IMF Policy on Lending into Arrears to Private Creditors

Prepared by the Policy Development and Review and Legal Departments

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Some material contained in this advance copy of *IMF Policy on Lending into Arrears to Private Creditors* may be amended or augmented in the course of publication. The published version of this paper may be combined with other papers, which will be available later in the fall, and will be the document of record.

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Preface

During the course of 1998, as part of its work on strengthening the architecture of the international financial system, the IMF's Executive Board modified the Fund's policy, established in 1989, regarding Fund lending to members after sovereign arrears to commercial banks had emerged, but before agreements to restructure such debts had been reached—a policy that has come to be called "lending into arrears." The modifications consisted of an extension of the policy to cover (i) sovereign arrears to other (i.e., nonbank) private creditors and (ii) nonsovereign arrears to private creditors arising from the imposition of exchange controls, on the basis of criteria broadly similar to those that had applied under the 1989 policy.

In reviewing this and other aspects of work on the international financial architecture in preparation for the October 1998 Interim Committee meeting, some Executive Directors expressed concern that the criteria adopted might be unduly restrictive and requested that they be revisited. In response, the staff prepared a paper reviewing the issues and proposing adaptations to the criteria, which were subsequently discussed and approved with certain changes by the Executive Board. The summing up of the Executive Board discussion on June 14, 1999, and the staff paper for the discussion, are attached. The views expressed in the paper are those of the IMF staff and should not be attributed to Executive Directors or their national authorities.

The paper was prepared by a staff team from the Policy Development and Review Department (PDR) and Legal Department (LEG) under the direction of Jack Boorman and Francois Gianviti.

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Directors welcomed the opportunity to reexamine the criteria set out earlier for Fund lending into arrears to private creditors stemming from sovereign defaults and from the imposition of exchange controls that lead to an interruption in debt-service payments by nonsovereign borrowers.

Directors emphasized that the modification of the financing assurances and arrears policies to permit lending into arrears is an adaptation of existing policies to changing circumstances, and is intended to reinforce the Fund's ability to promote effective balance of payments adjustment while providing adequate safeguards for the use of the Fund's resources.

Directors concurred that the criteria set out earlier for the case of sovereign arrears may be too restrictive and could lead to instances in which creditors))particularly bondholders))could exercise a de facto veto over Fund lending. They also considered that the criteria set out earlier for the case of nonsovereign arrears are too restrictive, as they may not take adequate account of the possibility that, even when both creditors and debtors are willing to participate in collaborative negotiations, the process of debt renegotiation may be protracted. Directors noted that in the case of nonsovereign arrears to private creditors, it would be important to ensure that appropriate steps are taken to protect creditors' interests. One suggestion to staff in this regard was to consider the establishment of an escrow account into which debt-service payments in local currency to nonresident creditors would be made. Against the background of variations in institutional arrangements and members' capacity, however, Directors considered that it would be difficult to specify as a criterion for lending into nonsovereign arrears the implementation of specific mechanisms to protect creditors' interests; instead, this judgment would need to be made on a case-by-case basis.

Directors agreed that Fund lending into sovereign arrears to private creditors (including bondholders and commercial banks) should be on a case-by-case basis and only where:

(i) prompt Fund support is considered essential for the successful implementation of the member's adjustment program; and

[1]The staff paper, "Fund Policy on Arrears to Private Creditors—Further Considerations," was discussed by the IMF Executive Board on June 14, 1999. This summing up represents the Acting Chairman's summary of the Board discussion.

(ii) the member is pursuing appropriate policies and is making a good faith effort to reach a collaborative agreement with its creditors.

Directors agreed that Fund lending into nonsovereign arrears stemming from the imposition of exchange controls should be on a case-by-case basis and only where:

(i) prompt Fund support is considered essential for the successful implementation of the member's adjustment program; and

(ii) the member is pursuing appropriate policies, is making a good faith effort to facilitate a collaborative agreement between private debtors and their creditors, and a good prospect exists for the removal of exchange controls.

In both cases, all purchases by the member would be subject, as provided at present, to financing reviews to bring developments at an early stage to the attention of the Executive Board, and to provide an opportunity for the Board to consider whether adequate safeguards remain in place for further use of the Fund's resources in the member's circumstances. Specifically, such reviews would provide a basis to assess whether the member's adjustment efforts are considered to be undermined by developments in creditor-debtor relations.

Directors noted that the policy outlined above supersedes all previous policies regarding lending into arrears to private creditors.

Finally, Directors noted that it would be important to monitor experience with lending into arrears and to keep the policy outlined above under review, so as to ensure that it achieves its objectives.

I

Introduction

In the context of discussions on Fund policy on sovereign arrears to private creditors and on involving the private sector in forestalling and resolving financial crises, in 1998 the Executive Board extended the scope of the Fund's 1989 policy on external payments arrears to commercial banks[2] to cover two additional circumstances. First, the possibility of Fund lending into sovereign arrears was extended beyond the case of syndicated bank creditors to encompass private bondholders and other private creditors. Directors agreed that such lending would be on a case–by–case basis and only where: (i) prompt Fund support is considered essential for the successful implementation of the members' adjustment program; (ii) negotiations between the member and its private creditors on a restructuring have begun; and (iii) there are firm indications that the sovereign borrower and its private creditors will negotiate in good faith on a debt restructuring plan. The first two criteria replicate the first two criteria of the 1989 policy, while the third criterion was intended to address specific concerns with regard to bond restructuring. Second, Directors decided that the Fund should be willing to lend into nonsovereign arrears arising from the imposition of exchange controls. This lending would also be on a case–by–case basis, with the intent to provide early support only where (i) the member was pursuing appropriate policies and making a good faith effort to facilitate a collaborative agreement between private debtors and their creditors; (ii) financial stability was not likely to be undermined by widespread creditor litigation; and (iii) a good prospect existed for the early removal of the exchange controls.

The 1998 modifications to the Fund's policy on external payments arrears were an adaptation of existing policies to changing circumstances in the international financial system, and were intended to support the Fund in the pursuit of its twin objectives in this area: the promotion of effective balance of payments adjustment, while providing adequate safeguards for Fund resources. However, in the context of the Board's consideration of the Managing Director's report to the Fall 1998 meeting of the Interim Committee,[3] a concern was raised that the agreed formulation of the criteria relating to lending into sovereign arrears could provide creditors with a de facto veto over Fund lending, even in cases where the member's policies are deemed appropriate and early Fund support was seen as essential for the successful implementation of the member's adjustment program. This paper revisits the issue and concludes that in the sovereign case, the criteria may be too restrictive and could lead to

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[2]See the Chairman's Summing Up of Fund Involvement in the Debt Strategy, Executive Board Meeting 89/61, May 23, 1989, page 179, Selected Discussions, Twenty Third Issue, IMF June 30, 1998.

[3]See www.imf.org/external/np/sec/pr/1998/pr9847.htm for the Communique from that meeting.

instances where creditors—particularly bondholders—could exercise a de facto veto over Fund lending. Separately, there is a question whether the criteria for lending into nonsovereign arrears stemming from the imposition of exchange restrictions are too restrictive, as they may not take adequate account of the possibility that, even when both creditors and debtors are willing to participate in collaborative negotiations, the process of debt reorganization may be protracted. Revisions to the criteria are suggested for both the sovereign and nonsovereign cases. The paper also discusses the possibility of an additional criterion in the nonsovereign case intended to protect creditors' interests during a period of nonpayment stemming from the imposition of exchange controls.

II

Issues relating to bonded debt

There is very limited modern experience with restructuring sovereign bonds, and it is difficult to predict how negotiations will unfold.[4] In circumstances before a member has fully lost access to capital markets, it may be possible to arrange for a voluntary exchange of instruments, and thereby avoid a default. Similarly, in circumstances in which the bonds in question are held by a relatively small group of homogeneous creditors disposed toward an orderly workout, it may be relatively straightforward to arrange for a restructuring. More generally, however, the legal and institutional framework governing bonds is significantly different from that governing commercial bank syndicated loans and is likely to complicate the task of reaching a negotiated settlement. This, in turn, would increase the probability that in extreme cases—when a member is facing severe balance of payments pressures after spontaneous access to capital markets has been lost—it may not be possible to reach a prompt agreement on a consensual restructuring, and a default may be unavoidable.

It is also difficult to predict the consequences of a default for the subsequent negotiations. Legal aspects of defaults on sovereign debt instruments, and their implications for debt restructuring, were discussed in a recent Board workshop. In short, the prospects for reaching agreement on a restructuring in a collaborative framework, and avoiding disorderly relations, with the potential for aggressive creditor litigation and a protracted stalemate, seem likely to depend on the particular circumstances of individual cases. Specifically, the process of negotiation is likely to be affected by the terms of the debt instruments subject to renegotiation and the composition of the creditor group.

As noted in a previous paper,[5] the process of achieving an orderly restructuring may be particularly difficult for members with significant debt in the form of American–style bonds, the most prevalent form of bonds issued by emerging market sovereigns. Such instruments do not include contractual provisions for qualified majorities to modify the terms of the bond and to impose such modifications on minority bondholders. Moreover, in the event of a default, the bonds provide few contractual limitations on the ability of individual bondholders to initiate, and benefit from, litigation both to obtain settlement of their claims through the attachment of assets and to apply pressure for a favorable settlement.

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[4]For a discussion of bond restructuring before a default, see Involving the Private Sector in Forestalling and Resolving the Financial Crisis, IMF Publication, April 15, 1999.

[5]Ibid.

In contrast, British–style bonds contain a number of features that may facilitate an orderly restructuring. There are two commonly used legal structures for British–style bonds: Trust Deeds and Fiscal Agency Agreements. Both include provisions for the debtors, bondholders, or the trustee (if applicable) to call bondholder meetings, and for a qualified majority of bondholders represented at the meeting to agree to a modification of the terms binding on all holders of the issue—regardless of whether they were represented at the meeting. Moreover, under Trust Deeds (but not Fiscal Agency Agreements), individual bondholders are generally prohibited from accelerating the bond and initiating litigation. Instead, any such action rests with the trustee, acting on the instructions of creditors holding a specified proportion of principal.

In contrast to the experience with syndicated bank loans, which were generally held within a relatively narrow range of banks, bonds may be held (and frequently traded) by a wide range of financial institutions, other institutional investors, and individuals. Bondholders may include investors with a wide range of appetites for risks and interests in orderly restructurings. While most would presumably be willing to participate in an orderly restructuring, there is a possibility that a minority may resort to disruptive tactics in order to obtain a favorable settlement from the debtor, or to be bought out by other creditors. Difficulties associated with dissident creditors are likely to be particularly pronounced in the case of American–style bonds. The contractual provision of British–style bonds, in contrast, reduces substantially the attractiveness of these instruments for investors seeking to use litigation to obtain a favorable settlement. (Unless individual investors hold a significant proportion of an issue, they would have no assurance that other creditors could not modify the terms of their instruments, thereby potentially eliminating the basis for litigation.)

A further complication concerns the role of fiduciary agents, who manage assets on behalf of investors holding the economic (or beneficial) interest. Such agents are likely to play an important part in the restructuring process, as many bonds involve one or more fiduciary relationships. With the development of the asset–backed securities market (in which bonds are repackaged with financial derivatives to create synthetic investment opportunities), the lender of record can be a special purpose entity with a fiduciary relationship with investors holding the asset–backed securities. Similarly, managers of pension and mutual funds have fiduciary responsibilities to their investors. Fiduciary agents have binding contractual obligations to protect investors' interests, and are also likely to be concerned with the impact of any debt restructuring on their professional reputations. These factors are likely to make agents very cautious, particularly in cases in which the holders of the economic interest are relatively unsophisticated investors, such as in the household sector. This could, at a minimum, introduce protracted delays into the negotiation process, and could even lead fiduciary agents to initiate litigation in order to protect themselves from civil suit. (For example, it is understood that the decision by a major investment bank to initiate litigation against Russian banks in respect of defaults on forward contracts reflected, in part, responsibilities stemming from its fiduciary relationships with the holders of the economic interests.)

Without contractual provisions to facilitate a coordinated restructuring in American–style bonds, and in the absence of mechanisms to limit the scope for potentially disruptive litigation by dissident creditors, there is a risk that there could be a failure of collective action, leading to the process of restructuring becoming disorderly and producing a stalemate in debtor–creditor relations. These difficulties could be compounded to the extent that there are significant holdings by so–called “vulture” creditors who specialize in extracting salvage value from distressed debt, or fiduciary agents who have limited scope for maneuver and are thus reluctant to strike a deal on the basis of their commercial judgment. Such difficulties could seriously complicate a member’s efforts to resolve its balance of payments problems. Moreover, until the member has reached voluntary agreement with all bondholders, it would remain vulnerable to the threat of litigation for an extended period.

Against this background, there is a question of how and under what circumstances the Fund can best achieve its objectives regarding promotion of effective balance of payments adjustment for members willing to undertake appropriate policies, while safeguarding the Fund’s resources.

III

Considerations on the Criteria for "Lending into Arrears"

Arrears on Sovereign Bonds

At first blush, it appears likely that in most cases private creditors would be willing to enter into negotiations with sovereign debtors following a default with a view to preserving the value of their assets. However, there is also the possibility that creditors may delay negotiations following a default for a variety of reasons. First, as alluded to above, the heterogeneity of the creditor base could result in coordination difficulties, complicating the task of assembling a representative creditor group. Second, the creditor base may include a large element that has no ongoing interest in the debtor. As a result, the incentives to negotiate, inter alia, in order to return the debtor to good standing in the international financial community may be less than for commercial bank creditors of the 1980s, who were generally seen as having a long–term business interest in the debtor country. Finally, given the magnitude of the financing potentially available to emerging market borrowers, the outcome for debtors of being shut out of the market is likely to be at least as serious, and possibly worse, than in the 1980s. This could lead creditors to raise their reservation price in any negotiations (i.e., they could be less disposed to reach a settlement).

If any combination of the factors discussed above were to prevail, and assuming that the member's policies were appropriate and Fund support was deemed essential to the adjustment effort, under the 1998 policy on lending into arrears on sovereign bonds, the Fund could, nonetheless, be precluded from lending since the second criterion (that negotiations between the member and its private creditors on a restructuring have begun) and the third criterion (that there are firm indications that the sovereign borrowers and its private creditors will negotiate in good faith on a debt restructuring plan) would not be fulfilled. While the factors discussed above would tend to delay a member's return to capital markets, they would not, in themselves, prevent the Fund from encouraging policy measures to bring about an adjustment in the member's balance of payments. Accordingly, in order to allow the Fund to support financially a member's adjustment efforts in such circumstances, consideration could be given to limiting the tests of efforts toward a negotiated settlement to actions on the part of the debtor by replacing criteria (ii) and (iii) with a test based upon assessments of whether the member is making good faith efforts to reach a collaborative agreement with its creditors.

Notwithstanding a member's good faith efforts, there is a risk that the accumulation of arrears to holders of international sovereign bonds would be accompanied by aggressive creditor litigation. In some cases such litigation, while a nuisance, would not in itself jeopardize financial stability. However, it is possible that in some cases widespread litigation might have a severe adverse impact on the member's adjustment program and prospects for regaining spontaneous access to international capital markets. This would erode the catalytic effect of any Fund involvement (particularly under successor arrangements) and could undermine the authorities' continued ability to implement adjustment programs. This, in turn, would raise serious concerns regarding the ability to obtain adequate financing assurances. Thus, even if the requirement that negotiations with creditors have begun were modified as suggested above, a question would remain as to whether early Fund involvement following a default on international bonds could in all cases serve to promote balance of payments adjustment, with necessary safeguards for the Fund's resources, as effectively as it has in the case of arrears to commercial banks. (These concerns would be of particular relevance in cases with debt structured as American–style instruments.) This issue could be addressed in the context of financing reviews, which would provide an opportunity to consider whether adequate safeguards remain in place for further use of Fund resources.

In light of the lack of experience in cases of sovereign bond default and how such a situation would evolve, it would be prudent to mention the provision requiring that all drawings by a member with sovereign arrears to private creditors be subject to financing reviews to bring developments to the attention of the Executive Board, providing an opportunity for the Board to consider whether adequate safeguards remain in place for further use of Fund resources in the member's circumstances.

Arrears on Nonsovereign Debt to Private Creditors Arising from the Imposition of Exchange Controls

In light of recent events, it is clear that a number of countries may still be potentially vulnerable to financial market developments that could lead to excessive pressure on the exchange rates and/or reserves. To attenuate the adverse impact of such pressure, the sovereign might be forced to prioritize the use of foreign exchange and undertake actions to help alleviate the crisis: that is, to impose or intensify exchange controls that, inter alia, limit the ability of the private sector to fulfill contractual obligations to make certain debt payments abroad, which would lead to the emergence of nonsovereign arrears.

As in the sovereign case, lending into arrears in such conditions using the criteria adopted in 1998 would be intended to allow the Fund to support a member's adjustment efforts during possibly protracted negotiations between debtors with creditors. Early Fund support for the implementation of adjustment programs would provide a needed source of financing while policies take hold in the face of a loss of spontaneous access to international capital markets. However, in addition to the issues that arise in the sovereign case, the problems of creditor coordination could be particularly severe in a complex environment in which some enterprises would have little difficulty in servicing debt, perhaps on a restructured basis, while others might require a more extensive debt reorganization (including, possibly, some combination of debt write–down and debt–equity conversion). Local bankruptcy systems, even if efficient, might be overwhelmed by the number of corporations needing to reorganize their debts. Moreover, the institutional capacity of domestic creditors (such as local banks) to participate in debt reorganizations is likely to be stretched thin. In such circumstances, it would be difficult to form a judgment regarding the third criterion adopted in 1998—that a good prospect existed for the early removal of the exchange controls—even in circumstances in which the member is implementing appropriate policies and is making good faith efforts to facilitate a collaborative agreement with creditors, and where creditors are willing to participate in such a collaborative process. However, the difficulties of resolving a complex situation, even if protracted, would not in themselves prevent the Fund from promoting effective balance of payments adjustment. Accordingly, this criterion—that a good prospect existed for the early removal of the exchange controls—appears to be too stringent, and could in the staff's view be eliminated without undue risk to the Fund. In addition, as in the sovereign case, drawings would be subject to timing reviews, which would provide the opportunity for assessment where adequate safeguards remain in place for further use of Fund resources.

With this change, the criteria for lending into sovereign arrears, and nonsovereign arrears stemming from the imposition of exchange controls, would be the same in substance except in one respect. In the sovereign cases, the member would be a party to the negotiations, and would be expected to be making good faith efforts to reach an agreement with creditors. In the nonsovereign cases, in contrast, the sovereign would not be a party to the negotiations. Instead, its role would be that of facilitating an agreement by, for example, specifying the terms of a restructuring under which foreign exchange could be made available to service restructured claims.

A question has been raised as to whether the existing criteria on Fund lending into nonsovereign arrears are sufficient to protect creditors' interests during the period that exchange controls are in force. In some instances, exchange controls are coupled with a prohibition on all payments to nonresidents, even those made in local currency to local accounts. Such exchange controls have the practical effect of preventing creditor actions to recover from debtors, which may give debtors an opportunity to resort to asset stripping, leaving little or nothing to settle creditors' claims once the controls are lifted. In the case of a bank, for example, asset stripping might take the form of loans to shareholders, made in the expectation that they would not be repaid. Indeed, such behavior on the part of debtors was reported to be widespread in a recent case of exchange controls. In the absence of a criterion to address this issue, the policy on Fund lending into nonsovereign arrears could be seen giving an unfair advantage to the private sector debtors, among other things potentially harming the medium–term reform of sound private sector borrowers to international markets.

In order to address this problem, consideration could be given to a requirement that exchange controls not be coupled with a prohibition on payments in local currency to nonresidents. Governments could be asked by the Fund to institute a mechanism requiring debtors to pay the requisite amount of debt service in local currency into blocked accounts with the central bank. To the extent that such payments had not been made by debtors, creditors would be free to use available legal remedies (in the debtors' home jurisdiction) to require debtors to make payments or to seek the protection of a bankruptcy court.

Against the background of variations in the institutional capacity among members to implement such arrangements, however, it would be difficult to specify as a criterion for lending into nonsovereign arrears the implementation of a specific mechanism designed to protect creditors' claims that would be robust across all cases. Instead, it would seem to be preferable for the Board to make an assessment, on a case–by–case basis, of whether appropriate steps had been taken to protect creditors' interests.

IV

Conclusions

In light of the discussion above, the staff proposes that the criteria for Fund lending into sovereign arrears on debts to bondholders and all other private creditors (including commercial banks) be modified as follows:

(i) prompt Fund support is considered essential for the successful implementation of the member's adjustment program; and

(ii) the member is pursuing appropriate policies and is making a good faith effort to reach a collaborative agreement with its creditors.

Also in light of the above, staff proposes that the criterion for lending into nonsovereign arrears stemming from the imposition of exchange controls be modified as follows:

(i) prompt Fund support is considered essential for the successful implementation of the member's adjustment program; and

(ii) the member is pursuing appropriate policies and is making a good faith effort to facilitate a collaborative agreement with creditors.

In both cases, all purchases by the member would, as provided at present, be subject to financing reviews to bring developments to the attention of the Executive Board, providing an opportunity for the Board to consider whether adequate safeguards remain in place for further use of Fund resources in the member's circumstances. Specifically, such reviews would provide an opportunity to assess whether or not a member's adjustment efforts are considered to be undermined by developments in creditor–debtor relations. Under this proposal, the only difference between the criteria for the sovereign and nonsovereign (exchange control) case relates to the role of the member. In the sovereign case, the member would be expected to reach a collaborative agreement with its creditors, while in the nonsovereign case the member would be expected only to facilitate collaborative agreements among debtors and creditors.