

**Remarks of Michael M. Chamberlin
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regarding

**"Sovereign Debt Contracts: What Do We Need to Change?"
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"Can We Break the Crisis Cycle for Emerging Markets?"
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Introduction

They say that the devil is in the details. Mark Walker and I have the enviable task of talking about these devilish legal details, as the transition between a very long day and a drinks reception. Thank you, Charles [Dallara].

For your briefcases, there are two hand-outs relevant to my remarks today: (1) Model Clauses for Sovereign Bonds, an Executive Summary in Discussion Draft (9/26/02) prepared by the Gang of Six trade associations and (2) EMTA's Position regarding the Quest for More Orderly Sovereign Work-Outs (10/17/02), both of which are available on the table outside and, together with these Remarks, on EMTA's website.

Before turning to our assigned topic 'What Needs to be Changed?', I should note that I am a late, and somewhat reluctant, supporter of collective action clauses. In fact, I am skeptical that anything really needs to be changed. Secondly, though I am a lawyer (and neither a doctor nor an architect), I believe that the first law of medicine should apply equally to financial architecture - 'First, do no harm'.

Now is the time to concentrate on how to attract new flows, not the time to push for major changes or to conduct experiments aimed merely at trying to lock-in the capital that hasn't already fled. Such experiments can only erode market confidence and further reduce private sector flows to the Emerging Markets.

I cannot think of more credible or more articulate speakers on these matters than our previous panelists (notably CSFB's David Mulford, former Under Secretary of the US Treasury for International Affairs, and Jacques de Larosiere, former Managing Director of the IMF), so I won't attempt to say too much about the SDRM proposal. But allow me to say that]

A. Conflicting Views about the SDRM and the Need for It.

At the recent joint IMF/World Bank meetings in Washington, DC, the G-7 endorsed a twin-track approach to address what the official sector generally considers as the need for greater order in resolving sovereign debt crises. The first track is the IMF's sovereign bankruptcy regime (or, as the official sector prefers to call it, the SDRM). The second track is the voluntary inclusion of collective action clauses (or CAC's) in sovereign bond documentation, an approach first proposed by the US Treasury. The G-7 (and other official sector bodies) have repeatedly characterized these two approaches as 'complementary'.

Various private sector representatives have been anything but 'complimentary' in their nearly unanimous criticism of the SDRM and of the twin-track approach generally. In general, the private sector has articulated its consensus view that the SDRM is a radical and ill-timed proposal to address an asserted but unproven problem that would unduly upset the delicate balance that now exists between the rights of sovereign debtors and their private creditors and would inevitably further dry up, and drive up the cost of, private sector flows to the Emerging Markets. Moreover, the private sector has expressed serious concerns about whether the SDRM is an unhelpful distraction from the complex and more important issues facing policymakers of how best to support economic and political reform and help prevent economic and financial crises in the Emerging Markets. Various EM countries have expressed their own concerns about these same issues.

B. Toward a More Marketable Approach.

(1) The Need for More Orderly Restructurings is Mostly an Unproven Assumption.

Instead of an SDRM, the private sector (through a group of major financial trade associations) has proposed the development and implementation of collective action clauses in a context that would maximize the likelihood of their being accepted by the marketplace of issuers and investors.

To best understand this proposal, it is important to note that, in the view of many in the private sector, the official sector has consistently overestimated the dangers of minority creditors in the restructuring process (whether as free-riding hold-outs or as precipitous litigants) (and therefore has over-estimated the potential benefits of collective action clauses). The resulting assumption, that existing mechanisms for resolving financial crises are, for that reason, ineffective or insufficiently orderly is not widely shared by market participants. In fact, that assumption is contradicted by the experience in a number of recent sovereign debt restructurings (including Ecuador, Pakistan, Russia, the Ukraine and even Peru, where the restructuring itself was hardly affected at all and any later disruption was due more to a 'rogue court' in Belgium than to a so-called 'rogue' creditor (whatever that is anyway)). It may be useful to recall that the 'precipitous' litigation against Peru occurred in the context of a country that had been in default under its external debt for well over a decade.

(2) Less Is More.

Accordingly, the basic philosophy underlying the private sector's effort to design marketable collective action clauses is that 'less is more', in the sense that only small changes in existing bond documentation would be necessary to improve the bond restructuring process; and broader changes are likely to do more harm than good. In other words, the private sector does not agree with the official sector's current call for 'regime change'. Making greater changes would unnecessarily raise borrowing costs and further restrict capital flows from the private sector (concerns generally shared by EM country officials).

(3) The Private Sector's Proposed Clauses.

The collective action clauses proposed by the private sector, which would reconcile certain existing discrepancies between NY and English-style documentation (while retaining their basic structures), would make Bonds easier to restructure by:

(a) Majority Action. Permitting the amendment and waiver of key Bond terms (including payment terms, as well as governing law, submission to jurisdiction, waiver of immunity and other substantive covenants as appropriate) by approval of a Super-Majority of Bonds outstanding.

- To facilitate voting logistics, the amendments and waivers may be approved by written resolution as well as at a Bondholder meeting.
- To address concerns about possible unfairness in the voting process, Bonds owned or controlled, directly or indirectly, by the Issuer would be excluded from the voting calculation.
- The specific Super-Majority % should be appropriate to the realistic size of the hold-out problem, as well as to the circumstances of the specific Bond issuance.

What is the appropriate critical mass of creditors that should be required to override the existing rights of, and bind, a minority?

The Taylor proposal itself suggested a 75% test, which is generally in line with standard English-style documentation. Noting that free-riders have not previously been an obstacle in reaching agreement on restructurings, the six trade associations, in their June 3 letter to the G-7, have proposed 90-95% for issues in which institutional investors predominate (with a lower % for issues with a high share of retail investors).

As a guiding principle, it seems reasonable that the appropriate balance between the rights of debtors and creditors should be found where the Super-Majority voting % is roughly proportionate to the realistic size of the free-rider problem (simply because, to the extent that such % is disproportionately low, the legitimate rights of some minority creditors may be unduly compromised). Unfortunately, although some recent experience suggests that no more than 2-3% of any debtor country's bonds have been held by free-rider hold-outs, there is no consensus (anywhere in the official sector, private sector or issuing countries) regarding the potential size of the free-rider problem going forward, or even regarding the standards that should be applied in reaching judgments about the appropriate Super-Majority for binding the minority Bondholders of an EM sovereign.

In the face of what seems like a very subjective question, the best approach may be to encourage debtor countries and their creditors to seek case-by-case solutions, based upon the facts and circumstances of a particular Bond issue or presumed investor profile and a country's past experience with its investor base. While not necessarily providing the certainty (or ease) desired by the official sector, such a pragmatic approach may at least avoid the type of arbitrary determinations that would result from adopting any 'one size fits all' model. Alternatively, it may be possible to identify Bond issue scenarios (based, for example, on manner of distribution) for which more standardized approaches could be prescribed.

At any rate, it appears that the current bid/offer is 75%/90% (or possibly 2/3's/95%).

(b) Engagement. To help facilitate constructive dialogue between a sovereign debtor and its Bondholders when a restructuring seems necessary, new clauses could provide for the appointment by the Bondholders of a Committee to represent Bondholder interests, after an Event of Default (or incipient Event of Default) has occurred or the Issuer has clearly indicated its intention to seek a restructuring. Any such committee would need to adopt such internal rules and procedures as it saw fit and engage legal and financial advisors, subject to reimbursement by the Issuer. It seems reasonable to assume that the establishment of such rules and procedures (as well as efficient coordination across Bond issues) could be guided by relevant practices in the areas of international corporate bonds or sovereign loans, aided by the creation of a code of best practices or left to a process of ad hoc development.

(c) Initiation. Although there are considerable pragmatic barriers and little history of precipitous litigation against sovereign debtors, as a practical matter such litigation can be effectively deterred by requiring a 25% Bondholder vote to accelerate principal and providing for a Super-Majority to rescind any such acceleration. In any event, the Super-Majority voting provisions should also help mitigate this potential threat by binding the minority to approved waiver proposals.

(d) Transparency. To enhance transparency, Issuers not already doing so should be required to comply with the IMF's existing SDDS standards and rolling 12-month forecasts, as well as reporting of proposed treatment of other creditor classes. To take advantage of more modern communications (than publication in the Luxemburger Wort), Bond documentation should provide for greater use of financial community websites for the distribution of notices and other information.

(e) Better Credit Barometer. EM investors have made it very clear that they will accept making Bonds easier to restructure only if, at the same time, greater efforts are made to ensure that making them easier to restructure will not simply result in their default and/or restructuring becoming more likely. Making collective action clauses marketable probably requires some mechanisms to provide greater assurance and/or barometers of creditworthiness and better early warning of potential credit difficulties. Given the complexity of a sovereign's circumstances, what form could such a mechanism take?

In some cases (such as in the context of a specific restructuring), it may be appropriate for an Issuer and its creditors to discuss stronger legal documentation, including the possible design of financial covenants.

In an environment as rich with potential defaults as the Emerging Markets, there are many circumstances where new covenants providing earlier (or simply more) events of default serve no useful purpose and should be avoided. In many of these cases, however, building upon previous work in the area of crisis prevention, it may be possible for Issuers and their creditors to develop such credit barometers in the form of better disclosure (where it is not already made) of key indicators of creditworthiness. [Picking up on one of Sir David Walker's thoughts this morning,] By drawing attention to key variables (rather than providing additional legal remedies), such a credit barometer could provide clearer signalling of changes in creditworthiness and perhaps facilitate an earlier (and possibly more constructive) dialogue between sovereign debtors and their creditors.

Similarly, stronger documentation practices (already prevalent among leading Issuers) could be encouraged for others (again building upon existing mechanisms) by developing a charting system for EM sovereign bond documentation that identified the omission or inclusion of particular types of clauses or other documentation variables.

C. Next Steps.

It is critical to hear the perspectives of Issuers, and for the private sector to work with them as a marketable alternative to the SDRM is developed. Unfortunately, increased pressure by the IMF and others in the official sector to produce an SDRM very much complicates the development of a marketable alternative.

In short, the idea of an SDRM may have served a limited purpose (by catalyzing an effective market-based alternative) but, at this point, the official sector's continued insistence on it is making things harder on themselves, and on the markets, than need be. [As David Mulford put it so well earlier today, 'Respect the Market'.] Putting the SDRM to sleep for awhile may allow the official sector

shortly to graciously declare victory and prepare to collaborate in the roll-out of the private sector's marketable collective action clauses.