build to use it. In particular, the introduction of the SDRM could sanction a shift in sovereign credit culture making default an acceptable alternative, fundamentally breaking with the past. By providing a legal basis for formal stays and subsequent restructuring, the SDRM could contribute to an environment in which some politicians may be under the illusion that following this approach is a relatively attractive alternative to painful reform measures. Especially if domestic debt holders are excluded from the mechanism, governments with populist approaches could consider default as creating sufficient room in the fiscal account to pursue social goals.

A Market-Based Alternative That Makes the SDRM Unnecessary

Since early 2002, the private financial community has intensified its search for a more effective approach to crisis management that would solve more problems than it creates. It is essential that such an approach be market-based and developed within a comprehensive framework to strengthen the global financial system, cope with crises flexibly as the need arises, and encourage sustainable private capital flows to emerging markets. Our goal is to develop and implement a marketable approach to collective action clauses that would operate in the context of an international Code of Conduct for crisis resolution to be applied on a case-by-case basis. As stated on numerous occasions, the resolution of such cases would not necessarily involve extraordinary official support packages. We are firmly of the view that we are well advanced in the effort to achieve these goals.

A market-based approach would lead to prompt resolution in cases where comprehensive debt restructuring appears to be unavoidable, while avoiding some of the unfortunate consequences of an SDRM. In fact, such an approach would make an SDRM unnecessary. As part of our approach, we have been working to develop new bond clauses that would help facilitate effective restructurings where unavoidable while protecting essential creditor rights. This approach represents a proportional and more appropriate response to the concerns that need to be addressed in the restructuring process, and limits the risks to future capital flows from the private sector.

The private sector's model clauses would:

- <u>Majority Action</u>. Permit the amendment and waiver of key Bond terms (including payment terms, as well as governing law, submission to jurisdiction, waiver of sovereign immunity and other substantive covenants as appropriate) by approval of a super-majority of Bonds outstanding.
    - May be approved by written resolution as well as at Bondholder meeting.
    - Bonds held or controlled, directly or indirectly, by the Issuer to be excluded from the voting calculation.

- <u>Engagement</u>. Provide for the appointment by Bondholders of a Committee to represent Bondholder interests, after an Event of Default has occurred or the Issuer has initiated restructuring discussions, in connection with such discussions with the Issuer and other creditors. Committee may adopt such internal rules as it sees fit and engage legal and financial advisors, subject to reimbursement by the Issuer.

- <u>Initiation</u>. Require 25% Bondholder vote to accelerate principal for Event of Default and provide for a super-majority vote to rescind acceleration.

- <u>Transparency.</u> Provide for SDDS and rolling forecasts, as well as reporting of proposed treatment of other creditor groups. Provide for greater use of financial community websites for notices and other information.

The private financial community is also of the view that collective action, engagement, and initiation clauses on the one hand and steps to strengthen transparency and creditor protections on the other hand are inseparable components in any future changes to bond documentation. This position is based on the informed judgment that investors will accept making bonds easier to restructure only if, at the same time, greater efforts are made, contractually and otherwise, to ensure that making them easier to restructure will not simply result in their default and/or restructuring becoming more likely. To that end, the private sector is proposing to work with issuers to develop better early warning mechanisms, as well as more transparent documentation and disclosure practices.

For these model clauses to become a global industry standard, it is important that they be adopted on a market basis by underwriters, investors, and issuers. For investors, it is crucial that transparency and creditor protection be enhanced in exchange for greater ease of restructuring where needed, and that collective action clauses (CACs) are not seen as a slippery slope leading toward a process that could abrogate basic creditor rights or increase the likelihood of default. For issuers, it is essential that the price impact of new contract clauses is minimal, and that inclusion of CACs is perceived as a sign of strength, not weakness.

Another key element of such a market-based approach is creation of a framework for dialogue on individual crisis cases in order to improve upon the current approach of ad hoc communications. Early consultation between the debtor and its key creditors can help policymakers identify measures that avoid upheaval, restore confidence and avert a deepening crisis. In fact, successful efforts at this stage can reduce significantly the number of cases requiring sovereign debt restructuring.

An informal, country-specific advisory group comprised of leading market participants from a broad spectrum of financial institutions could provide a mechanism for such consultations. Such a group could be initiated when a country is facing performance challenges but market access is sustained, or when early signs of vulnerabilities emerge and investor confidence is slipping. Such a mechanism could complement the important work of the IMF Capital Markets Consultative Group that focuses on systemic issues.

The advisory group could discuss and, if needed, help authorities develop basic strategies for halting the erosion of confidence and for embarking on a path toward rebuilding credibility. At the same time, such a consultative mechanism could reinforce the desire to avoid unduly large official packages and focus instead on the catalytic role of IMF financing. In cases in which broad debt restructuring by public and private creditors may be required, the advisory group would give way to constructive dialogue between the debtor country and a broad spectrum of creditors reflected in a creditor group. As indicated in the pending case of Argentina, the bondholder community has already shown an increased ability to form such creditor groups.

A Proposal to Issue Credit Enhanced Global Development Bonds for Infrastructure Financing in Developing Countries

Proposals to promote the issuance of global development bonds (GDBs) for infrastructure financing have long been supported by the Business Interlocutors, and presentations on these proposals have been made by Lincoln Ratham and, more recently, by Daniel Bond. The objective is to stimulate a higher flow of private project financing in developing countries.
Unfortunately, the yield that private investors require on emerging market bonds, including those for infrastructure financing, is generally higher than the rate of return that infrastructure projects in these countries can be expected to provide. To overcome this hurdle, a wide range of investor incentives have been proposed. These have included, but are not limited to the extension of tax incentives, the provision of risk insurance and various co-financing arrangements, which match public and private financings, perhaps tying them with cross default clauses .

Another alternative that we propose be added to this list is to have an agency such as an arm of the World Bank or the Overseas Private Investment Company (OPIC) provide, to purchasers of qualifying GDBs, an option to purchase credit default swaps (CDS) to be issued by that agency or its designee.

A CDS is a form of bilateral financial contract that isolates the credit risk (from other forms of risk such as operational risk) of a reference credit (in this case the GDB) and transfers that risk from one party to another. The option would be given to the bond purchaser who would then have the right, but not the obligation to purchase a CDS, generally 5 years in length, whose payoff is contingent on the realization of a credit event (such as bankruptcy, failure to pay, obligation acceleration, restructuring, repudiation/moratorium, etc.). Pricing of these instruments should reflect market assessments of the likelihood of a credit event (estimate of the probability of default) and the expected value of the reference security(the GDB) after the event (recovery value), but would be expected to be substantially cheaper than CDS now available in emerging markets.

If the purchaser of a GDB decides to excersize the option he then purchases a CDS from the issuing agency(the protection seller). The protection buyer pays a (fixed rate) premium to the protection seller in exchange for a contingent payment in case a credit event involving the GDB occurs during the contract period. The premium (default swap spread) reflects the credit risk of the bond issuer (the sovereign or the project entity), and is usually quoted as a spread over a reference rate such as LIBOR or the swap rate, to be paid either upfront, quarterly or semiannually. If no credit event occurs before the end of the contract, the contract is terminated, with the Seller having received the premium payments. If a credit event occurs, the payment of losses made to the buyer takes either of two forms (specified in advance in the contract).

The International Swap and Derivatives Association (ISDA) set and defined standard credit events (bankruptcy, failure to pay, restructuring) and standardized terms of CDS contracts in 1999, substantially aiding development of this market. Applying the credit enhancement outlined above could prove to be a viable mechanism to mobilize substantially greater private sector resources for infrastructure financing in developing countries and if properly priced would make that financing more cheaply available to the issues of GDBs while actually generating solid returns for the agencies issuing the CDS.

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