INTERNATIONAL MONETARY FUND

Reviewing the Process for Sovereign Debt Restructuring within the Existing Legal Framework

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I. INTRODUCTION

1. **This paper discusses the process for restructuring sovereign debt within the existing legal framework.**[1] This is a first step in responding to the IMFC's request for the Fund to continue its analysis of issues that are of general relevance to the orderly resolution of financial crises. Drawing on recent work and experience in debt restructuring cases, the paper focuses on information gaps that inhibit debtor and creditor decision-making, and sequencing and coordination issues.[2] The paper does not attempt to provide a definitive treatment of these issues, but is intended to provide the Executive Board with an overview and an assessment of recent experience.

2. **Efforts to improve the process for restructuring sovereign debt are currently proceeding along several fronts.** First, the use of collective action clauses is gaining wider acceptance in international sovereign bond markets. Second, discussions are underway on the possible formulation of a voluntary Code of Conduct. A group of official and private sector representatives – led by the Banque de France and the Institute for International Finance – is attempting to produce a common document that might gain wider acceptance.[3] The Fund has been asked to participate in this endeavor. We intend to circulate any eventual Code, along with a staff commentary, to the Board for discussion. A progress report will be circulated to the Board prior to the Annual Meetings.

3. **The current paper describes the context for these ongoing efforts, and may serve to inform the work program moving forward.** The paper is organized into two parts. The first part (section II) describes the diversity of approaches that have been followed in recent restructuring cases, both pre- and post-default, and highlights some obstacles to an efficient workout process between debtors and creditors.[4] The second part (Section III) sets out elements that could strengthen debtor-creditor dialogue, focusing in particular on the

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[1]The recent IMFC communiqué stated that: "The Committee, while recognizing that it is not feasible now to move forward to establish the SDRM, agrees that work should continue on issues raised in its development that are of general relevance to the orderly resolution of financial crises. These issues include inter-creditor equity considerations, enhancing transparency and disclosure, and aggregation issues."

[2]See "*Crisis Resolution in the Context of Sovereign Debt Restructuring—A Summary of Considerations*," SM/03/40, January 29, 2003 and "*Sovereign Debt Restructuring and the Domestic Economy: Experience in Four Recent Cases*," SM/02/67, February 21, 2002.

[3]Preliminary considerations regarding a Code of Conduct are laid out in *"Proposed Features of a Sovereign Debt Restructuring Mechanism"*, SM/03/67, February 12, 2003.

[4]Henceforth, the term pre-default will be used to indicate circumstances where restructurings were used to avoid payment default.

modalities of information exchange, issues related to creditor coordination and inter-creditor equity, and techniques to resolve collective action problems in a pre- and post- default context. Section IV provides concluding observations.

II. THE EXISTING PROCESS FOR SOVEREIGN DEBT RESTRUCTURINGS

4. **The current system for sovereign debt restructuring is characterized by a diversity of approaches.**[5] The experience in recent years can be classified along several dimensions (see also table 1):

- Pre-default (Moldova, Pakistan, Uruguay, Ukraine[6]) versus post-default (Argentina, Ecuador, Russia) situations;

- Restructuring processes where the debtor initiated wide-ranging contact with creditors at an early stage (Uruguay) versus cases where the debtor maintained only limited contacts through a number of channels (Ecuador);

- Comprehensive coverage versus selective approaches to restructurings (Ukraine initially);

- Parallel negotiations (Pakistan) versus sequential (Ecuador) negotiations with creditor groups;

- Use of legal instruments (CACs and exit consents) to resolve collective action problems (CACs in Ukraine, Moldova and Uruguay, and exit consents in Ecuador and Uruguay) versus the absence, or non-use, of such instruments (Pakistan).

The diversity in approaches reflects the diversity in the circumstances of each sovereign restructuring event. In practice, both the length of time needed to complete the process of sovereign debt restructuring and the terms of the restructuring have varied considerably.[7]

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[5]Annex 1 and 2 provide a more detailed description of recent experience in Uruguay and Argentina.

[6]The Ukraine restructuring was initiated pre-default. However, the grace periods for the payment default under two of Ukraine's bonds expired while the exchange offer was still open. From that point on and until completion of the exchange, Ukraine was in default.

[7]For instance, Uruguay completed its debt exchange in only a few months from the date of announcement of the restructuring, while Ecuador's restructuring took more than 10 months from the date of default (Argentina is 18 months and counting). There have also been large variations in the ownership of the debt being restructured along several dimensions: (i) a predominance of retail investors (Ukraine) versus significant holdings by large institutional investors (Ecuador); (ii) large exposure of residents or domestic banks (Argentina) versus exposure by non-residents (Ecuador, Moldova); and (iii) cases where sizeable claims were

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This flexibility is a necessary and desirable feature of the present framework and any future framework, but it entails an unavoidable degree of uncertainty on how a restructuring process will unfold.

5. **A range of additional factors contributes to the complexity of the debt restructuring process and the manner and timing of its initiation**. The main obstacles tend to relate to sovereign debtor fears that a debt restructuring would impose economic and reputational cost on the country, litigation risks, and a sustained loss of access to international capital markets, reflecting investors' perceptions of higher country and market risk.[8] Debtors, therefore, have a tendency to delay in the hope that with sufficient time they will succeed in resolving the current crisis without having to resort to a debt restructuring.

6. **Once a decision to restructure has been taken, the depth and complexity of the financial challenge to restoring medium-term viability and the strength of the member's economic program against that challenge is an important factor affecting the time frame in which the sovereign is able to achieve a collaborative agreement with creditors.** Prominent in this context is the difficulty of defining the macroeconomic policy response in the midst of a severe crisis. In these circumstances, key macroeconomic variables may display unusual volatility and move far from long-run equilibrium levels. There is likely to be substantial uncertainty about factors that have a bearing on a debtor's capacity to generate resources for debt-service, medium-term economic prospects, and fiscal costs of resolving financial and corporate sector difficulties.[9] In such environment, debtors may be unwilling to commit to an early restructuring agreement that may need to be reopened at a later stage. Creditors may also judge that their interests are best served by retaining the legal status of their original claims rather than making concessions in the face of considerable uncertainty on the debtor's payments capacity.

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held by official bilateral creditors (Pakistan) versus cases where debt was primarily in private hands (Uruguay).

[8]The treatment of debt restructurings by credit rating agencies is discussed in Annex 3.

[9]Indeed, the fiscal costs of resolving underlying financial and corporate sector difficulties may not be known for a while. The impact on banks' balance sheets may be significant but difficult to quantify in situations of stress, partly because this will be highly dependent on the particular actions taken, and partly because the repercussions on asset quality and bank equity may take time to materialize. See "*A Framework for Managing Systemic Banking Crises*", SM/03/50, February 6, 2003. See also "*Crisis Resolution in the Context of Sovereign Debt Restructuring – A Summary of Considerations*", SM/03/40 (January 29, 2003) for a fuller discussion of the interaction between a country's economic policies and the debt restructuring process.

7. **Another layer of complexity relates to the need to address the likely deterioration in bank balance sheets in cases where the domestic banking system holds a large share of sovereign debt.** In addition to exposure to losses on their holdings of government debt instruments, banks may be vulnerable to a deterioration in credit quality as a result of debt-servicing difficulties in the household and corporate sectors, exacerbated by the increase in interest rates and the depreciation in the exchange rate, and to deteriorating liquidity conditions as a result of deposit withdrawals and the interruption of interbank credit lines which typically accompany a debt crisis.

8. **While these economic policy challenges are of paramount importance, the lack of procedural clarity that characterizes the current restructuring processes may nevertheless compound the difficulty of achieving agreement in a timely manner.** This paper focuses on two issues that have figured prominently in calls for improving the existing process: information exchange between debtors and creditors, and coordination issues that arise when the restructuring involves a large and diverse group of creditors.

9. **With respect to information disclosure, several types of problems have been raised in the course of recent debt restructurings. Among these are the following:**

- First, there have been concerns about insufficient information being provided by debtors and the Fund on the status of program negotiations and the medium-term policy strategy to put the country on a path of recovery.[10] [11]

- Second, the scope, quality, and timeliness of public disclosure on the liabilities of the public sector is still short of what is desirable. More systematic disclosure on a timely basis of details on the composition of those claims, the maturity and amortization

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[10]The Fund can publish staff reports related to a member's economy only with the approval of the member in question. Despite significant progress, the publication practice is not yet universal. Slightly over half of all stand alone staff reports for use of Fund resources are published, while some 90 percent of LOIs/MEFPs are published. See "*The Fund's Transparency Policy – Issues and Next Steps*", SM/03/200, June 5, 2003. Letters of Intent may be published by the member itself in advance of Board meetings, as these are documents of the authorities, but this is rare. The Fund does not post Letters of Intent or Memoranda of Economic Policies on its website until after they have been discussed by the Board. In practice, therefore, there can be a considerable hiatus between the moment a restructuring decision is announced and the disclosure of the details of the economic program that is supported by a Fund arrangement.

[11]In the majority of cases (Moldova, Pakistan, Ukraine, Uruguay, Russia, and Argentina), a Fund arrangement was in place at the time the restructuring decision was announced, although some programs had slipped off track. In the case of Ecuador an arrangement was approved two months prior to the launch of the exchange offer.

profile associated with them, currency composition, and other factors is important to an accurate assessment of risks and credit fundamentals and is critical to any restructuring process (Box 1).

- Third, there is often limited information available at an early stage of the process on the scope of debt to be included in the restructuring and the implications of the sovereign's proposals for the treatment of different classes of creditors.

- Fourth, there is uncertainty regarding how the Paris Club will deal with individual country cases. This uncertainty relates mainly to the terms and coverage of the restructuring and the number of reschedulings that might take place, as well as how the Paris Club will interpret its comparability of treatment clause. Private creditors have noted that this reduces their ability to assess the impact of any rescheduling on the country's debt-servicing capacity, as well as inter-creditor equity.[12]

[12]The Agreed Minute, which lays out the restructuring terms between the debtor and Paris Club creditors, is currently not published. A detailed treatment of Paris Club operations and its comparability of treatment principles is contained in "*Involving the Private Sector in the Resolution of Financial Crises – The Treatment of the Claims of Private Sector and Paris Club Creditors – Preliminary Considerations*", EBS/01/100, June 27, 2001.

Box 1. Analysis of Sovereign Balance Sheets and Information Needs

The timely, comprehensive, and regular provision of information forms the basis for sound economic decision-making and underpins the efficient operation of capital markets in periods of relative tranquility and building stress, alike. At its most basic level, this requires the dissemination of high quality economic and financial statistics, both by individual firms and by governments. The Fund's Special Data Dissemination Standard (SDDS) was established specifically to guide members that have, or might seek, access to international capital markets in the provision of their economic and financial statistics to the public, in the expectation that this would contribute to the improved functioning of financial markets. To date, 53 countries have subscribed to the standard – including a large number of emerging markets - ensuring data dissemination in a minimum set of 18 data categories.1/ At the same time, there is a growing recognition of the importance of transparency and accountability on economic policies, so that market expectations are based, as far as practical, on informed assessments of current economic conditions and prospects. This is especially important in economies with open financial markets.

Although the scope of available information on sovereign balance sheets was limited only a few years ago, the availability of such information is growing rapidly, in recognition of the importance of such data for sovereign risk and debt sustainability analysis. For example, the new IMF *Government Finance Statistics Manual 2001* emphasizes the balance sheet approach, notably putting at the center of its core analytical framework the change in government net worth. Several areas, in particular, should now be considered as part of a broader dataset, necessary for improved decision making by both policymakers and private creditors alike: 2/

- Data on the composition of the sovereign's domestic and external liabilities (maturity, debt-service profile, type of instrument, and the degree of foreign exchange denominated and foreign exchange linked borrowing) as well as the composition of holdership. This should be complemented by information on the sovereign's future financing needs as well as the debt management strategy more generally.

- Data on the country's external assets (including foreign currency liquidity) 3/ as a measure of its ability to withstand shocks. A comprehensive measure would include the identification of explicit contingent liabilities.

- Basic information on the aggregate position of the banking sector, including timely data on foreign exchange denominated assets and liabilities, non-performing loans, provisioning, and profitability and capitalization ratios.

1/ These are listed at http://dsbb.imf.org/Applications/web/sddsdatadimensions.

2/ See, for instance, "*Investor Relations Programs: Report of the Capital Markets Consultative Group (CMCG) – Working Group on Creditor-Debtor Relations*", February 2, 2001, at http://www.imf.org/external/np/cmcg/2001/eng/061501.HTM.

3/ SDDS subscribers now disseminate and report such data under the Data Template on International Reserves and Foreign Currency Liquidity.

10. **With regard to creditor dialogue and coordination, among the issues that arise in the current restructuring process are**:

- The difficulty of organizing substantive discussions with a diverse group of creditors holding an array of financial instruments, and driven by different investment considerations, within varying legal and regulatory requirements.
- Collective action difficulties resulting from incentives for individual creditors to hold out in the hope of obtaining settlement on more favorable terms. It seems probable that this dynamic may be most acute when creditors are approached prior to a default.
- Difficulties in assessing and achieving inter-creditor equity both among private creditors and between private and official creditors can complicate and delay the process of achieving broad participation in an agreement.

11. **Against this background, the challenge for markets and policymakers is to strengthen the incentives for sovereign debtors and creditors to reach early agreement on a restructuring that preserves the economic value of assets and provides a credible exit from crisis.** Debtors will clearly be concerned about reputational and legal risks associated with a restructuring. At the same time, the efficient operation of capital markets requires that market discipline and the credit culture be maintained. The paper examines a number of aspects of the restructuring process where improvements might be made.

III. Addressing Shortcomings in the Current System

12. **Once a debtor has decided to restructure, the challenge is how to secure agreement with all affected creditors on a restructuring that restores medium-term sustainability.** A timely resolution of the debt problem would limit the economic disruption to the economy and curb the erosion of resources available for future debt-service. Similarly, broad acceptance of a restructuring proposal would reduce the risk of diversion of resources to free riders, and lay the ground for the normalization of relations with the creditor community.

13. **Before agreeing to a restructuring proposal, creditors would need to**:

- understand the economic rationale for the proposed restructuring;
- assess the sovereign's payments capacity in order to determine whether the restructuring proposal, and the associated mix of adjustment and debt relief, offers reasonable prospects for a return to financial viability; and
- be assured that private creditors in different circumstances will be treated reasonably fairly.

14. **In this context, what are the tools available within the present legal framework that can help improve the restructuring process**? While the diversity of country

circumstances inevitably calls for an approach tailored to the specific characteristics of individual cases, the rest of the section will examine the scope for achieving greater clarity on disclosure of information, transparency in the restructuring process, and a productive engagement and coordination of relevant parties.

A. Information disclosure to creditors

15. **During a sovereign debt restructuring a higher level of disclosure is likely to be required than in normal times, reflecting the heightened uncertainty associated with the restructuring decision and to facilitate the necessary due diligence by creditors.**[13] While the details of information to be provided will need to be decided on a case-by-case basis, once the decision to restructure has been taken, initial disclosure of information to creditors would normally include:

- An explanation of the economic problems and circumstances that justify a debt restructuring.
- A broad outline of the economic strategy to restore medium-term debt sustainability.
- Data regarding the debtor's economic and financial condition, with the necessary level of additional detail on the direct and contingent claims on the sovereign, potential claims on reserves, and the balance sheet of the banking system.
- The proposed coverage of the restructuring. This could include the list of specific claims that are intended to be subject to the restructuring and those that are not, and identifying those instruments that are held or controlled by the government.
- A broad mapping of the restructuring process and a timeline for its envisaged completion.

In this context, it is important for the debtor to consult with creditors on the design and process of the restructuring strategy and individual instruments to improve the prospects for a successful conclusion.

16. **Not all this information will be readily available at the beginning of the process.** In particular, the design of a comprehensive medium-term economic strategy may take time, particularly in situations where key macroeconomic variables display unusual volatility and

[13] The good faith criterion in the Fund's Lending into Arrears policy includes disclosure and transparency requirements for information needed to enable creditors to make informed decisions on the terms of a restructuring. See "*Fund Policy on Lending into Arrears to Private Creditors – Further Considerations of the Good Faith Criterion*" (SM/02/248, July 31, 2003, and BUFF/02/142).

the banking sector is under stress.[14] Hence, the effectiveness of a continuous dialogue requires that the information disclosed be regularly updated, particularly with respect to any changes in economic policy and any new external and domestic debt operations undertaken.

17. **Ultimately, it needs to be clear to all parties concerned that the restructuring agreements with different groups of creditors combine, with the adjustment path, to produce a payments profile consistent with a sustainable debt stock.** While creditors collectively have an interest in a restructuring that results in the resumption of debt-service and a viable debt-service path, each creditor would prefer a restructuring that minimizes its own financial concessions. The macroeconomic framework underlying a Fund arrangement provides a measure of the country's policies and future payments capacity, and brings clarity to the formulation, implementation, and monitoring of policy reforms. Indeed, in circumstances where a Fund arrangement is in place, publication of program documents has served an important role in improving disclosure and transparency.[15] If there is an obstacle to releasing program documents, perhaps because the arrangement has not been approved by the Board, the member may still release to creditors detailed information on its economic situation and policies. When this is precluded, there is precedent for publishing staff's analysis of the economic situation in consultation with the member.[16]

18. **Notwithstanding the overall benefits of transparency, several factors might lead the debtor to limit the degree of disclosure and the timeliness of dissemination of**

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[14]The impact on bank balance sheets may be significant but difficult to quantify in situations of stress, partly because the repercussions on asset quality and bank equity may take time to materialize.

[15]An alternative means of enhancing information exchange has been proposed through use of contractual covenants in bonds. Varying degrees of such covenants have been proposed by the G10 Working Group on Contractual Clauses and by certain financial industry associations. See "*Collective Action Clauses – Recent Developments and Issues*", SM/03/102 (03/25/03) and the Summing Up (BUFF/03/25). Notably, the new bonds issued as a result of Uruguay's recent debt exchange include a contractual commitment that Uruguay will provide certain information to investors (including any applicable stand-by or extended arrangement from the Fund, letters of intent and memorandum of economic policies) before any future modification of the bonds is sought.

[16]Staff's presentation at the meeting of Ecuador's bondholders in May 2000 was immediately published on EMCA's website. The Fund has also recently developed guidelines for the content, review and circulation of assessment ("comfort") letters or statements. In principle such letters could, with the consent of the member, be used to inform private creditors of the member's macroeconomic conditions and prospects, as well as relations with the Fund. See "*Operational Guidance Note for Staff on Letters and Statements Assessing Members' Economic Conditions and Policies*", SM/03/216, June 20, 2003.

information. First, the early release of specific information or tentative restructuring plans could lead to market reactions that might hamper the restructuring effort. For instance, in a situation where domestic banks are particularly exposed to the sovereign, the scope and terms of the debt restructuring will be affected in part by the financial conditions of the banks involved. While this source of vulnerability would be an input into the negotiating process, the debtor may be unwilling to disclose detailed information about the exposure of banks due to concerns about triggering a deposit run. Second, negotiations may require the ability to keep tentative agreements confidential to avoid triggering large market price movements. For this reason, arrangements to safeguard confidentiality of market-sensitive information may be necessary (Box 2). Third, if the debt-restructuring proposal contemplates an exchange or offering of securities, information disclosure could be constrained by securities regulations.[17] The expectations of the parties in the negotiation process will need to be tempered by confidentiality considerations and by legal constraints, where applicable.

[17]In some circumstances, securities regulations could constrain the types of information that a sovereign can release to the market prior to an offering of securities. For example, Section 5 of the U.S. Securities Act of 1933 prohibits “conditioning the market” through selling or offering to sell securities in a public offering in the United States before a registration statement has been filed with the U.S. Securities and Exchange Commission (SEC). In the recent case of Uruguay, the proposed scope of the debt exchange was only disclosed after the filing of relevant documentation with the SEC, because of “conditioning the market” concerns. Also, in the Ecuador restructuring, Ecuador’s representatives argued that they were prevented from providing information on the proposed exchange prior to filing with the SEC.

Box 2. Handling Confidential Information

The timely and open communication of information supporting proposals and counter-proposals by respective parties is essential to advancing negotiations during a debt restructuring. While widespread dissemination of information and tentative proposals may be advantageous for achieving a restructuring, in some cases debtors may prefer to limit dissemination to a narrow group. In such situations, negotiations may be unduly complicated because some of those privy to the discussions may be unable to safeguard the confidentiality of information received. Inter-creditor equity concerns would be raised if some creditors use confidential information for trading purposes or to pursue a litigation strategy that would advance their position.

Confidentiality concerns have been largely directed at the bondholder community. For example, these concerns arose during the Ecuador restructuring in relation to small investors. In addition, and in contrast to the large financial institutions (mainly banks) that made up the steering committees during the 1980's debt crisis, many of the bondholders that now play a large role in emerging markets, including hedge funds, do not have secure internal "Chinese walls" for confidential information received during negotiations.

Several formal arrangements could assist in overcoming confidentiality concerns:

- **Creditor committees** have generally provided an effective vehicle to achieve confidential exchanges of information. Representation of bondholders on the committee could be limited to professional advisors that have signed confidentiality agreements that, among other things, preclude them from trading on the basis of the information received. The professional advisor would be able to advise its clients as to the overall merits of the restructuring being negotiated, the advisor would be precluded from passing on to them any specific confidential information. 1/

- **Contractual assurances** by creditor committee members that they will not trade on confidential information may also be appropriate. The effectiveness of such contractual assurances of confidentiality is enhanced where they are a condition of membership of the creditor committee.

The misuse of confidential information relating to securities is also a regulatory concern. Securities laws of the principal financial centers that prohibit "insider trading" activity and impose criminal penalties on those who trade on the basis of such confidential information supplement the use of contractual confidentiality agreements, although the problems with detecting violators is a potential limitation on the deterrent effect of such laws. 2/

1/ This approach is contemplated in the August 2000 Council of Foreign Relations Working Group's Principles for Sovereign Bond Restructurings and draws on established corporate workout practices.

2/ The U.S., Section 10(b)(5) and Rule 10b-5 of the Securities Exchange Act of 1934 prohibits the use of material non-public information in connection with the purchase or sale of a security by a person in breach of a fiduciary or similar relationship of trust and confidence owed to the source of the information. See United States v. O'Hagan, 117 S.Ct. 2199 (1997). Under English law, the *"insider dealing"* provisions contained in Part V of the Criminal Justice Act (1993) broadly prohibit dealings in securities on the basis of non-public inside information likely to have a significant effect on the price of securities. In a similar vein, Part VIII of the Financial Services & Markets Act (2000) prohibits "market abuse" which is behavior likely to give a false or misleading impression as to the price or value of securities. Under German law, Section 14 of the Securities Trading Act (1998) broadly prohibits a person with knowledge of inside information from taking advantage of that knowledge by acquiring or disposing of the relevant securities.

B. Enhancing dialogue and coordination

19. **In addition to improving disclosure of information, there is merit in exploring ways to facilitate improvements in dialogue and coordination.** In general, although there may be economic reasons for attempting a more targeted restructuring, achieving a satisfactory debt-service profile is likely in many cases to require a comprehensive approach both in order to bring the overall debt-service level and profile to a sustainable position, and to achieve sufficient inter-creditor equity to garner support for the restructuring proposals.

20. **Enhancing dialogue and resolving inter-creditor equity issues has at least two aspects**: (i) coordination among private creditors; and (ii) coordination between private and official bilateral creditors in cases where both groups hold a significant share of the claims to be restructured.

Consultation between a debtor and its creditors in the context of restructuring

21. **In deciding how to handle relations with private creditors, a debtor needs to consider how best to structure the dialogue, and whether a restructuring proposal should be developed through a process of informal consultation or formal negotiation. There are two broad options for structuring the dialogue.**

- The first approach is to consult with creditors informally with a view to developing a restructuring proposal that could attract broad support.

- An alternative approach is to structure the dialogue through a representative creditor committee.

The relative merits of these options depends on a range of factors, including whether the restructuring takes place ahead or following a suspension of payments, the complexity of the debt stock and diversity of the creditor base, and the time available for concluding the restructuring agreement.

22. **Informal consultations are likely to be the preferred option in cases where a debtor is seeking agreement on a restructuring *prior* to a default but in the shadow of a credible threat of default.** In a pre-default setting, time is likely to be of the essence to secure agreement quickly to avoid a payment default. Informal consultations could provide initial market soundings of the debt-restructuring proposal, and may be particularly effective in facilitating a quick resolution of a debt exchange in a scenario where the debt reduction sought is not substantial.[18] Such informal consultations could take place, inter alia, through

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[18]Uruguay's recent debt exchange illustrates that informal consultations can be effective, even in cases with a large retail investor base. Several factors may have been critical to the success of Uruguay's pre-emptive exchange offer: (i) a realization by investors that

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road shows, focus groups, or one-on-one meetings. Contacts could also be made with lead managers of bond issues, the dedicated investor base, including institutional investors holding a large proportion of principal, and retail investors. However, to be effective, informal consultations will have to be conducted in a way that provides adequate opportunity for investors to provide input into the restructuring process, that ensures wide-spread dissemination of information (so that even creditors who do not participate in the consultations directly can nevertheless conduct their due diligence) and that is broad-based and collaborative.

23. **In post-default cases, the urgency of securing agreement may be less pressing, and so debtors would typically have more options as to how to consult with their creditors.** In some cases, a process of informal consultation may provide an efficient tool for both designing a proposal and building broad support among creditors. In other particularly complex cases, however, it may be difficult to achieve this objective through informal means, and consideration could be given to moving toward a collective framework through negotiation with a representative creditor committee.

24. **Clearly, the modalities of consultation would need to be decided on a case-by-case basis.** Nevertheless, there are a number of circumstances in which a committee might be helpful.[19] These include, first, cases in which it may be difficult to reach a broad consensus regarding the debtor's medium-term capacity to generate resources for debt-service. In such circumstances, a committee could provide an effective forum for detailed discussions of economic prospects, which may include the sharing of confidential information. The endorsement of a proposal by a committee following such discussions may be helpful in persuading the universe of investors to lower their expectations and accept the deal, particularly with respect to diffuse investors in the retail sector. Second, a committee may be an effective device for achieving adequate intercreditor equity, as it could provide a forum for a representative group of private investors to negotiate how the burden should be shared among various creditors with differing instruments and/or economic interests. Third, a

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Uruguay's debt and external position were not manageable without the exchange – buttressed by effective Fund conditionality which conditioned further disbursements on satisfactory financing assurances; (ii) a well-designed exchange offer, acceptable to a wide range of investors while meeting financing constraints, and marketed effectively (particularly by domestic retail intermediaries) in a cooperative approach; (iii) the relative attractiveness of the new bonds (greater liquidity) versus the old ones (exit consents, worse regulatory treatment); (iv) the relatively modest change in the financial terms of the bonds (maturity extension at the existing coupon); and (i) the general rally in emerging market debt during the exchange period.

[19] A comprehensive earlier discussion of the role of creditor committees is contained in "*Involving the Private Sector in Forestalling and Resolving Financial Crises – the Role of Creditor' Committees – Preliminary Considerations*" (SM/99/206).

representative committee of private creditors could provide an effective counterparty for discussions with other creditors groups, notably Paris Club creditors. This could be particularly important in cases in which questions of fairness regarding the treatment of these creditor groups arise. Notwithstanding these potential benefits, however, a debtor would need to consider whether, as a practical matter, it is feasible to form a reasonably representative committee on a timely basis, and if so, whether it is likely to lead to the rapid development of a restructuring proposal that could garner broad support.

25. **In circumstances in which creditors have organized a representative committee on a timely basis, the debtor's interests would normally be well served by elaborating a restructuring proposal in close cooperation with this committee**. While a committee would generally only play an advisory role in the negotiating process – and would not be able to legally bind the wider creditor body – announcing intention to participate in the deal could carry significant weight if the committee is sufficiently representative. In the context of debt restructurings with commercial banks, creditor committees have typically allowed creditors to reach informal agreements about, for instance, the provision of new financing and voluntary standstills on litigation. However, it remains to be seen if this could be achieved in the context of bondholder committees. This said, as in the case of informal contacts, to the extent a creditor committee excludes relevant creditors it runs the risk of generating restructuring proposals that may not be widely accepted. Indeed, the identification of creditors may be a difficult issue (Box 3).

26. **If the authorities decide to utilize a committee structure, there could be merit in a pro-active approach to facilitating the formation of a representative committee, in post-default restructurings where timing may be less pressing.** The authorities could retain the services of an experienced professional mediator to facilitate the process. This could lead to more constructive discussions than might be the case with a committee that forms spontaneously, and which may not necessarily be populated by a representative group of creditors.

Box 3. Debt Registry

In an environment where a sovereign's debt is held by many different investors, and claims are actively traded in the secondary markets, identifying and coordinating creditors may pose particular challenges. In this environment, a global registry of sovereign debt might assist in the orderly resolution of debt crises. Since the 1980s, various proposals have been made for a comprehensive registration of sovereign debt. It has been argued, inter alia, that greater transparency in the composition and ownership of the sovereign's debt would improve the restructuring process by facilitating inter-creditor coordination and by limiting the opportunity for manipulation of voting by creditors under the control of the debtor. 1/

The establishment of an ongoing registration system that requires transparency as to the identity of the end-investor would require a significant change in the structure of bond financing. The prevailing structure entails an indirect holding pattern whereby bonds are typically held either in certificated or book-entry form by private settlement companies and their depositories. These agents are the creditors of record, but they operate accounts on behalf of participants who are typically large financial institutions. In turn, these financial institutions often act on account of the ultimate beneficial owners of the bonds. The indirect holding system facilitates transactions in bonds, but it also veils the ultimate ownership. In these circumstances, the lender of record, normally easier to identify, may not be in a position to speak on behalf of the end-investors, particularly where these investors are widely dispersed and their interests are in conflict with each other.

Short of changing the existing system, one could envisage the establishment of a voluntary registry that would operate in parallel – and would not displace - the indirect holding system. The operation of such a registry would be particularly designed to facilitate the restructuring process in financial crises. The registry could operate through voluntary disclosure by creditors of their interests down to the level of the end-investor.2/ One of the functions of a permanent voluntary forum (See Section III.C) could be to maintain such a registry. Of course, the effectiveness of a voluntary global registry would depend on the comprehensive participation by creditors who, however, may be unwilling to give up the anonymity of the current system for the putative benefits of a global registry. 3/

1/ In addition to issues related to debt holdings, it has also been argued that a global registry of sovereign debt would assist in preventing debt crises by allowing creditors easily to assess the total indebtedness of sovereign's before deciding to lend and in monitoring deterioration in debt sustainability.

2/ Under the SDRM, registration was mandatory and was a necessary means of implementing an aggregated voting process. As was recognized, however, potential difficulties in identifying the end-investor for voting purposes would still be apparent. See, *The Design of the Sovereign Debt Restructuring Mechanism—Further Considerations*, EBS/02/201, 11/27/02.

3/ Other narrower techniques are currently used to address manipulation in creditor voting. For example, the terms of Uruguay's new bonds from the recent exchange require Uruguay to certify affirmatively in future restructurings whether any bonds are owned or controlled directly or indirectly by Uruguay and its public sector entities.

Coordination among official bilateral and private creditors

27. **Close consultation and cooperation among official bilateral and private creditors could help improve the restructuring process, particularly in cases where the value of claims held by both groups is significant.** In analyzing coordination issues, it is important

to note key elements of the Paris Club operations in the existing framework for crisis resolution.[20]

28. **The Paris Club provides an effective tool to marshal support among official bilateral creditors with well established coordination procedures.** Throughout its history, the Club has displayed a willingness to adapt its procedures and instruments in response to changes in the international capital markets.[21] In a number of respects, the operations of the Paris Club are distinct from those of the private creditors. Four features stand out:

- The speed of restructuring – Paris Club creditors typically meet and agree on a rescheduling shortly after the approval of a Fund arrangement, while agreements with private creditors often come with a longer lag. The readiness of the Club to provide financing assurances at an early stage in the elaboration of Fund-supported programs can provide a strong signal of support by the official bilateral creditors for the debtor's adjustment efforts and facilitate the restoration of confidence and macroeconomic stability.

- The form of restructuring—to date, Club creditors have typically provided only flow restructurings for middle-income countries. As a rule, Paris Club reschedulings involve only debt-service falling due within an agreed period (the consolidation period) and only on debt contracted before a cut-off date (to protect new financing by official creditors against rescheduling).[22]

- The process for restructuring—typically, early consultations take place between Fund staff and the Club to help ensure a common understanding of the financing requirements, and the conditions under which creditors would be willing to extend relief.

[20]A detailed treatment of the involvement of Paris Club creditors in the resolution of financial crises is contained in *"Involving the Private Sector in the Resolution of Financial Crises – The Treatment of Claims of Private Sector and Paris Club Creditors – Preliminary Considerations"*, (EBS/01/100), June 27, 2001. See also "*Note by Staff on Official Bilateral Creditor Claims and SDRM*" (SM/03/51), February 5, 2003.

[21]Not all official bilateral creditors are members of the Paris Club. Achieving a coordinated restructuring that includes all official debt requires separate coordination efforts with non-Paris Club debtors. Experience indicates that non-Paris official bilateral creditors often restructure on terms very similar to those agreed in the Paris Club.

[22]This implies that the coverage of the rescheduling may not necessarily be consistent with broader sustainability considerations.

- Comparability of treatment issues – Paris Club agreements include a clause under which the debtor country agrees to seek comparable terms to those obtained in the Club rescheduling from other non-multilateral creditors. If the Paris Club judges that the debtor has not received comparable treatment, the Paris Club could reconsider the status of the restructuring.

29. **There has been recent discussion within the international financial community on the respective roles of the Paris Club and the private sector in restructuring a sovereign's debt, and ways to improve their coordination.** Among the issues that have been discussed are how to ensure that the combined relief provided by the private and official creditors brings the debtor back to financial viability, how to assess the respective contributions of the official and private creditors given their distinct financing roles, and, related to these issues, the sequencing of the debt relief provided. Addressing these issues in a satisfactory manner suggests that it might be helpful if the Paris Club were to consider somewhat greater flexibility in the timing and form of debt relief provided by Paris Club creditors.

30. **Given the different interests and perspectives of official and private creditors, it is understandable that the assessment of comparability of treatment by the Paris Club has not always coincided with the concerns of private creditors with inter-creditor equity.** The focus of the Paris Club is on resolving external financing difficulties of the sovereign. Hence, the Paris Club creditors' focus on comparability of treatment is confined to external claims, whereas private creditors may also focus on domestic capital markets and instruments. More broadly, the assessment of comparability is complicated by differences in treatment (stock versus flow), differences in repayment terms, and differences in coverage. In addition, the conceptual basis for assessing debt reduction tends to be different, with private creditors focusing on the difference between the secondary market value of the restructured claim and the face value of the original claim, whereas one of the ways the Paris Club assesses comparability is to compare the face value of each category of the debt with the NPV of payment obligations calculated using a near-risk free interest rate. Transparency about these different perspectives is important in reconciling these different approaches with each other and with the needs of the macro-economic program.

31. **In circumstances where a Paris Club rescheduling took place after private restructurings (Ukraine, Russia and Ecuador), private creditors have called for "reverse comparability".** Unlike the Paris Club, private creditors have not included in their restructuring agreements claw back mechanisms to ensure that the official sector provides broadly comparable relief to that granted by private creditors. This may be due to the significant uncertainty that would surround restructured debt contracts with such provisions and the consequent difficulty in pricing them, which in turn would hamper tradability and thereby reduce liquidity.[23] Private creditors have argued that official creditors should provide

[23] A somewhat different form of insurance – against the risk of the overall restructuring deal not achieving a (permanent) exit from the unsustainable debt situation - is included in the

(continued)

debt relief on terms that are roughly equivalent to those contained in the private restructuring arrangements, to achieve medium-term viability and to avoid a de facto subordination of private claims to official claims. While the Paris Club accepts the notion of comparability for all creditors, it has not found the arguments of the private sector on reverse comparability to be convincing thus far.[24]

32. **The Paris Club has taken a number of steps over the last few years to improve cooperation with private creditors.** Progress has been made to increase transparency of the Club procedures by providing extensive information on its website on Paris Club policies, procedures, and restructurings, and through meetings with private sector representatives, who, at their last meeting, requested ex ante consultations on specific cases.

33. **The IMF and the Paris Club have considered a range of possible approaches for how to improve the process for restructurings in cases where both official bilateral and private claims are significant.** Among the issues relevant to this objective is the sequencing of the various stages of the restructuring process in cases where there may be a delay in reaching agreement with private creditors, possibly because of uncertainties at the early stages of a Fund supported program regarding medium-term prospects, or the need to resolve complex inter-creditor equity issues. In such circumstances, it may be appropriate for creditors to consider a staged process. Under such an approach:

- In the first stage, official creditors (organized in the Paris Club) could signal early support for the debtor's adjustment program through a flow rescheduling over the program period with an understanding to provide for a more comprehensive treatment before or at the end of the program. During the program, the agreed flow relief and commitment to more comprehensive treatment would provide adequate financing assurances for the Fund-supported program, provided the member is seeking equivalent relief from its other creditors (this would likely be in the context of the Fund's lending into arrears policy). So long as this interim restructuring did not encompass substantive cash payments to Paris Club creditors, the staged approach

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bonds that emerged from Ecuador's debt exchange. In particular, should Ecuador default again the bonds stipulate that the principal outstanding prior to the 2000 exchange would be reinstated.

[24]Official bilateral creditors have argued that their policy of holding their claims to maturity and generally eschewing trading claims in secondary markets benefits private creditors by preserving the secondary market value of private investors' claims. Moreover, the fact that Paris Club creditors reschedule over extended periods at interest rates linked to their cost of funds typically implies a substantial reduction in the present value of claims when discounted at the secondary market yield on the debtor's other liabilities. In addition, in some cases, debtors have obtained rescheduling of their claims to the Paris club creditors after extended periods of arrears while remaining current on their obligations with the private sector.

would not prejudice the interests of private creditors. To avoid providing disincentives to a rapid restructuring the length of the program period in which the initial relief would be provided could be truncated in some circumstances but could be longer in other, depending on individual country factors.

- Under the second stage, the Club could provide a more substantial and comprehensive debt reorganization. The latter would reflect the Paris Club view on the magnitude of relief required for medium-term sustainability and to ensure an exit from future rescheduling. The terms being negotiated with private creditors (and taking into account relief already provided by both official and private creditors) would also likely enter the Club's considerations. It should be noted, that depending on the relative magnitude of the Paris Club debt, the willingness of official creditors to provide relief would likely depend on the existence of an effective private sector counterpart.

34. The "Evian Approach" recently adopted by the G-8 addresses these and other issues that are relevant to the process of coordination between official bilateral and private creditors. The proposal provides a framework for a case-by-case approach with some greater flexibility in instruments to provide debt relief for certain non-HIPC countries. The Communiqué notes that the Paris Club could tailor its rescheduling to the specific financial situation of each country and calls for early discussion with the private sector on the issue of the comparability of treatment of their respective claims.[25] In the period ahead, the Paris Club is considering how to make these proposals operational.

C. Institutionalizing Dialogue and Mediation Services

35. **There have been a number of proposals for the establishment of a standing debt forum to address various dimensions of the collective framework for restructuring sovereign debt.**[26] [27] These proposals have been directed at several different objectives, including the provision of:

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[25]Annex to the Deauville Communiqué – A New Paris Club Approach to Debt Restructuring.

[26]See "*Involving the Private Sector in Forestalling and Resolving Financial Crises – The Role of Creditors' Committees – Preliminary Considerations*", (SM/99/206), August 11, 1999, for an overview of historical experience with standing creditor bodies. See also "*The Corporation of Foreign Bondholders*", by Paulo Mauro and Yishay Yafeh (WP/03/107).

[27]Among the proposals by the private sector, is a proposal for a forum, including a mediation services element, by Richard A. Gitlin, "*A Proposal, Sovereign Debt Forum*", oral presentation at IMF Legal Department and IMF Institute Seminar on Current Developments in Monetary and Financial Law, May 9, 2002.

- Services to assist in establishing a voluntary debt registration system;
- Mediation services that could be used to facilitate the resolution of inter-creditor issues and dialogue between debtor and creditors; and
- A channel for disseminating best practices on technical issues, such as the scope of confidentiality requirements during the restructuring process.

These proposals face a number of complications, not least of which is the difficultly of organizing a standing body given the diversity and fluidity of creditor groups. Similar to a temporary creditor committee, a voluntary forum would have no decision-making authority, unless creditors had entered into agreements to confer the voluntary forum with such authority (e.g., through the inclusion of arbitration clauses in their original debt contracts that confer authority). In addition, the establishment of any standing body raises questions associated with its functions and funding during inactive periods.

36. **Even without a permanent institutional structure, more informal arrangements, such as using the services of a mediator, could be beneficial to a collective voluntary negotiation framework.** An experienced and independent professional capable of assisting the process could provide confidence to all the participants that there was a support mechanism in place to advance negotiations.

37. **A mediator might have two complementary roles.** One would be to provide general facilitation and coordination services to assist in the resolution of inter-creditor issues. The other role would be to facilitate discussions between the creditors and debtors. In no circumstance would the mediator determine legal rights and wrongs. Furthermore, in contrast to the role of a creditor committee that undertakes negotiations with the debtor on behalf of the creditors, the mediator would be independent from any of the participants in the restructuring negotiations.

D. Techniques to resolve collective action problems

38. **The Board has discussed collective action problems on a number of occasions, including in the context of the proposals for a sovereign debt restructuring mechanism and efforts to promote the use of collective action clauses.** So far, however, the actual experience with the use of techniques to resolve collective action problems is relatively limited, the experience concerning exit consents, for instance, being confined to Ecuador and, more recently, Uruguay.[28] Against this background, this section provides a summary of the main issues involved.

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[28] For a detailed discussion of collective action clauses, see, *The Design and Effectiveness of Collective Action Clauses*, SM/02/173 (06/07/02). For a detailed discussion of exit consents, see: *Involving the Private Sector in the Resolution of Financial Crises – Restructuring*

(continued)

39. **Whether or not in practice collective action problems are an obstacle to the restructuring process will depend on a number of factors.** The incentives for individual investors to decide whether to participate in a restructuring, or to hold out in the hope of receiving more favorable terms, would depend on an evaluation of the extent to which a proposed deal protects their individual interests and the likely payoff of alternative strategies. In the evaluation of these payoffs, the expected market value of the claim on a post restructured basis will be compared with: (i) the probability that the debtor would service the original claim, and the likely market value of such a claim that continued to be serviced; and (ii) the likely risk and return of seeking to obtain recoveries on distressed debt, in the event that the claim is not serviced.[29] Box 4 highlights two examples where collective action problems may have played a role in shaping the decision process by the authorities.

40. **The typical holdout strategy involves waiting until the conclusion of a restructuring agreement with other creditors. In some cases, this may reflect expectations that the claim may continue to be serviced spontaneously by the debtor; in others the attempt to recover more on the holdout claims, possibly through litigation.** This strategy could be successful if the holdout claims are so small that the debtor has sufficient capacity to service them, and if the debtor decides to settle instead of being drawn in protracted legal disputes that could risk complicating the normalization of the country's relations with its creditors.

41. **In general, the holdout strategy may be more appealing in cases in which either the restructuring is conducted without a default or the potential recoveries on distressed debt may be large in relation to the secondary market price.** In pre-default situations the threat of default may not be sufficiently credible, providing creditors with an incentive to gamble on continued repayment of claims. Moreover, the sovereign's attempts to restructure prior to default may itself be taken as an indication of the debtor's desire to stay current on claims, even if the holders of such claims choose not to participate in the exchange offer. Holdout incentives are also likely to depend on the difference between the price at which the exchange takes place and the face value of the claim. The larger the potential

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International Sovereign Bonds, EBS/01/03 (01/11/01) and Seminar on Involving the Private Sector in the Resolution of Financial Crises, *The Restructuring of International Sovereign Bonds, Further Considerations*, EBS/02/15 (01/31/02.)

[29]Factors that will have a bearing on the first point include the economic circumstances of the debtor, the extent to which nonparticipating claims may be small, rated as "selective default" by credit rating agencies (not withstanding the fact that they continue to be paid during the restructuring period), and the likely liquidity of the instrument. Factors that will have a bearing on the second point include the appetite for litigation (including willingness to bear the financial costs and possible reputational damage), and the availability of assets or payment streams vulnerable to attachment.

recovery value relative to the secondary market price, the greater the chance of benefiting through a holdout strategy.

Box 4. Two Examples of Collective Action Problems

Russia. In July 1998, in the face of mounting pressures in the domestic capital market, Russia tried to secure agreement on a voluntary market-based swap of ruble-denominated domestic instruments (GKOs and OFZs) for medium-term dollar denominated Eurobonds. The exchange was intended to form an element of the policy package agreed with the Fund, which centered on fiscal adjustment. The authorities hoped that if the exchange attracted sufficiently high participation, and the credibility of the overall adjustment package had been accepted by the markets, domestic interest rates (which had exceeded 70 percent , in the context of the ruble being pegged to the U.S. dollar) would return to more normal levels, thereby contributing to a successful resolution of the crisis. In the event, participation in the exchange was \$ 6.4 billion out of a total of \$ 41 billion of eligible domestic debt. Within days prices for Russian debt began to fall again, contributing to the rapid escalation of the crisis. A number of factors is likely to have contributed to the low participation in the exchange. First, reports and discussions with investors after the deal pointed to both a lack of incentives in the exchange (in particular, the government stressed its commitment to maintain payments on the old bonds), and a collective action problem. In this regard, some investors were understood to have held on to their GKOs and OFZs in the hope of benefiting from a decline in interest rates, which would have followed the successful completion of the deal. Second, a number of investors felt the deal was poorly marketed, while others did not agree that the deal would contribute significantly to debt sustainability. Third, there was a widespread perception among investors that the international community would not allow Russia's economic program to fail (a moral hazard problem).

Argentina. In October 2001, the Argentine Government recognized that its debt burden was unsustainable, and that it required comprehensive restructuring. The authorities, with the help of legal and financial advisers, explored the possibility of seeking agreement on a pre-default restructuring, which would have been intended to put the debt on a sustainable basis. The government was, however, reluctant to commit to this course of action for a number of reasons, including fears that it would be impossible to implement a debt restructuring involving substantial haircuts for creditors without being forced off the currency board arrangement and without inflicting severe damage to the banking system. With mounting pressures, the authorities became concerned that too many investors would hold out for payment on the original terms—a collective action difficulty—and that the deal would fail, with the attendant risk of a banking system collapse. Against this background, they decided not to proceed with a comprehensive exchange offer and instead attempted a two-stage restructuring. The first stage, involving domestic institutions, was intended to protect the banking system from any difficulties that could arise in the restructuring of nonresidents' claims. The authorities were unable to implement the second stage of the restructuring before the full-blown crisis developed, forcing default and the exit from the currency board.

42. **Operating within the existing legal framework, contractual provisions – if appropriately designed –can mitigate the collective action problem**. As has been discussed in earlier papers, collective action clauses can play an important role in this regard and have proved beneficial in a number of recent restructurings. In particular, majority-restructuring provisions were used to restructure Ukraine's bonds governed by Luxembourg law, in the pre-default restructurings involving Uruguay's Japanese law-governed bonds, and

in Moldova's English law-governed bonds.[30] One of the limitations of the CACs, however, is that they do not exist in most of the outstanding bonds governed by New York law, which currently represent the largest percentage of emerging market bonded debt. Resort to exit consents is a means of addressing collective action problems under such bonds. Indeed, exit consents were used in both Ecuador's and Uruguay's New York law bond restructurings.[31] As is discussed in Box 5, however, exit consents – as with collective action clauses – are subject to important limitations.

43. **A move toward the widespread adoption of trust deed structures and aggregation clauses could be helpful in enhancing the effectiveness of CACs**. Trust deed structures weaken the incentives for litigation by individual creditors, as the trust deed requires the trustee to share among all bondholders of the same issuance the proceeds obtained through litigation on a pro-rata basis. Aggregation clauses could also make it more difficult for holders of a single bond to holdout from a restructuring.

[30]In Moldova's case, the process was greatly facilitated by the fact that the majority of outstanding bonds were held by one asset management company.

[31]The scope of the Uruguay exit consents was narrower than that in Ecuador. The Uruguay exit consents limited the waiver of sovereign immunity, which sought to exclude future payments on the new bonds from the assets available for attachment in a suit brought on the original bonds. In the Ecuador case, the use of exit consents was perceived as part of "take-it-or-leave-it" strategy. In Uruguay, participants could opt out of the exit consents.

Box 5. Collective Action Clauses and Exit Consents

CACs provide a technique for mitigating the holdout problem. Majority restructuring provisions undercut the holdout strategy. They allow amendment of key financial terms by the vote of a qualified majority made binding on all bondholders within the same issuance. Majority enforcement provisions also constrain the holdout strategy in that in order to proceed to recovery on defaulted holdout claims, litigating holdouts would still need to satisfy the thresholds of the enforcement provisions.

One of the limitations of CACs is that their gradual introduction does not affect the existing stock of international sovereign bonds that do not include CACs. This problem is particularly germane to the substantial stock of international sovereign bonds governed by New York law that until recently have not contained majority restructuring provisions but since March 2003 typically do.

Exit consents offer a partial solution to the above limitation. The exit consents technique is borrowed from the U.S. corporate bond restructuring context and is used in an exchange offer where bondholders agree before the exchange to amend the non-payment terms of the bonds from which they are exiting. This technique takes advantage of the fact that bonds governed by New York law contain clauses allowing for majority amendment of nonpayment terms, even though there is no majority restructuring provision with respect to amendment of payment terms. 1/ The amendment agreed through the exit consent impairs the bonds left in the hands of holdouts and is intended to induce higher participation in the exchange, otherwise a holdout faces the risk of holding an impaired instrument. As was done in the case of Uruguay, exit consents could also be used to limit the ability of holdouts to disrupt the servicing of new bonds offered in the exchange, thereby protecting the new bondholders.

The use of exit consents has raised some legal questions. First, there is the concern of inter-creditor equity; unlike majority restructuring provisions where the minority is bound by the same terms as the majority, the actions taken by the majority through exit consents result in a minority, who do not participate in the exchange, faring worse than the majority. **Second, there is the concern that some amendments achieved through exit consents circumvent the contractual provisions requiring that payment terms can only be amended by unanimous consent.** In addition, there are more definitive legal limitations on an exit consent strategy:

- Exit consents cannot be used with respect to bonds that do not provide for majority restructuring of non-payment terms (as is typically the case with German law bonds).
- Like CACs, exit consents have no bearing on bondholders that have already obtained judgments before the exchange, leaving such judgment creditors outside of the contractual framework, and their rights to enforce their judgment claims cannot be affected by any amendment to the original bonds.

1/ The existence of majority restructuring provisions in English law bonds, generally obviate resort to exit consents. There appears, though, to be no legal impediment, as such, to use of exit consents in a restructuring of English law bonds. However, the process used in a U.S. style exchange offer would need to be modified to accommodate the requirements of English law bonds. See, James Cole, *How to Apply US-style Exchange Offers in Europe*, International Financial Law Review, September 2002.

IV. CONCLUDING OBSERVATIONS

44. This paper provides an overview of several aspects of the process of debt restructuring under the existing legal framework. Staff will continue to work on these issues with a view to identifying areas that could contribute to a more effective and collaborative resolution of a sovereign's debt problem.

45. Operating within the current legal framework, the paper identifies key areas where disclosure of information and engagement of creditors in a transparent process would support the authorities' objective of garnering the support needed to reach a timely restructuring agreement. Progress in the identified areas would allow creditors to carry out their due diligence and help address their concerns pertaining to inter-creditor equity issues. At the same time, it needs to be recognized that there are likely to remain information gaps at the nadir of a crisis. This is particularly the case in relation to public sector contingent liabilities. One issue that arises is whether Fund arrangements should play a more active role in ensuring the provision of a minimum list of information to creditors in a debt restructuring process. The Fund's policy on lending into arrears is conditioned on the debtor making good faith efforts to reach a collaborative agreement with its creditors, which includes efforts to disclose the information needed to enable creditors to make informed decisions on the terms of a restructuring. However, the policy stops short of stipulating in detail the types of information that the member should provide. These are issues that could be returned to in a future review.

46. The paper has discussed different approaches to creditor coordination, addressing the need to coordinate various forms of debt dispersed across diverse creditor groups. In some circumstances, informal consultations with the various creditor groups can be effective, particularly in a pre-emptive restructuring aiming at avoiding a payment default. In other cases, particularly where the creditor base is diverse, inter-creditor issues are paramount and holdout incentives prominent in post-default circumstances, formal consultations through the use of representative creditor committees could be advantageous. The effectiveness of all approaches, however, is conditioned on an adequate degree of information disclosure, collaboration, and broad-based dialogue. In cases where a country's debt to private and official bilateral creditors is significant, coordination between these creditor groups is also important. The implementation of recent initiatives arising from the Evian meeting, as well as the possible formulation of a Code of Conduct, could allow for further progress in these areas.

47. Collective action issues, however, might continue to affect the process. The use of legal techniques, such as collective action clauses and exit consents, could help in preventing these problems from derailing restructurings that are supported by the large majority of the affected creditors.

Table 1. Recent Cases of Debt Restructuring

	Initiation and duration of restructuring	Restructured debt	Terms of restructuring	Debt relief	Use of CACs and exit consents	Investor base
Post default cases						
Argentina	Initiated restructuring of domestic and foreign debt in late October 2001 under a two-phase approach. Phase 1 was completed in December 2001. Phase 2 has not been initiated. Argentina defaulted on Phase 2 in late December 2001.	Under Phase 1, U.S. dollar and Argentine peso bonds were eligible for exchange. The authorities accepted federal bonds with a face value of $41 billion and a further $9 billion in provincial debt.	Under Phase 1, all eligible U.S. dollar and Argentine peso bonds were exchanged for new domestic loans featuring (i) a reduction of interest rates to 70 percent of the contractual level (ii) a grace period for interest until April 2002, after which interest was to be paid monthly, (iii) a three-year extension of maturity in the case of bonds maturing up to 2010, and (iv) a guarantee under which payments on the new loans were to be secured on Financial Transactions Tax receipts.	Pending.	None.	Of the $100 billion debt subject to restructuring, about $50 billion was estimated to be held by domestic financial institutions (roughly equal number of banks and pension companies); $20 billion by European retail investors; $3 billion by Japanese retail investors and the remaining $27 billion largely held by US institutional investors.
Ecuador	Defaulted on Discount Brady bonds in September 1999. Later defaulted on other Brady bonds and Eurobonds. Almost eleven months later, announced on July 27, 2000 a comprehensive exchange offer, which was completed on August 25.	The instruments restructured were collateralized Discount Brady bonds, collateralized Par Brady bonds, uncollateralized Past-Due Interest, and Interest Equalization Brady bonds and Eurobonds with a total face value of $6.5 billion.	Bondholders were given the option to swap the defaulted bonds into a single global US dollar denominated step-up 30 year bonds, with an option to convert the 30-year bond into a US dollar denominated 12-year bond for additional debt reduction. The new bond included a principal reinstatement clause to reduce the risk of future default by Ecuador and amortizing features.	The exchange resulted in a reduction in the face value of the bonds of $1.8 billion or 27 percent of the restructured debt. The cash flow relief provided by the exchange equaled about $349 million in the first year (100%), $506 million in the second year (71%) or about $1.5 billion in the first five years (42 %).	Ecuador was the first sovereign to use exit consents to make the bond less attractive through modification of non-payment provisions in order to reduce the leverage of holdout creditors.	Widely held by institutional investors in New York and London, who had substantial holdings of emerging market debt.

Table 1. Recent Cases of Debt Restructuring

	Initiation and duration of restructuring	Restructured debt	Terms of restructuring	Debt relief	Use of CACs and exit consents	Investor base
Post default cases						
Russia	Defaulted on its restructured loans (PRINs) in December 1998. Six months later, in June 1999 , Russia defaulted on its interest arrears notes (IANs). An agreement was reached with the Bank Advisory Committee on February 11, 2000 on a comprehensive debt and debt-service reduction operation. The exchange offer was launched on July 18, 2000 and completed on August 25, 2000.	The exchange covered claims estimated at $31.8 billion. The claims composed of about $22.2 billion of PRINs, $6.8 billion in IANs and $2.8 billion of past due interest on PRINs and IANs (PDI).	PRINs and IANs were exchanged for new 30-year Eurobonds, which also featured below market coupons, front loaded interest rate reduction and a 7-year grace period. PDIs were exchanged for a special 10-year Eurobond at par, with a six-year grace period. The amount of PDI exchanged was equal to the outstanding amount minus a cash payment of $0.27 billion.	The exchange resulted in a reduction in the face value of the bonds by $13.4 billion (PRINs and IANs of $10.6 billion; front loaded interest reduction in Eurobonds of $2.5 billion in debt; and PDI of $0.27 billion) or 42% of the restructured debt. The cash flow relief provided by the exchange averaged about $1.7 billion per year (for the first 14 years).	Russian Eurobonds were issued under English Law, and therefore contained CACs, but these bonds were not restructured.	Of the restructured debt, about 70 percent was held by domestic banks and the remainder by non-residents.
Pre-default cases						
Moldova	Initiated restructuring in June 2002. The final restructuring agreement was signed on October 15, 2002 and became effective on October 30.	The exchange covered the only Eurobond issued by Moldova. The 5-year Eurobonds, with an outstanding balance of $39.7 million, was to mature on June 13, 2002.	Under the exchange, creditors received an immediate cash payment of 10% of outstanding principal ($3.97 million) and a new 7-year amortizing bond. The amortization schedule was backloaded.	The exchange resulted in a reduction in the face value of the bonds by $4 million or 10 % of the restructured debt. The cash flow relief provided by the exchange was $33 million in the first year.	The single Eurobond was issued under English Law and contained CACs. The majority restructuring provision was used by bind in minority creditors.	Collective action problems were minimized by the fact that a single asset management company held 78 % of outstanding bonds.
Pakistan	Exchange offer was launched in November 1999 and was completed on December 13, 1999. The restructuring took place as a requirement under the comparability of treatment clause for a Paris Club rescheduling.	Three Eurobonds with a face value of $608 million, had bullet redemptions in the period December 1999 to February 2002, and coupons ranging from 6 to 11.5 percent. One Eurobond (exchangeable notes) had a put option exercisable February 26, 2000.	Outstanding Eurobonds were exchanged for a new amortizing bond with an overall maturity of six years including a three year grace period and with a coupon of 10 percent.	The exchange resulted in an increase in the face value of the bonds by $6 million. However, there was a significant cashflow relief in the first year of the exchange of $ 539 million.	The three Eurobonds were governed by English law and contained CACs. But Pakistan chose not to make use of the CACs because they were concerned that calling a bond holders meeting might facilitate the organization of bondholders opposed to a restructuring.	Roughly one third of the restructured bonds were held by domestic residents with the rest by financial institutions and retail investors from the Middle East. U.S. and European investment firms had only small holdings of the debt.

Table 1. Recent Cases of Debt Restructuring

	Initiation and duration of restructuring	Restructured debt	Terms of restructuring	Debt relief	Use of CACs and exit consents	Investor base
Pre-default cases						
Ukraine	After piecemeal attempts at earlier restructurings, Ukraine announced a comprehensive exchange offer in February 2000. To address inter-creditor equity concerns, Ukraine decided not to make a principal payment due on one of the bond issues in January 2000 and coupon payment due on another bond issue in February 2000. As the grace period of both payments expired while the exchange offer was still open, Ukraine was in default during the exchange. The exchange was completed in April 2000.	The exchange involved four Eurobonds with face value of $2.3 billion and $1 billion of Gazprom bonds. Coupons on the instruments ranged from 8.5 percent to 16.75 percent.	Claims were exchanged for new amortizing instruments with maturities of seven years, including a grace period of one year. Investors were offered a choice of a Euro-denominated Eurobond bond bearing a coupon of 10 percent, and a US dollar denominated Eurobond with 11 percent coupon.	The exchange resulted in no reduction in the face value of the bonds by. The exchange yielded cash flow savings of $835 million in the first year of the exchange and $719 million in the second year.	Three bonds governed by Luxembourg law contained CACs, and a bond governed by German law did not include such clauses. The use of a novel hybrid mechanism that combined an exchange offer for all of the instruments with the use of CACs in three of the instruments eliminated potential holdout problems.	The three bonds which contained collective action clauses were held by a relatively limited number of investment banks and hedge funds. The remaining bond issue was widely held in the retail sector in Europe.
Uruguay	The exchange offer was announced on April 10, 2003. The exchange was successfully completed on May 29, after the deadline for offers was extended by one week from May 22 to allow for further participation. During the one-week extension, participation rose to 93 percent and $5 billion out of $5.4 billion of eligible bonds were exchanged.	The exchange involved nearly all market debt, accounting for about half of total sovereign debt. Eligible securities comprised 46 domestically issued bonds, accounting for US$1.6 billion in principal; 18 international bonds, accounting for US$3.5 billion, and one Samurai bond, accounting for US$250 million.	Investors were offered a choice between two options. Under the first option (the "maturity extension" option), each existing bond would be exchanged for a bond with similar coupon and extended maturity (5 years longer, generally), blended in some cases with a 30-year bond. Under the second option ("benchmark bond" option), investors would receive one of a smaller number of benchmark bonds, which are longer-dated but more liquid than under than the maturity extension option, also blended in some cases with a 30-year bond.	The exchange resulted in a reduction in the face value of the bonds of $49 million. The exchange yielded cash flow savings of $411 million in the first year, $192 million in the second year or about $ 1.6 billion in the first five years. The net present value of future flows on new bonds was about 20 percent less than the NPV of the pre-exchange flows, when discounted at a common factor (16 percent, the implied yield when the exchange was launched).	Uruguay used CAC provisions on the Samurai bond to bind bondholders to the restructuring agreement. To further reduce hold-out incentives, it also used exit consents with respect to New York law bonds to reduce the old bonds' liquidity and their holders' ability to attach payments made on new bonds. In a new innovation, Uruguay introduced CACs on the new bonds issued with an aggregation clause, lowering the threshold of outstanding principal required to consent to modifications of payment terms of individual series if a larger majority of all affected series approve the change.	More than half of all bonds were held by domestic investors, which were to a large extent the retail sector. The Samurai and euro-denominated bonds had a large retail investor base in Japan and Europe, respectively. International dollar denominated bonds were widely held by institutional investors in the United States.

Argentina—The Process Toward Sovereign Debt Restructuring

Background: In the fall of 2001 and amidst a deepening economic crisis, the authorities considered a strategy based on the comprehensive restructuring of its roughly US$100 billion of domestic and external debt owed to private creditors. To mitigate risks of unsettling the stability of the domestic financial system, the authorities announced a two-phase approach in late October 2001. Phase 1 was aimed at domestic resident investors and was completed in December 2001. Before the second phase could be initiated to restructure the roughly US$50 billion of mainly foreign-held sovereign debt, the financial and political situation deteriorated considerably. Argentina announced a moratorium on payments to non-Phase 1 private debt in late-December 2001. Argentina also suspended payments on its US$4.5 billion debt to official bilateral creditors (of which, US$1.8 billion is owed to Paris Club creditors). Despite occasional delays, Argentina has remained current on its obligations to multilateral financial institutions.

Authorities' strategy: Efforts to lay out a debt restructuring strategy were complicated in 2002 by the significant uncertainty regarding Argentina's macroeconomic environment and the authorities' policy framework. Against difficulties in securing political consensus on a program that could lay the basis for debt negotiations, the authorities' dialogue with creditors remained limited. The implementation of a stabilization program in early 2003 helped abate economic pressures and restore a measure of economic stability. Following the presidential elections in the spring of 2003, the debt strategy of the new administration evolved into a two track approach. First, to develop a medium-term macroeconomic framework to help form the basis of an economic program that can be supported by the Fund and other multilateral institutions, and define the broader envelope of resources available for debt-service, in line with debt sustainability requirements. Second, with the assistance of external advisors, develop procedures to consult with creditors, in preparation for a debt restructuring offer. As part of this strategy, the authorities indicated that they hope to announce the outline of a restructuring proposal by the time of the 2003 Annual Meetings.

Dialogue with creditors. Several meetings with creditors were conducted in the United States, Europe, and Japan in late 2002 and early 2003. Most creditors expressed disappointment that the dialogue lacked substance although some creditors expressed understanding on the grounds that the authorities were not able to make credible commitments regarding the debt restructuring prior to the May 2003 presidential elections. In meetings with creditors held in Paris, London, Zurich and Frankfurt in June 2003, the authorities announced their intention to form creditor consultative groups to share information and better understand investors' needs and expectations. These groups are intended to reflect the structure and geographical distribution of Argentina's international bonded debt. In particular, three regional groups represent retail investors in Germany, Italy, and Japan, and one global group based in New York represents institutional investors. The authorities expect eventually to coalesce these groups into a single global consultative group. Membership was decided by the authorities, based on a number of criteria, including a member's representativeness of a particular investor base and potential to contribute to a constructive dialogue. The authorities intend to engage these groups in successive rounds of meetings, starting in late-July, at which the broad parameters of a medium-term framework would be presented, issues regarding the debt coverage as well as the treatment of various forms of debt will be clarified, and creditors' views regarding the design of debt instruments will be sought. The main points of the meetings with the consultative groups will be made available to all bondholders via press releases. Creditors' views have so far been muted on the formation of regional creditor groups. While some creditors have expressed a preference for negotiations to be conducted within a formal creditor committee framework, others considered that the formation of representative negotiating committees would not be practical given the size and diversity of bondholders.

Creditor coordination. In the 18 months that have lapsed since the default, institutional investors and retail bondholders have made only modest progress in coordinating their actions. To some extent this may reflect the vast number of creditors (it is estimated that 400,000 retail investors hold half of the defaulted debt) and the diversity of interests, but also the fact that serious negotiations have not yet begun. The most significant creditor coordination actions to date include the establishment of a committee of institutional bondholders in the US in early 2002, and more recently, the formation of an association by Italian banks to represent retail investors and the formation of a special purpose vehicle (ABRA) to coordinate representation for other European retail bondholders which is backed by a group of European banks and investment funds. The authorities have welcomed these efforts and expressed their intention to work with all creditor groups and initiatives, without discriminating against any creditor. In this context, they announced that they would not reimburse fees associated with legal or financial advisors retained by these committees.

Paris Club bilateral creditors have had a number of discussions with the Argentine authorities. The participating creditor countries have also agreed, in principle, to a meeting to consider Argentina's debt in due time. So far, there has been limited dialogue between private creditors and official bilateral creditors.

Creditors' legal actions. Although most creditors seem prepared to wait for the authorities to initiate the process of debt restructuring, a number of lawsuits have been filed in New York and in Europe. These include two class action suits filed in New York, which, however, were dismissed on the grounds that the classes were amorphous and ill-defined. Argentina has had mixed success in defending other cases filed and some litigating creditors have succeeded in obtaining court judgments.

The Uruguay Debt Restructuring

Background: In the aftermath of a severe currency and banking crisis in the summer of 2002, partly the result of contagion from neighboring Argentina, the authorities were confronted with acute debt problems. Uruguay's total debt had escalated to about 100 percent of GDP, or roughly US$ 11 billion, with significant debt-service obligations falling due in 2003 and 2004. To alleviate the cash flow pressures and help restore debt sustainability, the authorities embarked on a voluntary debt exchange aiming at lengthening the average maturity on the market private debt. With the assistance of financial and legal advisors and in the context of the Fund-supported program, the authorities prepared a first draft of a plan in October 2002 but considered it insufficient to address the underlying problems. The stabilization the banking system over the last months of 2002 delayed the preparation of a revised plan. This was completed in February 2003 after a renewed bank run and further loss of reserves in late January/early February and fears of a pending default. On the basis of the revised plan the authorities proceeded to engage creditors in a dialogue over the debt restructuring. The debt restructuring involved essentially three components: an external component, covering mainly those bonds issued in Europe and the US (all without collective action clauses, amounting some US$ 3.6 billion), a domestic component, covering bonds issued in the domestic market (some US$ 1.6 billion), and a Japanese component, covering Uruguay's Samurai bonds (US$ 250 million, containing collective action clauses). Following a period of informal dialogue with creditors, the authorities launched the exchange on April 10 and completed it on May 29 after a brief extension period.

Authorities' strategy: A primary consideration for the authorities was to avoid default. In this context their strategy aimed at a collaborative process and a voluntary exchange. Since time was of the essence, the authorities relied on informal contacts with creditors. As near-term debt-service relief was a major consideration, bondholders were offered to swap existing bonds for new longer maturity instruments with broadly the same face value and coupons as the old bonds, implying a NPV reduction. To encourage high participation rates, the authorities established a commitment to complete the offer if participation exceeded 90 percent, maintaining discretion if participation levels fell between 80 and 90 percent. They also announced that the exchange would not go ahead if participation fell below 80 percent.

Creditor coordination. Given the time constraint for the completion of the restructuring, inter-creditor coordination was limited. Generally, no serious inter-creditor equity issues were raised, particularly since the debt exchange involved nearly all of Uruguay's market debt, and the design of the final plan took into account investors' concerns. Additionally, Uruguay's official bilateral debt was very small, implying that its exclusion from the exchange was not perceived to be a problem by affected creditors.

Dialogue with creditors. The authorities actively sought to involve bondholders in an informal consultation process. The dialogue was guided by the premise that the authorities wished to resolve the debt situation in a voluntary and collaborative manner. The authorities held a first round of meetings (in the United States, Europe, Japan, and Uruguay) to explain their current situation and have the creditors' input on the debt restructuring offer. On the domestic front, the authorities maintained contacts with major institutional investors. Since domestic market participants had been exposed to the effects of the 2002 financial crisis, they were generally receptive to the proposed plans. Benefiting from creditors' input in this first round of talks, the authorities formally launched the exchange offer on April 10, 2003, which was to remain open until May 15. They then proceeded to a second round of meetings with investors, this time to explain the main features of the proposal and its consistency with the envisaged macroeconomic adjustment and financing envelope. The authorities published the Staff Report for the Second Review, to provide further information to the public on their economic and financial program. They also stepped up their communication efforts through interviews and advertisements in the local media while remaining in close contact with key investors and analysts.

Special features of the new bonds. The new foreign-law bonds include collective action clauses enabling Uruguay to change the payment terms of each series of bonds with the consent of investors representing 75 percent of outstanding principal of the specific series. Additionally, the new bonds also include an "aggregation clause" allowing Uruguay to change the payment terms in more than one series of bonds with the consent of investors representing only two thirds of outstanding principal of each affected series, as long as there is also agreement by at least 85 percent of aggregate bondholders affected by the change.

Strategy to deal with the holdouts. The authorities explicitly warned that, if unable to meet all debt-service obligations, they would service the new debt in preference to the old. In addition, they used legal and regulatory incentives to deter non-participation. Holders exchanging the external bonds were asked to approve exit consents, which would reduce the ability of holders of the old bonds to enforce debt-service payments. On the domestic component, the authorities established that the old bonds would: (i) require a 100 percent risk weight for banks' computation of risk-adjusted capital ratios; (ii) need to be marked-to-market; (iii) be delisted from the stock exchange; and (iv) not be acceptable as collateral for liquidity assistance from the central bank. On the Japanese component, the authorities and advisors relied on the activation of collective action clauses at a bondholders' meeting, requiring a quorum of bondholders with 50 percent of outstanding principal, with a favorable vote of more than 2/3 of the principal represented at the meeting.

Results. After a short extension, the offer finally closed on May 29, achieving participation rates of nearly 99 percent on the domestic component, some 90 percent on the external, and 100 percent on the Japanese component. Overall, participation rates reached an average of about 93 percent, with participation on bonds maturing in 2003 and 2004 reaching about 95 percent. Several factors may have contributed to the success of the exchange: (i) realization by investors that Uruguay's debt and external position were not manageable without the exchange—buttressed by effective Fund conditionality which clearly conditioned further disbursements on satisfactory financing assurances; (ii) a well-designed exchange offer, acceptable to a wide range of investors while meeting financing constraints, and marketed effectively (particularly by domestic retail intermediaries) in a cooperative approach; (iii) relative attractiveness of the new bonds (greater liquidity) versus the old ones (exit consents, worse regulatory treatment); (iv) the relatively modest size of the haircut (around 20 percent); (v) the general rally in emerging market debt during the exchange period; and (vi) Relatively high prices on the old bonds initially (trading at an average of around 50 cents on the dollar prior to the announcement of the exchange) may have reduced incentives to holdout as the potential upside was limited in the event of recovery of the old bond, either through litigation or because the old bonds were repaid, while the downside was substantial in the event the exchange were to fail and default were to materialize.

Treatment of Debt Restructurings by Credit Rating Agencies

I. How do credit rating agencies define sovereign defaults?

Credit rating agencies define sovereign defaults as being triggered by a payment default or a distressed debt exchange. Since a sovereign cannot file for bankruptcy, credit rating agencies consider a sovereign borrower to be in default if it missed a payment on one or more of its financial obligations, or if a distressed debt exchange results in a reduction in coupon, principal or increase in maturity. An exchange that occurs under the threat of default or has the apparent purpose of helping the borrower avoid a "stronger" event of default (such as a missed interest or principal payment), as well as unfavorable bond covenants and changes in legal jurisdiction, would also be a sufficient condition to declare the sovereign to be in default. The three largest credit rating agencies, Standard & Poor's (S&P), Moody's and Fitch, generally follow this definition of sovereign default.

II. How are distressed debt exchanges rated?

Although credit rating agencies have the same definition of sovereign defaults, they differ in their approach for classifying defaulted debt. The differences in approach can be illustrated with the recent debt restructuring in Uruguay. Uruguay announced the intention to engage in a bond exchange on April 10, 2003. The authorities proceeded with the exchange offer on May 15, after a sufficient number of eligible bondholders participated, and subsequently completed the exchange on May 29 when new bonds were issued.

Upon the announcement of the exchange offer, S&P lowered the long-term foreign currency ratings to "CC" and indicated that it would downgrade Uruguay's foreign currency debt to selective default ("SD") if the authorities proceeded with the exchange offer, because it viewed the transaction as a distressed exchange (Table 1). On May1 6, S&P downgraded the foreign currency debt to SD, but clarified that it would consider the selective default to be cured if the debt exchange was successfully completed and new bonds were issued. Following the completion of the debt exchange on May2 9, new ratings on Uruguay debt were determined based on a forward-looking assessment of the sovereign's creditworthiness. S&P raised Uruguay's foreign currency rating to "B-" on June 2.

Upon the announcement of the exchange offer, Fitch placed Uruguay and exchange-eligible bonds in the "C" category, signaling that default was imminent. The debt was downgraded to the default category ("DDD") on May1 6 when the authorities agreed to proceed with the debt exchange. The ratings remained in the default category for 30 days. On June1 7, new ratings were assigned to the old bonds and the sovereign based on the new financial profile, the debt servicing capacity and payment willingness of the government. Fitch raised Uruguay foreign currency debt to B- in line with the rating on the new bonds issued as part of the exchange. Fitch rated the new bonds higher than the old bonds that were not tendered for exchange (CCC) on the assumption that the government's willingness to service the old bonds may be lower than the new bonds. So far, the Uruguayan authorities have not made clear their intention to service holdouts.

Moody's considered Uruguay to be in default following the announcement of the debt exchange, but because it does not assign default ratings, kept the rating on foreign currency debt at B3 with a negative outlook. The B3 rating reflected Moody's assumption that if the exchange were successful it would provide substantial liquidity relief and improve the recovery values on the defaulted debt.

Table 1. Changes in Ratings on Foreign Currency Long-Term Debt during Debt Restructuring

	S&P	Moody's	Fitch
Uruguay, 2002-03	B-→CCC→CC→SD→B-	B3	B-→CCC-→C→DDD→B-
Argentina, 2001	B-→CCC+→CC→SD	B3→Caa1→Caa3→Ca	CCC-→CC→C→DDD
Ukraine, 1998-2000	NR	B3→Caa1	NR
Ecuador, 1998-99	NR	B3→Caa2	NR
Pakistan, 1998-99	CCC-→CC→SD→B-	B3→Caa1	NR
Russia, 1998-2000	CCC→CCC-→SD→B-	B1→B2→B3	BB-→B-→CCC→B-→B

Source: Bloomberg; NR means not rated. Investment grade ratings are BBB- or Baa3 and above. None of the sovereign borrowers had an investment grade rating a year prior to the debt restructuring.

III. Possible impact of rating actions on the restructuring process

Rating actions on distressed debt exchanges could facilitate the restructuring process. For either prudential or internal risk management reasons, a downgrade to below investment grade rating or near default status could trigger sell orders by investors (such as pension funds and banks) who cannot hold debt with such ratings or who may be required to put up higher provisioning against more risky exposures. The sell-off, or the anticipation of it, would depress secondary market prices and raise yields, but potentially make the debt exchange less costly for the sovereign (the sovereign can buy the old bonds at a lower price). Secondly, rating agencies may signal in advance that completion of the debt exchange would reduce the debt burden and improve medium-term viability, and therefore the post-exchange sovereign credit rating is likely to be higher than the pre-exchange rating. This may help to persuade investors to participate in the debt exchange. Thirdly, rating agencies may signal in advance that ratings on the new bonds resulting from the exchange would be higher than the ratings on the remaining bonds that were not tendered for exchange. This may further reduce the incentive to hold-out.