

# IMF Working Paper

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## The Corporation of Foreign Bondholders

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**IMF Working Paper**

Research Department

**The Corporation of Foreign Bondholders**

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**Abstract**

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This paper analyzes the Corporation of Foreign Bondholders (CFB), an association of British investors holding bonds issued by foreign governments. The CFB played a key role during the heyday of international bond finance, 1870–1913, and in the aftermath of the defaults of the 1930s. It fostered coordination among creditors, especially in cases of default, arranging successfully for many important debt restructurings, though failing persistently in a few cases. While a revamped creditor association might once again help facilitate creditor coordination, the relative appeal of defection over coordination is greater today than it was in the past. The CFB may have had an easier time than any comparable body would have today.

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*"During the autumn of last year, a Conference of jurists and public men of various countries was held [...], having for one of its objects a discussion of the possibility of international agreements upon the principles of law which should determine the liability of Sovereign States and foreign subjects in their relations to one another. As a preliminary condition to the application of the moral force which is, after all, the sole ultimate sanction in such cases, there can be no question as to the advantage that would result from such an agreement."*

*(Corporation of Foreign Bondholders, Annual Report, 1874, London, p. 73.  
The Conference referred to was the Congress of International Law held in Geneva in 1873 and attended by Isidor Gerstenberg, Chairman of the Council of the CFB).*

## I. INTRODUCTION

Improved creditor coordination in cases of sovereign default is a key objective of some proposals for reforming the international financial architecture, notably those related to a sovereign debt restructuring mechanism, more widespread use of collective action clauses, and a voluntary code of conduct for creditors and sovereign debtors.<sup>2</sup> In today's era of bond finance, creditor coordination is difficult—probably even more so than it was in the 1970s and 1980s, when the bulk of flows to emerging markets took the form of syndicated bank loans. Bondholders are more numerous, anonymous, and difficult to coordinate than are banks. Thus, potential lessons for improved creditor coordination today may be sought by going further back into the past and examining the experience of the most recent previous era of global financial integration and bond finance, namely 1870–1913.

The present paper focuses on the detailed workings of the Corporation of Foreign Bondholders (CFB), an institution formally set up in 1868 by private investors to help them coordinate their actions in cases of international default. The CFB, a London-based association of British investors holding foreign securities, was active and extremely influential between the late 1860s (when international lending attained a very large scale) and the early 1950s (the time

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<sup>2</sup> See, for example, International Monetary Fund (2003), Krueger (2002), and Rogoff and Zettelmeyer (2002).

of the last restructurings of international defaults that had taken place in the early 1930s).<sup>3</sup> The CFB is thus of particular interest today, having operated during the first era of bond finance for emerging markets—when many countries ranging from the large (Argentina, Brazil, China, Japan, Russia, Turkey, ...) to the small (Antigua, Guatemala, Liberia, ...) issued bonds in London (Mauro, Sussman, and Yafeh, 2000, Table 1). That era bears many similarities to the current environment: indeed, it is only during the 1990s that bonds returned to be as sizable a vehicle of finance for emerging markets, and that global financial integration again reached the high levels experienced before World War I (Obstfeld and Taylor, 1998).<sup>4</sup>

Economists (Eichengreen and Portes, 2000; and Portes, 2000), lawyers (Macmillan, 1995b), and investment bankers (Buchanan, 2001) have pointed to the potential relevance of institutions such as the CFB in today's environment.<sup>5</sup> A few key bondholders have already taken tentative steps in the direction of recreating a bondholders' association: the Emerging Markets Creditors Association (EMCA) was established in 2000, although it has thus far focused on issues of international financial architecture rather than playing an explicit role in country-specific cases.<sup>6</sup>

Could a revamped creditor association similar to the CFB provide a “private sector alternative,” or at least a complement, to proposed reforms such as the introduction of collective action clauses or a sovereign debt restructuring mechanism? In what respects was the CFB successful in the past, and how successful would it be in the current environment? Which present-day problems are likely to be resolved through an association of this type? To address these questions, the present paper seeks to explore key similarities and differences in this context between today and 1870–1913, and to provide the most detailed and comprehensive description to date of the CFB's mode of operation.

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<sup>3</sup> While similar bondholders' associations were established in other countries at various times in history, the CFB was the longest-lived, best known, and most important among these institutions, in light of London's pre-eminence as the main financial center during the period we focus on. Other bondholders' associations included the Association Belge pour la Défense des Détenteurs de Fonds Public (Belgium), the Association Nationale des Porteurs Français de Valeurs Mobilières (France), the Association Suisse de Banquiers (Switzerland), the Caisse Commune des Porteurs des Dettes Publiques Autrichienne et Hongroise (France), the Committee of the Amsterdam Stock Exchange (Netherlands), the Conseil de la Dette Publique Répartie de l'Ancien Empire Ottoman (France), the Foreign Bondholders Protective Council (United States), and the League Loans Committee (United Kingdom) (Winkler, 1933, pp. 156–178).

<sup>4</sup> More generally, focusing on domestic financial development, Rajan and Zingales (2001) show that today's advanced countries were more financially developed in 1913 than they were in 1980; only recently have they surpassed their 1913 levels.

<sup>5</sup> The official sector has also considered the potential role of creditor committees (International Monetary Fund, 1999; Haldane, 1999, p. 186).

<sup>6</sup> See <http://www.emta.org/ndevelop/emca.pdf>.

Much has been written on the first era of international financial integration, 1870–1913, when Britain and other European countries lent vast amounts of capital to the emerging markets of the day (see, for example, Bordo and Eichengreen, 2002; Mauro, Sussman, and Yafeh, 2002; and Obstfeld and Taylor, 1998). Fishlow (1985) and Lindert and Morton (1989) provide excellent overviews of that era with a focus on international defaults. The CFB’s importance in that context is well recognized, but its detailed workings remain relatively underexplored. Feis (1930), Borchard (1951), and Wynne (1951) provide early and fascinating treatments. More recent, and closely related to the present paper, are a study by Kelly (1998), who discusses sovereign defaults and international trade in 1870–1913, and an impressive series of studies by Eichengreen and Portes (1986, 1988, 1989a, 1989b and 2000), who discuss sovereign debt, defaults, and workouts in the interwar period (with some reference to earlier cases and the 1980s), and analyze the CFB in substantial detail. In particular, Eichengreen and Portes assess the CFB’s effectiveness using two approaches. First, they compare the ex post returns on holdings of foreign bonds obtained by British bondholders to those obtained by American bondholders, who lacked a permanent organization to pursue their interests until the Foreign Bondholders Protective Council was created in 1933 (Eichengreen and Portes, 1989a). Second, they compare the typical delays between default, reorganization, and return to market access, before and after the establishment of the CFB (Eichengreen and Portes, 2000). Finally, Wright (2000) argues that the CFB’s main role was to enforce collective behavior among creditors by disseminating information of members who “defected” and lent money to a defaulting country while it was embargoed; he presents a game-theoretic model that analyzes this function of the CFB.

Our analysis is mostly based on our own independent reading of the original sources (especially the *Annual Reports* of the CFB), but our interpretation is heavily influenced by what we have learned from previous studies on this topic. Our intended objective is not only to add important unearthed details to previous analyses of the CFB’s mode of operation but also to provide a single reference point to what is known about the CFB, which had previously been scattered around a number of different studies.

Our evaluation of the CFB and the potential lessons from its experience proceeds as follows. We first review the key differences between the international financial environment of 1870–1913 and that of today (Section II), and then analyze the CFB’s success record (Section III) and mode of operation (Section IV). Our main conclusions (Section V) may be summarized as follows. A revamped creditor association today might somewhat facilitate coordination among creditors, especially as it relates to coordination among holders of different bonds issued by the same country. At the same time, for today’s bondholders, the appeal of “defection” rather than cooperation with other creditors seems to be greater than it was in the past. Indeed, much of the original rationale for creditor associations seems to have disappeared, notably the need for creditors to coordinate in taking over collateral and tax revenues in defaulting countries. Moreover, a revamped creditor association may not be able to tackle challenges that existed to a far lesser extent in the past, such as avoiding lawsuits on the part of individual creditors.

## II. THE NEED FOR CREDITOR COORDINATION, 1870–1913 VERSUS TODAY

There are many similarities between the international financial environment of 1870–1913 and that of today. The scale of international capital flows was massive in the pre-WWI era, when it amounted to an even greater share of output than it does today. The London stock exchange saw tremendous activity on the primary and secondary markets for bonds—mostly sovereign—issued by the emerging countries of the day. International lending was risky business—and international defaults and renegotiations messy business—during that first era of global financial integration, just as they are today. Nor are present day proposals to set up a sovereign debt restructuring mechanism and to encourage more widespread use of collective action clauses in sovereign bonds by any means entirely novel. Indeed, the absence of a clear legal framework—let alone a sovereign debt restructuring mechanism—to deal with cases of international default was lamented as early as 1873, as evidenced by the quote reported on page 1. Yet, borrowing sovereign governments and private investors managed, with varying degrees of success, to give some structure to their often turbulent relationships and to find their own ways to deal with international defaults. The CFB emerged spontaneously as a—possibly insufficient—response by private creditors to the need to coordinate their actions.

Despite the similarities, however, in assessing the CFB’s potential relevance for today it is important to take into consideration a number of differences between 1870–1913 and the present. On balance, these differences suggest that the incentives for cooperation among creditors may have been greater in the past than they are today.

- **Extent of sovereign immunity:** In the pre-WWI era, the doctrine of sovereign immunity made it almost impossible for individual creditors to sue sovereign debtors. As late as the early 1950s, Edwin Borchard concluded that as a general principle it was not possible to sue a foreign state on its public bonds (Borchard, 1952). For example, an English Court of Appeal denied an action to attach sales of Peruvian guano shipments designated as security for Peruvian loans, stating that “so-called bonds amount to nothing more than engagements of honour” that could not be enforced without the consent of the debtor country’s government (cited in MacMillan 1995a, p. 336). Over the past few decades, there has been a gradual erosion of the principle of sovereign immunity. Beginning in the 1950s, the United States adopted a policy of restricted foreign immunity, whereby governmental activities that can also be conducted by private persons can be subject to standard domestic commercial law. This policy was formalized in the Foreign Sovereign Immunities Act of 1976. Britain adopted similar legislation—the State Immunity Act—in 1978. Lawsuits involving sovereign debtors have become rather common in recent years, as in the often-quoted case

of Elliott Associates vs. Peru.<sup>7</sup> The lack of scope for successful action on the part of individual creditors may have made creditor coordination easier to attain in the pre-WWI era than it is today.

- **Collateralized bonds, debt/equity swaps, takeover of tax revenues, and (rare) use of gunboats:** The range of actions that could be conducted by a group of creditors in 1870–1913 was wider than it is today, making for a higher demand for a creditor association before WWI than it would be now. Bonds were often secured by collateral in the form of a railway or other easily identifiable assets, or even specific tax revenues. It was common for creditors to take over assets or even tax revenues (and, in extreme cases, the administration of tax revenues) of defaulting sovereigns. Even when the bonds were not formally collateralized, often they were used to finance a specific project, such as the construction of a railway, implying that the creditors had a natural choice for an asset to take over in lieu of debt repayments. Bonds used to finance railways (including both private and public) were some 40 percent of overall British holdings of overseas investment assets (Feis, 1965, p. 27; Fishlow, 1985, p. 392; Bordo, Eichengreen, and Kim, 1998, pp. 16–17).<sup>8</sup> Taking over and monitoring a railway or a stream of tax revenues requires substantial resources and therefore provides a strong incentive for creditor cooperation. At the same time, as we document below, conflicts often emerged regarding which investors had priority over the collateral, especially in cases where the same collateral was used to back up more than one bond. Finally, in extremely rare cases, gunboat diplomacy was resorted to. The extent to which the actual or potential use of force affected the relationship between international borrowers and lenders has been hotly debated. Tomz (forthcoming) reviews the experience of 300 years of international lending and borrowing and finds few cases in which the prospect of direct sanctions such as trade embargoes, the seizure of assets, or diplomatic/military pressure motivated countries to honor their debts and gave investors the confidence to lend. While the exact impact of the use of force in the past remains an open question, it seems clear that an association of bondholders was occasionally able to approach the creditor country

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<sup>7</sup> In 1995 Peru announced its Brady debt restructuring deal. One and a half years later, Elliott Associates, a “vulture fund,” purchased some commercial loans that had been guaranteed by Peru. Elliott did not accept Brady bonds in exchange for the loans it had purchased; instead, it sued for the full value plus interest. In 2000 Elliott obtained a judgement against Peru and an attachment order against Peru’s assets, which it used to delay Peru’s payment of interest to its Brady bond creditors. Peru settled to avoid default on the Brady bond payments (International Monetary Fund, 2001, Box 2.6). For a list of other notable lawsuits against sovereign governments, see Singh (2002). Lawsuits of this type have provided much of the impetus for the current proposals to introduce collective action clauses and a sovereign debt restructuring mechanism (see, for example, Krueger, 2002).

<sup>8</sup> More than one third of railway bonds were issued by entities in the United States. Data drawn from *The Economist’s Investor’s Monthly Manual* for earlier years, courtesy of Nathan Sussman, suggest that railway bonds were somewhat less prominent than in the conventional estimates reported above, and that *sovereign* railway bonds, as opposed to private and other public railway bonds, amounted to approximately one third of total railway bonds.



authorities and attempt to persuade them to intervene on its behalf; by contrast, individual creditors would have been unlikely to be listened to. In today's environment, neither the seizure of collateral or tax receipts, nor military intervention are serious options, thus reducing the need for creditor cooperation in this respect.

- **Number of financial centers:** Despite London's unchallenged pre-eminence as the main financial center for emerging bond market issuance in the past, emerging market bonds could be issued in several financial centers in 1870–1913, not unlike today. Russia issued bonds in various currencies (sterling, francs, florins, marks, and roubles—gold, silver, and paper) and financial centers (St. Petersburg, London, Paris, Amsterdam, Hamburg, Berlin, and Warsaw), often with exchange rate clauses or metallic clauses. It was common for emerging countries to issue a bond simultaneously in a number of centers, with coupons payable in a variety of currencies. For example, in 1913 China issued a bond with coupons payable in sterling, roubles, marks, francs, or yen (Flandreau and Sussman, 2002). Although strictly comparable data are not available, the share of bonds issued on the four or five largest financial centers does not seem to be very different today from that observed in the past. Four countries accounted for 85 percent of the entire stock of international investment in 1914: the United Kingdom (44 percent), France, (20 percent), Germany (13 percent), and the United States (8 percent) (Woodruff, 1967, p. 154, cited in Fishlow, 1985, p. 394).<sup>9</sup> The CFB reports mention only one other country—the Netherlands—that had lent significant amounts to emerging markets. Today, the four largest financial centers account for an even greater share of emerging market bond issues than was the case in the past. Out of a total of 2452 bonds issued by emerging market borrowers, Becker, Richards, and Thaicharoen (2002) report that 41 percent are issued under English law, 35 percent under New York law, 10 percent under Japanese law, 7 percent under German law, and the remainder in a variety of other laws (including those of Luxembourg, Italy, Spain, Switzerland, Hong Kong SAR, and Austria).<sup>10</sup> Thus, the number of financial centers where one could potentially issue today does not seem to be substantially different from the past.
- **Number and variety of types of bonds:** The number of bonds issued by a given country tended to be somewhat lower in the past than it is today. In 1883, Russia, the largest borrower at the time, had 23 bonds (though there may have been multiple issues of the same bond, as some were perpetuities) traded in London and Paris (Flandreau and Sussman, 2002). By contrast, Argentina currently has an estimated 152 different bonds outstanding, issued in several financial centers, in a variety of currencies and legal jurisdictions, and with different features (Marx, 2003, p.7). Disagreement over the relative treatment of different types of creditors is therefore an even more thorny issue today than it was in the past.

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<sup>9</sup> Latin American external debt was slightly more concentrated in British hands, but the percentage of held by the four largest investor countries is similar, at 88 percent in 1914: Great Britain held 68 percent, France 14 percent, the United States 4 percent, and Germany 2 percent (United Nations, 1965, p. 16, cited in Lipson, 1985, p. 48).

<sup>10</sup> Type of law and location of the exchange are closely correlated.

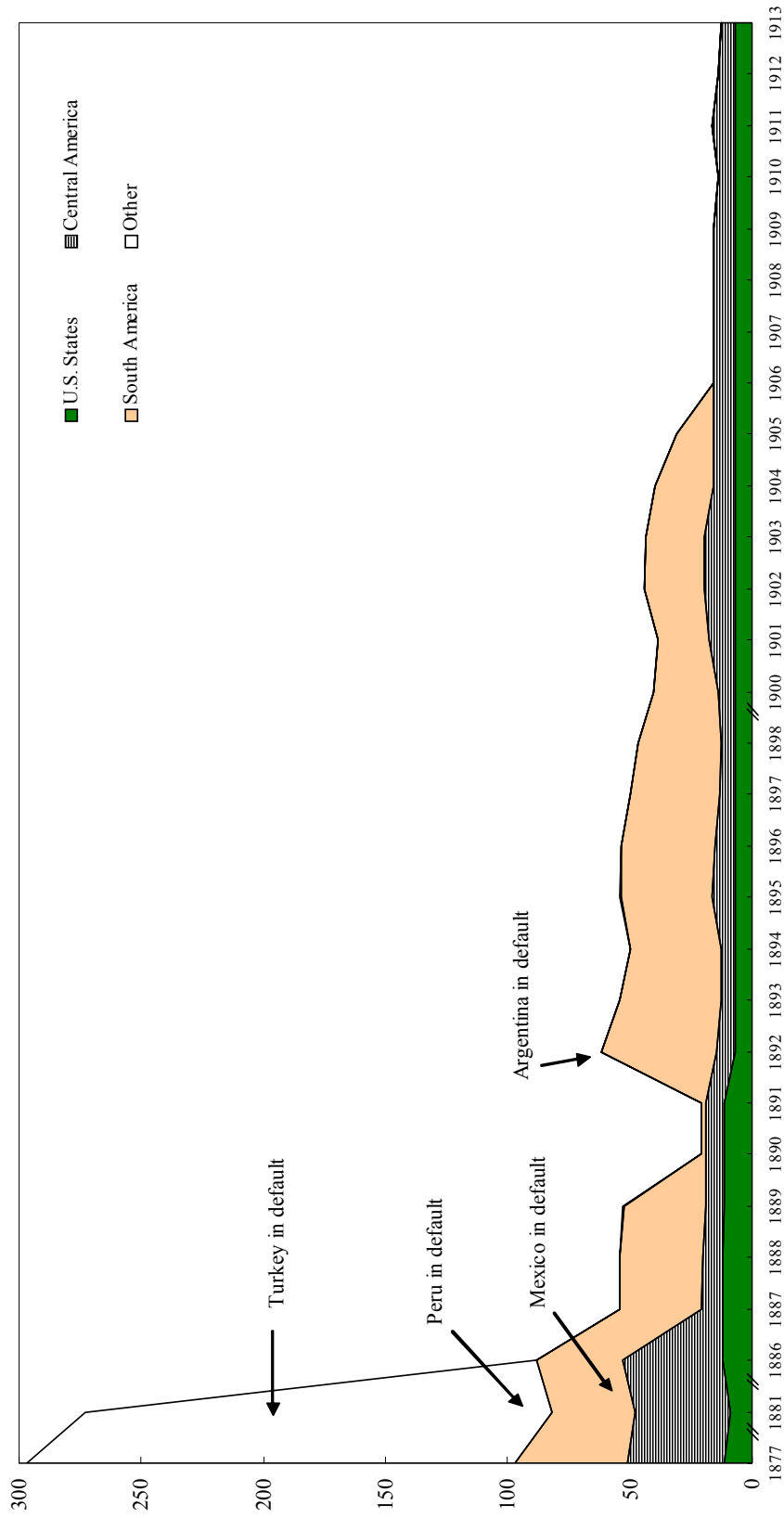
- **Degree of diffusion of bondholders:** As noted by Olson (1965), the number of potential members of an organization is a key determinant of whether an organization emerges and operates successfully. There are substantial differences in the degree of diffusion of bondholders then and now, although it is not clear whether they ultimately make for easier or more difficult coordination among bondholders today than in the past. Despite lack of systematic evidence, it seems clear that the number of ultimate individual holders of sovereign bonds in 1870–1913 was far smaller than it is today. On the basis of the CFB reports, one could guess that the order of magnitude of holders of bonds of a typical emerging market in 1870–1913 was probably in the hundreds—clearly more than enough to present coordination challenges, but still a manageable number that could fit in a large room. By contrast, today there seem to be—at the very least—tens of thousands of individual investors. However, today’s coordination problems are substantially mitigated as the majority of ultimate individual investors hold their bonds in mutual funds, whereas this was less common in the past.
- **International Financial Institutions:** Finally, previous studies have emphasized that, in today’s environment, international financial institutions are involved in an ongoing dialogue with member countries regarding their policies, through surveillance and—in the context of programs—conditionality. They have also noted that the resolution of debt crises may be faster in today’s environment partly because of the provision of new loans by the international financial institutions. In particular, Portes (2000) has argued that for the International Monetary Fund to “get out of the big bailout package business,” appropriate institutions to deal with international debt problems would have to be in place, including revamped creditors’ associations.

### III. EFFECTIVENESS: SUCCESSES AND FAILURES

It is difficult to provide a single measure of the CFB’s degree of success, and in many respects the counterfactual is not clear—one can only speculate about what would have happened in the absence of the CFB. Nevertheless, several pieces of information related to the CFB’s effectiveness are reported in this section, with the obvious caveat that different readers may interpret them differently.

The CFB was ultimately able to reach agreement in all renegotiations with important borrowers, such as Turkey, Spain, Greece, Portugal, Mexico, Argentina, and Brazil. The agreements proved to be acceptable to the bondholders, who otherwise would have been able to reject them. The CFB itself (obviously not an unbiased observer), seemed to be moderately happy with its ability to reach agreement with its large borrowers. In the early 1900s, the CFB stated that it had been able to manage “enlightened countries,” none of which were in default any longer (1905–1906 Report, pp. 1–2). In fact, the number of countries and total amounts in default declined dramatically between the 1870s (when the CFB began to operate) and the early 20<sup>th</sup> century (Figure 1), although this may have been due in part to other factors such as improved macroeconomic conditions in the emerging markets of the day.

Figure 1. Loans in Default, 1877-1913  
(in millions of pounds sterling)



Source: Annual Reports of the Corporation of Foreign Bondholders  
Notes: Data are unavailable for 1878-80, 1882-85 and 1899. The prominent debt defaults of Argentina, Mexico, Peru and Turkey are highlighted.

By early 1907, the only countries remaining in total default were three small Latin American countries: Costa Rica (since 1901), Guatemala (since 1899) and Honduras (since 1873). Despite the lower frequency of new defaults, the CFB lamented that by the early 1900s “...the problem of effecting satisfactory settlements of debt remaining in default ha[d] increased in difficulty.” The CFB recognized that in “small and backward” countries it had to either accept unsatisfactory settlements or face seemingly indefinite default (1905–1906 Report, pp. 1–2). By 1913, only Honduras remained in default, in addition to the U.S. states.

Debt repayment problems with some Latin American countries persisted for much of the period, especially with respect to smaller countries, which often reneged on their debt for decades and, when repaying, favored local or even U.S. creditors. For example, Honduras was criticized as follows: “It is incredible that the Government should (reject a CFB offer and) prefer to enter its thirty-first year of unbroken total and disreputable default” (1901 Report, p. 23). Costa Rica, in default for 22 out of the preceding 39 years, tended to pay its internal obligations while defaulting on its external debt (1909 Report, p. 23): “The conduct of the Costa Rica Government in leaving its External Debt year after year in total default while regularly paying its Internal Obligations is deserving of the severest condemnation” (1903 Report p. 22). Ecuador completed a railway, while in default to its foreign bondholders, by investing a sum equal to its external debt. The CFB was less critical of Ecuador (1907 Report, p. 11) than it was of Honduras, possibly because it viewed investment in a railway as productive and ultimately leading to better ability to repay. Guatemala preferred to continue interest payments to American bondholders, but not to British ones (1909 Report, pp. 24–25), and so did Honduras and Ecuador. Guatemala even let an American syndicate possess coffee export duties. In Honduras a railway was leased to an American company and in Ecuador half of the export duties were given as security for an American loan.

Some of the Southern U.S. States represented another consistent source of trouble for the CFB. Attempts to negotiate debts in arrears with Alabama, Virginia and other states starting in the early 1870s were largely unsuccessful. One source of difficulty was that coordination was required with New York bondholders (see below). Moreover, the bondholders’ ability to access U.S. courts was severely limited, owing in part to a constitutional amendment that prevented individuals from taking legal action against States (1907 Report, p. 16). These defaulting U.S. states also favored American creditors (1911 Report, pp. 11–13).

Why did the CFB eventually manage to find an acceptable agreement with the large borrowers, whereas it seemed to fail in its dealings with small Latin American borrowers and Southern U.S. states? The answer seems to relate to international politics and the ability to borrow in the U.S. markets (which were able to provide sufficient finance to the Southern U.S. states and the small Latin American countries, but not to the larger emerging markets). Indeed, willingness to pay seems to have been more important than ability to pay (proxied by debt per capita or other macroeconomic indicators). The 1908 Annual Report of the CFB (pp. 11–15) contrasts Ecuador—which reached a settlement with its creditors—with other Latin American countries in this respect: it concludes that heavy debt burdens did not cause default. For example, Uruguay paid its debt even though on a per capita basis it was higher than for the three defaulters mentioned above. Venezuela’s excellent repayment history (a few years after a

military blockade by creditor countries) is praised as “a record in the history of the smaller Spanish-American republics.” Salvador also had a very good record. By contrast, Guatemala was in default for 13 years and repudiated four negotiated agreements despite its relatively low debt burden (1911 Report, pp. 20–24).

Countries’ willingness to repay their debts to British bondholders was likely determined by their relations with Britain as a trading partner (Kelly, 1998) and as an international superpower. Countries such as Argentina, which despite its location viewed Britain as a key partner, eventually came to terms with the British bondholders. By contrast, as explicitly recognized by the CFB itself, some of the smaller Latin American countries were evading payment by taking refuge behind the Monroe Doctrine, which regarded Latin America as the United States’ “back yard” and sphere of influence (1911 Report, p. 26). One indication that this was a major factor is the significant decline in spreads for Latin American bonds between 1901 and 1905 following President Theodore Roosevelt’s statement that he would not let Latin American countries use U.S. protection to avoid debt repayment. This decline reflected investor optimism about the prospect of successful settlement negotiations with Latin American countries (1904 Report, p. 11). The CFB’s failure and the American creditors’ success with small Latin American countries and the Southern U.S. States also show that trade links and international politics are far more important in this respect than is creditor coordination, as American bondholders did not have a permanent association during this period.

Another evaluation of the CFB’s success record is provided by Eichengreen and Portes (2000) who, relying on Suter (1992), point out that the average duration of default periods (or the time required to arrive at a settlement) was shorter during the heyday of the CFB than it was in other periods. Defaults lasted on average about six years in the 1871–1925 period, a figure which may appear long by today’s standards, but is substantially shorter than the comparable figures for 1821–1870 (14 years) and for 1925–1976 (over 10 years). In addition, drawing on a large sample of bonds issued in London and New York in the 1920s, Eichengreen and Portes (1989a) show that British bondholders realized higher ex-post rates of return on their holdings of foreign bonds than did American bondholders. They argue that this difference could result in part from the organization of British bondholders through the CFB, and the lack of such a permanent association for American bondholders for much of the period they consider.

Finally, it would be interesting to know whether the presence of the CFB affected the frequency of defaults. Today, opponents of a sovereign debt restructuring mechanism or collective action clauses argue that arrangements aimed at facilitating the restructuring process might make defaults more frequent. While defaults in 1870–1914 were not especially frequent compared with other periods, unfortunately there are too many other determinants of defaults (and potential endogeneity problems—the CFB itself being a response to prior defaults) to say anything conclusive. In this context the CFB at the time would probably have said that one of its objectives was to let borrowing countries know that if they defaulted they would have a tough negotiating counterpart capable of coordinated action in seeking to punish them. In addition, it is interesting to note that, while providing investors with information on *all* borrowing countries, the CFB was primarily in the business of dealing with defaults after they occurred. But clearly the ex-ante impact of the CFB on defaults remains an open question.

The record of the CFB could be viewed as an upper bound on what could be expected from a modern association of bondholders, for two reasons. First, the CFB was the most successful and longest-surviving among the historical bondholders associations. Second, the incentives to deviate from cooperative arrangements among creditors are probably higher today than they were in the past. To summarize the assessment of its effectiveness, the CFB had a fairly impressive record overall, even though it was unable to guarantee successful debt settlements for those few defaulters that did not wish to regain access to the capital markets in London and Europe more generally. To analyze the sources of the CFB's successes and failures, we now turn to examining its mode of operation in detail.

#### **IV. THE CORPORATION OF FOREIGN BONDHOLDERS: MODE OF OPERATION**

##### **A. The CFB's Objectives—Provision of Information and Creditor Coordination**

The CFB's ultimate goal was the protection of the interests of the holders of foreign Government, State, or Municipal securities. That goal was pursued by providing information to bondholders about the borrowing countries (in particular, the less developed countries), and by fostering coordination among creditors, especially in cases of default. The information provided to bondholders included vast amounts of economic commentary and data, and analysis of political developments. For example, the CFB collected eighteen volumes of newspaper clips about Brazil in the period 1870–1913 and a total of over 500 volumes containing information and correspondence of the CFB regarding different countries. It also had agents in various countries providing “valuable and often confidential information,” which it placed at the disposal of its members (1873 Report). The CFB's Annual Reports included a wealth of information on individual countries, such as a comprehensive history of debt and default, trade statistics, fiscal debt and expenditures, and the political environment.

Coordination among bondholders in taking action vis-à-vis borrowing countries was pursued in a number of ways, discussed in detail below. It may be argued that the provision of information itself facilitated coordination among creditors: creditors were more likely to agree on a common strategy if they based their decisions on similar data and analysis. Moreover, the CFB's reading room and library, and the lectures given at the CFB on topics of interest to its members, must have provided opportunities for members to exchange ideas and socialize. Finally, the CFB provided one simple but crucial piece of information that might not otherwise have been easily available to all bondholders, namely whether countries had defaulted to some bondholders. Wright (2000) suggests that this piece of information helped reduce the likelihood that other creditors might extend new credit to a defaulting country.

##### **B. The CFB's Institutional History, Organization, and Officers' Incentives**

The CFB was founded in 1868 and incorporated under License from the Board of Trade in 1873. In the first decades of its existence, the CFB was often criticized for being too willing to settle quickly for debt restructurings that were unfavorable to bondholders, allegedly because of the excessive influence within the CFB of banks that were involved in the bond underwriting

business (Feis, 1930; Portes 2000, pp. 58–59).<sup>11</sup> The CFB was then reconstituted in 1898 (by Special Act of Parliament in 1897) and the influence of underwriting banks in it was greatly reduced, by revising the election mechanism. Starting in 1898, the Council (governing body) of the CFB consisted of 21 members, six of whom were appointed by the British Bankers Association, six by the London Chamber of Commerce, and nine co-opted by the Council as a whole (from among eligible “certificate holders”). The majority of the members after 1898 were therefore appointed by independent outside bodies, in contrast with the bank dominance in previous years. To help dissipate any remaining concerns, all annual reports starting in 1903 included a clear statement on the origins, functions, and procedures of the CFB.

The CFB was a non-profit organization, and many its officers were virtually unpaid: yearly stipends amounted to 1,000 pounds for the president, 500 pounds for the vice president, and 100 pounds for other members of the Council. CFB activities were funded by the interest proceeds on an initial fund of 115,000 pounds, raised from members. Most of the CFB services to members were free of charge, although committee members were sometimes rewarded by a “small fee” if a settlement was reached. Such fees were kept small to minimize the possibility that the committee members might be tempted to agree to an unfavorable restructuring deal just in order to secure a fee for themselves.

Country-specific committees were organized ad hoc, at the request of bondholders, to deal with loans to countries with repayment difficulties. A committee was organized if there was a “sufficient number” of interested bondholders. The President and vice-President of the Council of the CFB were members *ex-officio*; other members were elected in a general meeting—they typically held bonds issued by the defaulting country but were otherwise essentially volunteers. Committees could act independently, without interference by the Council. The CFB provided the committees with housing, assistance, and advice; it was also responsible for some of the administrative and legal expenses. The vast majority of committee members were not members of the Council. In 1903 there were 20 separate Bondholders’ Committees affiliated with the CFB, consisting of 215 members: of these, only 32 members (exclusive of the president and vice-president) were also members of the CFB; and 17 out of those 32 had been appointed directly by the bondholders. Country-specific committees had a

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<sup>11</sup> *The Economist* argued that “it is notorious that in all the negotiations for the re-arrangements of the debts of foreign States a powerful influence is exercised upon bondholders by the issuing houses, who find it practically impossible to do fresh business with the debtors while the default lasts, and who are, therefore, naturally anxious that some sort of settlement should be arrived at, more especially as settlements of the kind yield substantial pickings in the way of commissions, are frequently followed by new loans” (November 20, 1897, p. 1624). Similarly, “there are the financial houses interested in foreign loans, who, being only too well aware of the fact that business is altogether precluded while default exists, are also disposed to come to terms, self-interest being their only guide in the matter. But it was precisely because these evils were recognized that the Corporation was constituted” (February 20, 1897, p. 276).

larger number of members, the larger the debt or the number of debt holders: for example, committees had more members for Spain and Portugal than for small Latin American countries.

Following a default, committee members would travel to the defaulting country and meet with senior officials, often the country's chief executive or key ministers. The committee would conduct its own negotiations with the country authorities, return to London and, in consultation with the Council, present a proposed restructuring deal to the membership of the CFB in the context of a general meeting of bondholders.

In a few cases, country-specific committees disagreed with the CFB Council regarding the desirable course of action. For example, in 1875 the Mexican committee tried to act independently of the CFB, though ultimately with little success (1875 Report, pp. 26–27). However, this seems to have been rare (1903 Report). Occasionally, the Council of the CFB also conducted some activities on its own initiative: examples include its appointing of the British representative on the Council of Administration of the Ottoman Public Debt and its occasional direct interventions on behalf of individuals whose rights had been “prejudiced” by the action of foreign governments. However, as a general rule the Council acted through the various country-specific committees associated with it.

### **C. Coordination Among British Creditors**

One of the key functions of the CFB was to coordinate creditors' actions. Indeed, to the extent possible, attempts were made to foster unanimity among bondholders: “every measure of the Council tends to promote that union of the bondholders which consists a real force against antagonists” (1873, p. 60). Although individual bondholders were not formally barred from taking independent action, “... the advantages of co-operation are so great that there can seldom be sufficient ground for separate action” (1873 Report, p. 50). The CFB attempted to register the holders of bonds, even if deposited in banks or with brokers, to facilitate coordination in time of need.

One determinant of the ease with which creditors can coordinate their activities is the number of creditors; unfortunately, systematic evidence is not available on this point. Nevertheless, it appears that coordination under the auspices of the CFB typically involved hundreds of bondholders, representing a significant block, though not always the majority, of bondholders. For smaller bond issues, bondholders were often no more than a couple of hundred. About 200 bondholders were present at a general meeting regarding Costa Rica in 1874 (Minute Book, Costa Rica, 7%, 1874–1885). A general meeting of holders of New Granada Bonds held on November 18, 1872, was attended by 70 bondholders; a similar meeting in May 1873 was attended by about 150 bondholders (Minutes of the General Meetings of the Committee of Holders of New Granada and Colombia Bonds). Reports on other meetings of holders of bonds of small Latin American railway companies usually indicate the presence of twenty to eighty people.

Similarly, one determinant of the potential influence of a creditors' association in debt renegotiations is the share of total bonds held by creditors that it represents. Again, lack of



systematic data makes it difficult to measure the CFB's influence in an accurate manner. It is clear, however, that the relative importance of CFB creditors varied substantially, ranging from cases where CFB bondholders had a very small share of the bonds, and where the CFB's involvement was minimal, to cases where the CFB spoke for the majority of outstanding bonds and was effectively the sole counterpart in the renegotiations. A number of specific cases and episodes illustrate this variation. In the case of Argentina's debt negotiated in 1889, about one sixth of all holders of dollar denominated debt were represented by the British CFB. In the case of Cedula Bonds issued by the Province of Buenos Aires, voters within the CFB held about a quarter of all bonds in 1903 (1903 Report, p. 13).<sup>12</sup> In the case of the Pisco to Ica Railway (Peru), as of 1881, holders of 180 million pounds worth of bonds were registered with the CFB out of an original issue of 290 million pounds, of which 260 million pounds were unredeemed (National Pisco to Ica Railway Committee, 1878–1892 Minutes). In the case of Ecuador, the amount of bonds represented by bondholders present at a “well attended” meeting in January 1907 was about 4 million pounds, a third of the total debt (1907 Report, pp. 140–142). In the case of Nicaragua, holders of 1 million pounds worth of bonds out of a total of 1.2 million attended a meeting in 1912 which, interestingly, was described as a “low turnout” (1912 Report, p. 12).

#### **D. Mechanisms for Reaching Consensus Within the CFB**

All proposed deals (renegotiated agreements) with countries were brought to a vote in a public meeting of bondholders: for example, in 1874, a general meeting was convened to discuss overdue Spanish loans, where an overwhelming majority supported an agreement proposed by representatives of the CFB Spanish committee following their negotiations with the Spanish authorities. The renegotiated agreement did not let bondholders obtain their “full rights,” but was enough to prevent outright Spanish default. “Dissentients were ultimately convinced” (1874 Report, p. 16). A debt restructuring proposal was occasionally brought to a general vote even if the country-specific committee itself did not have sufficient internal consensus on whether it should recommend the proposal (as was the case with the New Zealand Midland Railway in 1901, see 1902 Report, p. 14). A vote could also be taken by sending a “circular” to all bondholders—as indeed was done in the case of the New Zealand Midland Railway. Once a settlement was accepted, bondholders had to “lodge their securities for stamping in formal assent” (1903 Report, p. 13). If the proposed deal involved conversion or redemption of some of the bonds, a drawing would typically take place during the general meeting. Other payments to bondholders were also effected through the CFB.

Although the Council and the Committee played an extremely important coordinating role, the power to accept or reject a deal ultimately rested in the hands of the bondholders. For

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<sup>12</sup> A general meeting was poorly attended, so a “poll” was taken instead. Votes of holders of 23 million pounds (book value) were in favor of the proposed settlement; holders of 8.5 million pounds were against. The total value of outstanding Cedula Bonds at the time was 133 million pounds or more than 162 million pounds including various coupons and bonos certificados.

example, when Santo Domingo proposed to exchange its existing bonds for new bonds with a much lower face value, neither the Council nor the Committee accepted the offer, but the bondholders accepted it at a General Meeting convened by the debtor (1886 Annual Report, p. 140).

### **E. Internal Disagreements and Coordination Among Holders of Different Bonds**

While systematic evidence is hard to come by, the Reports of the CFB often refer to difficulties in reaching consensus among British creditors: “In cases of arrangements of Foreign Loans, there are generally some parties antagonistic to a settlement, and often either the negotiating Governments or some Bondholders wish to enforce their own peculiar views or terms upon the Council, which may be contrary to the general interest” (1874 Report, p. 8).

Internal conflict within the CFB membership often resulted from different interests among holders of different bonds issued by the same country. Therefore, one objective in negotiations with defaulting countries was the guarantee of “equal treatment” to all classes of bondholders. The settlement with Spain in 1876 involved a conversion of the old bonds with reduced interest payments at similar rates to all classes of creditors (1876 Report, pp. 44–50). In 1877, the CFB passed a decision providing that no arrangement with foreign governments would give preferential terms to any group of bondholders. This seems to have been in response to some cases in which individuals or groups of bondholders acted separately, particularly in the case of Turkey, where union among bondholders and concerted action were hard to achieve (1878 Report, pp. 1–11). Nevertheless, it is not clear how frequently equal treatment across different classes of bondholders was actually attained in practice.

Internal conflict among holders of different bonds also often emerged when the same collateral was used to guarantee different bonds. Wynne (1951, p. 419) reports conflicts resulting from the use of the same securities to guarantee different bonds. Moreover, he reports instances in which bondholders with relatively easy access to the collateral guaranteeing their bonds pursued separate negotiations with a defaulting government. Following Turkey’s default in the mid-1870s, for example, a group of British holders of Turkish bonds pursued separate negotiations because the debt they held was secured by Egyptian “tribute” payments, which were routinely channeled through London prior to the crisis, whereas the collateral securing most other bonds was held in Turkey.

As a general rule, the CFB made an effort to resolve conflicts among holders of different bonds and encourage joint action; the mechanism to reach consensus seems to have been, again, the general meeting. Occasionally, the Council of the CFB or an independent arbitrator (as in the case of Chile, where more than one bond had been guaranteed by the same securities—Wynne, 1951, p. 164) would mediate among committees representing different classes of borrowers. In 1902 arbitration between bondholders and banks regarding a proposal to unify all Turkish bonds was tried first in Turkey (with no result), and then in England. In this case, arbitration seems to have been a mechanism to reconcile the interests of different claim holders

within the CFB—in particular, banks versus individuals. (Continental bondholders supported individual British bondholders against a consortium of banks).

### **F. Forceful Coordination Among Creditors**

*Lawsuits among creditors.* In rare instances, some bondholders appealed to the Courts against a deal reached by the CFB. Such disagreements often related to different treatment of different bonds. In the case of the default by Peru, the Peruvian Bondholders' Committee acted independently of the CFB, and the CFB only represented the interests of the holders of the bonds issued by the National Pisco to Ica Railway. An expensive and protracted litigation between these two groups resulted in an agreement confirmed by the High Court of Justice in 1885. One prominent bondholder, Mr. Proctor, appealed this agreement but lost the subsequent lawsuit (Annual Report 1886, p. 106).

*Dealing with defectors.* Wright (2000) argues that the CFB occasionally tried to put to shame those creditors who extended credit to countries in default to CFB members, and that the main function of the CFB was indeed to harm the reputation of defecting creditors. However, we have not found mention of this type of activity in the CFB reports.<sup>13</sup> Our own impression, therefore, is that this may have been, at best, only one of a variety of ways in which the CFB attempted to foster creditor coordination and protect the bondholders' interests more generally.

*Majority action clauses.* In our research, we found no mention of majority action clauses (or collective action clauses). Previous research has shown that such clauses were introduced in corporate bonds in Britain by Francis Beaufort Palmer in 1879 (see Buchheit and Gulati, 2002, and Billyou, 1948) and rapidly gained popularity in corporate bond issues. Today, similar clauses are common in sovereign bonds issued under United Kingdom law, but it is not clear when they gained prominence.

### **G. Coordination with Bondholders in Other Countries**

The CFB was well aware of the importance of coordination with creditors and stock markets in countries outside Britain: “It is the duty of the Bondholders of England and the Continent to remain united in their policy... and to preserve a common action, maintaining and promoting credit to the honest, and inflicting penalties on dishonest governments” (1873

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<sup>13</sup> Wright (2000) reports examples of this type of activity by creditor committees in the mid-1860s, prior to the establishment of the CFB. He also mentions a citation from *The Economist* in April 1897, stating that the intended function of the CFB was to safeguard against the evils of financial houses interested in issuing further loans. Our interpretation is different, however: at the time, there were widespread complaints against the issuing houses' excessive influence in the CFB, and their tendency to push for quick but unsatisfactory settlements in order to gain new business with countries emerging from default. As mentioned above, the CFB was restructured later that year to curb the influence of the issuing houses.

Report, p. 43). Indeed, a major objective of the CFB was to “obtain unanimity of action among bondholders, and particularly with our influential allies in Holland” (1873 Report, p. 39). Since its early days, the CFB had constant relations with the Bourses of Amsterdam and Rotterdam “because of their high position in finance.” It also cooperated with the Bourses of Frankfurt, Berlin, and Hamburg, and maintained correspondence with the Bourses of Paris and to some extent New York (1873 Report, pp. 51–52).

Coordination with bondholders based in other countries took place at various stages in the monitoring and renegotiation of debt contracts. International coordination during renegotiation was reported in many instances, such as the following. In 1875–1876, negotiations with Spanish representatives in London by the English committee of the CFB were communicated “step by step to committees of Bondholders in Paris, Brussels, Amsterdam and Frankfurt...” (1876 Report, pp. 5–11). Coordination took place with creditors in Frankfurt in several instances, including overdue Alabama bonds in 1874, and Buenos Aires bonds in 1897. Separate committees formed in London, Paris, and Amsterdam to deal with Peruvian debt in 1877 seemed to coordinate their actions (1877 Report, p. 31). The committee of Egyptian bondholders of 1876 included both French and British representatives. On April 24, 1873, a proposal to restructure the debt of New Granada was rejected by British bondholders, “with the concurrence of the Bondholders in Amsterdam” (Minutes of the General Meetings of the Committee of Holders of New Granada and Colombia Bonds). Coordination with creditors in other countries was also important in obtaining collateral and distributing the proceeds resulting from it: for example British creditors and representatives of the French Société Générale coordinated the sales of Peruvian guano in 1876 and the division of the proceeds (1876 Report, pp. 34–40).

Coordination with bondholders in other countries was crucial in blocking defaulting countries’ access to international capital markets, one of the most effective and important tools at the CFB’s disposal—as shown in further detail in later sections. In 1874, “after consultation with the Bourses of the Continent it appeared desirable to make it known to the Mexican government that Mexico would no longer be allowed to avail herself directly or indirectly of European markets for the purpose of raising capital... The effect of this intimation became immediately apparent...” (1874 report, p. 44) and the Mexican President sought settlement with the CFB. A similar boycott on Greek loans was enacted during negotiations with the Government of Greece in 1874, in both London and Amsterdam, in coordination with Dutch bondholders.

In cases where other countries’ creditors had a greater share of the overall debt issued by a country in default, the CFB let others take the lead but lent its support in the negotiations. For example, the negotiation following Greece’s default is described as follows: “The holders in Holland, under the guidance of Mr. Louis Drucker, have taken a most active part in the vindication of the rights of the Bondholders, and the Council have given their hearty cooperation. Mr. Drucker himself visited Athens, and addressed the Ministers... It has been determined to announce to the Greek government that until the English loans in England and Holland are adjusted, no countenance shall be given to public or private enterprise connected with Greece. This policy is accepted by the Council, by the influential Bourse of Amsterdam,

by that of Rotterdam, by Brussels, and by Antwerp. The declaration [...has been] published in English and French in the journals of Europe, and communicated to the leading papers in Greece, the diplomatic body in Europe and the East, and to others able to influence opinion” (1873 Report, p. 18).

Coordination with Continental European bondholders was usually smooth, but difficulties emerged in a few cases. For example, the Amsterdam-based bondholders accepted the conversion of the old New Grenada debt into new Colombian debt only when the deal involved cash payments instead of a land exchange that had been favored by the CFB bondholders (1873 Report, pp. 38–39). Similarly, disagreement arose between the British committee and the French and German committees with respect to a proposed settlement with Portugal in 1901, though eventually differences among the creditors were resolved (1901 Report, pp. 1–3).

The relationship with American bondholders was often far more conflictual, especially with respect to precedence in payments on Latin American debt. For example, the American Honduras Syndicate obstructed a settlement between British bondholders and the government of Honduras, and apparently demanded to be paid first (1903 Report, p. 233). There was also a dispute with US creditors regarding the debt of Santo Domingo (1904 Report, pp. 21–22). British creditors eventually received substantially less than did US creditors (and even Continental European creditors, who obtained separate deals in this case), leading the CFB to appeal to the US government (1908 Report, p. 15). In the case of the Guayaquil-Quito Railway in 1907, the origin of the differences between British and American investors was that the Americans held stock (equity) while the CFB represented (British) holders of debt. More generally, Eichengreen and Portes (1989, p. 16) point out that sterling and dollar covenants often differed significantly in interest rates and security offered by the borrower. As a result, the British and American committees often disagreed on the appropriate treatment of different categories of bonds. American committees often settled unilaterally with the borrowers; the CFB was critical of its American counterpart; however, in some instances it had no choice but to accept American terms.

## **H. Relationship with the British Government**

The CFB kept in close touch with H.M.’s Treasury and the Foreign Office, and occasionally requested the support of H.M.’s Government. Good relations with the Foreign Office may have been rendered easier by similarities in social background and by the involvement of some former diplomats in the CFB. Occasionally the CFB used these good relations to solicit diplomatic pressure on borrowing countries. The CFB stated that “it is the endeavour of the Council to request as seldom as possible and in every case to the least possible extent the assistance of the Foreign Office. An employment of moral influence is all that is required for the solution of many of the most difficult cases that come before the Council, and it is the utmost that they can venture to solicit at the hands of H.M. Government.” Indeed, the British government was usually reluctant to intervene on behalf of investors who had sought

higher returns abroad, and usually regarded defaults as the consequence of imprudent investment (Lipson, p. 187).<sup>14</sup> Nevertheless, government intervention did take place on a number of occasions: diplomatic pressure was applied on countries such as Salvador (1875 Report, p. 28). In extreme cases, issues of foreign government defaults were brought to Parliament for examination, e.g., the case of Honduras in 1875. In 1903 the CFB asked the British authorities not to recognize the new republic of Panama unless it assumed a fair share of the Colombian external debt. The continued default of Guatemala ultimately led to diplomatic pressure, which finally resulted in a renegotiated agreement in 1913—after approximately 14 years of default (1913 Report, pp. 12–13).

In many instances, British diplomats provided the CFB with some degree of cooperation with respect to perhaps more mundane tasks. They served as agents of the CFB in the country where they were posted (e.g., the consul and chargé d'affaires, and H. M.'s minister resident in both Colombia and Guatemala—1873 Report, pp. 40–41, 50, and 54), received payments on behalf of the CFB, or supervised the collection of securities for the CFB (1873 Report, p. 49).

The Council members' social background greatly facilitated good relations with the British government. In most cases, Council members had previously held high-level positions in government, parliament, the military, or finance. The 1938 Report contains a complete list of those who served as members of the Council of the CFB since its inception: of the 107 members, 13 had Lord as their main title, 12 Honourables or Right Honourables, 19 Sirs, 9 high-ranking military officers or judges, and 6 Earls or Viscounts; of the remaining Esquires, 3 had the title of Member of Parliament and many were well-known former diplomats.

On the whole, the CFB seems to have had close relations with the British government. At the same time, it could be argued that such relations between bondholders' associations and governments were at least as close in Continental European countries such as Germany and France, where bondholder committees occasionally seemed to be used as a foreign policy tool. For example, Wynne (1951, pp. 374–376) reports that, in the negotiations following Portugal's default in the early 1890s, the French and German creditors' associations sought to gain an active role in the collection and administration of some of Portugal's taxes at the behest of their respective governments. The CFB took a more conciliatory approach in this respect, though again because the British government at the time did not wish to infringe upon Portugal's sovereignty.

## **I. When Negotiations Between the CFB and the Borrowing Government Failed**

*Arbitration and mediation.* When direct negotiations with defaulting countries failed to lead to an agreement, the CFB occasionally sought arbitration or mediation. Arbitration took place in England between creditors and the Ecuador-Quito Railroad in 1897 and is described in

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<sup>14</sup> Lipson (1985, p. 45) cites late 19<sup>th</sup> century socio-philosopher Herbert Spencer: “The ultimate result of shielding men from the effects of folly is to fill the world with fools.”

great detail (22 pages) in the 1897 Report. International arbitration was used in a few cases, including with respect to the debt owed by Santo Domingo. The CFB demanded (unsuccessfully) arbitration also in the cases of Guatemala and Honduras. Arbitration outcomes were not always favorable to the CFB: in the case of Venezuela, total bondholder claims were around 10 million pounds, but the amount awarded by arbitrators was only 1.84 million (1907 Report, p. 22). Mediation was also occasionally used. For example, Lord Rothschild assisted in mediating between bondholders and the Brazilian government regarding the debt of the Ituana Railway. Similarly, in the case of Venezuelan bonds, a “unification scheme” (of all bonds) was discussed under the auspices of the Banque de Paris et des Pays-Bas (1903 Report, p. 10, p. 14). However, these methods often failed to yield satisfactory outcomes.

*Mechanisms for punishment: Blocking access to capital markets.* The CFB’s main method for punishing defaulting countries was to attempt to block them from obtaining new credit. Formally, this method relied on the London Stock Exchange, which—following a practice adopted in 1827—would refuse quotation to new bonds to be issued by governments that were in default on existing obligations and had refused to negotiate in good faith with their creditors (Morgan and Thomas, 1969; Lipson, 1985, p. 154). In extreme instances, the Exchange would delist all loans of the offending government. However, the CFB played the key role in this process, as the Exchange relied on the CFB for information on the status of loans and renegotiations (Eichengreen and Portes, 1989, p. 15; and Feis, 1930, pp. 114–115).

This method seems to have generally been effective: “... (The use of the) negative power of withholding money ... exercises its own effective influence... (on defaulting governments). ... Greece, Ecuador, the Southern States of the Union and other defaulting states... find that it is not possible to find an open market when one has been closed.” (1873 Report, pp. 60–61). A new bond issue by the government of Guatemala was prevented (with Amsterdam’s cooperation) in 1873 because of “fallacious promises” to repay old loans. In 1875, the CFB reported that Colombia was unable to “appeal for foreign capital” until a settlement was reached regarding its outstanding debt in arrears (1875 Report, p. 32). A similar approach was successfully used in the cases of Turkey and Austria (1873 Report, p. 19).

While coordination with other stock exchanges usually prevented defaulting countries from tapping international capital markets, there were a few exceptions. For example, despite blacklisting by the CFB, Ecuador was able to obtain funds from French creditors and later U.S. creditors (1911 Report cited in Kelly, 1998, p. 42). Guatemala was able to secure a German and an American loan despite defaulting on its British external debt (1895 and 1908 Reports, cited in Kelly, 1998, p. 34).

In the language of the day, blocking further access to international capital markets was viewed as a form of punishment, a sanction, a way to tarnish the defaulting country’s reputation and to prevent diluting the claims of existing bondholders. In today’s debate on the relative importance of sanctions versus reputation in international lending (Eaton and Gersovitz, 1981; Bulow and Rogoff, 1989), this would be labeled not as a sanction but rather as a formal manifestation of the fact that if borrowers default on their obligations, they will lose their reputation and therefore will not receive new lending.

*Harsher ways of punishing countries.* More extreme ways of punishing countries, such as diplomatic action or even military action by Britain, were used rarely. "...Diplomatic intervention...would only be accorded under very exceptional circumstances...Any expedient by which willfully defaulting States can in effect be "posted" on the Stock Exchanges and Bourses of Europe, is likely to prove in the end the most practical vindication of the Bondholders' rights. The issue of "certificates of default" is an expedient by which this end may ultimately be attained, and to which recourse has already been had with success" (1874 Report, p. 72).

Nevertheless, in a few famous instances, creditors succeeded in protecting their rights through their government's force, although British military intervention was typically also motivated by geopolitical considerations. The rather spectacular case of Egypt, where gradually increasing intervention in local affairs on the part of the European creditor powers culminated in Britain's military intervention in 1882, was only partially motivated by a desire to protect the interests of the bondholders (Feis, 1930). The blockade of Venezuela in 1902 by Britain, Germany, and Italy provides a similar example of successful use of force: by the end of 1906 "Venezuela ha[d] completed the whole of the payments to the three blockading Powers (1907 Report, p. 22). Again, intervention was partly caused by a longstanding dispute regarding the boundary between Venezuela and British Guiana (Kelly, p. 34). The Hague Peace Conference of 1906 accepted the legitimacy of the use of force in settling debt disputes, though only in cases where defaulters refused international arbitration or failed to comply with the terms of an international arbitration agreement (1907 Report, cited in Kelly, p. 43).

*Lawsuits against countries.* Legal action against foreign governments, though occasionally attempted, for example, in the cases of Costa Rica (1874), Brazil (1897), or the New Zealand Midland Railway (1901), was viewed as largely ineffective. Attempts were also made to use the US court system in resolving the defaults of the Southern states. The legal disputes vis-à-vis some of the defaulting Southern states (notably Virginia) were costly, complicated, and extremely protracted. They often took a particularly vicious nature (for example, at some point any lawyers that chose to represent the interests of the CFB in Virginia would be automatically disbarred). Occasionally they even reached the US Supreme Court, which in some cases ruled in favor of the CFB. Nevertheless, the CFB generally failed to obtain significant payments from the Southern states.

## **J. The Nature of Settlements**

The CFB usually operated under the principle that if a country could not meet its obligations, only mutually agreed (rather than unilateral) changes in the contracts were possible (e.g., 1874 Report, pp. 70–72). For example, Argentina's attempt to unilaterally redeem its dollar denominated debt in 1889 prompted an immediate letter of protest by the CFB (1889 Report). Debt forgiveness was to be avoided, as a matter of principle, although it was sometimes considered. Eichengreen and Portes (1989, p. 17) report that while the CFB opposed writing down principal (or interest arrears), in a few instances it displayed flexibility. Common ways of settling disputes included the following.



*Debt/equity swaps.* When possible, the CFB committees tried to take over assets in defaulting countries, subject to the goodwill of the local governments and courts. For example, in 1874 bondholders took over some land in Colombia instead of some unpaid bonds. In 1876, with the default of the Alabama Railroad, a sale was forced by the CFB. The bondholder purchased the railroad in exchange for a fraction of the debt due, and the bonds were converted to shares. The CFB appointed trustees to whom the possession of the railroad was surrendered in February 1876 (1876 Report, pp. 13–17). All of this was done under the auspices of US courts. Peru offered guano to creditors as a security for its unpaid coupons (proceeds from its sale were divided among creditors), as well as some degree of control over state railways, customs, steamer lines on lake Titicaca, and plots of government land (Wynne, 1951, p. 171). In Paraguay, the CFB took over collateralized assets, railroads and arable land, which were sold to repay the outstanding debt (1877 Report, pp. 29–31).

*Taking over customs and tax revenues.* In more extreme cases, the foreign bondholders took over customs and tax revenues, most notably in Turkey, following the defaults of the 1870s, and Greece, following the Peace of Constantinople—when the Great Powers enabled creditors to control state revenues pledged to bondholders. In both cases, this was a result of substantial diplomatic pressure and dire circumstances that forced local governments to accept a substantial degree of foreign financial control. Similarly, the Egyptian defaults of the 1870s resulted in foreign control of domestic finances, and eventually in the loss of Egypt’s national sovereignty (Fishlow, 1985, also cited by Kelly, pp. 42–43).

In Turkey, half of the members of the board controlling the Ottoman revenues were from the CFB, which had direct control over the revenues arising from taxes on items such as tobacco, stamps, spirits, and silk. Such revenues were directed to a sinking fund for the payment of the bondholders. Given that the CFB’s representatives were responsible for monitoring the tax revenues, the Annual Reports of the CFB provide an extraordinary amount of detail and analysis on the budget and the determinants of actual revenues (see, for example, the 1886 Report). In Uruguay, creditors took over the country’s custom revenues in 1903. By 1906, Uruguay had pledged 75 percent of its customs revenues to pay its external debts, and the English bondholders’ representative collected these receipts daily (1906 and 1907 Annual reports, cited by Kelly, p. 42).

The management of customs revenues in defaulting countries was not always easy. In Turkey, a persistent problem was the distribution of proceeds between the Turkish government and various claim holders including banks and individual bondholders in different countries (1902 Report, pp. 15–18). Taking over other assets also occasionally proved difficult. For example, the CFB was unable to take over a railway, which had been pledged as security to the Honduras External Loans in 1901, because the government of Honduras preferred to let an American syndicate take it over. Probably for similar political reasons, the government of Liberia preferred an American-appointed Receiver General when it had to surrender its state revenues to creditors (1911 Report, p. 37).

*“Conditionality.”* On a number of occasions, the CFB offered advice regarding economic policies and, when it had sufficient bargaining leverage, sought to impose conditions

on borrowing countries, much like what would be called today “conditionality.” Not surprisingly, such advice and conditions were typically aimed at improving fiscal sustainability, the borrowing country’s ability to repay its foreign creditors, and investors’ ability to monitor developments in the borrowing country. Paraguay was encouraged to form a central bank in 1876 to regulate its finances (1876 Report, pp. 33–34). Turkey was able to obtain two new loans only after it allowed creditors to manage its customs revenues (during a period when British bondholders assumed the presidency of the Turkish Debt Council, 1904 Report, p. 26). Of course, debtor countries did not always comply with the CFB’s advice and conditions. The CFB attempted to advise US southern states on fiscal policies (1874 Report), and it urged the Greek authorities to enact legislation undertaking reforms in the financial and fiscal areas—essentially aimed at balancing the government’s budget (1904 Report, p. 24)—but to little avail in both cases. On the whole, the CFB’s attempts to impose conditionality seem to have been limited, and not very successful except when they took an extreme form through the takeover of the administration of customs and other tax revenues.

## V. ASSESSMENT, IMPLICATIONS, AND OPEN QUESTIONS

The CFB emerged in response to a wave of defaults in the 1800s, and the rationale for its existence gradually disappeared with the demise of the international bond market and the declining importance of British investors: the CFB was formally wound up more than a decade ago.<sup>15</sup> Today the market for sovereign debt issued by emerging countries is again large—and defaults frequent and potentially difficult to resolve. This has led to renewed interest in creditor associations, and the experience of the CFB may provide a number of relevant lessons for today.

This analysis of the experience of the CFB leaves many questions open for further research, including the following.

- Should official intervention attempt to foster the creation of a revamped creditors’ association? Portes (2000) argues that advanced country authorities and international institutions should do so, through moral suasion. He points out that the United States’ Foreign Bondholders Protective Council was set up thanks to the encouragement and support of the State Department. While the CFB emerged spontaneously from the private sector, it was recognized by the British authorities and often interacted with them. One might also note that the CFB was formed only decades after the initial wave of defaults in the 1820s and 1830s. Olson (1965) analyzes the *tragedy of the commons* with respect to setting up associations, especially those with a potentially diffuse membership: no individual has a sufficiently strong incentive to set up an association even though collectively its members would be all better off if the association were to be established. In practice, associations in a wide variety of domains have emerged both as the result of government intervention—such as the Farm Bureau, the longest-lasting

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<sup>15</sup> *Financial Stability Review*, Bank of England, No. 8 (June 2000), p. 144.

among farmers' associations (Olson, 1965, pp. 148–153)—and spontaneously—such as today's Emerging Markets Creditors Association.

- Who would be the natural members of a revamped creditors' association today? Would the investor base be carved relying on nationality or size of the investors, location of the exchange, or type of bonds? MacMillan (1997) argued that a resurrected Foreign Bondholders Protective Council could represent holders of government bonds issued under New York law and a resurrected Corporation of Foreign Bondholders could represent holders of government bonds issued under London law. However, many countries issue bonds under both types of law and many investors hold bonds issued under both types of law. The solution was clearly simpler in the past, when location of the exchange, type of law, and nationality of the investors tended to coincide to a great degree.
- Finally, today's debate on creditor coordination focuses on the need to prevent defection by "vulture funds," for which it makes sense to seek repayment in full (through lawsuits) because of their small relative size. In the past, however, one of the roles of the CFB might have been to protect small bondholders from large bondholders who might otherwise arrange for a separate, advantageous deal for themselves in exchange for the promise to provide the country with new lending.<sup>16</sup>

On the whole, our impression is that the CFB may have had an easier time than any comparable body would have today. The CFB facilitated creditor coordination in the past, and a club of bondholders would likely also be helpful today. However, the CFB's track record was far from perfect, and a similar institution today would be unlikely to fare better. The CFB often faced difficulties in reaching consensus among creditors—especially among groups holding different types of assets. Such an institution would probably face even greater challenges today. In particular, it is hard to see how an association of bondholders would be able to prevent lawsuits from dissenting creditors. Moreover, some of the rationale for creditor coordination in the past has essentially disappeared: few sovereign bonds today have tangible collateral for creditors to seize, and it is difficult to imagine a foreign creditor association taking over the tax administration of a defaulting country. In addition, the main bargaining strength of the CFB was its ability to block defaulting governments from accessing capital markets. Replicating that aspect of the CFB's role in today's international financial environment might be difficult. And an institution keeping track of which countries have defaulted and blocking them from access to exchanges around the world seems unnecessary, as there are basically no cases of defaulting countries that have been able to tap capital markets without previously settling their existing claims. Our main conclusion is therefore that the experience of the CFB provides modern-day observers with an "upper bound" on what could be achieved through a revamped creditor association.

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<sup>16</sup> This is somewhat related to the issue of protecting small shareholders who might be expropriated by large shareholders with controlling stakes (La Porta and others, 2000).

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