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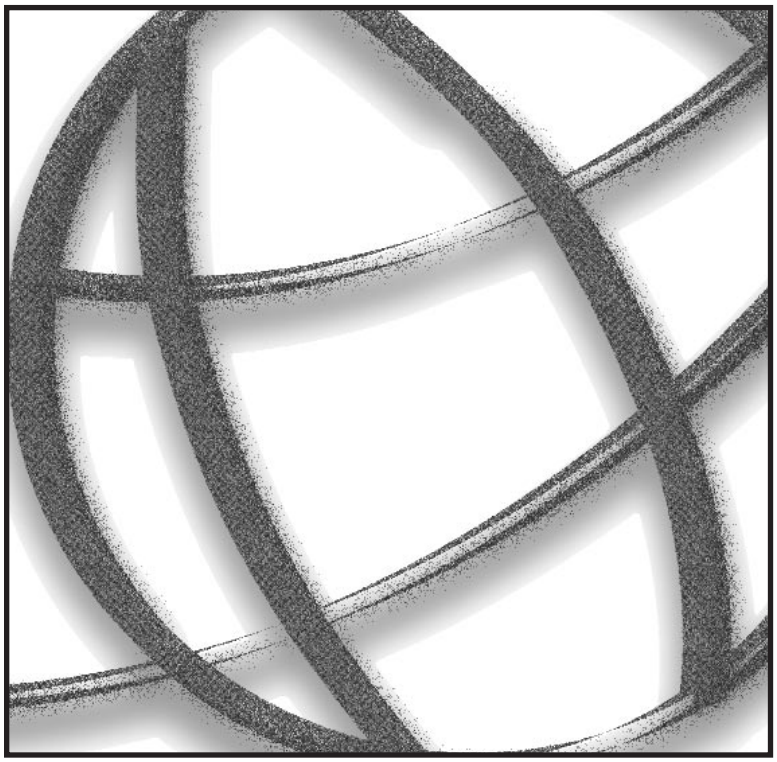
INVOLVING THE PRIVATE SECTOR

in

FORESTALLING AND RESOLVING FINANCIAL CRISES



Prepared by the Policy Development and Review Department

INTERNATIONAL MONETARY FUND

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Conventions

The following conventions have been used in this report:

... To indicate that data are not available;

— To indicate that the figure is zero or less than half the final digit shown or that the item does not exist;

– between years or months (for example, 1997–1998) to indicate a fiscal or financial year.

"Billion" means a thousand million; "trillion" means a thousand billion.

"Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

Minor discrepancies between constituent figures and totals are due to rounding.

As used in this report, the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

March 22, 1999

Summing Up by the Acting Chairman

Involving the Private Sector in Forestalling and Resolving Financial Crises—Further Considerations
Executive Board Meeting 99/28
March 17, 1999[1]

Executive Directors welcomed the opportunity to discuss further the important and complex issues associated with involving the private sector in forestalling and resolving financial crises.

Directors emphasized that recent crises have brought with them extensive economic dislocation, heightening the need for—and the rewards to—much stronger efforts at prevention. Nevertheless, crises will occur, and when they do, or when they threaten, the resulting uncertainty provides country authorities, and the international community more generally, with a difficult balancing of choices. While there are no easy answers, Directors agreed that more needs to be done to create incentives and instruments for the private sector to remain involved. A range of options in this area has been discussed in a number of fora, and some of the more promising options are becoming clearer. Directors agreed that there is no silver bullet to ensure that private creditors will participate fully in the resolution of financial crises, and that improvements in this area are likely to be evolutionary rather than revolutionary. They underscored, however, that neither the inherent complexity of the issues and the potential risks involved, nor the need to acquire additional experience, should hold back progress. Directors therefore broadly agreed that in those areas where consensus can be achieved and progress seems possible, the Fund should now move expeditiously and pragmatically to develop and implement workable options in areas of its purview, and national authorities and other fora should be encouraged to expedite their work on other options to move the process forward.

Looking at the experience of the past 18 months, Directors noted that the private sector has by no means escaped losses in the crisis countries. In some cases, exposures have been maintained, and private creditors have taken substantial losses on longer-term and illiquid claims. Yet, short-term capital flows remain the Achilles' heel of the international monetary system.

Prevention remains the key and is the primary responsibility of individual members working in collaboration with the Fund and the international community more generally. Directors noted that members' efforts should be aimed at improving both their macroeconomic and structural policies, and the environment for private sector risk assessment

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[1]The staff paper, "Involving the Private Sector in Forestalling and Resolving Financial Crises—Further Considerations," was discussed by the IMF Executive Board on March 17, 1999. This summing up represents the Acting Chairman's summary of the Board discussion.

and decision making by improving the flow of information and the regulatory environment. But prevention needs to be buttressed by measures designed and adapted ex ante to better ensure the involvement of the private sector in crisis avoidance or orderly resolution. In this regard, several Directors observed that, over the medium term, any effect of such measures reflected in higher interest rate spreads could well reflect greater efficiency and improved risk assessment in private capital markets.

Mechanisms are also needed for dealing with extreme situations when ex ante measures do not deliver the needed support and it is not possible to reach agreement on an orderly debt restructuring. In working to foster a system that produces more orderly adjustment, Directors stressed the principle that contracts should be honored. It is important for the efficient operation of markets that proposals to permit the modification of contracts ensure that both lenders and borrowers understand the rules of the system and abide by them and that in extreme circumstances cooperative solutions be sought to countries' financing problems.

Several Directors warned that care is required to ensure that solutions adopted to help avoid or resolve a crisis in one case do not have broader adverse effects that could potentially cause more difficulties than they solve. They noted that, for each member, this requires avoiding excessive damage to prospects for the resumption of market access following a crisis. For the international community as a whole, care must be taken to avoid actions in periods of stress that could have adverse systemic effects through contagion to other markets and longer-term effects in impeding international capital flows.

Prevention

Directors noted the importance of countries maintaining an appropriate debt structure, by avoiding the excessive accumulation of short-term debt, and by ensuring adequate levels of both official reserves and banking system liquidity, to help provide an orderly handling of a temporary reduction in capital market access. In this connection, they were encouraged that a number of countries are establishing systems for the high-frequency monitoring of private external liabilities. These systems can play an important role in allowing countries to better monitor short-term capital flows and provide early warnings of emerging difficulties. Directors urged the staff to continue its work in assisting members in this area.

Directors further underscored the importance of countries exercising appropriate restraint with respect to their own off-balance sheet transactions and taking account of financial entities' vulnerability to financial derivatives. Limiting the use of put options in sovereign debt instruments, and ensuring that appropriate action is taken in the context of supervision of banks' exposure to such instruments, should reduce the likelihood and/or the severity of financial crises. Directors encouraged the staff to give more attention to potential vulnerabilities associated with debt structures and financial derivatives in the context of both surveillance and the use of Fund resources. Transparency in the operations of a variety of financial intermediaries, such as hedge funds and investment banks, is also essential to help limit the size and volatility of short-term capital flows. Some Directors also supported recourse to market-based controls on capital inflows on a temporary, limited basis as a means

of addressing the volatility of short-term flows, but cautioned that this should be part of a broader package of appropriate adjustment measures.

Creditor Contacts

Directors highlighted the importance of maintaining effective communication between emerging market borrowers and private capital markets. Most Directors felt that such contacts have thus far proved their worth during periods of market stress in Latin America. In this regard, several Directors suggested that the Fund should seek to assist member countries in establishing regular communication with their creditors, including giving further consideration to the creation of creditor-debtor councils, with due attention to potential problems such as those of insider information. The Fund should also consider expanding its regular contacts with markets.

Proposals Regarding Interbank Credit Lines

Most Directors saw merit in proposals that reduce the perceived bias toward short-term interbank credit lines from industrial countries to emerging market banks.

Ex Ante Measures and Extreme Situations

Directors considered a number of specific proposals for involving the private sector. A few Directors considered that a number of these options could be among the criteria used for assessing members' eligibility for any facility in the Fund for the provision of contingent credit lines to member countries.

Private Contingent Credit Lines

Directors considered that there would be merit in the greater use of contingent lines of credit from the private sector that could be drawn on in times of difficulty. Many Directors noted that, if fairly priced, these mechanisms could provide efficient insurance against adverse market developments, including liquidity risk, and could contribute to effective burden sharing during periods of stress. At the same time, Directors recognized that, in complex financial markets, hedging strategies of private financial institutions could affect the additionality in private sector exposure associated with such arrangements. To the extent that banks implement such strategies for managing country and overall emerging market exposure, the activation of particular arrangements in times of crisis could lead to offsetting transactions with the country concerned and/or shift pressures to other markets. Nevertheless, Directors considered that, while care would need to be taken in their design, members should be encouraged to explore contingent credit lines with private financial institutions.

Call Options in Interbank Credit Lines

Directors also revisited the proposal to embed call options in interbank credit lines as a means of providing a contractual basis for an extension of maturities under specified conditions. Some Directors cautioned, however, that interbank credit lines often were a key

source of short-term liquidity for countries, and that concerns regarding the triggering of such options could lead to a loss of maturing short-term credit lines in advance of a call, thereby exacerbating liquidity difficulties. But some others felt that these instruments should be given further consideration as they could provide an important safety valve to address the volatility of short-term capital flows.

Debt Service Insurance

Directors saw merit in further study of the feasibility of using debt instruments, including structured notes, that generated a debt service burden that varies counter-cyclically against overall economic developments of the country. A few Directors noted that such instruments are more likely to be feasible for members that have highly concentrated exports (such as many oil or primary commodities exporters), where contracts can be linked mainly to exogenous developments and where there are counterparties willing to share the risks. Here, too, Directors encouraged the members to explore such instruments with their creditors.

Guarantees

Directors noted that a number of recent proposals for involving the private sector entail official enhancements of new debt through full or partial guarantees of new sovereign or private emerging market debt instruments by official creditors, including international financial institutions. Directors took note of the recent experience with such guarantees in encouraging private sector involvement. A few Directors believed that such guarantees held promise at times when market access is very limited, for example during the emergence from a crisis. Some other Directors, however, expressed concern about the effectiveness of guarantees. Directors noted that the World Bank has recently reviewed its experience with guarantees and has proposed a limited guarantee program, and they looked forward to a further assessment of the experience with policy-based guarantees at an appropriate point.

Concerted Rollovers of External Debt

Directors noted that short-term, cross-border interbank credit lines have been a source of particularly acute balance of payments pressures in a number of recent cases. Most Directors agreed that in the case of Korea, against the background of a hemorrhaging of official reserves and the prospect of an imminent default, the concerted rollover of short-term bank lines was successful in stabilizing a critical situation and facilitating a restructuring of interbank claims into sovereign guaranteed bonds. However, some Directors noted that Korea's success reflected some special circumstances, and could be difficult to replicate in other cases. Moreover, the impact of a sovereign guarantee on the restructured instruments could reduce the incentives for creditors to assess and manage risks. Some Directors underscored the danger that concerted operations in one case could lead creditors to withdraw credit lines in advance of a crisis elsewhere for fear of a concerted rollover. Several Directors stressed that concerted rollovers could be effective only when supported by appropriate adjustment policies deemed credible by markets. Directors were encouraged by the recent success of the Brazilian authorities in securing the agreement of international banks to maintain their exposure to Brazilian financial institutions. This agreement promises to provide

a steadying hand during a difficult period, and should enable Brazil to secure the necessary financing and return to normal creditor-debtor relations, without either a concerted rollover operation or sovereign guarantees of the rollovers.

Bankruptcy

Directors emphasized the importance of countries pressing ahead with efficient and effective bankruptcy procedures to facilitate orderly resolution of private sector insolvency.

Restructuring International Sovereign Bonds

Directors underscored that the question of whether or not, in the face of a severe liquidity crisis, sovereign bonds should be included in a comprehensive debt restructuring raises difficult issues, which would need to be considered on a case-by-case basis. Generally speaking, Directors saw a trade-off between the immediate cash flow relief associated with bond restructuring and the reduction over the medium term in the member's ability to mobilize resources from private creditors. They noted that, in recent years, there has been limited experience with restructuring sovereign bonds and similar instruments, and so it is difficult to predict how bond restructurings will unfold. Many Directors supported moving forward with the recommendations regarding the modification of bond contracts to include: sharing clauses; provisions for the modification of terms by qualified majorities; and collective representation provisions. A few Directors noted that British-style Trust Deed bonds contained such clauses and could serve as a useful model for future issues. While consideration was being given to this issue in other fora, little concrete progress had occurred to date; this suggests that some form of concerted action by major industrial countries to encourage emerging market borrowers to modify the terms of their new issues will be required. They considered that one approach would be to rely upon a combination of a demonstration effect, through the inclusion of the new contractual terms in international bond issues by G-10 sovereigns, and a coordinated regulatory requirement for new sovereign issues admitted to domestic markets to meet specified minimum conditions regarding contractual provisions. A concerted regulatory approach, intended to reflect systemic concerns, would go beyond the traditional role of security market regulators to protect investors. Some Directors also thought the Fund should encourage members to include such terms in bond issues, including in the context of the use of Fund resources. These steps could be complemented by efforts to build a consensus in support of these changes among the financial institutions involved in issuing and underwriting sovereign bonds.

Extreme Situations

With respect to extreme situations, the Fund's policies on lending into arrears to private creditors are being modified so as to permit, on a case-by-case basis and under well-defined conditions, early Fund support for a member's adjustment efforts during a possibly protracted period of good-faith negotiations following the emergence of arrears to private creditors. Certain issues remain to be resolved regarding the conditions under which

the Fund would proceed, and Directors will return to this at an early date. But in general, Directors reaffirmed their readiness to consider lending into arrears to private creditors where warranted.

Directors gave further consideration to the possibility that aggressive litigation by dissident creditors could block progress toward orderly restructuring of debt and challenge the Fund's ability to support a member's adjustment efforts. A number of Directors considered that the possibility of amending Article VIII, Section 2(b) so as to allow the Fund to sanction a temporary stay on creditor litigation warranted additional consideration. Other Directors saw little potential danger of creditors resorting to disruptive litigation on any significant scale, and were not persuaded by the need for an amendment or for consideration of other similar approaches. Directors will have an opportunity to return to these issues shortly in the context of an Executive Board workshop on legal issues associated with debt workouts.

Directors noted that the agenda for the future will require the broad support of the international community. In cases where actions fall mainly within the responsibility of the Fund, it will need to proceed expeditiously. Where authority lies elsewhere, the Fund should do what it can to assist in moving deliberations forward. In particular:

In the area of prevention

1. National authorities should intensify their efforts at prevention, including through maintaining an appropriate debt structure, and improving early warning systems.

2. Staff should continue to assist countries in establishing systems for the high frequency monitoring of private external liabilities, and intensify its surveillance over debt structures and financial derivatives.

3. Countries should maintain effective communication with private capital markets. The Fund also should consider expanding its regular contacts with markets.

4. Members are encouraged to support, on a fast track within the BCBS, measures to eliminate the bias in favor of short-term interbank credit lines.

As regards ex ante measures and extreme situations

1. Members should consider establishing contingent credit lines from commercial banks, while taking care in their design to reduce the risks that drawings on such facilities will lead to offsetting transactions in that or other markets.

2. Fund staff will continue its study of various instruments, including call options in interbank credit lines.

3. Members should explore with their creditors the possibility of debt instruments that efficiently and appropriately shift risk (including structured notes).

4. National authorities should move urgently to reach agreement on modification of bond contracts to include: sharing clauses; provisions for the modification of terms by qualified majorities; and collective representation provisions.

5. The Fund will return to its policies on lending into arrears to the private sector shortly. A number of Directors recommended that further consideration be given to whether and how to respond in the event that creditors were to block progress toward orderly restucturing of debt.

6. Further consideration is required of the handling of extreme situations.

Finally, while crises cannot be avoided, with progress in these areas the risk of future crises can be reduced and the dislocations associated with crises alleviated.

Preface

This paper was prepared by the staff of the International Monetary Fund, for consideration by the IMF's Executive Board in the context of its deliberations on the role of the private sector in forestalling and resolving financial crises. The views expressed in the main paper and the background paper are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities. The Board's views on this topic, as expressed at a March 17, 1999 meeting at which the staff's report was discussed, are highlighted in the summing up on the blue pages at the front of this report.

The paper was prepared by a staff team from the Policy Development and Review Department under the direction of Jack Boorman, Director, and Thomas Leddy and Mark Allen, Deputy Directors. The staff team comprised of Matthew Fisher (Chief of the Capital Accounts Issues Division), Robert Kahn, Timothy J. Bond, Joshua Charap, Paul Gruenwald, and Jens Nystedt.

The authors are grateful to numerous colleagues in the Fund for detailed comments on drafts of this paper. In particular, the authors wish to acknowledge the major contribution to the analysis of bond restructuring by Sean Hagan (Assistant General Counsel) and Richard Gordon (Senior Counsel), of the Fund's Legal Department. More generally, the analysis presented in the paper has been informed by informal discussions with commercial and investment banks, securities firms, central monetary authorities, and legal practitioners. The authors would also like to thank Lucia Buono, Julia Baca, and Maame Baiden for their dedicated help with word processing; and Angeliki Economopoulos for her essential contribution through research assistance. They also wish to thank Patricia Gillett-Lorusso for supporting research assistance, as well as the staff of the Capital Account Issues Division, which provided help and encouragement throughout the project.

I

Foreground

Involving the private sector in forestalling and resolving crises remains among the most difficult challenges being addressed in the continuing discussions of new architecture for the international financial system. Some degree of involvement of the private sector has been achieved in many of the recent crises countries. In some cases, exposures were maintained, and a breathing space was provided for policies to engineer a return of confidence. Creditors with long–term and illiquid claims, particularly on nonsovereign borrowers, and which as a group had no way to unwind their involvement, suffered losses.[1] Investors with claims on bankrupt enterprises received no special treatment. However, destabilizing outflows of short–term capital have proved to be the Achilles heel of official support efforts. In some cases, the outflows predominantly reflect domestic capital flight; in other cases, short–term claims of international banks have been at the heart of the problem.

Over the last 18 months, the international community has sought to involve the private sector in the resolution of the financial crises in emerging market economies by using various mechanisms, and by building on experience. In large part, the approach has relied on a combination of strengthened economic policies and official financing, designed to restore confidence in these economies and facilitate their return to market access. Additional steps were taken in individual cases to involve private creditors more directly. In Thailand, moral suasion on Japanese banks (having the largest bank claims on Thai borrowers and many with close ties to Thai corporations) helped stabilize the external environment in the early months of the program. Korea, with the support of moral suasion on foreign creditor banks by monetary authorities abroad, and with the offer of a sovereign guarantee, was ultimately successful in stabilizing a situation that had become critical, avoiding default on interbank lines, and facilitating a restructuring of the short–term interbank debt. In Indonesia, the focus was on providing a framework for private sector debtors and foreign private creditors to restructure corporate debts bilaterally on a voluntary basis, as well as maintaining trade and interbank exposure. In Ukraine, the IMF's involvement facilitated a voluntary refinancing of maturing international bonds in the context of securing financing for the program.

Efforts to better involve the private sector in crisis resolution are intended to serve a number of purposes. By reducing outflows that occur in the context of a member's programs, private sector involvement can make the adjustment process more orderly. Mechanisms for involving the private sector can also help to limit moral hazard and strengthen market

[1]The Institute of International Finance, for example, calculates potential losses in East Asia and Russia of about $240 billion for foreign equity investors, $60 billion for international banks, and $50 billion for other private foreign creditors. Such calculations, however, must be set against the backdrop of large gains in previous years, and a subsequent partial recovery.

discipline, and, in the process, help to increase the efficiency of international capital markets and the ability of emerging market borrowers to protect themselves against volatility and contagion.

Proposals for strengthening the international financial architecture to better involve the private sector in forestalling and resolving crises have been discussed extensively in a range of fora. In addition to IMF's the Executive Board, there have been discussions in the G–7, G–10, and G–22, and ideas have been advanced by national authorities, academicians, and market commentators.[2] This debate has highlighted the following central lessons:

- **There is no "silver bullet."** To date, satisfactory, practicable methods of better involving the private sector have proved elusive, and it has become increasingly apparent that there are no simple or easily available solutions that can ensure that private creditors, in the aggregate, will participate fully in the resolution of financial crises.

- **Prevention is key**. Efforts should be aimed at improving the environment for private sector risk assessment and decision making, improving the flow of information, implementing appropriate macroeconomic and structural policies, and ensuring the efficient pricing of short–term debt. Prevention needs to be buttressed by measures designed and adopted ex ante to better ensure the involvement of the private sector in orderly crisis avoidance or resolution. Mechanisms are also needed for dealing with *extreme situations*, when ex ante measures do not deliver the needed support, and a crisis results, forcing the country to consider some combination of a default on sovereign obligations and the imposition of exchange controls.

- **Contracts should be honored**. Although there has been a great deal of emphasis in discussions of the recent crises on the need to find ways of allowing debtors to delay or not to make scheduled payments at times of crisis, it is important for the efficient operation of markets that contracts be honored. This principle—that contracts be honored—is not one that can or should be given up. Accordingly, the need is to find ways of modifying contracts and the operation of the international system in a way that increases its efficiency while ensuring that both lenders and borrowers understand the rules of the system and abide by them—not to find ways to allow borrowers to abrogate contracts at their convenience, or to permit creditors to force adherence to contracts in situations of extreme stress.

[2]See, for example, IMF, "Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund," October 4, 1998 and April 16, 1998; "Report of the Managing Director to the Interim Committee: Strengthening the Architecture of the International Monetary System," October 1998; and "Summary of Reports on the International Financial Architecture" (October 1998).

- **Improvements in this area will be evolutionary rather than revolutionary**. However, there is an urgent need to move forward in a number of key areas that offer promise. With a dedicated effort, the risk of future crises can be reduced substantially; but where inflexible and inappropriate debt policies have left countries vulnerable to large external shocks, crises may be difficult to avoid with even the best policies.

- **Contagion is always a concern**. Care must be taken to ensure that the solutions adopted to help avoid or resolve a crisis in one case do not have broader adverse effects that could potentially cause more difficulties than they solve. For the country itself, this requires avoiding excessive damage to prospects for the resumption of market access following a crisis. For the international community, care must be taken to avoid actions in periods of stress that have adverse systemic effects, through contagion to other countries or other markets.

- **Some of the measures proposed to reduce vulnerability to crisis could have the effect of reducing lending, or increasing its cost, in normal times**. Many of the measures that have been proposed to facilitate private sector involvement in the resolution of crises would make it more difficult for investors to withdraw funds early in a crisis, and therefore are likely to reduce the willingness of private investors to lend to emerging market countries. Accordingly, the implementation of the measures discussed here may both reduce the rate of inflow of resources to emerging market countries in normal times and raise the spreads on liabilities of these countries. Such a change might reduce the gap between the social and private costs of borrowing.

- **Measures to resolve crises may instead cause them**. Measures that make it easier for borrowers to prevent the exit of lenders once a crisis is under way are likely also to make investors more sensitive to the possibility of being locked when a crisis occurs, and thus make them quicker to run in anticipation of one. Accordingly, measures that make it easier to deal with a crisis after it has occurred may increase the likelihood of a crisis. This is a risk against which all proposals need to be tested.

Table 1.1 provides a summary of the main proposals that have been made, many of which were discussed earlier in the IMF and in other fora and, for each proposal, the IMF Executive Board's view, progress to date, and needed actions. Although the proposals that were endorsed by the Board at that time generally retain the broad support of the international community, there has been very limited further development or implementation to date. In a few cases, decisions and actions fall mainly within the responsibility of the IMF. For others, however, authority to act lies mainly elsewhere, although the IMF can assist in moving deliberations forward.

Against this background, this report provides an interim assessment of the framework for involving the private sector in forestalling and resolving financial crises, with an eye to identifying practical approaches that are proving workable and where concrete actions by member countries, creditors, the IMF, and the international community as a whole could help

Table 1.1 Progress on Previously Identified Measures to Improve Private Sector Involvement in Forestalling and Resolving Financial Crises

Proposal	Action Required	IMF Executive Board's View	Progress to Date	Next Steps
Capital controls. Use market-based capital controls to raise cost of short-term capital.	Consensus on appropriateness of controls and whether to promulgate their use.	Mixed. Some Executive Directors saw a role for controls on inflows (speed bumps) in limiting vulnerability; others stressed distortion; controls on outflows generally opposed.	Debate continuing. Some countries (e.g., Chile, Turkey) have eased controls to stimulate short-term inflows.	Board consideration of forthcoming papers.
Raise cost of short-term cross-border capital flows (*Greenspan suggestions*).	Make capital requirements a function of type of funding; have monetary authority charge banks directly for existence of sovereign guarantee; and, on the lending side, assign higher risk weight to interbank lines under Basle Accord.	Believed that suggestions warranted consideration.	None.	Basle Committee on Banking Supervision.
Contingent credit lines (as in Argentina and Mexico).	Contract market-based contingent credit lines with commercial banks to trigger liquidity support in times of crisis.	Generally supportive, but noted that experience was not yet sufficient to form judgement.	None.	Official community—assess whether there is a role for official sector to support; Debtor countries—discuss with creditors.
Call options. Embed call options in interbank loan agreements.	Introduce ability of debtor to extend maturity of loans under pre-specified conditions.	Most Directors thought further consideration warranted, but noted perverse incentives.	None. Uncertainties remain as to design of trigger and pricing of proposed instruments. Concern about loss of liquidity.	None proposed.

Table 1.1 (concluded)

Creditor-debtor councils. Organize creditor-debtor councils to improve the flow of information.	Decision on desirability of such councils, and their composition.	Mixed. Directors considered it desirable to improve information flows, but noted risks including those relating to insider information.	None.	Proposals from Fund, G-10, IIF.
Bond covenants. Modify the terms of foreign sovereign bond contracts. G-10 proposal.	Introduce sharing clauses and majority decision rules to speed negotiation process and rein in potential rogue creditors. Introduced to market in concerted initiative by major industrial governments.	Directors supported the proposal, and encouraged industrial countries to introduce such terms in their own bond contracts.	None.	Concerted action by industrial creditor governments. Could perhaps build on endorsement by trade association of ideal clauses.
Sovereign arrears. Allow Fund to lend into sovereign arrears to private bondholders to support adjustment measures during negotiations.	Extend 1989 policy to allow Fund to lend into arrears to private bondholders.	Directors agreed to extend the 1989 policy on lending into arrears on a case-by-case basis.	Done.	
Nonsovereign arrears. Allow Fund to lend into nonsovereign arrears arising from the imposition of exchange controls, again to support adjustment measures during negotiations.	Extend further the 1989 policy to lend into nonsovereign arrears.	Directors considered that the Fund should be willing to lend into arrears under these circumstances, again on a case-by-case basis.	Done.	
Litigation stays. Impose stay on creditor litigation to facilitate orderly nonsovereign debt renegotiation.	Amend Article VIII, Section 2(b) to allow Fund to provide a means to impose a stay on enforcement of creditor claims.	Some Directors thought that amending Article VIII, Section 2(b) warranted further consideration; others did not see the need for such action.	None.	Board consideration of forthcoming papers.

make progress in the period ahead. The next provides a brief discussion of preventive measures, followed by an examination of the key proposals for involving the private sector in forestalling and resolving crises, highlighting the need to balance possible gains in times of crisis against the costs in terms of the efficient operation of markets in normal times and the risk of contagion. The next section presents some concluding remarks. The second part of the report provides more comprehensive background discussion of several key policy issues: (1) liability management, including the use of market innovations to provide a more flexible debt structure that is less vulnerable to disruption from external shocks; (2) external debt monitoring and concerted debt rollovers; (3) issues in restructuring international sovereign bonds; and (4) the role for official guarantees in catalyzing new money for emerging market borrowers.

Prevention

Prevention must continue to be the first line of defense against financial crises. As noted in previous papers,[3] this includes sound macroeconomic and regulatory policies; effective oversight of the domestic financial system; orderly sequencing of capital account liberalization; appropriate debt structures that reduce vulnerability to external shocks; and limiting implicit or explicit guarantees of the private sector in order to force a clearer recognition of the risks involved in particular actions. To this list, one could add, based on the experience over the past year, the importance of countries exercising appropriate restraint with respect to their off–balance–sheet transactions, and taking account of banks' vulnerability to financial derivatives. A full accounting of the risks would include both direct exposure resulting from derivative provisions in their own external debt instruments (whether held onshore or booked offshore), and also the extent to which the value of banks' claims on large corporate customers could be adversely affected by corporations' use of derivatives.

A critical element in prevention concerns the assessment of a country's vulnerability to shocks—either external or internal—that can threaten its external position. This is a major challenge facing the IMF and its emerging market members, in particular. The more so as the pace of development in financial systems highlights the importance of better monitoring of capital flows and updating analytical frameworks for vulnerability assessments to reflect the latest market practices. A number of countries that are not in crisis are starting to put in place systems for the high–frequency monitoring of private external liabilities, complementing existing systems for sovereign debt.[4] Originally developed in Korea as a tool to facilitate a

[3]See, for example, IMF, "Report of the Managing Director to the Interim Committee on Strengthening the Architecture of the International Monetary System," October 1998 (www.imf.org/external/np/omd/100198.htm).

[4]Such efforts have often focused on short–term external liabilities of domestic financial institutions; these liabilities are often particularly vulnerable to a loss of confidence, and can be

(continued...)

concerted rollover and restructuring of bank claims, such systems are intended to help authorities improve surveillance over short–term capital movements and to provide early warning of emerging problems.[5]

As a country's external financing situation worsens, the availability and terms of external financing also deteriorate. Examples include a shortening of maturities and increase in yield spreads on interbank and other cross–border credit lines, as well as a progressive loss of access to new financing across maturities. In a number of cases, these developments have been accompanied by a shortening of maturities and increases in yields in domestic government debt markets. To some extent, this reflects a normal market reaction to an increase in the perceived level of risk. But in some cases, these developments also have reflected contractual provisions embedded in debt instruments, such as put options, which allow creditors to demand early repayment of debt instruments, including in the face of deteriorating economic prospects.

The Asian crises, and more recently the cases of Moldova and Romania, have raised particular concerns about the impact on the balance of payments of put options in medium– and long–term debt instruments. A number of sovereign and nonsovereign borrowers—in the face of a total loss of access to international capital markets—have had to repay their medium– and long–term debts ahead of final maturity, following creditors' decisions to exercise put options. For 1999–2000, available data suggest that puts on sovereign and private external debt of emerging market borrowers amount to $32 billion, compared with scheduled bond redemptions of $89 billion during this period. In light of the significant source of balance of payments vulnerability posed by put options, particularly for a number of Asian markets and Brazil, IMF staff are giving attention to these issues in the context of both surveillance and the use of IMF resources. In addition to informing the policy dialogue, this is expected to help facilitate the examination of the consequences of adverse contingencies in balance of payments scenarios by explicitly allowing for the possibility that put options will be exercised en masse.

Limiting the use of put options in sovereign debt instruments, and ensuring that appropriate account is taken in the context of supervision of banks' exposure to such instruments, is likely to raise the interest rates paid by emerging market borrowers on their external borrowing. At the same time, however, this would likely reduce the likelihood or severity of financial crises by limiting the extent to which creditors can demand prepayment on medium– and long–term debt. Country authorities, in the context of risk management, need to

[4](...continued)
more easily monitored by the central bank, in its supervisory capacity, than foreign borrowings of corporations.

[5]The IMF is providing substantial technical assistance in this area, drawing on best practice and lessons from the recent crises.

balance the costs of higher up–front debt–service payments against decreased vulnerability over the medium to long term.

Clearly, the best insurance against the adverse effects arising from shocks to the availability and terms of external debt lies with prevention, including through maintaining an appropriate debt structure. Specifically, there is a need to avoid the excessive accumulation of short-term external indebtedness, and to ensure adequate levels of both official reserves and banking system liquidity to allow a temporary reduction in capital market access to be handled in an orderly fashion. A closely related point is the importance of avoiding excessive reliance on the use of short–term domestic debt instruments to finance (or refinance) ongoing fiscal deficits. Countries also should avoid an excessively rigid debt structure with too much senior debt, which could result, for example, from collateralizing debt instruments with export receivables. Further, there may be scope for greater diversification of risk. While such innovations may not provide an immediate solution, as market access is regained there may be scope for countries to enter into contractual arrangements to buy some form of insurance for the future, designed to counter the tendency for external financing to float with respect to economic developments. For example; such instruments could allow for lower payments, or the additional provision of liquidity from creditors, in the event of an exogenous adverse development, such as a shock to the price of a key commodity export.

Another element of prevention is effective communication between emerging market borrowers and private capital markets. Communication between a country and its creditors during normal periods can help build long–term business relationships and can provide a basis for constructive dialogue during periods of financial stress, thereby helping to ensure the sustained involvement of the private sector. Conversely, private investors who are not kept abreast of the authorities' thinking and are not given the opportunity to participate in informal exchanges of views regarding economic development and prospects are more likely to unwind their exposure during periods of heightened uncertainties. These contacts have thus far proved their worth during periods of market stress in Latin America.

In addition to better risk management by borrowers, there may be a case for coordinated action by the international community to improve the efficiency of international capital markets by closing the wedge between private and social short–term capital costs. One such approach—the ***Greenspan suggestions—***involves measures to impose greater discipline on the cross–border interbank market by addressing capital market bias towards short–term financing intermediated through the banking system.[6] This could be done on the debtor side by having the monetary authority charge banks directly for the existence of an implicit sovereign guarantee (for example through unrenumerated reserve requirements on interbank liabilities) or, on the lending side, by increasing the capital charge through the assignment of a higher risk

[6]These suggestions were first discussed in "Understanding Today's International Financial System," Remarks by Chairman Alan Greenspan before the 34th Annual Conference on Bank Structure and Competition of the Federal Reserve Bank of Chicago, May 7, 1998 (www.bog.frb.fed.us/boarddocs/speeches/1998/19980507.htm).

weight than under the Basle Capital Accord (currently 20 percent for short–term claims on banks). It appears this approach has broad support, but until now progress has not been made on it as a stand–alone proposal. An initiative in this area could be implemented within the context of a comprehensive reassessment of Basle treatment of credit risk. The Basle Committee on Banking Supervision (the Basle Committee) has a task force working on an accelerated timetable to revise the Basle Capital Accord and has made welcome progress. It is important that early consideration be given to this initiative and, if possible, to early implementation of proposals that can gather international support.

Measures to Facilitate the Private Sector's Involvement in Forestalling and Resolving Financing Crises

A number of recent proposals have focused on the potential for *ex ante measures* that can be designed and put in place before the event, which would help facilitate the orderly resolution of problems should they materialize. These relate, mainly, to the question whether it is possible to develop mechanisms that effectively precommit private sector participants to maintain or provide additional net exposure, or at a minimum reduce debt–service burdens, in times of crisis, while limiting moral hazard and the distortion to markets in normal times. Many of these proposals also speak to mechanisms for dealing with *extreme situations*. While there is clearly a need to make progress in some areas, all of the proposals have potential drawbacks or tradeoffs that need to be borne in mind. This section discusses the following proposals, in turn:

- **Contingent financing arrangements from commercial banks** that could be drawn on in times of difficulty;

- **Embedding call options in interbank lines** that, in principle, provide a contractual basis for an extension of maturities under specified conditions so as to help lock in private creditors;

- **Debt–service insurance** through the use of structured notes allows for the sharing of risk, by linking payment, or the issuance of new debt, to (mainly exogenous) economic developments;

- **Official enhancements of new debt**, and in particular the use of partial guarantees of balance of payments (nonproject) finance from multilateral and bilateral creditors to catalyze private sector exposure and help restore market access;

- **A concerted**[7] **rollover and restructuring of interbank lines** to provide a breathing space, which proved to be an effective means of stanching capital outflows in Korea;

- **Bankruptcy procedures for corporations** could help to improve the efficiency of capital markets by addressing the financial difficulties of individual corporations;

- **The modification of sovereign bond contracts** could make an important contribution to facilitating the orderly restructuring of new international sovereign bonds; and

- **In extreme cases, if efforts to reach voluntary restructurings fail, a default on sovereign obligations or the imposition of exchange controls leading to an interruption in nonsovereign debt service may be unavoidable**. The recent experience with Russia underscores the potential risks in terms of triggering massive capital flight and contagion to other markets. Moreover, defaults by borrowers with assets located in foreign jurisdiction could lead to extensive litigation that could both complicate the task of economic management and lead to a loss of asset value. However, a consensus has yet to emerge on either the need for or the feasibility of a mechanism for the international community to sanction both a temporary interruption of payments and a stay on creditor litigation.

The rest of this section provides a brief discussion of these issues. It is worth noting that the first three issues—contingent lines of credit, call options, and structured notes—all reflect efforts to use innovative financial instruments to produce a more flexible debt structure that is less vulnerable to disruption from external shocks. Many of the instruments discussed below already exist in the private sector; there is scope for sovereigns to explore their use in the context of heightened attention to risk management. A fuller treatment of these and other issues is presented in the second background part of this report.

Contingent Lines of Credit

As discussed in the first section of the background material, Argentina, Indonesia, and Mexico have arranged lines of credit with private banks that they can draw upon in the event of difficulties. Contingent financial arrangements are a form of private, market–based insurance: the debtor pays an insurance premium to compensate the writers of the option (the creditors) for the risks undertaken. Thus, if fairly priced, these mechanisms can provide efficient insurance against adverse market developments, including liquidity risk. Second, such

[7]Concerted, in this context, refers to the existence of a degree of moral suasion to encourage a cooperative outcome based on creditor–debtor consultations, but it does not involve central monetary authorities directly mandating lending actions of the banks.

contracts may contribute to effective burden sharing during periods of stress in that they involve the private sector in the provision of additional financing to help offset adverse developments in the external accounts. Further, such lines have been cited as a possible basis for discussions of involving the private sector, in the context of the proposed IMF contingent credit lines.

These contingent arrangements, which have taken different forms, all involve the payment of a regular commitment fee by debtors to creditors in exchange for opening and maintaining a credit line, with an "evergreen" clause to provide for renewal (generally with the consent of the lender). The Indonesian and Mexican lines were subsequently drawn. Although Mexico's drawing adhered strictly to the terms of the arrangement, Mexico's creditor banks argued against the drawing, contending that it was unnecessary, would hurt Mexico's creditworthiness, and would lead banks to reduce lending to Mexican corporate borrowers or other Latin American sovereign borrowers. In the event, yields initially rose 100 basis points after the drawing but quickly fell back to previous levels, and Mexico was able to successfully refinance the facility in March 1999. The Argentina line has not been drawn, but its existence may have helped to forestall market pressures.

It is premature to draw definitive conclusions from the limited recent instances when these arrangements have existed and have been utilized. It is unclear to what extent lenders would be prepared to provide this type of financing to a broader range of market participants, or how best to address concerns about moral hazard to the extent that the country can affect the conditions under which a credit line can be exercised. It has also not been demonstrated that such lines are cost effective compared with other funding sources. Perhaps for these reasons, the use of contingent lines for sovereigns has lagged the small, but rapidly growing, private market for catastrophic event risk, which has demonstrated the capacity for markets to shift large, exogenous risks through contingent lines of credit and derivatives to counterparties best willing or able to carry those risks. Nonetheless, contingent lines offer the potential for encouraging a degree of private sector participation through a market–based, risk–sharing mechanism. Emerging market countries should be encouraged to talk to their banks about the possibility of arranging such contingent financing mechanisms. To the extent that commercial banks are concerned about the drawing just ahead of a repricing, this could presumably be addressed through changes in the pricing clauses. If these lines are desirable, yet markets are not arranging them, there is a question whether the official sector has a role to play in supporting the use of such instruments.[8]

There is a question about the extent to which the activation of contingent credit lines would provide truly additional balance of payments financing during a crisis. If perceived as senior debt, contingent credit arrangements could partly crowd out other (more junior)

[8]One example of official support for contingent arrangements resulted when the World Bank, in November 1998, provided a contingent $500 million loan to Argentina to finance the purchase of collateral for margin calls. Argentina will draw on the loan if and only if the contingent arrangement with the banks is activated.

lenders. Further, the banks involved in extending credit lines may adopt dynamic hedging strategies, whereby they offset the increase in exposure associated with the line so as to leave overall exposure to the country (or possibly a group of similar emerging markets) unchanged. To the extent that banks do implement such strategies for managing country and overall emerging market exposure, the activation of such arrangements in times of crisis could lead to partially offsetting transactions with the country concerned, and export the pressures to other markets.

Call Options in Interbank Lines

Another mechanism that has received attention in the context of involving the private sector in crisis resolution is embedding call options in interbank credit lines that would provide a contractual basis for an extension of maturities under specified conditions. The objective would be to alter the terms of such loans with a view to allowing for the possibility of locking–in this type of financing at the discretion of the borrower under prespecified conditions. While similar to the contingent credit lines discussed above, in that such a mechanism would allow the debtor access to financing (in this case, in the form of extended maturities) negotiated ex ante, the modalities of such an instrument appear problematic. In particular, the design of a satisfactory trigger is elusive, and this does not augur well for pricing the instrument. Thus, the market in "modified" interbank loans could be very illiquid. Moreover, the uncertainties regarding whether the option would be exercised highlight concerns about "spooking" creditors. Indeed, there is concern that the announcement of discussion between a member country and the IMF could raise concerns regarding the triggering of the option, which could lead to a loss of maturing short–term lines in advance of a call, exacerbating liquidity difficulties. In short, the IMF could have a *negative* catalytic effect, undercutting the appeal of this mechanism given the central role of interbank lines in providing liquidity. Against this background, for the moment it does not appear that this proposal will yield a practical approach.

Debt–Service Insurance

A further possible use of derivatives would be to design debt instruments that generate a debt–service burden that varies countercyclically against overall economic developments. That is to say, instruments that provide insurance by having a debt–service burden higher in good times than in bad. Instruments that could be adapted to this purpose are commonly known as structured notes (see the first section of the background material). These are usually customized short– to medium–term instruments with a bullet redemption. Either the redemption value or the coupon—if any—can in principle be linked to movements in any currency, interest rate, asset or commodity price, or combination thereof. Clearly, it will only be possible to market instruments that float against the overall economic developments to the extent that the developments are credibly beyond the control of the authorities. By the same token, to make such insurance operational, the economic developments would need to be

objectively defined and independently measurable.[9] By way of example, there may be merit in countries that have highly concentrated exports (such as many oil or primary commodity exporters), exploring with their financial advisors the possibility of placing structured notes incorporating oil futures contracts, under which debt–service obligations would float against the world price of oil.

Official Enhancements of New Debt

A number of recent proposals involve full or partial guarantees (enhancements) of new sovereign or private emerging market debt instruments by official creditors, including international financial institutions (see the fourth section of the background material).[10] These guarantees are intended to leverage official capital, allowing a limited amount of official capital to support a larger amount of financing while lowering the costs of private financing for emerging market borrowers. The case for guarantees rests on their ability to help solve a market failure and allow for additional private sector exposure, at reasonable cost, for countries pursuing appropriate macroeconomic and structural policies. Such enhancements could be used on a limited scale at times when market access is very limited, as during crisis. In the current environment, this means enhancements could be used to help reestablish market access.[11]

There are questions, however, about the effectiveness of enhanced instruments in achieving these objectives; about the potential drawbacks of such instruments; and about their advantages relative to direct official lending. While official enhancements may help to mobilize additional finance for emerging markets, particularly at times normal market access is restricted, the question of "additionality" (defined broadly as a willingness of the private sector to accept additional unguaranteed exposure, or longer maturities, resulting in reduced risk premia) should be considered. Such enhancements raise issues concerning the possibility of excessive accumulation of inflexible debt and entanglement of public and private sector interests, creating new problems down the road. Moreover, there may be crowding out of direct official lending—an issue of some concern to borrowers, as enhanced instruments tend to be more expensive than direct official loans. In addition, borrowers may be concerned that the need to enhance new borrowing may adversely affect existing obligations and the

[9]The World Bank is actively considering a role as an intermediary in helping countries access commodity futures markets through structured instruments.

[10]Initiatives on new money should be distinguished from the use of official resources to provide collateral to facilitate the restructuring of existing debt, as under "Brady" operations.

[11]In certain situations, it may be worth distinguishing two different situations: in the context of a country without market access, to introduce the country to its creditors (overcoming market failure); and in restoring access after crisis. In both cases, the focus here is on balance of payments financing, rather than project financing.

possibility of future nonenhanced borrowing. Also, enhancements should not be used as a means of bypassing the conditionality associated with direct official lending.

These issues underscore the importance of care in the design of, and caution in the application of, guarantees, as well as the need to weigh the relative merits of guarantees versus direct lending. Against this background, and in response to shareholders' call for enhanced use of guarantees, the World Bank has reviewed its experience with guarantees and incorporated the lessons learned in its recent proposal to extend its existing partial credit guarantee instrument beyond project–based to policy–based guarantees (see Box 2.6 in the background material). This proposal recommends that the Bank proceed cautiously, with a pilot program of up to $2 billion in partial–credit guarantees, aimed selectively at good performers. This will allow, over time, a careful assessment of the effectiveness of the new guarantee structure. The design of any guarantee program developed by other official entities will face similar challenges.

External Debt Monitoring and Concerted Rollovers

Short–term interbank lines have been a source of particularly acute balance of payments pressures in a number of recent cases. This reflects the combination of the liquid character of the instruments, on the one hand, and the authorities' reluctance to allow banks to default for fear of a systemic banking system collapse, on the other. In the case of Korea, against the background of a hemorrhaging of official reserves and the prospect of an imminent default, the central monetary authorities in the principal financial centers decided to apply some degree of moral suasion on banks under their supervision to maintain their exposure, and to participate in a concerted restructuring (see the second section of the background material).[12] Any operation of this sort inevitably raises concerns about borrowers' willingness to adjust when moral suasion is a possibility, and about creditors withdrawing lines in advance of crisis elsewhere for fear of a concerted rollover. Nevertheless, the operation was successful in stabilizing a critical situation and allowing Korean financial institutions to avoid a default, and facilitating a restructuring of $21.8 billion of interbank claims into sovereign guaranteed bonds with maturities of one, two, and three years. In connection with the forceful implementation of adjustment policies, and an acceleration in the planned disbursement of official reserves, this helped pave the way for Korea's reentry to international capital markets in April 1998 with a $4 billion sovereign global bond issue, and a restoration of Korea's investment–grade credit rating in January 1999.

There are several reasons to believe that Korea's success reflected unique circumstances and would be difficult to replicate in other cases. First, Korea's restrictive capital account regime forced a high proportion of imported foreign savings to be channeled

[12]The monitoring also helped the Korean central bank to ensure that its foreign currency support to Korean commercial banks was replacing interbank lines that had been pulled during the crisis by international banks (resulting in severe liquidity problems for the banking system), rather than funding other investments or ongoing operations of the domestic banks.

through domestic banks. This facilitated coordination of creditors during the crisis and provided the assurance that, once the outflows from the banking system had been stanched, the capital account would be stabilized. Second, a low sovereign external debt burden meant that, in the face of the inevitable pressures to "nationalize" the debt, the extension of a sovereign guarantee in the context of the restructuring operation did not place an excessive burden on the sovereign (although it risks giving rise to moral hazard in future operations of Korean banks). Third, the Korean government did not have a need to roll over substantial maturities of domestic debt obligations, and the fiscal position was well contained. In contrast, where continuing fiscal deficits and adverse domestic debt dynamics exist, the effectiveness of a concerted rollover will depend critically on the effects on market confidence. To the extent to which the concerted rollover is seen as ensuring that the program is fully financed, and as being complementary to the forceful implementation of an ambitious adjustment program, the impact on the domestic debt market is likely to be favorable, and could pave the way for a combination of a spontaneous lengthening of maturities and reduction in interest rates. However, to the extent that a concerted rollover is seen as providing a substitute for appropriate macroeconomic policies, and is seen as presaging a unilateral restructuring of domestic debt instruments, there is a risk that it could severely complicate domestic debt management and make draconian policies unavoidable.

More generally, there are concerns about the systemic consequences of concerted rollover and restructuring operations, that suggest that their use should be limited strictly to cases in which a default is imminent. To the extent that foreign banks maintain country exposure limits, pressuring banks to maintain their exposure to financial institutions is likely to amplify pressures on the corporate sector, and thereby intensify the risks of economic dislocation. By the same token, to the extent that banks maintain regional exposure limits, concerted operations may tend to export the financial pressures to neighboring countries. These operations also raise concerns from the perspective of the stability of the international financial system. If used as a technique to "bail in" private creditors in the context of an IMF arrangement, in anything other than the most extreme circumstances in which a default is imminent, there is a serious danger that the market reaction to news that a country had initiated policy discussions with the IMF could be to trigger a run, as foreign banks attempt to unwind their exposure before getting caught up in a concerted rollover. Indeed, similar concerns may have contributed to the relatively low rollover rates for Brazil in October 1998, before the announcement of the details of the authorities' IMF–supported adjustment program.

Finally, supervisory authorities are likely to be reluctant to exert moral suasion over the commercial decisions of the banks under their supervision, except in the most extreme circumstances, and especially in the context of debtors that do not pose a systemic threat to national or international banking systems. By the same token, countries that emerged from protracted periods of difficult relations with their commercial bank creditors in the aftermath of the 1980s debt crisis are likely to be reluctant to reenter a period of concerted financing with their commercial bank creditors. Perhaps reflecting these considerations, the willingness to exert such pressure differs between creditor banks' country authorities.

While high–frequency debt–monitoring systems have to date been used primarily in countries facing crises, efforts are under way to strengthen established monitoring systems in a number of emerging markets. These efforts seek to improve surveillance over short–term capital movements and to provide early warning of developing problems. Implementing monitoring systems in emerging markets during normal times would help to avoid dangers of adverse market reaction to the implementation of such systems during periods of acute financial stress and provide the authorities on an ongoing basis with an additional tool to strengthen economic management in the context of closer integration with global capital markets.

Bankruptcy Procedures

Many studies have discussed the role of bankruptcy procedures in improving the efficiency of both domestic and international capital markets. They have also examined the ability of bankruptcy procedures in the borrowing countries to provide an effective mechanism for bailing in creditors who would otherwise be in a position to block a restructuring of an economically viable, but insolvent, corporation that was supported by the majority of creditors, thereby preserving both asset values and productive capacity. However, while bankruptcy is a powerful tool for addressing the financial difficulties of individual corporations during periods of relative tranquility, even efficient systems are likely to be rapidly overwhelmed in periods of widespread financial turmoil. In these cases, alternative informal mechanisms, such as the so–called London terms,[13] and the Jakarta initiative,[14] are likely to be required.

Restructuring International Sovereign Bonds

The sharp increase in emerging market bond financing in the 1990s has brought to the fore the question of involving private sector bondholders in crisis resolution. The difficulty of reaching agreement on a voluntary market–related bond restructuring is likely to be particularly acute for members with significant sovereign debt structured in the form of American–style international bonds, the most prevalent form of bonds issued by emerging market sovereigns (see the third section of the background material). Such instruments do not include contractual provisions for qualified majorities to modify the terms of the bond—and to impose such modifications of minority bondholders. Moreover, in the event of a default, the bonds provide few contractual limitations on the ability of individual bondholders to initiate,

[13]Under the "London Approach," developed by the Bank of England, authorities lend their good offices to set in motion a restructuring process, the success of which will rely on adherence to certain collective action principles, none of which are legally binding.

[14]The Jakarta Initiative provided a legal and regulatory framework (supported by coordinating task force) as a basis for *decentralized* corporate restructuring subject to an agreed set of basic principles.

and benefit from, litigation, both to obtain settlement of their claims through the attachment of assets and to apply pressure for a favorable settlement. In contrast, British–style bonds[15] contain a number of important features that may facilitate an orderly restructuring.

The question of whether, in the face of a severe liquidity crisis, sovereign bonds should be included in a comprehensive debt restructuring raises difficult issues, that would need to be considered on a case–by–case basis. In general, countries and official creditors will face a tradeoff between the immediate cash–flow relief associated with a bond restructuring, and the reduction over the medium term in the member's ability to mobilize resources from private creditors. This decision has all the concomitant implications for the prospects for economic growth, on the one hand, and the country's reliance on financing from official sources, on the other. Although, in most situations, it will be difficult to come to firm judgments in the midst of a crisis, a number of policy cases could be considered. For countries that are generally considered to be uncreditworthy and that have limited prospects for regaining market access—even with forceful implementation of adjustment measures—the medium–term cost of a bond restructuring may be small. However, for countries with strong medium–term prospects, the impact on future market access of a restructuring may be substantial. In all cases, the country must balance these assessments against the potential scope for additional adjustment, and the availability of financing from official sources. A further consideration concerns the risk of contagion, specifically, the risk that the restructuring of the international bonds of one emerging market sovereign borrower could lead to an interruption, possibly abrupt, in the market access of a range of other emerging market borrowers.

The aftermath of the August 1998 Russian crisis has highlighted the potential role of fiduciary agents in bond restructurings. Fiduciary agents manage assets on behalf of investors who hold the economic interest in the assets (but are not the lenders of record), and they have binding contractual obligations to protect investors' interests. In many cases, fiduciary agents may consider that they have limited room for maneuver in negotiations as a result of their potential liability to investors in respect of legal suits for civil damages. Experience with nonsovereign debt restructuring suggests that when the number of investors is small, it may be possible to reach an agreement directly with the investors, who would then instruct the fiduciary agent to act on their behalf. By the same token, however, when the economic interest is widely dispersed, fiduciary agents—who would have no choice other than to act without instructions—may tend to be very cautious, thereby introducing protracted delays in reaching agreement.

[15]British–style bonds contain provisions for bondholders to more easily bind in dissident creditors through the modification of terms by qualified majorities. In addition, Trust Deed British–style bonds include prohibitions on the ability of individual bondholders to accelerate bonds and initiate litigation. Instead, litigation must be conducted by the trustee; any resources recovered must be shared with all holders of the issue, thereby imposing a de facto sharing clause.

In recent years there has been limited experience with restructuring sovereign bonds and similar instruments. While it is premature to draw firm conclusions, three points may be noted: (1) only in a few cases (Nigeria, Panama) were instruments restructured that had been in arrears for sustained periods, and the unique circumstances in these cases provide little comfort that litigation can be avoided; (2) in none of the cases were debtors able to secure any debt or debt–service reduction; and, (3) in the recent examples it proved to be substantially more difficult to secure agreement on a substantial extension of maturities, with relatively low spreads and modest up front payments, than was the case during the 1980s. Indeed, in the case of Ukraine, reaching a voluntary agreement on a bond renegotiation entailed substantial up–front cash payments, with the balance restructured on short maturities with very high spreads. To the extent that this reflects the increased diversity among creditors, and their greater financial and legal sophistication, this may become more typical in future restructurings.

To the extent that future experience with bond restructuring tends to demonstrate that the contractual provisions of British–style bonds make a significant practical difference to the ease of bond restructuring, it appears likely that British–style bonds will come to be viewed by markets as subordinated to American–style bonds, particularly for less creditworthy borrowers, with obvious implications for the pricing and composition of new bond placements. This underscores the importance of moving forward with the G–10 Deputies' recommendations regarding the modification of bond contracts to include sharing clauses, modification of terms by qualified majorities, and collective representation provisions. If adopted, these changes would, in a number of important respects, produce instruments similar to British–style Trustee Deed bonds. To date, however, little movement has occurred; a wide range of emerging market borrowers continue to place American–style instruments.

Thus, progress will require efforts to encourage emerging market borrowers to modify the terms of their new issues and some form of concerted action by G–10 countries. One approach would be to rely on a combination of a demonstration effect, through the inclusion of the new contractual terms in concerted international bond issues by G–10 sovereigns;[16] and a concerted regulatory requirement for new sovereign issues admitted to domestic markets to meet specified minimum conditions regarding contractual provisions. A concerted regulatory approach, intended to reflect systemic concerns, would go beyond the traditional role of security market regulators to protect investors. These steps could be complemented by efforts to build a consensus in support of these changes among financial institutions involved in issuing and underwriting sovereign bonds.

While the modification of bond terms could, over time, make a significant contribution to facilitating orderly workouts, the initial impact would be limited, since it would apply to the *flow* of new placements but would not affect the outstanding *stock* of bonds. At the same

[16]Because several G–10 countries are not currently active in international markets, this could require bond placements beyond their normal funding program. The creditworthiness of the countries concerned suggests that cost—in terms of additional spread—would be negligible.

time, to the extent that the modification of bond terms is seen as increasing the likelihood that they could be restructured in a future crisis, it may have the effect of increasing spreads and limiting access, particularly for less creditworthy borrowers. By strengthening incentives for creditors to manage and assess risk, on the one hand, and for debtors to implement policies designed to strengthen their creditworthiness, on the other, this could have a beneficial impact on the operation of global capital markets.

Extreme Situations

In extreme situations, if ex ante mechanisms put in place fail to deliver the needed support in sufficient amounts or if efforts to reach agreement on a voluntary debt restructuring fail, and pressures in the external accounts do not abate, countries may need to consider some combination of a default on sovereign bonds and the imposition of exchange controls that would lead to an interruption in the ability of nonsovereigns to service their external debts. The IMF's policies on arrears and financing assurances have been modified so as to permit, on a case–by–case basis, early IMF support for a member's adjustment efforts during the possibly protracted period of negotiations, by lending into arrears.

Sovereign Bond Default

In the event that it is not possible to restructure bonds, and the country has sufficient reserves to cover the scheduled payments, it would face the choice between making the payments and defaulting. A number of issues have a bearing on this choice.

- **The impact on reserves of making the payment**, and the willingness of official creditors to provide support to allow bondholders to receive principal payments.

- **The impact of a payment on the authorities' credibility**. If the authorities step back from the brink and avoid a default in one case, it may be more difficult in any subsequent debt negotiations to use the threat of default to bring about agreement on a restructuring. Conversely, the threat of default may reduce the positive reputation effects arising from eventual repayment.[17]

[17]Standard and Poor's published a report highlighting the possibility of Pakistan defaulting on its international bonds, as a result of comparability of treatment requirements from the Paris Club, and examined the effects on Pakistan's upcoming negotiations with its private creditors ("Paris Club Agreement Raises Probability of Default on Sovereign Bonds", S&P Credit Week, (02/15/99)). To the extent that this report leads bondholders to consider that in the absence of a restructuring Pakistan would default, this may increase their willingness to participate in a voluntary restructuring.

- **Whether default would expose the member to litigation by creditors holding distressed debt** (including instruments on which payments had been missed, as well as those on which cross default clauses have been triggered). Clearly, this will depend on the volume of relevant claims and the contractual provisions of the instruments (including, for example, whether the instruments are American–style or British–style bonds; and whether the immunity of attachment of the central bank's official reserves have been waived). The cost of a default to the member will also depend on whether the authorities are planning new capital market operations (such as privatization) that could potentially be disrupted (or severely complicated) by litigation.

- **The impact on confidence in domestic financial markets**, and the question of whether a default on international sovereign bonds would be seen as presaging a more extensive interruption in creditor–debtor relations (for example, through a unilateral restructuring of domestic liabilities) and a weakening of the authorities' commitment to maintain the existing degree of capital account convertibility. If so, a default could trigger capital flight. By the same token, there is also a question of whether the depletion of reserves resulting from making the payment would also erode confidence and trigger capital flight.

- **The medium–term impact of a default on a country's access to capital markets**. While it is difficult to predict how events would unfold after a default, experience with commercial bank lending in the 1980s suggests that market access would not be fully restored until a final settlement has been achieved with bondholders and the country has rebuilt its track record of creditworthiness. This may be reinforced by the existence of creditor remedies that would allow creditors holding distressed debt to try to attach the proceeds of any new capital market borrowing. Such litigation would presumably cut off any recovery in market access and would be intended to apply pressure for a favorable settlement.

- **The dangers of contagion**, and the concerns that a default by one country could have adverse effects on capital market access by a wide range of other emerging market borrowers.

Imposition of Exchange Controls

A comprehensive discussion of the likely consequences of the imposition of exchange controls and the unilateral restructuring of domestic sovereign debt in crisis is beyond the scope of this report. It may be noted, however, that in the case of Russia, the combination of the imposition of controls, the unilateral restructuring of domestic debt, and the floating of the ruble intensified a crisis of confidence and massive capital flight, while leading to severe contagion across a wide range of other emerging markets. It is understood that Russian corporations with assets located abroad continued to service their obligations. (Informal market contacts suggest that, in many cases, this reflected creditors' liens on export

receivables, which protect the payments capacity from the effect of exchange controls.) At the same time, a number of Russian commercial banks were subject to litigation to recover missed payments in respect to forward contracts. Finally, creditors holding distressed domestic debt instruments (GKOs and OFZs) have not initiated litigation in foreign jurisdictions. One potentially important development, which had not been anticipated in earlier studies, is the possibility being explored by a major investment bank of seeking restitution under the provisions of a Bilateral Investment Treaty between the Russian Federation and the United Kingdom.

Temporary Stays on Creditor Litigation

There is a question regarding the ways that the international community could position itself to respond in the event that aggressive litigation by dissident creditors were to block progress toward orderly restructurings of debt, and to challenge the IMF's ability to support a member's adjustment efforts. Specifically, earlier discussions have examined the possibility of amending Article VIII, Section 2(b) of the IMF's Article of Agreement so as to allow the IMF to sanction a temporary stay on creditor litigation. Such a stay would not permanently affect creditors' rights; rather, it would force dissident litigants to exercise the forbearance traditionally exercised by commercial bank creditors.

Would a temporary stay help to encourage an orderly renegotiation process? Legal mechanisms that give temporary stays on litigation against private sector entities have facilitated the restructuring of private debt. In some cases, creditors have recognized that litigation would not be cost–effective because it would result in a borrower's seeking the protection of a bankruptcy court, and debts (including junk bonds) have been restructured without the activation of bankruptcy procedures. By the same token, the availability of a mechanism to enforce a temporary stay on litigation with respect to sovereign bonds could discourage disorderly behavior, possibly without the need to activate the mechanism, and could thereby facilitate the orderly restructuring of such bonds.[18] A temporary stay would presumably diminish the attractiveness of distressed debt to secondary market "vulture" companies and therefore increase the likelihood that the claims would be held by

[18]The imposition of a temporary stay should have no operational impact on the renegotiation of the claims of official bilateral creditors. Such negotiations are held under the auspices of the Paris Club or are conducted bilaterally. This is generally an orderly process that has stayed out of the courts. Suspending official creditors' ability to seek legal remedies is therefore unlikely to have any practical effect. By the same token, the effect on commercial bank renegotiations would be limited to preventing the few instances of small rogue creditors seeking redress through litigation. Because such litigation is rare, a suspension of creditors' ability to seek legal remedies would likely have little effect on the conduct of negotiations. A stay would also have no effect on creditors' positions regarding domestic sovereign bonds, which typically do not provide legal remedies in the event of a default.

creditors interested in orderly workouts. By the same token, a temporary stay would avoid any danger that fiduciary agents managing assets would initiate litigation in order to protect themselves against legal suits for civil damages.

The adoption of a mechanism to limit the ability of creditors to enforce their contractual claims would be a major step, and would need to be subject to safeguards. Moreover, to ensure that it could be used only in extreme situations, consideration could be given to requiring that the decision be taken by a qualified majority in excess of 50 percent of the voting power. In addition, consideration could be given to adopting a cutoff date for the stay, to preserve the contractual rights of creditors on loans committed after a specified date, so as to preserve access to new financing during the IMF–supported adjustment program.

In the context of a stay on litigation against a sovereign, protecting the interests of creditors, by assuring that the stay was being used to provide breathing room for adjustment measures to take hold (rather than allowing a postponement of adjustment) could be provided by standard conditionality under an IMF program. In contrast, however, mechanisms would need to be developed to ensure that a stay on litigation against nonsovereign debtors provided adequate protection for creditors, and did not facilitate asset stripping by debtors. A consensus has yet to emerge on either the need for, or feasibility of, an amendment to the IMF's Article VIII, Section 2(b).

Concluding Observations

The crises experienced over the past 18 months have caused extensive economic dislocation; future crises are also likely to impose substantial economic losses. They must be avoided if at all possible, by the means mentioned above. But if crises do occur, there will be difficult choices: In the midst of the crisis, it is generally not possible to determine whether the international community is dealing with a case that can be resolved through a combination of policy adjustment and some official money, which would lead to a spontaneous return to capital markets, or whether a more innovative or concerted approach is required. This uncertainty provides the authorities, and the international community more generally, with a difficult balancing of choices at a time when events threaten to outpace the ability of the authorities to act. It is critical that the IMF retain a catalytic role in helping its member countries to mobilize financing in support of their adjustment efforts. Nevertheless, part of the balancing act is in the determination of how much official support should be provided, and the extent to which the private sector should be expected to participate. A number of factors have a bearing on this issue.

First, over the past 18 months, the international community has achieved some degree of involvement of the private sector in the affected crisis countries. In large part, the approach has relied on a combination of strengthened economic policies and official financing. In addition, in certain instances moral suasion by the international community, or IMF involvement in negotiations, has assisted in securing adequate financing for the program or in stemming a run. As a result of these cooperative efforts, exposures have been

maintained, and some burden sharing achieved. But destabilizing outflows of short–term capital remain a central challenge.

Second, the absence of a "silver bullet" underscores the difficulty in formulating measures for resolving crisis that do not have counterproductive effects, either during the crisis or during the normal operations of markets. Many of the proposals that have been made raise substantial concerns about their effectiveness and their systemic, longer–term costs. Thus, changes to the international financial architecture in this area will be evolutionary rather than revolutionary; nevertheless, they are necessary.

Third, prevention is key to any effective effort to involve the private sector. The Asian and Russian crises have highlighted the critical role of inappropriate macroeconomic and exchange rate policies; ad hoc approaches to capital account liberalization; financial system weaknesses; and debt stocks that leave sovereigns and financial systems excessively exposed both to shorter maturities and to financial derivatives. Reducing vulnerabilities associated with domestic and external liabilities will not only take time, but may also require some combination of a strengthening of macroeconomic fundamentals and of financial sector institutions and the supervisory process, and a reduction in capital market turbulence.

Fourth, contagion may be extensive and may complicate choices elsewhere in the world. Care must be taken to ensure that the solutions adopted to help avoid or resolve a crisis in one case do not have broader adverse effects that could cause more difficulties than they solve. For the country itself, this requires avoiding excessive damage to prospects for the resumption of market access following a crisis. For the international community, care must be taken to avoid actions in periods of stress that have adverse systemic effects, through contagion to other markets. To the extent that measures to address contagion raise the cost of capital to emerging markets in normal times, it could make markets more efficient by offsetting distortions that have lead to excessive lending; in contrast, contagion may cause crises where none would have existed.

Fifth, there are a number of ex ante proposals that appear to be promising and should be pursued as a matter of urgency.

- There is a need for the Basle Committee to complete its work associated with the Greenspan proposals expeditiously, so as to eliminate a tendency for financial institutions to rely excessively on short–term liabilities.

- There is a need for G–10 and other countries to take concerted action to encourage the modification of bonds placed by emerging market borrowers. The G–7 has called for agreement on a strategy for introducing such modifications by the time of the Cologne Summit.

- There is a need for emerging market countries to explore with private financial institutions the possibility of obtaining contractual arrangements to ensure that

financing floats against economic developments. Specifically; countries should explore the possibility of arranging contingency financing facilities, and countries with heavily concentrated exports should explore the possibility of linking debt–service obligations to commodity prices.

- There is a need for rapid progress with the ambitious agenda regarding standards and transparency, so as to improve the environment of efficient private sector decision making.

- There is a need to strengthen efforts to ensure effective communication between debtors and creditors, which would help to build relationships in normal times and deal with periods of market stress.

- There is a need for countries to strengthen debt monitoring *in advance of crisis.* This can play a critical role in allowing countries to monitor short–term capital movements and provide early warnings of emerging difficulties.

- Finally, there is a need to ensure that in crises, if countries are forced to default on sovereign obligations or to impose exchange controls, aggressive creditor litigation does not block efforts to arrange orderly debt restructuring or challenge the IMF's ability to promote effective balance of payments adjustment. Further consideration needs to be given to the possibility of adopting a mechanism to allow the official community a temporary stay on creditor litigation, possibly through an amendment to Article VIII, Section 2(b) of the IMF's Articles of Agreement.

This agenda for the future has the broad support of the international community. However, there has been very limited further development or implementation to date. In a few cases, decisions and actions fall mainly within the responsibility of the IMF. For others, however, authority to act lies mainly elsewhere, although the IMF can assist in moving deliberations forward. Although crisis cannot be avoided, with progress in these areas, the risk of future crises can be reduced, and the dislocations associated with crisis alleviated.

II

Background

This part of the report contains four sections that provide additional analytical material in support of the discussion in the foreground material. The objective is to provide stand–alone analysis on issues of key importance, and where recent developments have implications for involving the private sector in forestalling and resolving crises. To this end, there is a certain amount of repetition of material presented earlier.

Managing Risk and Liquidity in Volatile Emerging Debt Markets

International financial crises have highlighted a tendency for developments in countries' access to both international and domestic capital markets to amplify balance of payments pressures, and to complicate the task of macroeconomic management. In short, there is a tendency for the availability and terms of financing to "float" with respect to economic developments. Examples include a shortening of maturities and increase in spreads on interbank and other cross–border credit lines, as well as a progressive loss of access to new financing across maturities.[19] In a number of cases, these developments have been accompanied by a shortening of maturities and increases in yields in domestic government debt markets. To some extent, this reflects a normal market reaction to an increase in the perceived level of risk. But in some cases these developments also reflected contractual provisions embedded in debt instruments, such as put options, that allow creditors to demand early repayment of loan principal in the face of deteriorating economic prospects. This suggests that there may be scope for countries to enter into contractual arrangements to buy some form of insurance designed to counter the tendency for external financing to float with respect to economic developments.

Clearly, the best insurance against the adverse effects arising from the tendency for the availability and terms of external debt to float with economic developments lies with prevention. Specifically, there is a need to avoid the excessive accumulation of short-term external and domestic indebtedness, particularly by the sovereign and the financial system, as well as a need to ensure adequate levels of both official reserves and banking system liquidity to allow a temporary reduction in capital market access to be handled in an orderly fashion. In a similar vein, it is important for banking supervision to take full account of banks' vulnerability to financial derivatives, both directly through the inclusion of such provisions in their own external debt instruments, and indirectly through the inclusion of such provisions in

[19]By way of example, in late 1997 and early 1998, interbank exposure to Korean financial institutions progressively shifted toward overnight rollovers, while spreads increased from a precrisis level of around 40–60 basis points to around 500 basis points.

the external debt instruments of their corporate customers. Beyond prevention, however, there may be scope for greater diversification of risk heading out of a crisis as market access is regained.

The rest of this background material is organized as follows. The next section provides a discussion of put options, followed by a brief discussion of considerations about private sector contingent financing arrangements. A final section provides a preliminary examination of the possibility of using derivative products in tandem with debt instruments to buy insurance and ease debt–service burdens during periods of balance of payments difficulties.

Embedding Derivatives in Debt Contracts

Put Options

Experience during the Asian crisis, and more recently with Moldova and Romania, has raised concerns regarding the impact on the balance of payments of put options in medium– and long–term debt instruments. A number of sovereign and nonsovereign borrowers—in the face of a total loss of access to international capital markets—have had to repay their medium– and long–term debts ahead of final maturity, following creditors' decision to exercise put options. Tables 2.1 and 2.2 provide an overview of outstanding identified put options in debt issued by sovereign and nonsovereign emerging market borrowers that matures by end–2000. (The figures cover only contractual puts, so called "hard puts"; issues associated with so called "soft puts" are discussed below.)

According to available public databases, debts in the form of bonds and loans with a face value of $32 billion are "putable" over the next two years. Of this, $20 billion is putable in 1999. Put options are concentrated in Asia ($23 billion through end–2000) and Brazil ($8 billion through end–2000[20]). Other large borrowers in international capital markets (including Argentina, Hungary, and Mexico) have made little, if any, use of put options. The majority of puts are nonsovereign; the use of puts on sovereign issues with a direct claim on the central bank's international reserves (defined here as central government plus state banks) are less than 10 percent of the total.

A large proportion of puts can be exercised at the sole discretion of individual creditors acting on their own claims. Such options are likely to be exercised when they are "in the money," that is in circumstances in which the secondary market price of the underlying debt instrument (identical in every respect except for the absence of a put option) is below the put price (usually par). This allows creditors wishing to maintain their exposure to relend the

[20]Figures from Brazilian databases point to a significantly higher value of puts, on the order of $19 billion. This highlights that public databases are not comprehensive with regard to private placements (for which prospectuses are not publicly available), and underscores the importance of the authorities' monitoring the exposure to these derivatives independently.

Table 2.1 Bonds That Can Be Put for Emerging Markets, 1999-2000 1/ 2/
(In millions of U.S. dollars)

	Sovereign		Nonsovereign		Total	
	1999	2000	1999	2000	1999	2000
China	0	0	310	250	310	250
Hong Kong SAR	0	0	773	1,869	773	1,869
Indonesia	165	30	668	100	833	130
India	0	0	240	0	240	0
Korea	500	0	2,657	829	3,157	829
Malaysia	0	650	855	225	855	875
Philippines	0	0	0	0	0	0
Singapore	0	0	0	30	0	30
Thailand	0	0	778	535	778	535
Vietnam	0	0	0	0	0	0
Total	665	680	6,281	3,837	6,946	4,517
Slovak Republic	0	0	0	0	0	0
Turkey	140	0	0	0	140	0
Total	140	0	0	0	140	0
Estonia	0	0	0	0	0	0
Kazakhstan	0	0	0	0	0	0
Russia	0	0	0	0	0	0
Total	0	0	0	0	0	0
Argentina	0	100	128	92	128	192
Brazil	0	0	4,186	1,891	4,186	1,891
Colombia	0	0	0	0	0	0
Panama	0	0	0	0	0	0
Uruguay	0	0	0	0	0	0
Total	0	100	4,314	1,983	4,314	2,083
Total	805	780	10,596	5,820	11,401	6,600

Sources: Bloomberg Financial Markets, LP; *Euromoney* Bondware; and IMF staff estimates.

1/ Sorted by first put date. Sovereign bonds consist of central government and public bank bonds. All others are nonsovereign. Report is based on sources indicated and covers part of the market.
2/ These databases report on a residence of issuer basis, and, consequently, in certain circumstances could include in one country's total, bonds issued by wholly owned subsidiaries of foreign financial institutions. This is particularly an issue in areas that serve as financial centers (e.g., Hong Kong SAR and Panama).

Table 2.2 Loans That Can Be Put for Emerging Markets, 1999-2000 1/ 2/
(In millions of U.S. dollars)

	Sovereign		Nonsovereign		Total	
	1999	2000	1999	2000	1999	2000
China	0	0	550	700	550	700
Hong Kong SAR	0	0	1,309	240	1,309	240
Indonesia	20	0	1,947	909	1,967	909
India	0	0	0	0	0	0
Korea	0	0	1,273	1,990	1,273	1,990
Malaysia	0	0	150	397	150	397
Philippines	0	0	75	0	75	0
Singapore	0	0	195	337	195	337
Thailand	0	0	1,313	367	1,313	367
Vietnam	30	0	62	50	92	50
Total	50	0	6,872	4,990	6,922	4,990
Slovak Republic	0	0	0	35	0	35
Turkey	150	0	190	40	340	40
Total	150	0	190	75	340	75
Estonia	0	0	74	0	74	0
Kazakhstan	50	0	0	0	50	0
Russia	105	0	250	0	355	0
Total	155	0	324	0	479	0
Argentina	0	0	245	0	245	0
Brazil	0	275	150	1,000	150	1,275
Colombia	0	0	0	0	0	0
Panama	0	0	100	0	100	0
Uruguay	0	0	0	0	0	0
Total	0	275	495	1,000	495	1,275
Total	355	275	7,881	6,065	8,236	6,340

Source: Bloomberg Financial Markets, LP; *Euromoney* Loanware; and IMF staff estimates.

1/ Sorted by first put date. Sovereign loans consist of central government and public bank loans.
All others are nonsovereign. Report is based on sources indicated and covers part of the market.
2/ These databases report on a residence of issuer basis, and, consequently, in certain circumstances could include in one country's total, loans issued by wholly owned subsidiaries of foreign financial institutions. This is particularly an issue in areas that serve as financial centers (e.g., Hong Kong SAR and Panama).

resources and benefit from the higher spread, and creditors wishing to unwind their exposure to do so at an attractive price. With yields on emerging market paper currently, in most cases, well above yields at issue, puts may appear attractive in the period ahead. Some puts can be triggered only by specified "credit events," such as the borrower's credit rating falling below a prespecified threshold. Here, too, creditors will elect to exercise the put, once the contractual conditions are satisfied, if the put is "in the money." Finally, all but a handful of puts are discrete puts, which may be exercised only on specified days. Most putable instruments include one or two put dates, although a few instruments are putable semiannually. (Fewer than 1 percent of a sample of 500 puts examined for this study are putable on a continuous basis.)

Why are put options included in debt instruments? Debtors write put options as a means to achieve lower spreads. To the extent that they believe that the yield on their debt is inflated by information asymmetries, they may consider that over time their spreads will decline, or at least remain stable, in which case the put would not be in the money and would not be exercised. Debtors may also be willing to gamble that, even if the put is exercised, they will be able to reborrow the resources, albeit at a higher spread.[21] Further, puts may be motivated by legal or tax preferences (for example, lower reserve ratios or exemptions from withholding) that favor long–term loans relative to short–term money. It seems unlikely that debtors accepting put options fully anticipate the difficulties they would face if options were exercised in the face of a substantial loss of market access.

From the creditors' perspective, put options shorten the contractual minimum maturity of the debt while giving creditors the right to extend the maturity on the basis of the original interest rate. Thus, by way of example, a bond that would be recorded as a three–year bullet, with a put after one year, would be seen by creditors as a one–year bond, with the option of a two–year extension. This gives creditors the opportunity to get out early and benefit from any increase in yields by exercising the put and relending the resources at a higher spread, as well as the ability to lock in a favorable yield if interest rates decline.

The figures above refer to contractual puts (so–called "hard puts") and take no account of "soft puts" (that is, loan covenants that, if breached, give rise to an event of default and allow creditors holding a qualified proportion of principal to accelerate the instrument and demand immediate repayment). An important difference between hard and soft puts concerns the wider ramifications of triggering the put. Full payment under a hard put brings closure to the issue, while a default resulting from a breach of a loan covenant may trigger cross–default or cross–acceleration clauses in other external debts, at least until the default has been cured by a full payment on the debt in question.

[21]Debtors may also include call options in their debt contracts. Such options give debtors the right to prepay their debt. In the face of declining interest rates, this would allow the debtor to reborrow on more favorable terms.

Some covenants refer to specific actions of the borrower, such as the maintenance of legal structures. This issue arose in late 1998 with respect to a bond issued by the Romanian power utility, where creditors are reported have believed that a covenant was breached as a result of efforts to restructure the enterprise, and demanded repayment (see the third section, below for more details).[22] Other covenants, in contrast, relate to borrowers' financial health. It is understood, for example, that most syndicated loans to nonsovereign borrowers include covenants regarding the maintenance of debt–equity ratios below a specified threshold. Such covenants were a major problem in Thailand, where companies were faced with sharp exchange rate changes that led to breaches of the loan covenants.

In light of the significant source of balance of payments vulnerability posed by put options, particularly for a number of Asian markets and Brazil, IMF staff have strengthened their focus on these issues in the context of both surveillance and the use of IMF resources. In the context of the preparation of briefing papers for IMF missions to emerging market members, mission teams are being provided with summaries of put options in international bonds and syndicated loans. This should help staff and the authorities to identify sources of external vulnerability, and better inform the policy dialogue. In addition, it is expected to help facilitate the examination of the consequences of adverse contingencies in balance of payments scenarios by explicitly allowing for the possibility that put options will be exercised en masse.

Increasingly, in the context of policy discussions, IMF missions are ensuring that member countries, are fully aware of their external vulnerability associated with put options, and are advising national authorities to exercise appropriate caution with regard to the inclusion of such options in their sovereign instruments. At the same time, missions are stressing the importance of ensuring that prudential supervision over domestic financial systems take explicit account of the vulnerability of banks that have substantial liabilities including put options or large exposures to corporate customers with substantial foreign borrowings that include puts. In this context, staff missions have underscored the need for supervisors to ensure that banks have the capacity to assess and manage the associated risks, including, for example, through their liquidity management.

While the focus of this section has been on put options, payments associated with a wide range of derivative transactions can contribute to balance of payments pressures and complicate adjustment to external shocks. Here too, there is a strong tendency for payment obligations to "float" with respect to economic developments. Although a full treatment of these issues is beyond the scope of this paper, these points are illustrated by five examples in Box 2.1. These examples underscore the importance, from the perspective of maintaining macroeconomic stability, of ensuring that the public sector exercises appropriate restraint with respect to its off–balance–sheet transactions, and the critical need for efficient supervision of

[22]This highlights the importance of ensuring that full consideration is given to the potential ramifications of enterprise restructuring, including an examination of any contractual obligations.

Box 2.1 Derivatives and Balance of Payments Crises

- **Thailand**. In the run-up to the devaluation of the Thai baht in mid-1997, the Bank of Thailand mounted an ultimately unsuccessful defense of the pegged exchange rate through intervention in the forward exchange market. Following the floating of the exchange rate and the substantial depreciation of the baht, the cost of unwinding the forward book—essentially the notional value of the forward book multiplied by the difference of the exchange rate at which the contracts were entered into, and the exchange rate at which the local currency required to unwind the contracts was acquired—exacerbated pressures on reserves.

- **Indonesia**. In the second half of 1997, Indonesian commercial banks maintained substantial exposure in foreign currency options, presumably on the assumption that the exchange rate would remain stable. In late September 1997, the exchange rate came under pressure, and banks sought to hedge their foreign exchange to exposure risk by making spot purchases of foreign currency, thereby contributing to a further round of exchange rate depreciation.

- **Korea**. A number of Korean institutions entered in the complex off-balance-sheet transactions, in some cases booked through offshore subsidiaries. In a typical transaction, weakly capitalized financial institutions purchased structured notes that, in essence, borrowed in yen to finance bets on the exchange rates between the U.S. dollar and the Thai baht and Malaysia ringitt. Such bets may have been justified by the historical measure of correlation between these currencies. In the event, when the baht and ringitt depreciated sharply, investors were left owing substantial sums—in some cases several multiples of the initial investment.

- **Russia**. Russian commercial banks had substantial unhedged exposure in the forward markets for foreign exchange. Payments obligations in respect to these contracts following the floating of the ruble in August 1997 were substantial, and were a factor in the authorities' decision to impose exchange controls, limiting banks' ability to service these obligations.

- **Brazil**. During the second half of January 1999, the Brazilian central bank built a substantial net exposure in the currency futures markets traded on the Bolsa de Mercaderias y Futuros. Contracts traded on this exchange are marked–to–market at the close of business each day, and investors receive (pay) margin payments into blocked accounts in local currency equivalent to the loss (profit) on individual contracts associated with the change in the exchange rate during the course of that day. These accounts are unblocked when the contract expires or the position is sold. Following the sharp depreciation of the exchange rate on January 13, 1999, the central bank was required to make significant margin payments on these contracts.

financial institutions' on– and off–balance–sheet transactions, on a consolidated basis covering both on– and offshore transactions.

Private Sector Contingent Financing Arrangements

The previous section has examined the existing use of options and other financial derivatives that give creditors the right to demand prepayment in certain cases. This section, in contrast, looks at contractual arrangements that would allow a country to acquire new debt, or to extend the maturities on existing debt, under specified circumstances.

Lines of Credit and Swap Facilities

Lines of credit and swap facilities can be desirable from two perspectives. First, contingent financial arrangements are a form of private, market–based insurance: the debtor pays an insurance premium to compensate the writers of the option (the creditors) for the risks undertaken. Thus, if fairly priced, they can provide efficient insurance against adverse market developments, including liquidity risk. (Indeed, one advantage of contingent mechanisms is that—distinct from the embedded derivative contracts described above—they can protect against the risk that a government may lose market access for a period and run into difficulty rolling over its debt). Second, such contracts can provide effective burden sharing in that they involve the private sector in the provision of additional private financing to help offset adverse developments in the external accounts. The benefit of such burden sharing has been stressed by the IMF's Executive Board in discussions of the role of official support to countries in times of crisis, and has also figured in recent proposals for the IMF to provide contingent lines of credit to countries implementing adjustment programs to help forestall financial crises resulting from contagion. Finally, such arrangements could have a stabilizing effect during a period of relative tranquility by boosting confidence (analogous to the holding of additional reserves).

Argentina, Mexico, and Indonesia have each entered into financing agreements with consortiums of foreign commercial banks with the aim of creating a mechanism to provide liquidity in times of crisis.[23] These arrangements, which have taken different forms, all involve the payment of a regular commitment fee by the debtor to creditors in exchange for opening and maintaining the credit line, with an "evergreen" clause to provide for renewal, generally with the consent of the lender.[24]

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[23]The fact that Argentina and Mexico were able to enter into such facilities without the benefit of an investment–grade, sovereign credit rating suggests that similar arrangements could be pursued by other emerging market economies that are active in international credit markets and have equivalent or better credit ratings.

[24]Under the Argentine arrangement, which can be exercised at the discretion of the central bank (the sole borrower), government securities owned by the central bank or financial

(continued...)

Contingent financing arrangements have been tested in practice on two occasions. In both instances, lending banks sought to dissuade the borrower from exercising the option, but they subsequently provided the funds on demand as required under the terms of the contract.

- In April 1998, Indonesia was able to draw some $700 million of the $900 million in commitments under its facility, despite the significant downgrade in its credit rating.

- In contrast, the Argentina arrangement, for a total of $6.2 billion, has not been drawn. Established as a response to the Tequilla crisis, when domestic banks lost nearly 20 percent of their deposit base and credit to all but the best borrowers was severely curtailed, the central bank created a repo facility allowing drawings, in the event of shock, with maturities of two–five years (This facility can be renewed at the borrower's initiative.). Although not drawn, the facility may have played a helpful role in forestalling market pressures and reducing the risk of crisis.

At the time of the decision by the Mexican authorities to draw on the facility, although the drawing adhered strictly to the terms of the agreement, creditor banks involved in the arrangement argued against the drawing, contending that it was unnecessary, would hurt Mexico's creditworthiness, and would force banks to reduce lending to Mexican corporations or other Latin American sovereigns. The activation of this stand–by credit initially induced a sell–off in Mexican bonds, raising yields by about 100 basis points.[25] After about a week, however, yields had declined to around their earlier levels.[26]

In addition, options or warrants could be used to provide liquidity in unfavorable conditions to borrowers facing specified adverse developments, and their use could presage a shift toward more complex bond structures by a wide range of emerging market sovereign borrowers, particularly as they seek to regain market access without paying excessively high

[24](...continued)
entities are swapped for U.S. dollars. The Mexican scheme, in contrast, is a pure revolving credit facility. Both arrangements were virtually unconditional.

[25]The Mexican experience raises a more general question about whether these lines provide additionality when other lines can and are being pulled. Drawings on contingent lines will increase bank exposure to a country in such circumstances to the extent that the withdrawal of other credits would have occurred in any event, in light of adverse market conditions. Conversely, to the extent that a bank's commitments to contingent lines are reflected in dynamic hedging strategies aimed at maintaining a certain exposure and risk profile, additionality can be called into question.

[26]In March 1999, Mexico successfully renegotiated $1.9 billion (70 percent) of the facility into two– and five–year instruments. In addition, $0.5 billion of the facility was retired from the proceeds of a $1 billion, 10–year bond issued in February 1999.

spreads.[27] (One difference is that the authorities write the option, which can then be exercised at the choice of the investor, whereas the reverse is true in the case of contingent lines.) These innovations raise complicated issues of pricing, particularly in the early stages of their development where the lack of liquid benchmarks makes assessment of the instrument particularly difficult, and will require further study. When countries are considering such mechanisms, it is important that the proposed transactions be carefully analyzed to ensure that the insurance being offered meets the needs of the authorities and is fairly priced. In particular, authorities should be careful to avoid being locked into high rates for extended periods.

Some lessons for the future of contingent financing can be drawn from an assessment of recent innovations in private financial and insurance markets, which in the last year have witnessed significant growth in the market for catastrophic event risk ("CAT bond market"). While the market remains small and has idiosyncratic features (for example, close linkage to weather–related risks that are amenable to sophisticated modeling), it demonstrates the capacity of markets to shift large, exogenous risks through contingent lines of credit and derivatives.[28] Concerns about moral hazard—to the extent that the country can affect the conditions under which such a line can be exercised—could, in principle, be addressed by linking drawings to aggregate emerging markets indices. This could be helpful for countries needing to address effects stemming from developments in emerging markets as a whole, although it would not be relevant for authorities facing country–specific difficulties.

A concern is that activation of these or other mechanisms may induce private creditors to reduce their other exposures to the country, region, or other emerging markets. To some extent, market reactions depend on the state of the financial world: in most circumstances, drawing on contingent credit lines would be unlikely to have ramifications beyond the country

[27]One recent innovation involves bond issues by Argentina in November 1998 and February 1999, by Mexico in February 1999, and by Colombia in March 1999. The structure of the Argentine bonds includes warrants that give the bondholder the right, but not the obligation, to purchase additional Argentine bonds at a specified price. The Mexican bond allowed holders to swap Mexican Brady bonds into additional holdings of the bond. The Colombian bond included one year, nondetachable options to exchange the 5–year bonds into 28–year bonds. While warrants and options in nonsovereign bonds are fairly common, the use of warrants in sovereign bond issues is rare.

[28]In a typical transaction, a large and internationally–active insurance company (the insured) pays a premium to a reinsurer or investment group (the investor). In return, the investor agrees to make a payment following an exogenous event with low probability but causing significant damage (for example, hail storms, hurricanes, earthquakes). This can be done through the issuer agreeing to purchase a security issued by the insured *following* the catastrophic event (such as a **naked put option** that allows the holder to sell a bond to the writer of the contract where there was no previous underlying position), or through securities issued prior to the event which allow for a sharing of losses through variable payments, depending on events.

concerned; in times of more general systemic problems, however, the actions by one country would be more likely to have spillover effects.

It is premature to draw definitive conclusions from the limited instances where these innovations have existed and have been utilized. It is unclear to what extent lenders would be prepared to provide this type of financing to a broader range of market participants, and the range of instruments available to the public sector seems to have lagged innovation in the private insurance markets. Nonetheless, such instruments offer the potential for encouraging a degree of private sector participation through market–based risk–sharing mechanisms. Emerging market members should be encouraged to talk to the banks about the possibility of arranging such contingent financing mechanisms.

Call Options in Interbank Lines

Another mechanism that has received attention in the context of involving the private sector in crisis resolution is embedding call options in interbank credit lines so as to provide a contractual basis for an extension of maturities under specified conditions. The objective would be to alter the terms of such loans with a view to allowing for the possibility of locking–in this type of financing at the discretion of the borrower under prespecified conditions. While similar to the contingent credit lines discussed above, in that such a mechanism would allow the debtor access to financing (in this case, rolled exposure) negotiated ex ante, the modalities of such an instrument are problematic. In particular, the design of a satisfactory trigger appears elusive, which does not augur well for pricing of the instrument. This suggests that the market in "modified" interbank loans could be very illiquid. Moreover, the uncertainties about whether the option would be exercised highlight concerns about "spooking" creditors. Indeed, there is concern that the announcement of discussion between a member and the IMF could raise concerns about triggering the option, which could lead to a loss of short–term lines, exacerbating liquidity difficulties. In short, the IMF could in this case have a negative catalytic effect.

Use of Derivatives in Debt Instruments to Provide Insurance

Previous sections have examined the use of options in both existing debts, and in a form that gives a member the contractual right to borrow under specified circumstances under various forms of contingent financing facilities to borrow. This section provides a preliminary discussion of the possibility of embedding other forms of derivatives in debt contracts with a view to engineering an instrument with a debt–service burden that "floats" *against* overall economic developments. That is to say, instruments that provide insurance by having a debt–service burden higher in good times than in bad. Instruments that could be adapted to this purpose are commonly known as structured notes.

Recent years have witnessed the rapid growth of structured notes on international markets. These are powerful tools for intermediating credit and risk, and they can be used to achieve virtually any profile of risks and returns. Popular with a wide range of professional investors, they offer a sophisticated tool for hedging a wide range of risks. (By the same token, however, they pose considerable pitfalls for financially unsophisticated players.) Structured notes are usually short– to medium–term instruments with a bullet redemption. Either the redemption value or the coupon—if any—can be linked to movements in any currency, interest rate, asset or commodity price, or combination thereof. (Although most structured notes are not leveraged, they can be highly leveraged, or geared, in which case their redemption value is not necessarily bounded by zero.)

There is a question of the extent to which such notes could provide countries with a useful tool for liability management. Clearly, it will only be possible to market instruments that float against the overall economic developments to the extent that the developments are credibly beyond the control of the authorities. (It is unlikely that creditors would be willing to provide insurance against adverse developments substantially under the control of the authorities, on account of moral hazard.) By the same token, to make such insurance operational, the economic developments would clearly need to be objectively defined and independently measurable.[29]

While contractual links between economic developments and contractual debt–service obligations are not unknown (several Brady bonds include so–called "value recovery" clauses that link payments to variables such as economic growth and world oil prices), they remain relatively unusual. Nevertheless, there may be merit in countries that have highly concentrated exports (such as many oil exporters) exploring with their financial advisors the possibility of placing structured notes under which debt–service obligations would float against economic developments.

External Debt Monitoring and Concerted Rollover of Short–Term Debt

In a number of recent cases, one aspect of the authorities' response to the crisis has been to put in place, with the help of IMF's staff, systems for high–frequency monitoring of the external liabilities of domestic financial institutions (Box 2.2).[30] First in Korea, and subsequently in Thailand, Indonesia, and Brazil, monitoring systems were introduced in the

[29]It is understood that the World Bank is actively considering a role as an intermediary in helping countries access commodity futures markets through structured instruments.

[30]In the context of providing this assistance, the staff has formed teams drawn from a number of departments and coordinated by Policy Development and Review Department, which is able to respond at short notice to assist member with the development of monitoring systems and the interpretation of the results.

context of IMF–supported adjustment programs (Boxes 2.3 and 2.4). As discussed below, the rationale for developing monitoring systems differed, ranging from an essential tool for a concerted rollover (Korea), to providing financing assurances regarding the continued involvement of private creditors (Brazil). Efforts are currently under way, or in the pipeline, to strengthen established monitoring systems in a number of countries that are not in crisis in order to improve surveillance over short–term capital movements, and to provide early warning of emerging problems.

Coverage of Debt Monitoring

The coverage of the monitoring systems has been limited to interbank transactions of domestic banks (including their offshore branches and subsidiaries) *vis–à–vis* foreign banks. This imposes two limitations. First, it does not capture commercial bank lending to the nonbank private sector of the countries concerned. Extending the coverage of the system to monitor banks' exposure to corporate borrowers from the debtor side is probably not feasible on account of the relatively large number of corporations, which would need to be covered by a survey.[31] An alternative and more ambitious approach would be to ask central monetary authorities of creditor countries to collect comprehensive high–frequency data regarding the exposure of banks under their supervision to the nonbank private sector of the country concerned. This information is not routinely collected, and initiating such a collection risks being interpreted as presaging a concerted rollover. In the absence of such an effort, databases maintained by IMF's Research Department and by wire services allowed IMF staff to monitor access to medium– and long–term private capital reasonably well. The second limitation concerns foreign banks' holdings of a wide range of marketable securities, many of which are unregistered bearer instruments (including tradable notes and bonds). While these are likely to be quantitatively important in countries with relatively sophisticated financial systems, it is difficult as a practical matter to see how banks' holdings of these instruments could be measured from the debtor side.

[31]Moreover, in many emerging market economies the authorities will not have statutory authority to require high–frequency reporting by nonfinancial corporations.

Box 2.2 Design of Monitoring Systems

Monitoring systems have been tailored to the specific circumstances of individual countries. The systems have been designed to generate timely high frequency data on the liabilities of domestic banks to foreign commercial banks. As the rationale for the systems is to enable the authorities to monitor developments in short-term capital flows that could put pressure on the balance sheets of head offices of commercial banks, and, potentially the official reserves, it has been necessary to have a somewhat broader coverage of transactions that would be captured by convention definitions of external debt. Specifically, instead of examining only debt of resident institutions to non-residents, the monitoring systems have also sought to consolidate the interbank transactions of offshore branches and subsidiaries of domestic banks vis–à–vis foreign banks. The monitoring systems have also sought to cover a wide range of instruments; in addition to short–term interbank credits, the coverage has included trade lines, medium– and long–term loans, and payments associated with financial derivatives. The transactions data have been consolidated across all branches and subsidiaries abroad. Individual banks have generally been reported as belonging to the financial center corresponding to their owners. Thus, by way of example, a loan from a Singapore branch of a U.K. bank to a offshore branch of a domestic bank and then onlent to the onshore headquarters of the bank would be shown as a loan from the U.K. bank to the domestic bank; similarly, a bank located in the U.S., but wholly owned by a Canadian bank, would be classified as a Canadian bank.

The implementation of a debt monitoring systems in the context of a crisis requires a capacity to collect, process, and communicate high-quality data with short lags. The success of such operations has depended critically on the close coordination between the authorities and IMF staff. In certain cases, additional staff of the central bank have been assigned to the effort, and new lines of authority established to ensure priority was given to the effort. A capacity also must be developed to respond promptly to questions and identify emerging problems, and key, in this regard, has been an ability to look directly at the disaggregated data. Further, country authorities must be prepared to approach domestic and foreign banks with questions, recognizing the work burden involved and the need to be sensitive to concerns that requests for information not be misinterpreted by markets.

Reporting Data to IMF Executive Directors

For Korea, Indonesia, and Brazil the data generated by the monitoring system has been routinely circulated to Executive Directors. The format of these reports has reflected the need to preserve commercial confidentiality, and the banking secrecy laws of the debtor countries. No information has been reported on the identity of the debtor banks. Each Executive Director receives a customized report showing the transactions of individual banks in his/her constituency, and summary statistics for transactions of banks located in other financial centers.

The role of IMF staff

IMF staff, both in the field and at headquarters, assisted the authorities in: (1) designing and modifying the surveys sent to banks to ensure conformity with the needs of the rollover exercise; (2) identifying contingent liabilities (including put options linked to credit ratings) that could potentially turn long-term obligations into short-term obligations; (3) assisting in identifying creditor banks that were “trading up”; i.e., cutting lines to relatively weak debtor banks and opening new lines in the same amount at a stronger bank, thereby maintaining country exposure unchanged (as allowed under the rollover agreement); and, in the context of Korea, (4) advising the authorities on various policy issues relating to the use of the emergency foreign exchange support window of the central bank.

In both Korea and Indonesia, IMF staff maintained a continuous presence in the country from the time the monitoring systems were established until agreement had been reached on the debt restructurings. In contrast, in the case of Brazil, IMF staff assisted with the design and initial implementation of the monitoring system, but have had little direct involvement in its day–to–day operation.

Box 2.3 Korea

Against the background of the unfolding events in Asia in late 1997, Korea was hit by the deepening regional financial crisis in October. The Bank of Korea's (BOK) attempt to support the won was unsuccessful, as capital outflows surged primarily as a result of the repayment of short-term debt of banks falling due. The BOK provided foreign currency support to the affected domestic financial institutions in November and December to meet their maturing obligations—Korean banks had requested these funds to repay their interbank lines to foreign banks, which were being cut as the crisis unfolded. Consequently, when usable reserves fell to alarming low levels in December 1997, it became clear that extraordinary measures were needed to stop the reserve loss. Subsequently, an agreement was reached with the G-10 whereby the supervisory authorities would seek to persuade the central monetary authorities would seek to persuade their creditor banks to maintain (roll over) their exposure to Korean banks while a more lasting solution to the debt problem was sought.

The significant repayments of short-term debt and the enforcement of an informal rollover agreement necessitated a monitoring capability that would allow the Korean authorities and IMF staff to assess the position of the relevant creditor banks vis-à-vis the Korean banks on a daily basis and to report these findings to the IMF Executive Board and to G-10 central banks. For this purpose, the effort involved a comprehensive assessment of stocks, including offshore and off-balance–sheet exposure. Information collected included daily information on the maturities, payments, new lines, and rollover rates of each creditor bank; estimates of the amortizations coming due in the upcoming week (from a weekly survey of the largest banks); and terms of interbank debt being rolled over, including maturity in days and spreads over LIBOR (London interbank offered rate; again, from a weekly survey of the largest banks). Coverage included interbank lines, medium- and long-term notes, bankers' acceptances, and commercial paper. BOK staff used this to forecast use of the foreign exchange support window as well as for alerting (and encouraging) domestic banks to seek other sources of funding for large amounts coming due.

Box 2.4 Indonesia, Thailand, and Brazil

While debt monitoring in ***Indonesia*** shared many similar characteristics with the exercise in Korea, there was an added focus on trade financing and corporate borrowings from foreign banks, the latter of which constituted a substantial portion of the external debt. (In contrast to Korea, only a small portion of external debt was interbank debt.) Resolving the problem of the corporate debt was complicated by the absence of bankruptcy procedures, which created strong incentives for creditors to cut individual deals with debtors that were unable or unwilling to repay. The **Frankfurt Agreement,** announced in June 1998, outlined initiatives addressing the key issues of rescheduling interbank debt, maintaining trade credit lines, and providing a framework and incentives for the voluntary restructuring of corporate debt consistent with Indonesia's overall payments capacity and the need to provide corporations with cash–flow relief.

External debt monitoring began in March 1998, as difficulties were encountered with policy implementation and the crisis intensified. Monitoring initially focused on the interbank lines, where comprehensive data could be collected through the central bank. Consolidated information was shared with central banks and IMF Executive Directors, on a daily basis, and discussed in regular conference calls with central banks of the G-10. However, in the run-up to the announcement of the Frankfurt Agreement, the monitoring effort was broadened to serve as a general technical resource for the authorities on external debt. By collecting available data and answering questions as they arose, the team sought to provide comfort to participating creditors and the official sector regarding the financing assurances for the program. In addition, the monitoring framework established in the context of the Frankfurt Agreement allowed financial institutions to self-monitor their exposure.

In ***Thailand,*** while the authorities closely monitored developments in the interbank market, debt monitoring played a less central role in the crisis response. As in Indonesia, Thai banks' external debt obligations were small, with maturing debt amounting to less than 20 percent of the private sector's total maturing obligations. (Far larger were maturing obligations of foreign banks resident in Thailand.) This suggested there might be less to gain from a high-effort exercise involving G-7 governments as in Korea. Second, since the major creditors of the foreign banks were usually the same bank's parent institutions in their home countries (importantly, Japan), it was presumed that foreign banks would not be willing to participate in a voluntary restructuring agreement that would affect their parent institutions' financial position. Instead, foreign banks were expected to enter into discussions directly with their parent banks. Also, there was concern that a Korea-style exercise could be counterproductive, delaying Thailand's return to international capital markets.

In ***Brazil***, the monitoring system initially covered 25 major debtor banks. The survey coverage was extended in February 1999 to include 35 debtor banks, as well as foreign commercial bank lending to the nonbank private sector. With this extension, the monitoring covers about $50 billion of foreign bank lending to *Brazil*, compared to total foreign bank lending of around $60 billion. Total foreign bank exposure to Brazil, including tradable paper, is estimated at $150 billion.

Use of Data Collected by Monitoring Systems

The information gathered by debt–monitoring systems has provided a valuable tool for banking supervisors during periods of financial stress and facilitates contacts with private creditors. In the case of Korea, the data collected from the monitoring exercise was used by central monetary authorities in the principal financial centers to apply some degree of moral suasion on banks under their supervision to maintain their exposure, and to participate in a concerted restructuring.[32] The decision to apply moral suasion was taken against the background of a hemorrhaging of the official reserves and the prospect of an imminent default. The operation was successful in stabilizing a critical situation and allowing Korean financial institutions to avoid default, and in facilitating a restructuring of $21.8 billion of interbank claims into sovereign guaranteed bonds with maturities of one–to–three years. In connection with the forceful implementation of adjustment policies, this helped pave the way for Korea's reentry to international capital markets in April, with a $4 billion sovereign global bond issue, and a restoration of Korea's investment–grade credit rating in January 1999.

In two recent cases, moral suasion did not play a role. In the case of Indonesia, the system facilitated both contacts between the authorities and the banks, but also discussions within the banking community as progress was made toward the eventual restructuring. In this context, the monitoring system helped to resolve the failure of collective action. Individual banks may be willing to maintain their exposure only if they have assurances that other banks will not exploit their forbearance so as to unwind their own exposures. In the case of Brazil, in addition to providing financing assurances regarding the participation of private creditors for the IMF and the participants in the Bank for International Settlements (BIS) loan, it has provided a basis for the authorities to have discreet contacts with individual commercial banks.

Concerted Rollover Operations

Notwithstanding the success of the Korea operation, a number of concerns have been raised regarding the appropriateness of trying to replicate the operation in other cases. In part, the success of the Korean operation reflected two specific features, which are unlikely to apply to other cases. First, Korea maintained a restrictive capital account regime that forced a high proportion of imported foreign saving to be channeled through domestic banks. This provided the assurance that once the outflows from the banking system had been stanched, the capital account would be stabilized. Second, at the onset of the crisis, the sovereign's external debt burden was very low. As a result, the extension of a sovereign guarantee in the context

[32]The monitoring also helped the Korean central bank ensure that its foreign currency support to Korean commercial banks was replacing interbank lines that had been pulled during the crisis by international banks (resulting in severe liquidity problems for the banking system), rather than funding other investments or ongoing operations of the domestic banks.

of the restructuring operation, while raising concerns from the perspective of moral hazard, did not place an excessive burden on the sovereign.

One consideration that did not rise in Korea, but that might arise in future cases, concerns the impact of a concerted rollover on investor confidence, and the dynamics of the domestic market of government debt. This could be a concern in cases in which the authorities have a substantial need to roll over maturing obligations and fund ongoing fiscal deficits from domestic sources. The impact on investor confidence is likely to depend on the circumstances of individual cases. To the extent that the concerted rollover is seen as ensuring that the program is fully financed and complimentary to the forceful implementation of an ambitious adjustment program, the impact on domestic debt markets is likely to be favorable, and to pave the way for a combination of a lengthening of maturities and reduction in interest rates. However, to the extent that a concerted rollover is seen as providing a substitute for appropriate macroeconomic policies, and is seen as presaging a unilateral restructuring of domestic debt instruments, there is a risk that it could complicate domestic debt management and make draconian policies unavailable.

More generally, there are concerns about the systemic consequences of concerted rollover and restructuring operations. In the context of an individual operation, to the extent that foreign banks maintain country exposure limits, pressuring banks to maintain their exposure to financial institutions is likely to amplify pressures on the corporate sector, and thereby intensify the risks of economic dislocation. By the same token, to the extent that banks maintain regional exposure limits, concerted operations may tend to export the financial pressures to neighboring countries. These operations also raise concerns from the perspective of the stability of the international financial system. If used as a technique to "bail in" private creditors in the context of an IMF arrangement, in anything other than the most extreme circumstances in which a default is imminent, there is a serious danger that the market reaction to news that a member had initiated policy discussions with the IMF could itself trigger a run, as foreign banks would attempt to unwind their exposure before getting caught up in a concerted rollover. Indeed, similar concerns may have contributed to the relatively low rollover rates for Brazil in October 1998, before the announcement of the details of the authorities' IMF–supported adjustment program.

Finally, supervisory authorities are likely to be reluctant to exert moral suasion over the commercial decisions of the banks under their supervision except in the most extreme circumstances, especially in the context of debtors that do not pose a systemic threat to national or international banking systems. By the same token, countries that emerged from protracted periods of difficult relations with their commercial bank creditors in the aftermath of the 1980s debt crisis are likely to be reluctant to reenter a period of concerted financing with these creditors.

Restructuring International Sovereign Bonds

The sharp increase in emerging market bond financing in the 1990s has brought to the fore, in the context of discussions on the new financial architecture, questions of involving private sector bondholders in crisis resolution. Past practice in the context of debt reorganizations of treating bonds as de facto senior to other forms of commercial finance appropriately reflected the characteristics of the instrument and their de minimis role. In a number of recent cases, however, payment difficulties and reschedulings by emerging market borrowers inevitably raise the question of whether to include international sovereign bond issues in a restructuring or refinancing effort. Indeed, as a result of the growing importance of bonds in members debt–service obligations, there can be no automatic presumption a priori that bonds will be excluded from any future restructuring. Instead, as discussed below, judgments on this matter will need to be made on a case–by–case basis.

This section provides a preliminary discussion of the modalities of a bond restructuring *before* the emergence of a default.[33] This analysis is followed by a review of some general considerations involved in assessing the case for bond restructuring. Next, possible modalities for bond restructuring are examined. A review of special factors that come into play when restructuring Brady bonds, or other instruments supported by collateral, follows the discussion then addresses restructuring bonds supported by liens on borrower's assets, and these lessons are applied to proposals for modification of bond contracts. This is followed by a summary of recent experience with the restructuring of international sovereign bonds and similar instruments.

General Considerations

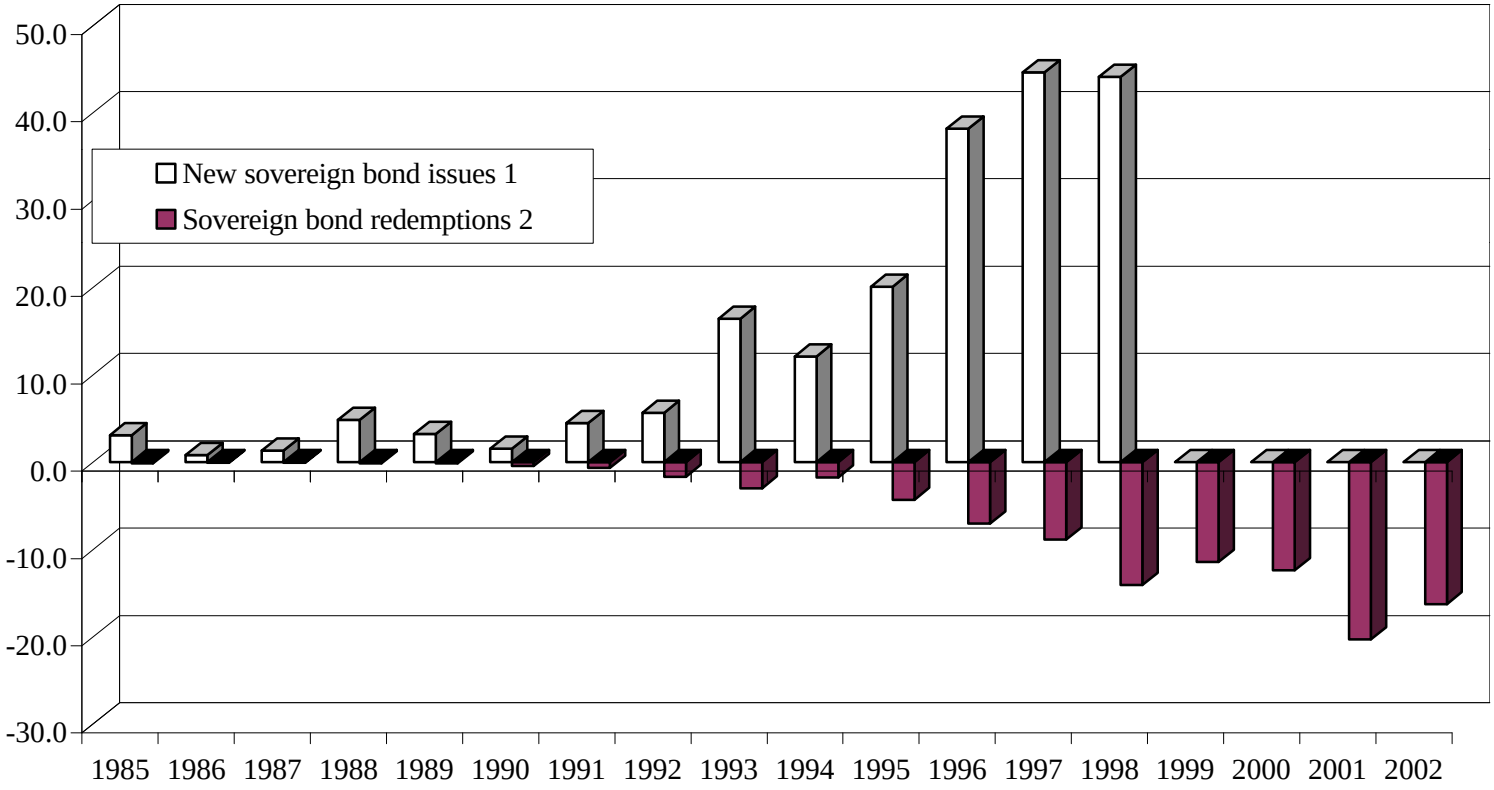
The gross flow of bond placements by sovereign emerging market borrowers has grown from $6 billion in 1992 to over $40 billion in 1997 and 1998 (Figures 2.1 and 2.2). Reflecting the perceived improvements in the creditworthiness of these countries, issuance surged through the third quarter of 1997 before subsiding following the onset of the Asian financial crisis. (For the past five years, bonds represented more than one–half of total issuance—bonds, syndicated loans, and equities by emerging market sovereign borrowers. This increase in bond issuance is now being reflected in a rapid increase in redemption payments. Scheduled redemption payments on bonds issued by sovereign emerging market borrowers are expected to total about $24 billion during 1999–2000 (Table 2.3), compared with total amortization of $89 billion.[34] In addition, a number of bonds may fall due ahead of the final redemption date as a result of creditors' decisions to exercise put options.

[33]To the extent that it is possible to reach agreement on such a restructuring, defaults could be avoided, and the question of IMF lending into arrears would not arise.

[34]Based on public databases. In several cases, country authorities' databases show significantly larger amortizations falling due.

Figure 2.1. International New Bond Issues and Bond Redemptions by Developing Country Sovereign Borrowers

(In billions of U.S. dollars)

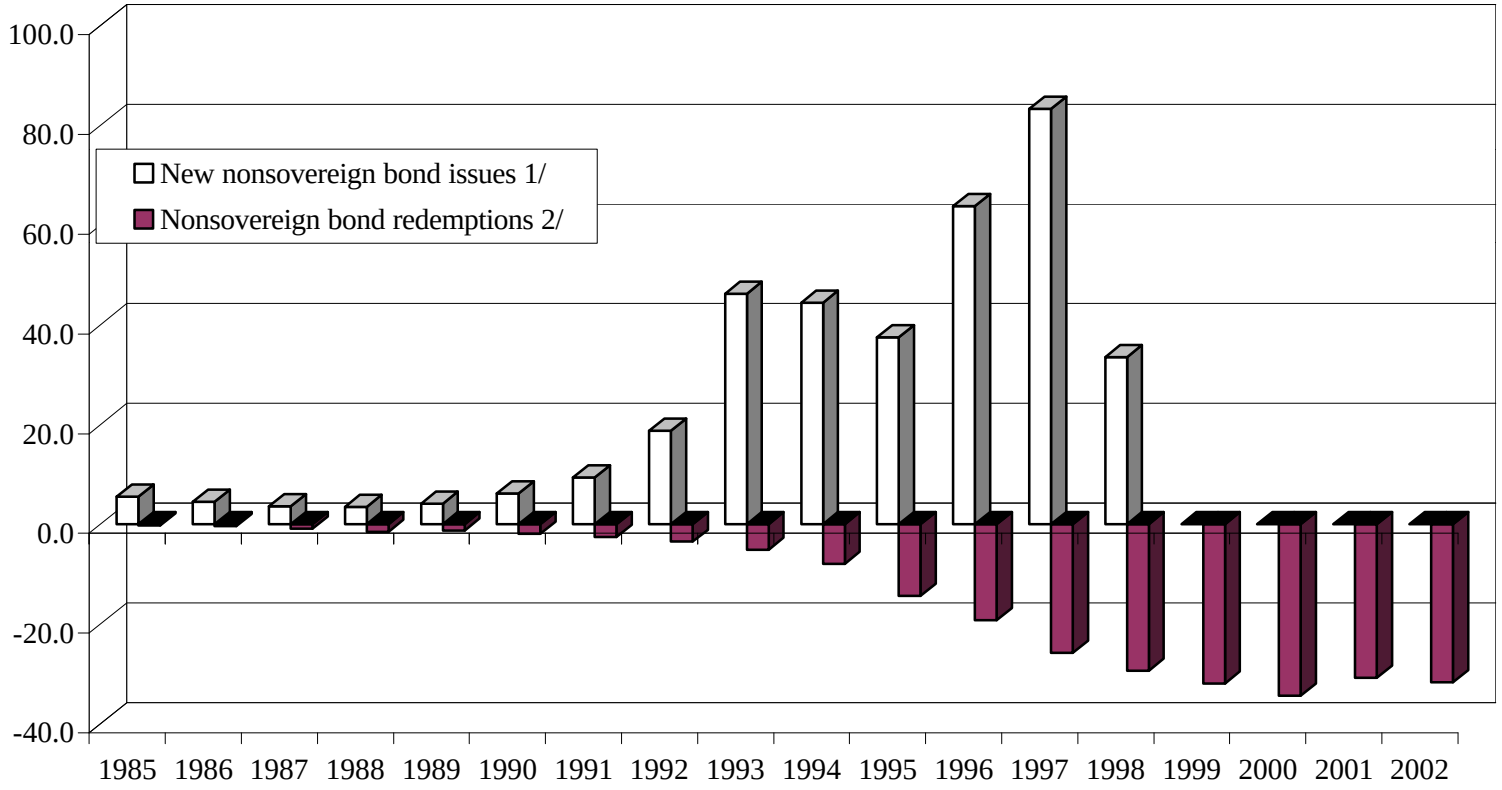


Source: DCBEL database.

1 Excludes Brady bonds but includes bonds issued to retire Brady bonds.

2 Based on bonds outstanding as of end-1998 and valued at the exchange rates prevailing as of end-1998. Excludes prepayments of bonds.

Figure 2.2. International New Bond Issues and Bond Redemptions by Developing Country Nonsovereign Borrowers (In billions of U.S. dollars)



Source: DCBEL database.

1 Excludes Brady bonds but includes bonds issued to retire Brady bonds.

2 Based on bonds outstanding as of end-1998 and valued at the exchange rates prevailing as of end-1998. Excludes prepayments of bonds.

Table 2.3 Maturing Bonds Issued by Emerging Markets and Sectors, 1999-2000

(In millions of U.S. dollars)

	Sovereign 1/		Public 2/		Private		Total
	1999	2000	1999	2000	1999	2000	1999-2000
Algeria	0	0	0	0	0	500	500
Argentina	2,363	2,090	0	100	1,781	1,626	7,960
Bahrain	0	0	0	0	0	150	150
Barbados	30	0	0	0	0	0	30
Brazil	260	100	421	150	2,215	2,040	5,186
Bulgaria	0	0	176	0	0	0	176
Chile	0	0	0	0	55	0	55
China	330	0	1,459	945	150	510	3,394
Colombia	285	372	150	0	125	110	1,042
Czech Republic	0	386	510	0	213	0	1,109
Estonia	0	0	64	0	90	43	197
Hong Kong SAR	0	0	350	150	3,326	4,723	8,549
Hungary	2,610	2,611	0	200	0	0	5,421
India	0	0	541	530	859	35	1,965
Indonesia	0	0	393	0	2,081	2,349	4,823
Israel	272	340	0	0	0	0	612
Jamaica	0	0	0	0	0	55	55
Kazakhstan	200	0	0	0	0	0	200
Korea	0	0	3,994	4,809	6,355	6,132	21,290
Latvia	0	0	0	0	0	30	30
Lebanon	0	400	150	0	60	50	660
Lithuania	0	0	0	0	0	0	0
Malaysia	330	200	0	0	205	290	1,025
Mauritius	0	150	0	0	0	0	150
Mexico	0	937	1,504	1,136	2,452	1,280	7,309
Moldova	30	0	0	0	0	0	30
Pakistan	150	300	0	0	0	0	450
Philippines	0	0	0	200	120	511	831
Poland	0	250	100	0	50	200	600
Romania	798	0	0	0	0	75	873
Russia	100	0	0	500	350	1,075	2,025
Saudi Arabia	280	0	0	0	0	0	280
Singapore	0	0	0	0	15	428	443
Slovak Republic	275	110	0	72	0	0	457
South Africa	803	330	53	328	0	482	1,996
Sri Lanka	0	50	0	0	0	0	50
Tajikistan	0	0	0	0	0	0	0
Thailand	310	305	0	100	1,053	976	2,744
Trinidad and Tobago	0	125	0	71	0	0	196
Tunisia	0	441	0	0	0	0	441
Turkey	1,985	1,848	110	350	0	107	4,400
Ukraine	8	1,140	0	0	0	0	1,148
Uruguay	0	142	0	0	0	71	213
Venezuela	0	213	125	500	0	0	838
Total	11,419	12,840	10,100	10,141	21,555	23,848	89,903

Source: IMF staff calculations.

1/ Includes central government and public banks.

2/ Includes the rest of the public sector.

The question of whether, in the face of a severe liquidity crisis, sovereign bonds should be included in a comprehensive debt restructuring raises difficult issues that would need to be considered on a case–by–case basis. In general countries and official creditors will face a tradeoff between the immediate cash–flow relief associated with a bond restructuring and the reduction over the medium term in the country's ability to mobilize resources from private creditors, with the concomitant implications for the prospects for economic growth, on the one hand, and the member's reliance on financing from official sources, on the other. While in most situations it will be difficult to come to firm judgments in the midst of a crisis, a number of polar cases could be considered. For countries that are generally considered to be uncreditworthy and that have limited prospects for regaining market access—even with the forceful implementation of adjustment measures, the medium–term cost of a bond restructuring may be small. At the other extreme are countries with strong medium–term prospects, notwithstanding a temporary severe liquidity crisis and associated loss of market access, for which the impact on future market access of a restructuring may be substantial. In all cases, the country must balance these assessments against the potential scope for additional adjustment, and the availability of additional financing from official sources. A further consideration for the international community concerns the risk of contagion, specifically, the risk that the restructuring of the international bonds of one emerging market sovereign borrower could lead to an interruption, possibly abrupt, in the market access of a range of other emerging market borrowers.

Before a member has lost capital market access, it may be relatively straightforward to arrange for a voluntary exchange of instruments or a new placement, since creditors may be willing to agree to an extension of maturities in exchange for some (possibly modest) improvement in the yield. This underscores the potential benefits of an early approach to bondholders before market access has been lost. It is likely to be substantially more difficult, however, to secure an orderly market–based bond restructuring *after* market access has been lost. To date, there has been very limited experience with the renegotiation of sovereign bonds in such circumstances, and it is premature to draw firm conclusions about the feasibility of restructuring, or about the factors that may determine the terms of restructured instruments. As noted in previous IMF staff studies, the experience with bond restructurings in the 1930s is of limited relevance, as a result of substantial changes to both bond contracts and sovereign immunity laws. Moreover, a number of interrelated legal and institutional factors that helped to ensure that the process of negotiations with commercial bank creditors generally remained orderly, do not apply to bonds (Box 2.5).

Possible Modalities of Bond Restructuring

After a country has lost market access, creditors' willingness to participate in a debt exchange will depend critically on there being a credible threat of a default, since creditors would clearly prefer a full–cash redemption to the further extension of credit in such circumstances. Considerable caution is required in signaling the threat of a default. On the one

Box 2.5 Comparison of Legal and Institutional Factors

Four key interrelated legal and institutional factors discussed below with respect to loans have helped to ensure that the process of negotiations with commercial banks generally has remained orderly. No comparable experience exists with bonds.

Regulatory Supervision

While bank supervisory bodies influenced bank syndicate members to reach a settlement through negotiation, not all of the numerous nonbank institutions and individuals that may hold bonds are covered by supervisory bodies.

Syndicated bank loans involve primarily commercial banks and occasionally other financial institutions, which are typically under the supervision of central banks and other regulatory authorities.

Bondholders, in contrast, may include not only banks and other financial institutions but also pension and mutual funds, other investment companies, and individuals. Therefore, because many bondholders are unlikely to be subject to regulatory oversight, there is no central mechanism for applying pressure to bondholders as a group to enter into orderly negotiations.

Sharing Clauses

The terms of syndicated loans require that any single member of the syndicate must share payments or other amounts it has received with other syndicate members which have not received similar amounts due to them. The terms of bonds do not include sharing clauses.

Syndicated loan agreements require syndicate members to share any money recovered from the debtor with other members of the syndicate, in proportion to holdings of principal. Therefore, in the event of a default, if a bank recovers any money from the borrower, including the proceeds of any litigation, that bank can keep only a fraction of the proceeds. The inability to keep all or even a substantial part of any recovery substantially curtails the potential gains of individual creditors from legal action and provides a strong incentive for negotiated solutions to debt–servicing difficulties.

Bonds generally do not include sharing clauses; thus, individual bondholders would be able to retain any money recovered through litigation. This greatly increases the incentive of a single creditor to sue. One exception is provided by Trust Deed bonds, under which individual bondholders are prohibited from initiating litigation. Instead, litigation must be conducted by the trustee. Any resources recovered through litigation must be shared among all holders of the issue in proportion to principal, thereby imposing a de facto sharing clause.

Acceleration: Right to Payment of Both Interest and Principal

While it is difficult to "accelerate" syndicated loans in the event of default, it is relatively easy to accelerate bonds.

Virtually all international credit extended to sovereign borrowers includes a provision allowing for acceleration of unpaid principal (which would make all unpaid principal immediately payable) following an event of default. Such acceleration can only be effected, however, if sufficient support among creditors is secured. Syndicated loans typically require the support of banks holding more than 50 percent of unpaid principal to force an acceleration. This relatively high threshold serves to ensure that creditors with a relatively small exposure cannot force an acceleration. In contrast, bond terms require only modest support to force an acceleration of principal, which after a default, is likely to be easily obtainable.

Secondary Market Trading

Syndicated loans are typically traded primarily within the banking community, but bonds are traded in secondary markets open to both banks and nonbanks. While it is difficult to predict who would buy distressed bonds, the possibility that some would be acquired by "vulture companies," (companies that specialize in extracting "salvage value" through litigation), cannot be precluded.

Although it is possible for individual banks in a syndicated loan to sell their share of a syndicated loan, such secondary market trading has generally been primarily among other banks and financial institutions. Financial institutions that have acquired

hand, it must be perceived as being credible; on the other, it should stop short of an explicit declaration of the borrowers inability or unwillingness to pay, which could in itself be an event of default on the instrument in question, and, as a result of cross–default provisions, on other external liabilities.[35]

The difficulties of achieving an orderly restructuring after market access has been lost are likely to be particularly acute for members with significant sovereign debt structured in the form of American–style international 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.

In contrast, British–style bonds contain a number of important features that may facilitate an orderly restructuring.[36] There are two commonly used legal structures for British–style bonds: Trust Deeds and Fiscal Agency Agreements. Both include provisions for the debtor, 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 terms binding on all holders of the issue—regardless of whether they were represented at the meeting.[37] Moreover, under Trustee Deeds (but not Fiscal Agency Agreements), individual bondholders are generally prohibited from accelerating the bonds and initiating litigation. Instead, the trustee, acting on the instruction of creditors holding a specified proportion of principal (typically 25 percent), will accelerate the bond issue and initiate litigation. The trustee must distribute any funds recovered to all bondholders in proportion to principal. In the context of litigation, but not more generally, this provision provides a de facto sharing clause, which will provide a disincentive for creditors with small exposure to resort to

[35]This underscores the importance of ensuring that members attempting to restructure external debt owed to private creditors retain the services of independent legal and financial advisors at an early stage. Such advisors should not have conflicts of interest in the form of either taking positions in the instruments subject to renegotiation, or advising creditors.

[36]Reflecting the additional cost of retaining the services of a trustee, Fiscal Agency Agreements are the prevalent form of British–style bonds. It should be noted that Brady bonds issued under English law follow the structure of American–style bonds.

[37]While the details vary among individual issues, British–style bonds generally require a quorum at the first bondholders meeting of creditors holding 75 percent of the issue. If a quorum is not achieved, the meeting can be reconvened after a specified period (typically 15 days); the quorum at the second and subsequent meetings declines to creditors holding 25 percent of the issue. The modification of terms generally requires the support of creditors holding 75 percent of the principal represented at the meeting.

litigation, and a corresponding incentive for creditors to agree on an orderly restructuring before a default.

It is generally not possible for borrowers to identify creditors holding their bonds.[38] Accordingly, bondholders would need to be approached indirectly through paying agents[39] [40] and advertisements in the financial press, which would indicate the authorities' intention to renegotiate the bonds, and invite bondholders to identify their claims and to attend a meeting.[41] Such an approach should indicate that a restructuring is intended to provide financing while adjustment policies take hold and confidence builds, rather than being used to

[38]Although some bonds are bearer instruments, there is an increasing tendency for bonds to be issued in the form of "global" notes held by custodians; this is intended to eliminate the need for the physical delivery of securities on each occasion when they are traded. In Europe, custodial services are provided predominantly by the two frequently used clearing systems, Euroclear and Cedelbank. In the United States, custodial services are generally provided by institutions acting as nominees for the Depository Trust Company (DTC). (In addition to custodial services, these institutions provide clearing services for secondary market transactions.) The accounts of custodians are confidential and are generally not made available to an issuer. Moreover, while individual bondholders may maintain accounts with custodians, many do not. In such these cases, bonds will generally be credited to the account of a bank or broker who holds the instruments as nominee for the investor.

[39]While the paying agent would know the identity of bondholders at the time of the last coupon payment, the creditor population might have shifted subsequently as a result of secondary market trading.

[40]A further complication is introduced by the possibility that bondholders may have purchased credit derivatives to insure their portfolios against payment difficulties. Credit default swaps give creditors contractual rights to sell a security to the counterparty of the swap at a specific price following a defined "credit event." There are a number of relatively standard forms of credit events, which range from missing scheduled payments or declaration of debt moratoria, to downgrading by major credit rating agencies to below a specified threshold. To the extent that the initiation of a bond renegotiation is associated with a credit downgrading, there may be an automatic preagreed change in bond ownership. To the extent that the counterparties to credit derivatives are willing to cooperate in an orderly workout, this is likely to facilitate a debt reorganization. Conversely, to the extent that the counterparties are companies specializing in extracting salvage value from distressed debt, so called vultures, this may complicate the process of reaching an orderly agreement.

[41]In contrast to the experience in the 1980s debt crisis, of rapid communication with the universe of commercial bank creditors through steering committees, the process of communicating with bondholders is likely to be slow and uncertain, particularly in the early phase of contacts.

delay adjustment. An early approach would have the obvious merit of providing breathing room for negotiations before a default on a bullet redemption payment became unavoidable.

Once creditors have been identified, and prior to a bondholder meeting, the borrower (or the borrower's financial advisors) could have initial contacts with the large creditors with a view to exploring the potential basis for an agreement. In elaborating an exchange offer, borrowers could consider including a menu of options, so as to attract as wide as possible participation at a reasonable cost. (This approach has been successfully applied in negotiations with commercial bank creditors.) Clearly, an offer would need both to be potentially acceptable to creditors and consistent with the overall macroeconomic framework, and progress toward medium–term viability.[42] It would clearly be desirable for restructurings to be exit instruments to avoid the need for repeated negotiations of individual claims. To the extent that creditors are concerned with the secondary market value of their claims, they will be disposed to press for a combination of up–front cash payments, large coupons, and short maturities on the restructured claims—properties that are likely to challenge a borrower's payment capacity during, and in the aftermath of, a severe crisis, and may give rise to the need for a subsequent restructuring.

A high participation rate will be critical to the success of a voluntary exchange. Creditors electing not to participate in an exchange pose a difficult challenge. If the borrower honors the original obligation, the cost may be large in relation to the limited payment capacity in a period of financial crisis. Moreover, creditors disposed toward accepting an exchange offer may be unwilling to participate if they see a significant problem with free riders.[43] By the same token, if the borrower defaults on the claims of nonparticipating creditors, the borrower would be vulnerable to litigation. Creditors' remedies could be particularly effective in the hands of "vulture companies" in such circumstances, since there would be a relatively small volume of remaining principal chasing scarce assets. Indeed, vultures do not like the company of other vultures! As noted above, the inability of a qualified majority of bondholders to bind in dissident creditors would make this a particularly acute problem in the context of the restructuring of American–style bonds. Such instruments provide powerful incentives for dissident creditors to try to become free riders, severely

[42]An exchange offer would need to be accompanied by supporting documentation outlining the circumstances leading to the need for a debt reorganization. Here, too, there is a need for the close involvement of legal and financial advisors, since any material misrepresentations could form the basis for creditor legal action to declare a default.

[43]Participating creditors may insist on contractual provisions requiring the borrower to ensure, retrospectively, that they receive at least as favorable treatment as creditors who elected not to participate in the initial exchange. In principle, such provisions would make the cost of a full cash settlement with creditors not participating in exchange prohibitive, since comparable treatment would need to be extended to participating creditors. In practice, however, creditors seeking to be free riders are likely to be familiar with techniques for circumventing these requirements.

complicating the task of reaching a collaborative agreement and raising the prospect of negotiations resulting in either a protracted stalemate or agreement being reached on terms that may lead to undue strain on the country's external and fiscal accounts.

In the context of British–style bonds, in contrast, it may be relatively easy to achieve high participation rates to the extent that creditors who are reluctant to participate in an exchange recognize that they may face the alternative of a modification of terms on their existing instruments imposed by a qualified majority of bondholders.[44] Moreover, in the case of Trustee Deed bonds, limitation on the ability of individual creditors to initiate litigation provides a further incentive to participate in an orderly restructuring. In this sense, the negotiation of a voluntary exchange for a British–style sovereign bond would be analogous to negotiations between an illiquid—but solvent—nonsovereign borrower and its creditors in the shadow of bankruptcy. In both cases, the incentives facing dissident creditors are shaped by the certainty that legal mechanisms could be used to modify the terms of the claims without their consent.

Beyond the terms of the individual bonds, and the availability of assets susceptible to attachment in the event of a default, there are a number of further factors which may influence the course of negotiations. The first concerns the composition of bondholders, and the second concerns intercreditor equity.

First, the course of negotiations is likely to be influenced by the composition of bondholders. At one extreme, it may be relatively straightforward to arrange for a restructuring of instruments held by either the household sector, or proprietary positions of commercial banks, since both groups seem likely to cooperate in orderly negotiations. At the other extreme, it is likely to be difficult to arrange a restructuring in cases in which vulture creditors have a significant role.

An issue that has arisen in the aftermath of the August 1998 Russian crisis, concerns the potential role of fiduciary agents in bond restructurings. Investors who hold the economic (or beneficial) interest in bonds—and who bears risks associated with nonpayment—may not actually hold title to the instruments, and be the lenders of record. Instead, the instruments may be held by financial institutions acting as fiduciary agents.[45] Fiduciary agents manage

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[44]Moreover, the ability of a quantified majority to bind in dissident creditors provides a powerful incentive for creditors with large exposures to increase their exposure through secondary market trading in order to help ensure that creditors interested in orderly workouts can master sufficient support to ensure the satisfactory conclusion of a debt renegotiation.

[45]A fiduciary relationship with investors could arise in a number of circumstances. A first example concerns fiduciary loans extended by financial institutions, but in which the economic interest has been sold to investors. In contrast to normal intermediation between lenders and debtors, in which the intermediary's capital is exposed to the risk of nonpayment by the

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assets on behalf of investors who hold the economic interest in the assets, and these agents have binding contractual obligations to protect investors' interests. The nature of these obligations will depend on the specific provisions of individual fiduciary agreements. In many cases, however, fiduciary agents may consider that they have limited room for maneuver in negotiations as a result of their potential liability to investors in respect of legal suits for civil damages. Experience with nonsovereign debt restructuring suggests that in circumstances in which there are a relatively small number of investors holding the economic interest, it may be possible to reach an agreement directly with the investors, who would then instruct the fiduciary agent to act on their behalf. (This is consistent with the experience of restructuring a fiduciary loan to Ukraine,[46] below.) By the same token, however, experience in nonsovereign cases suggests that in circumstances in which the economic interest is widely dispersed ("atomized"), fiduciary agents—who would have no choice other than to act without instructions—tend to be very cautious, thereby introducing protracted delays in reaching agreement.[47]

A second factor which may influence the progress of negotiations concerns market perceptions of inter–creditor equity. Holders of one bond issue are unlikely to agree to restructure on terms markedly inferior to the terms offered to holders of another issue, even though there would be no contractual link between the instruments and their restructuring. This could be of particular importance in circumstances in which a member is seeking to negotiate both American and British–style bonds in the same time frame. Moreover, other creditor groups may also wish to ensure that the terms of the restructuring of their own claims are not markedly inferior to those obtained by bondholders (particularly in cases in which bonds account for a significant proportion of the claims subject to renegotiation). Among other private creditors, commercial banks may demand broadly similar terms as those given to

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borrower, the fiduciary assumes no credit risk in such transactions. A second example concerns the large market for asset–backed securities in which the economic interest in instruments issued by debtors is repackaged by fiduciaries as synthetic instruments, possibly in tandem with derivatives—such as interest rates or currency swaps—so as to create investment opportunities that would not otherwise have existed. A third example concerns the economic interests of individuals in pension and mutual funds managed by professional money managers. To the extent that investment funds have invested in asset–backed securities, a number of fiduciary agents may be involved in the restructuring of individual instruments. The nature of the fiduciary obligations vary and would need to be examined on a case–by–case basis.

[46]In that case, the fiduciary—Chase Manhattan—acted as a go–between Ukraine's negotiations with the five principal investors.

[47]Such delays reduce the likelihood of reaching a prompt, orderly restructuring and increase the likelihood of delays leading to a default. An unresolved question concerns the extent to which fiduciary agents may initiate litigation following a sovereign default in order to satisfy their fiduciary responsibilities.

bondholders, while official Paris Club creditors—depending on specific circumstances—may require bond restructurings to be covered by the standard comparability–of–treatment provision of their Agreed Minute with the debtor concerned.

This suggests that in order to be able to predict the outcome of negotiations of a bond restructuring with any certainty, in addition to knowing the contractual provisions of the instruments subject to renegotiation, it would be necessary to know (1) the range of assets potentially available to settle creditors' claims following a default; (2) the composition of creditors, and the contractual obligations between the holders of the economic interest and the lenders of record; and (3) the way intercreditor dynamics are likely to unfold.

In the event that it is not possible to reach agreement on a restructuring before the redemption dates, and the country has sufficient reserves to cover the scheduled payments, the country would face the choice between making the payments and defaulting. A number of issues have a bearing on this choice including the impact of making the payment on the reserves, and the willingness of official creditors to provide support to allow bondholders to unwind their exposure. The impact of a payment on the authorities' credibility also matters. Further, if the authorities step back from the brink and avoid a default in one case, it would be difficult in any subsequent debt negotiations to credibly make any threat to default. The extent to which a default would expose the member to litigation by creditors holding distressed debt (including both instruments on which payments had been missed, as well as those on which cross–default clauses have been triggered) would need to be considered. Clearly, this will depend on the volume of relevant claims and the contractual provisions of the instruments (including, for example, whether the instruments are American–style or British–style bonds; and whether the immunity of attachment of the central bank's official reserves have been waived). The cost of a default to the member will also depend upon whether the authorities are planning new capital market operations (such as privatization) which could potentially be disrupted (or severely complicated) by litigation. Another factor is the impact on confidence in domestic financial markets, and the question of whether a default on international sovereign bonds would be seen as presaging a more extensive interruption in creditor debtor relations (for example, through a unilateral restructuring of domestic liabilities) and a weakening of the authorities' commitment to maintain the existing degree of capital account convertibility. If so, a default could trigger massive capital flight. By the same token, there is also a question of whether the depletion of reserves resulting from making the payment would also erode confidence and trigger capital flight. The medium–term impact of a default on a member's access to capital markets would also need to be considered. While it is difficult to predict how events would unfold after a default, it is probable that market access would not be restored until a final settlement has been achieved with bondholders, and the member has rebuilt its track record of creditworthiness. Finally, there are dangers of contagion, and the concern that a default by one member could have adverse effects on capital market access by a wide range of other emerging market borrowers.

Restructuring Brady Bonds

A restructuring of Brady bonds would need to address the additional complication of the treatment of collateral.[48] Immediately following an exchange of instruments, the Brady bonds would be extinguished, and the collateral released to the debtor. (Already, there are a number of examples of this for countries with market access that have exchanged Brady bonds for new 30–year noncollateralized bonds, as part of routine liability management.) The disposition of the collateral in the context of a country that has lost market access—whether as an up–front payment to creditors,[49] or to establish collateral for the new instruments—would be a matter for negotiation.

Restructuring Bonds Supported by Liens on Borrowers' Assets

A further complication arises in the context of bonds, and other securitized instruments, supported by collateral packages, such as liens on export receivables. In a typical transaction, an oil exporter would agree to escrow the proceeds of exports in an account abroad, administered by a trustee.[50] Bondholders have first claim on resources in the account (with any surpluses being paid to the debtor). The trustee will terminate the payments arrangement only after the claims of bondholders have been fully discharged. In such circumstances, it is likely to prove very difficult to persuade bondholders to exercise forbearance to agree to a restructuring. By the same token, however, by offering to expand and perhaps improve the coverage of the security arrangements, it may be possible to persuade creditors to extend new securities financing, though this too may be difficult and overly expensive for the debtor.

This underscores the concern raised, as a matter of routine in IMF policy advice, that the use of collateralized borrowing reduces the authorities' scope for maneuvering in the face of payment difficulties. Collateralization is a commonly used tool in the private sector to manage liabilities, and it may be seen by the sovereign as a technique for regaining market access in difficult periods. In the event of an adverse shock, however, the dedication of

[48]Depending on the type of instrument, Brady bonds may have principal or rolling interest collateral. The principal collateral takes the form of a zero–coupon U.S. treasury bond, which matures at the same time as the Brady bond.

[49]Although principal collateral cannot be accessed directly ahead of the final redemption on the original bond, in practice, collateral can be stripped from Brady bonds and traded separately.

[50]Such accounts may include provisions for a sinking fund to cover payments on coupons, and to build toward a redemption payment.

resources to these instruments would increase the difficulty of servicing the claims of unsecured creditors, including the IMF. For this reason, the IMF staff has strongly discouraged member countries from entering into collateralized borrowing agreements.[51]

Modification of Bond Contracts

To the extent that the contractual provisions of British–style bonds make a significant practical difference to the difficulty of restructuring, it appears likely that as experience with bond restructuring builds, British–style bonds will come to be viewed by markets as subordinated to American–style bonds, particularly for less creditworthy borrowers, with obvious implications for the pricing and composition of new bond placements.[52] This underscores the importance of moving forward with the G–10 Deputies' recommendations regarding the modification of bond contracts to include sharing clauses, modification of terms by qualified majorities, and collective representation provisions. If adopted, these changes would, in a number of important respects, produce instruments similar to British–style Trustee Deed bonds.[53] To date, however, little movement has occurred, suggesting that progress will require some form of concerted action by the G–10 or a larger group of countries. One approach would be to rely on a combination of a demonstration effect, through the inclusion of the new contractual terms in concerted international bond issues by G–10 sovereigns,[54] and a concerted regulatory requirement for new sovereign issues admitted to domestic markets to meet specified minimum conditions regarding contractual provisions.[55] Such steps could be

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[51]The use of collateral may conflict with the "negative pledge" clause in IBRD and other loan agreements.

[52]To date, there is no sign of the pricing of instruments in either the primary of secondary markets reflecting the nature of creditors' remedies. It is likely, however, that as experience with restructuring international sovereign bonds builds, the specification of creditors' remedies will be reflected in spreads.

[53]The principal exception concerns the scope of the sharing clause. As noted above, under a British–style bond the de facto sharing clauses apply only to monies recovered in the context of litigation, whereas the sharing clauses common to syndicated commercial bank loans cover all amounts recovered.

[54]As several G–10 countries are not currently active in international markets, this could require bond placements beyond their normal funding program. The creditworthiness of the countries concerned suggests that cost—in terms of additional spread—would be negligible.

[55]On its face, there would appear to be a tension between requiring a collective representation clause in a *sovereign* bond admitted to U.S. markets (which would limit the ability of individual creditors to initiate litigation) and the requirements of the U.S. Trust Indenture Act, 15 U.S.C.A. § 77ddd, which requires that, with respect to *nonsovereign* bonds offered in the

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complemented by efforts to build a consensus in support of these changes among financial institutions involved in issuing and underwriting sovereign bonds, and efforts to encourage emerging market borrowers to adopt these terms in their new issues. While the modification of bond terms could, over time, make a significant contribution to facilitating orderly workouts, the initial impact would be limited, since it would apply to the *flow* of new placements but would not affect the outstanding *stock* of bonds.[56]

Experience with Quasi–Sovereign and Sovereign Bond Restructuring

Table 2.4 provides a summary of the limited experience with restructuring of sovereign bonds and similar instruments.[57] During the 1980s, there were four examples: the restructuring of bonds by Costa Rica, Guatemala, Panama, and the restructuring of promissory notes by Nigeria. More recently, there have been actual or attempted restructurings by Moldova, Romania, Tartarstan, and Ukraine. In addition, Zambia has successfully restructured a private sector claim that, while having a somewhat different structure, had many features of a sovereign bond. With such limited experience, it is premature to draw firm conclusions. Nevertheless, four points may be noted.

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United States, the right of any bondholder to receive payments due or to sue to recover missed payments may not be impaired without his consent (except that terms allowing a 75 percent majority to agree to a postponement of interest of up to three years are permissible). A critical difference between *sovereign* and *nonsovereign* bonds, however, concerns the applicability of bankruptcy procedures. National bankruptcy laws provide a legally binding mechanism for modifying the terms of *nonsovereign* bonds held by creditors including all dissidents); such laws do not apply to *sovereign* debtors.

[56]In principle, this could be addressed through a global exchange of new bonds incorporating the modified terms for the outstanding stock of "old" bonds. Such an exchange would need to be voluntary, however, and would likely be difficult to arrange. If a single issuer were to undertake such an exchange, it might be interpreted by investors as a signal that a default was being contemplated by that issuer, whereas, if all sovereigns were to do so simultaneously, this interpretation would be less likely. However, issuers, particularly those with high credit ratings, may be reluctant to participate because they may consider that the addition cost of an exchange would not be matched by sufficient benefits. Consideration could be given to how the burden of an exchange could be shared among the international community.

[57]See: "Fernández–Ansola and Laursen, "Historical Experiences with Bond Financing to Developing Countries," IMF Working Paper 95/27, and Piñon, "Private Bond Restructurings: Lessons for the Case of Sovereign Debtors," IMF Working Paper 96/11.

Table 2.4 Selected Bond Restructurings

Country	Amount and Original Terms	Year of Settlement and New Terms
Costa Rica		
1985. Offer to extend the maturities of certain sovereign bonds.	$90 million of US$ floating rate notes falling due in 1985, at an interest rate of LIBOR + 7/8.	Interest arrears of $22 million were cleared prior to the exchange. Old bonds were exchanged for new US$ floating rate notes with an average maturity of 5 1/2 years (including a 3-year grace period), at an interest rate of LIBOR + 1 1/4. Banks had the option of converting old bonds to debt with an average maturity of 7 1/5 years (also a 3-year grace period), at an interest rate of LIBOR + 1 5/8.
Guatemala		
1989. Offer to restructure certain debt obligations.	$500 million of 1983-84 external bonds falling due in 1988-89, at interest rates ranging from 11 percent to 12 1/2 percent.	No interest arrears existed. Old bonds were replaced by either US$ bonds at a fixed interest rate of 10 percent and with a 10 1/2-year maturity (including a 4 1/2-year grace period), or local currency bonds at an interest rate of 16 percent and a 7 1/2-year maturity.
Nigeria		
1988. Offer to restructure debt related to trade arrears.	$4.9 billion of government-guaranteed promissory notes issued to refinance trade arrears, at an interest rate of LIBOR + 1.	Old claims were rescheduled over 16 years with a 2-year grace period at an interest rate of 5 percent.
Panama		
1994. Offer to exchange old bonds.	$450 million in total, of which $170 million were interest arrears. Bonds had been issued in the 1970s-80s to a diverse group of creditors and on different terms.	The offer included a 25 percent cash payment on past due interest and the restructuring of principal and remaining past due interest at par. New notes were in US$ and Japanese yen with a maturity of 8 years, including 1 1/2-years grace period, at an interest rate of LIBOR + 1 on US$ bonds or a fixed rate of 3 3/4 percent for yen bonds.
Ukraine		
1998. Offer to exchange external obligations.	A $109 million fiduciary loan to Chase Manhattan Bank and $350 million hedged and unhedged treasury bills and bonds owned by nonresidents led by Merrill Lynch.	**Chase Manhattan:** a 25 percent up-front cash payment, with the rest being converted into 2-year US$ international bonds at an interest rate of 16 3/4 percent. Principal payments will be limited to $2 million per quarter during the first year, with the balance paid in four equal installments in 2000. **Merrill Lynch**: on the hedged instruments, a 20 percent up-front cash payment, with the rest being exchanged to 2-year US$ international bonds at an interest rate of 20 percent with a bullet payment at maturity. Unhedged instruments were exchanged for new bonds with similar terms, but without the upfront cash payment.

Sources: Juan Jose Fernandez-Ansola and Thomas Laursen, "Historical Experience with Bond Financing to Developing Countries," IMF Working Paper WP/95/27 and IMF staff.

• First, in all cases the authorities arranged (or attempted to arrange) for a voluntary exchange of instruments, rather than a modification of the terms of existing instruments.

• Second, Nigeria, Panama, and Zambia restructured instruments that had been in arrears for sustained periods. In the first two cases, litigation was not a significant factor. This may have reflected the specific circumstances of the cases: Nigerian promissory notes—short–term trade arrears restructured into notes in the form of a British–style Trustee Deed—continued to be held by suppliers and did not fall into the hands of creditors adept at extracting salvage value from distressed debt. The Panamanian default occurred in the context of a conflict with the United States and a freeze on Panamanian assets; in these circumstances, creditors may have considered that litigation would have been of little value. These cases, however, appears to be *sui generis*. In the case of Zambia, in contrast, a claim held by a vulture (Camdex) led to extensive litigation. The claim was eventually settled on terms more favorable to Camdex than the terms given to other commercial creditors under the (IDA) debt–reduction operation, or to Paris Club bilateral creditors.

• Third, in none of the cases were debtors able to secure any debt– or debt–service reduction (DDSR). In the case of Panama, bonds were restructured on nonconcessional terms even though a Brady–style DDSR operation was negotiated with commercial bank creditors in the same time frame; this may provide an indirect indicator of the potential power of creditors' legal remedies.

• Fourth, in the recent examples it proved to be substantially more difficult to secure agreement on a substantial extension of maturities, with relatively low spreads and modest up–front payments, than was the case during the 1980s. Indeed, in the case of Ukraine, reaching a voluntary agreement on a bond renegotiation entailed substantial up–front cash payments, with the balance restructured on short maturities with very high spreads. To the extent that this reflects the increased diversity among creditors, and their greater financial and legal sophistication, this may become more typical in future restructurings.

Recent Developments

In the wake of the Asian and Russian crises, there have been a few examples of efforts to refinance maturing bonds and similar instruments on a voluntary basis.

In the second half of 1998, in the aftermath of the Russian crisis, **Ukraine** faced repayment obligations on two fiduciary loans[58] and nonresidents' holdings of domestic

[58]The fiduciary loans included contractual provisions regarding modification of terms and limitations on the ability of individual creditors to initiate litigation similar to those in British–style bonds. The loans were arranged by major investment banks, but sold to a wide range of investors. The instruments were governed by Luxembourg law. It is understood that Ukraine's choice of a fiduciary structure reflected legal limitations on the government's

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treasury bills partly supported by an exchange rate hedge.[59] With a loss of spontaneous market access, and severe pressure on usable reserves, the authorities sought a voluntary restructuring of these instruments. A default on these instruments could have triggered cross default clauses in other outstanding international sovereign bonds, with a face value of DM $1 billion (about $615 million) and ECU 500 million ($580 million). In the event, defaults were avoided.

• In September, creditors holding the $450 million fiduciary loan arranged by Nomura, were unwilling to participate in a renegotiation, and were repaid in full at maturity.

• In September, following the approval of an IMF Extended Fund Facility arrangement, which made no allowance for net payment of principal to private creditors, Ukraine entered into negotiations with Merrill Lynch, which had organized the sale of treasury bills and bonds to investors. After difficult negotiations, about 80 percent of creditors participating in the Merrill Lynch deal (and 100 percent of creditors holding hedged treasury bills) settled; an immediate cash settlement of 20 percent of principal, with the balance converted into a two–year zero–coupon bullet redemption Eurobond, with an annual yield to maturity of 20 percent; holders of unhedged bills and bonds received similar terms, but without an up–front cash payment. The remaining holders accepted settlement in local currency, which could be used to purchase goods and services locally, but which could not be repatriated directly.

• Subsequently, creditors participating in a fiduciary loan arranged by Chase Manhattan (these creditors are believed to have mainly been hedge funds) reached agreement on a restructuring which involved the up front payment of 25 percent of principal, with the balance converted into a two–year Eurobond, with a coupon yield of 16.75 percent. The better terms obtained by the participants in the Chase Manhattan loan, compared with the Merrill Lynch arrangement, reflected the stronger legal remedies available to them in their instrument, which, in the event of a default, would have enabled creditors to seek to enforce their claims without needing first to prevail on a number of complex legal issues.

In other cases, efforts to refinance Eurobonds have demonstrated the difficulty of the exercise.

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[58](...continued)
authority to place international bonds.

[59]The Merrill Lynch deal was governed by Ukrainian law. The authorities argued that the sole contractual obligation concerned payment in local currency on the treasury bills, and that the documents prepared by the National Bank of Ukraine did not include a binding contract, and provided neither an exchange rate nor a transfer guarantee. Had creditors wished to obtain settlement through litigation, they would have first needed to have prevailed on a number of complex legal issues. In the event, creditors did not initiate litigation.

• The **Republic of Moldova**, confronted in December 1998 with the exercise of an embedded put option in a $30 million three–year private placement international bond, sought to restructure payments. After extensive discussions, about 10 percent of creditors accepted an agreement to settle for 85 cents on the dollar, while other creditors represented by a major international financial institution broke off negotiations on a restructuring and received payment in full.

• The **Republic of Tatarstan** (an autonomous republic within the Russian Federation) similarly sought to refinance a $100 million public Eurobond maturing in October 1998.[60] Tatarstan was able to reach agreement with creditors on an up–front cash payment of full accrued interest and a 10 percent repayment of principal, while the balance was rescheduled over one year with 10 percent principal payments, starting in February 1999, at a graduated interest rate, increasing from 14.5 percent to 20 percent. The restructured bond also embeds a call option allowing Tatarstan to repay the remaining amount of the loan, making it possible for Tatarstan to take advantage of an improvement in market access.

• In **Romania,** a put option in a $75 million sovereign guaranteed bond issued by Bancorex, the largest state bank, led to a full cash payment in December 1998, without an attempt at renegotiation. Also, a covenant in a bond issued by the state–owned power utility was breached during the process of privatization of Conel (formerly Renel), allowing note holders to demand repayment of $135 million in outstanding bonds. The government offered a formal guarantee in return for the investors' forgoing the right to receive repayment. At a meeting of the bondholders in January 1999, over 85 percent approved a modification of terms reinstating the notes (above the 80 percent required to make a change in terms effective) in exchange for the extension of a full guarantee by the Republic of Romania.

Another recent development with important implications for the future treatment of Eurobonds is the decision by the Paris Club creditors, in the case of **Pakistan**, to require that the Pakistani authorities approach their bondholders to seek "comparable treatment" to that offered by the Club, although Club creditors have indicated their willingness to interpret comparability of treatment with a degree of flexibility. Pakistan has four outstanding bond issues, with a cumulative face value of $628 million. This is the first case in which bonds have been explicitly included in the comparability requirement of a Paris Club Agreed Minute.[61]

[60]The zero–coupon Eurobond was issued in April 1998 with an interest rate of 14.5 percent. *Euroweek* comments indicate that placement was almost equally divided between U.S. and European investors, consisting of asset managers, banks, and leveraged funds. The governing laws of the Eurobond were, as in the Moldova case, English and required a 75 percent vote to approve a modification of the bond terms.

[61]Few recipients of Paris Club reschedulings have had outstanding Eurobonds; in the recent case of Indonesia, scheduled bond redemptions fell outside the consolidation period.

In the near future Pakistan is expected to approach its bondholders for a voluntary restructuring. While it is not possible to anticipate the outcome of these negotiations, two points suggest that a restructuring may be a relatively straightforward process. First, all of the instruments are British–style bonds structured as Trustee Deeds. Second, there are indications that a substantial proportion of the bonds are held by individuals, rather than the type of investors who would bring considerable financial and legal expertise to the negotiating table. As noted above, however, to the extent that bonds are held indirectly through fiduciary agents, negotiations could nevertheless be difficult.

Restructuring of Russia's Domestic Bonds

In 1998 Russia was able to effect a voluntary exchange of ruble–denominated treasury bills for Eurobonds that was designed to lengthen the maturity of government debt and improve debt management. Russia's domestic treasury bill market was launched in 1993, and by end–June 1998 the stock of treasury bills (GKOs and OFZs) outstanding stood at close to $55 billion at the prevailing exchange rate. Starting in early 1997, the government took steps to lengthen the average maturity of the treasury bills by rolling over GKOs into longer–maturity OFZs. However, a decline in investor confidence in the fall of 1997 on account of the Asian crisis and further political and external shocks in the first half of 1998 made the rollover of ruble–denominated debt more difficult. The relatively short maturity structure of the outstanding treasury bills, together with high interest rates, resulted in debt–service payments exceeding $1 billion a week. To attenuate the budgetary pressures of these debt–service obligations, the authorities undertook a debt–exchange program in July 1998 under which about $4.4 billion of GKOs was converted into 7– and 20–year Eurobonds, including some holdings by Sberbank. Both bonds were issued at very high spreads (940 basis points about U.S. treasuries).

The amount of GKO conversion, however, was well below the amounts eligible for conversion (about $40 billion, including holdings by the Central Bank of Russia). Argument could be made that during the days in which the conversion offer was being made, investors were of the view that the government's new economic program being supported by the IMF under the Extended Arrangement would be successful in avoiding a devaluation of the ruble. To the extent that they believed that a devaluation could be avoided, investors expected to realize relatively higher returns on their GKOs holdings than on Eurobonds, inducing them to hold onto their GKOs and not accept the government's conversion offer.

In summary, recent experience has demonstrated both the advantages and limitations of voluntary approaches to refinancing Eurobonds. In most of the cases cited, it was possible to reach agreement on a voluntary restructuring. The risk of nonpayment was a factor bringing the parties together, but in no case was it an explicit threat to the investors. Agreements provided refinancing of most (but generally not all) of the amounts due, at high interest rates, reflecting the weak external environment facing the countries, but also well below the market spread on existing assets.

At the same time, the restructurings of bonds in Ukraine and Tatarstan produced relatively short–maturity instruments with up–front cash payment. It is important that in future cases every effort should be made to obtain longer maturities with reasonable up–front cash payments and yields, though the difficulty of achieving these objectives should not be underestimated. The implications of these agreements for external viability and financing assurances of a possible IMF–supported program will need to be examined.

Official Enhancements of Emerging Market Debt Instruments

The recent turmoil in international financial markets has led to a sharp reversal in the flow of new financing to emerging markets. Total issuance by emerging markets—bonds, loans, and equities—fell from a peak of $286 billion in 1997 to $149 billion in 1998. The decline was particularly sharp from the third quarter of 1998, with issuance of only $96 billion at an annual rate in the four months through January 1999. These developments have led to a renewed search for initiatives that can help countries reestablish market access coming out of the crisis.[62]

One set of such proposals calls for the enhancement of private debt instruments by official creditors, including international financial institutions. These initiatives involve full or partial official guarantees of new emerging market debt and should be distinguished from the use of official resources to provide collateral to facilitate the restructuring of existing debt (as under "Brady" operations). These guarantees are intended to "leverage" official capital, allowing a limited amount of official capital to support a larger amount of financing, while lowering the costs of private financing for emerging market borrowers. In general, the proposals aim to encourage a renewal of relations between governments and their private creditors, enhance the creditworthiness of the borrower, allow a speedier restoration of market confidence, and help to address concerns about burden sharing among official and private creditors.

This section addresses the potential for such guarantees to better involve the private sector and to help reestablish market access; the focus is on the effectiveness of enhanced instruments in achieving and sustaining an increase in unguaranteed private sector exposure (additionality).[63] It is this element that speaks most directly to the role of guarantees in the

[62]See "The Crisis in Emerging Markets," Chapter II in *the IMF's World Economic Outlook and International Capital Markets: Interim Assessment* (December 1998).

[63]In some cases there are other pragmatic reasons that official creditors may see guarantees as a preferred method of providing official resources to emerging market borrowers. In such cases, the use of guarantee may reflect the ability to mobilize additional *official* resources, including through appropriate leveraging of a capital constraint on lending. This report does

(continued...)

current debate over the role of the private sector in resolving and forestalling financial crisis. However, it is difficult to determine, ex ante, the extent to which guarantees are able to generate additionality—this remains an empirical question.

Notwithstanding the possibility of being able to mobilize additional private sector resources, depending on their design, guarantees may pose a number of potential pitfalls for the international financial institutions and other official creditors. Specifically, there are questions about the risk that the mobilization of additional private resources would come at a cost of transferring at least some degree of preferred creditor status to private creditors, and of the entanglement of public and private sector interests. In addition, there may be crowding out of direct official lending—an issue of some concern to borrowers—because enhanced instruments tend to be expensive relative to direct official loans. This underscores the importance of care in the design and application of guarantees, as well as the need to weigh the relative merits of guarantees versus direct lending.

Against this background, and in response to a shareholder's call for enhanced use of guarantees, the World Bank has reviewed its experience with guarantees and has proposed a revised policy that incorporates lessons learned and allows for the possibility of policy–based guarantees (Box 2.6). The proposal envisages a cautious, initially small, program in which stringent criteria are applied to seek to produce beneficial results (notably additionality), while minimizing the potential drawbacks. In particular, the proposal entails clear understandings with private creditors that the World Bank's preferred creditor status will not be extended to the unguaranteed portion of a loan. The proposal recommends that the Bank proceed cautiously, with a pilot program of up to $2 billion in partial–credit guarantees, aimed selectively at good performers. This will allow, over time, a careful assessment of the effectiveness of the new guarantee structure.

The design of any guarantee program developed by other official entities will face similar challenges. The need for caution in addressing the issues involved suggests that such programs are likely to remain small and well–targeted to countries with particularly strong track records and policy frameworks, while experience is gained and the extent to which guarantees are able to produce additionality in modern financial markets assessed. It remains to be seen the extent to which there is a role for well–designed guarantee programs to make an effective contribution to catalyzing private capital in difficult financial circumstances. The discussion in this section is limited to the use of guarantees to mobilize financial credits. (The use of guarantees to mobilize project financing raises a range of complex issues,

[63](...continued)
not deal with such considerations.

Box 2.6 The World Bank's New Policy on Guarantees

The World Bank has recently put forward, for consideration by committees of the Bank's Executive Board, a proposal to extend the application of the existing World Bank partial credit guarantee instrument beyond projects to borrowings in support of structural and social policy reforms. The objective of such policy-based guarantees, which would cover a portion of debt service on a sovereign borrowing (loan or bond) by an eligible member country from private foreign creditors, would be to play a catalytic role in helping World Bank borrowers with strong economic and social programs to improve their access to private foreign financing in support of agreed structural, institutional, and social policies and reforms.

The review underpinning the proposed program notes a number of concerns with past programs, notably the risk of extension of the Bank's preferred creditor status. Bank policy has evolved over time in response to these concerns, and the new proposal envisages tight operational safeguards to minimize the risks.

- There are tight limits on country eligibility: the program is aimed at strong performers "on the edge of the market," in order to catalyze access. Criteria include a strong track record of economic performance, and sound macroeconomic and structural policies in place; a demonstrated need for external finance for high-priority uses, and a coherent borrowing strategy and sustainable financing plans. The program would be limited to World Bank eligible countries.

- Countries receiving the guarantee would be expected to implement up-front conditionality (prior to Board approval), and financial efficiency would be rigorously assessed in terms of both the magnitude and terms of private financing mobilized by the guarantee.

- The initial program is small: the pilot program would be subject to review after the $2 billion in exposure is reached, or in any case after two years.

- Prudent financial guidelines and practices will be followed. First, as for project-based partial credit guarantees, The Bank would assess the nominal exposure under a policy-based guarantee as the net present value of the guarantee and determine the amount of capital to score against it on a risk adjusted actuarial basis. Second, exposure from policy-based guarantees would be accommodated within existing exposure limits; thus, policy-based guarantees would not be an avenue for additional lending to a country that has reached internal limits on World Bank exposure. Third, provisioning and reserve treatment would be the same as project-based guarantees, and projections of future reserves and provisioning would need to take account of any automatic increases in exposure built into the guarantees.

- The proposal makes explicit the Bank's position that it will not extend its preferred creditor status to the unguaranteed portion of the loan. All policy-based guarantees would be nonaccelerable, and there would be no provisions for sharing of debt–service payments.

which are beyond the scope of this report.[64]) General considerations that need to be brought to bear in assessing guarantee proposals are discussed, focusing on official support for financial credits. Some recent examples of credit enhancements are then examined. Finally, a brief discussion of official support for debt restructuring is offered.

Official Enhancements to Attract New Money: General Considerations

The case for guarantees rests on their ability to help solve a market failure and allow for additional private sector exposure, at reasonable cost, for countries pursuing appropriate macroeconomic and structural policies. In the current environment, this means helping to reestablish market access without creating new problems down the road through an excessively rigid debt structure. Also, enhancements should not be used as a means of bypassing the conditionality typically associated with direct official lending. This section focuses on some general considerations to be brought to bear in assessing *partial credit guarantees*, which are the primary focus of recent proposals for involving the private sector in crisis resolution.

Market Failure

The case for enhanced lending rests in the first instance on a judgment that the closure of markets reflects a market imperfection that justifies official involvement. Presumably, a critical element in this judgment is the existence of systemic effects on market access of developments in one or more emerging markets. Alternatively, it could reflect a view that credit rationing is preventing worthy projects from proceeding, and that guarantees can create a market that otherwise would not exist. Further, the use of guarantees may be an effective way for signaling the official community's view that the policies being financed are worthy of international support. Specifically, the commitments made by the borrower in accepting a World Bank guarantee, and the Bank's judgment that stringent eligibility criteria have been met, may provide an effective signal of the strength of the borrower's policies. It is hoped that such an endorsement, combined with firm implementation of policies, will lead a diverse range

[64]Project financing tends to rely upon *partial risk guarantees.* These guarantees protect against payment defaults on debt that are the result of specifically defined governmental risks—for example, the risk that a government will breach contractual obligations related to the financed project, such as a formula for setting tariffs or rules affecting market access. In the context of World Bank project finance, they can allow an efficient division of the many risks associated with the project between the official and private sectors. The World Bank generally takes on "policy risks," which because of its ongoing policy dialogue it is better able to manage and control; while the private sector takes on commercial risks, which it is better able to assess. In contrast, *partial credit guarantees*, the primary focus of this report, protect against general payments defaults on a specifically defined portion of debt service on the guaranteed borrowing.

of creditors to view exposure in the country more favorably than previously. In a market subject to booms, bust, and bandwagon effects, which could result in multiple equilibria, a well–designed official guarantee could allow a "good" equilibrium to prevail over a "bad" one, resulting in increased private lending and a decline in risk premia.

Additionality

A key question in evaluating the case for guarantees is whether the financial and legal structure of the associated financing packages provides *additionality.* For purposes of this report, additionality is defined to refer to a willingness of the private sector to accept additional unguaranteed exposure, or a lengthening of maturities, on reasonable terms (see Box 2.7).[65] In order to "bail in" the private sector, some degree of additionality will be critical.

- For new entrants (and reentrants) to capital markets, the use of official enhancements may be helpful in catalyzing additional private sector financing during the early efforts to tap international markets. In such cases, additionality needs to be assessed over the course of a number of transactions, including those without enhancements. That is, even if additionality is inconclusive on the guaranteed issue alone, there could be measurable benefits from the introduction to markets with a lag, once a track record has begun to be established.

- For established borrowers, in contrast, there should be a presumption that there will be measurable additionality on the individual project, viewed on a stand–alone basis or within a relatively short time frame. It is harder to argue here that a guarantee has benefits *only* one, two or three years later, as such access may well have been able to be achieved without the initial guarantee.

For a single transaction, additionality requires that the private sector accepts partial risk on principal or interest that it would not have accepted otherwise. Full guarantees of principle and interest, of course, provide no additionality on the specific transaction, since the credit exposure of the guarantor equals the value of the underlying debt instrument. Moreover, they are likely to be more expensive than a direct official loan. In addition, for partial guarantees structured in the form of a guarantee of principal, but not of interest, to have additionality, the guarantee must be "nonaccelerable." If the exercise of a principal guarantee following a default causes the principal to become immediately due and payable, private creditors would be shielded from risk associated with subsequent scheduled unguaranteed interest payments.

[65]This defines additionality broadly, to include either increased volumes of cross–border credit (the objective behind recent enhancements for Malaysia and Thailand) or a lengthening of maturities (as in an earlier operation for Hungary; see Box 2.7).

Box 2.7 World Bank Guarantee of Hungarian Bond

The World Bank's guarantee of Hungary's 1990 bond was considered a success in that it provided a longer maturity exposure (ten years) than could be achieved without the guarantee, thereby helping to avoid a hump in the debt service profile. Subsequently, Hungary was able to return to markets in larger amounts and for longer periods than previously, in the context of improved economic performance and better global financial conditions. The guarantee was nonaccelerable and covered approximately 45 percent of the present value of the flow of debt-service payments, or about $90 million, suggesting that the operation was successful in leveraging the Bank's capital. (This amount, which rises over time, is counted against the Bank's lending limit to Hungary and is used to compute the capital charge.) Importantly, if Hungary encounters debt-servicing difficulties, an interruption of interest payments on this bond would not automatically endanger its standing with the World Bank.

From the standpoint of creditors, this bond can be decomposed into a combination of a 10-year zero coupon bond issued by the World Bank, plus a slowly amortizing bond carrying Hungarian sovereign exposure. The maturity of creditors' exposure can usefully be compared on the basis of the duration[1] of the guaranteed and nonguaranteed payment streams. At the time of issue, the duration of the bond was approximately 6¾ years. The duration of the guaranteed principal bullet payment was 10 years, while the nonguaranteed flow of coupon payments had a duration of about 4½ years.[2] By way of comparison, Hungarian sovereign bonds issued shortly before and after the guaranteed issue had durations of approximately 4 years.

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[1]Duration is widely used in financial markets to measure the average life of a security. It is calculated as the weighted average of the present value of the cash flow associated with a debt instrument. Formally:

$$\text{Duration} = \sum(PV_i\, t_i)/\sum(PV_i)$$

Where PV_i is the present value of the cash flow in period *i*, evaluated at the instrument's yield to maturity. This should be distinguished from modified duration (which is calculated as the ratio of duration and one plus the yield to maturity), which provides a measure of the change in the price of an instrument in relation to a change in its yield.

[2]A creditor could isolate the sovereign risk by combining the bond with a short position in a stripped World Bank bond of approximately 10 years' duration.Thus, the yield on the partially guaranteed bond should be a weighted average of the borrowing rates of the World Bank and the Hungarian government. In practice, however, the interest rate was slightly higher. This may reflect that the markets dislike instruments—such as guaranteed bonds—that blend risks associated with multilateral/bilateral guarantors and the sovereign risk of the debtor country, and that stripping out these risks is costly.

A common market practice is to strip instruments into different risk classes. It is probable that markets would strip the guaranteed portion of risk from the unguaranteed portions, and trade the resulting payment streams separately. Against this background, there is a question why creditors would be willing to increase their exposure to sovereign risk in the framework of a partial guarantee, when they may not be willing to do so in the absence of a guarantee.[66] One possible explanation is that private creditors may perceive the structure of the instrument as in effect extending some degree of implicit or explicit senior status to the unguaranteed portion of the issue, which could lead private creditors to be willing to provide more money under the umbrella of such perceived seniority than they would in a less senior position. As discussed further below, however, engineering additionality through creating new senior instruments raises a number of concerns.

A second explanation—as relates to guarantees by multilateral institutions—is that the policy conditionality associated with the extension of a guarantee and additional official financing may be seen to improve creditworthiness and pave the way for inflows of other private capital. In these cases, guarantees can solve market imperfections for some borrowers in some circumstances. Where this is the case, the willingness of the private sector to accept additional exposure should be reflected in a decline in the risk premium on existing assets. Further, the use of enhancements may help to improve the borrower's relationship with private capital markets—for example, by disseminating information on the authorities' economic program, enhancing market contacts, and providing an official stamp of approval for the country's policies. While this argument may be relevant for countries that have yet to gain (or regain) capital market access, as noted above, it is less likely to apply to countries with well–established presence in international capital markets, and whose policies and performance are already closely followed by creditors and market analysts. Finally, enhancements (both multilateral and bilateral) may provide additionality if they increase overall market liquidity (Box 2.8). While these effects may be at work, the evidence for additionality is not unequivocal, and needs to be assessed on a case–by–case basis.

To be successful in addressing balance of payments difficulties and helping countries achieve sustainable growth, it is clearly important that resources be used to finance adjustment, rather than to finance a delay in adopting corrective measures. With regard to the provision of new money, guarantees should be provided in the context of a carefully specified economic program, subject to appropriate conditionality.

[66]The analysis of collateralized debt instruments to attract new money is essentially identical to that of partial guarantees. Markets are adept at separating the uncollateralized risk, and the problem of persuading creditors to accept additional exposure to sovereign risk remains unresolved. Markets also could offset the underlying sovereign risk through dynamic hedging, resulting in a reduction in exposure on other instruments, leading to little net new money.

Box 2.8 Liquidity Puts

A separate argument for official enhancements involves the reduction of liquidity risk. In recent periods of severe turbulence in financial markets, liquidity for emerging debt instruments declined sharply, and creditors were unable to unwind their positions through secondary market trading, except at large discounts. This potential lack of liquidity may lead to higher borrowing costs for emerging market debtors.

To address this concern, it has been suggested that put options could be attached to new debt issues, which would provide a guaranteed market price—underwritten by international financial institutions—at which creditors could put their claims in periods of rapid market declines. Specifically, during periods of sharp price declines, a liquidity put allows the holder to put the bond back to the issuer at a price below, but close to, the average price over some preceding period. The effect of such a put is to cap the extent to which prices can decline in a short period, providing a basic level of liquidity to the market.

This proposal for "liquidity puts," raises issues similar to those discussed in the main text. Moreover, it is not clear that a lack of liquidity is responsible for temporary interruptions in borrowers' market access. The proposal does not provide convincing arguments on the need for official—rather than private sector—action in this area; or on the structures' ability to catalyze new money. Further, such instruments raise issues of possible collusion among creditors holding a large share of the issue, to the detriment of the international financial institution that had written the put. (Such creditors could potentially engineer sharp but temporary price movements which would trigger the put at a price substantially above the secondary market prices of similar instruments without liquidity puts.) No instruments including liquidity puts have come to market to date, and the World Bank's policy on guarantees does not envisage support for such instruments.

Efficiency

The use of guarantees should be efficient in the sense that it provides additional finance, at lower cost, in support of sound policies. In a number of recent cases, the use of official multilateral and bilateral guarantees has allowed countries to borrow at roughly the cost of funds for a top–quality international bank, well below the countries' current market cost of funds but above the direct lending rate of the guaranteeing institutions.

Consequently, the case for the efficiency of guarantees generally rests on their possible effectiveness in increasing the flow of capital to borrowers. In addition to possible benefits through solving market failures, as discussed above, guarantees may be efficient if they surmount lending constraints on capital on the part of official creditors contemplating direct loans versus guarantees. Guarantees may offer the opportunity to take on additional exposure, although multilateral lenders have generally not sought to use guarantees to leverage their capital bases aggressively.[67]

Seniority, Entanglement, and Crowding Out

The potential for mobilizing additional funds through guarantees or other financial instruments with senior status may not come without costs, and these warrant careful consideration. In particular, depending on their structure, partial guarantees may tend to raise the stock of inflexible (unrestructurable) debt beyond the extent of the guaranteed portion, increasing the rigidity of the debt stock and reducing the borrowing authorities' scope for maneuver in the event of future balance of payments crises. (A direct official loan similarly raises the stock of inflexible debt, but in a more transparent manner than with guarantees; this underscores the need for a careful accounting of aggregate senior exposure.) Indeed, reflecting similar concerns, the IMF has generally discouraged members from issuing other senior instruments (for example, those collateralized through a pledge of export receivables) on these grounds. At the same time, increases in the volume of senior debt harm the repayment prospects for more junior debt. In the short term, new senior debt may provide additional new money, as long as existing junior creditors cannot substantially reduce their exposure (e.g., because most junior debt has relatively long residual maturities). Over the medium term, however, an excessive accumulation of senior debt is likely to crowd out new junior lending, exacerbating the difficulty of reestablishing spontaneous capital market access.[68]

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[67]For example, the IBRD assesses the nominal exposure under partial credit guarantees as the net present value of the guarantee and determines the amount of capital to score against it on a risk–adjusted actuarial basis.

[68]Preferred structures may also catalyze new money if they increase the expected stream of payments from the country. This may be true if countries are more willing to pay senior

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In addition, depending on their structure, guarantees may raise the possibility of *entanglement* of the interests of the multilateral or bilateral institutions and private creditors in the event of a default on the underlying instrument. This would be a case, for example, if a default on an unguaranteed interest payment enabled creditors to accelerate principal and call a principal guarantee.[69] Because a borrower unable to make a interest payment would clearly not be able to reimburse the guarantor for the call on the guarantee, the ability of the multilateral concerned to provide new money in a crisis may be severely curtailed on account of the normal prohibition of International Financial Institution from lending into their own arrears.[70] This was one of the considerations that led the World Bank to discontinue its B–loan program in the late 1980s.[71] This concern does not arise under the Bank's current guarantee program.[72]

[68](...continued)
creditors, owing due to the political and economic costs of default to preferred creditors, or the benefits of remaining in good standing with such creditors.

[69]Principal coverage under most World Bank partial credit guarantees has been structured as nonaccelerable obligations of the Bank.

[70]The financing difficulties could be further complicated by limitations on the IMF's ability to provide financial support to members with arrears to the World Bank, stemming from the strengthened cooperative strategy on overdue obligations.

[71]The B–loan program was designed to allow the World Bank to participate directly as a lender in a syndicated loan with commercial banks and provide partial guarantees for commercial loans. From 1983–88, 24 B–loan operations were completed, 5 involving guarantees.

[72]Under the Bank's current guarantee program, the counterguarantee (indemnity) agreements between the borrower and the Bank specify that the borrower is to repay the Bank on demand or as the Bank otherwise directs for any amounts paid by the Bank under its guarantee. In such a case, as long as the borrower does not default in making such repayments as directed by the Bank (which, at the Bank's discretion, could be over time rather than immediately), it would not be in arrears to the Bank, and the Bank could continue lending to the borrower.

Recent Examples of Credit Enhancements

The experience with nonproject, partial credit guarantees rests primarily with the World Bank, through the ECO program,[73] and the current guarantee program.[74] In the context of its recent proposal to introduce policy–based guarantees, the World Bank provided a qualitative assessment of the effectiveness of its guarantee program, concluding that such guarantees could have a potentially catalytic effect, for some countries under some circumstances, including potentially under extremely difficult market conditions. However, it recognized the complexity involved in such a judgment and noted features of past programs that had limited the effective additionality. In this regard, the Bank's report highlighted the evolution of its programs in response to concerns about the extension of its preferred creditor status under its earlier B–loan program.

This section focuses on the lessons to be drawn from partial credit enhancements that have been used by the Bank and other official lenders. One prominent example of such an instrument was the World Bank's guarantee under the ECO program of the bullet principal payment (but not the coupon interest payments) on a US$200 million, 10–year bond issue by Hungary in 1990. The guarantee was provided at a time when Hungary faced limited access to international capital markets, and generally only at shorter maturities (around five years). The guarantee of the loan was intended to extend the maturity of private sector exposure under this operation (Box 2.7). Although Hungary was subsequently able to return to capital markets at longer maturities, this took place in the context of improved economic performance, and it is difficult to establish a link between this improvement in access and the catalytic effect of the guaranteed bond.[75]

A more recent example of a more complex instrument developed under the Bank's general guarantee authority that was used to catalyze flows that may not have occurred otherwise was the World Bank's partial guarantee of a $300 million sale of 10–year bonds by the Electricity Generating Authority of Thailand (EGAT). The bonds also carried a Thai government guarantee. This has attracted a great deal of interest among private market

[73]The Expanded Cofinancing Program (ECO) operated during 1989–94 and permitted the use of guarantees to mobilize private cofinancing for public or joint public/private Bank projects. Four ECO guarantees were approved. In 1994, the ECO program was replaced by a more generalized use of guarantees as a mainstream instrument in Bank operations.

[74]Since 1994, the World Bank has approved 10 guarantee operations for projects in IBRD–countries, mostly in infrastructure. In addition, one IDA guarantee, for Côte d'Ivoire, was approved in December 1998.

[75]In the 14 months following the placement of the World Bank guaranteed loan, Hungary made ten further sovereign bond placements, seven with 5–year maturities, and three with 7–year maturities. Hungary's next 10–year bond was placed in November 1991, 15 months after the guaranteed placement.

participants. In this case, the World Bank guaranteed principal, provided a "rolling" guarantee of interest payments, and covered around 66 percent of the present value of the instrument.[76] As with the Hungarian bond, the guarantee of the bullet principal payment is nonaccelerable. In addition, however, there is a rolling guarantee of a single coupon payment, which may be perceived by markets as implicitly extending some degree of senior status to unguaranteed payments (Box 2.9).

The use of World Bank and Thai government guarantees in this case helped to bring a Thai corporate issuer to the market at a time when market access was otherwise unavailable. As such, independent of the assessment of additionality, the guarantee may have represented an effective use of official resources to solve a market failure.[77]

In a recent innovation, the World Bank and the Inter–American Development Bank (IDB) have provided official support for private contingent arrangements. (The potential benefits of such contingent arrangements are noted above; the discussion here is limited to the implication of official support for contingent arrangements.) In November 1998, in conjunction with a $2.5 billion Special Structural Adjustment Loan that focused on strengthening the financial sector, the Bank provided a contingent $500 million loan to Argentina,[78] cofinanced with the IDB, to be used for margin calls or repurchases from repo buyers. Specifically, if the contingent arrangement with the banks is activated, Argentina would be required to post collateral in domestic bonds totaling 125 percent of the credit provided by the international banks. Should the value of the collateral fall, the government could be required to provide foreign currency for margin calls. Argentina may draw on the World Bank loan for this purpose. The contingent World Bank loan was attractive to the authorities in the context of its convertibility law, since it ensured that the government would not be required to draw on reserves or borrow abroad to finance the purchase of collateral at the time of drawing the line. More generally, the provision of official support for this contingent facility, by lowering the all–in–cost, and strengthening the financial system's safety net, can effectively enhance the attractiveness to markets of these instruments. On the other hand, should margin calls be made, it could be seen as bailing out of the private sector through such arrangements. The operation therefore could be seen as encouraging the private sector to

[76]The share of payments covered by the Bank's guarantee rises over time until, in the period immediately preceding the maturity of the loan, the Bank covers all remaining risk.

[77]The extension of preferred creditor status to private or entities requires close monitoring by the central government. Unchecked, the proliferation of decentralized senior borrowing presents a classic "common pool problem," whereby each individual debtor may not take adequate account of its call on a country's limited capacity to support inflexible debt.

[78]Formally a "Special Repurchase Facility Support Loan." The loan was priced as LIBOR plus 400 basis points, with a maturity of five years, including three years grace, a 1 percent up–front fee, and a commitment charge of 75 basis points.

Box 2.9 The World Bank EGAT Rolling Coupon Guarantee

The World Bank rolling guarantee of interest on the bond issued by the Electricity Generating Authority of Thailand (EGAT) covers a single coupon payment. If a coupon payment is missed, the Bank would pay creditors and ask the government of Thailand (the counterguarantor) to repay the Bank on demand or as the Bank otherwise direct. If reimbursement is received within 60 days, the guarantee will be reconstituted and rolled forward to cover the next coupon payment. The rolling guarantee will terminate if reimbursement is not received in the form requested by the Bank and within 60 days of the request.

The rolling coupon guarantee has had an important impact on markets' perception of the risk of the nonguaranteed payments on the bond. Because markets do not expect Thailand to enter an extended period of overdue obligations to the Bank, the structure may be perceived by creditors as partially extending the Bank's preferred creditor status to the nonguaranteed payments. Such an extension of preferred creditor status is of greatest concern in relation to generally strong borrowers that run into temporary problems; in extreme situations, in contrast, there is a greater risk of multiple missed payments, in which case the rolling guarantee will not be reconstituted. It should be noted that if there is a call on the guarantee, the Bank could, at its sole discretion, extend a loan to the government covering any amounts paid to private creditors under the guarantee, thereby breaking the link between the borrower's payment difficulties and arrears to the Bank.

In the event, Standard and Poor's ranked the issue A-, three notches above Thailand's foreign currency credit rating of BBB-. The issue was priced at 285 basis points over a comparable U.S. treasury security. Because the World Bank is able to mobilize funds on fine spreads, this suggests a "stripped spread"—that is, the spread implied by the degree of unguaranteed exposure alone—of around 800 basis points, broadly similar to the quoted secondary market spread on Thailand's sovereign international bond prevailing at the time of the issue. It should be recognized that in periods of limited market access (as was the case for Thailand at the time), such calculations should be interpreted with caution.

bear additional exposure to sovereign risk during difficult periods (that is, after the contingent facility had been activated, in the framework of interest rates at normal levels and continued adherence to the currency board), at the cost of the official sector assuming some of the sovereign risk in the event that Argentina modifies its exchange arrangements or suffers a sharp increase in interest rates.

In sum, official guarantees entail risks as well as benefits. Judging from the results of a few transactions concluded to date, a case can be made that in some circumstances official enhancements have mobilized additional (unguaranteed private) finance to emerging markets. However, the evidence on additionality is mixed, and it would seem likely that sophisticated financial markets are increasingly adept at separating risks, with the effect of reducing additionality. In light of this, and the concerns discussed above, a careful balancing of the benefits and risks of official enhancements, relative to direct official lending, will be required under any program.

Official Support for Debt Restructuring

The suggestion has been made that the use of official resources for debt and debt–service reduction in the 1980s—including most prominently in Brady–style debt and debt–service reduction operations—represents a useful model for support for new money packages in the current environment. Those packages encouraged the restructuring of existing distressed debt or facilitated a buyback of existing debt at a discount, by providing official money to purchase principal and interest collateral on the new instruments. While official support for debt–restructuring/reduction operations shares a number of characteristics with the enhancements discussed above, the motivation and circumstances for the operations differ. Brady deals followed years of protracted negotiations over distressed debt between debtors and creditors; prospects for repayment absent an agreement were, in many cases, dim; and remedies were limited. The existence of a “captive” stock of distressed debt meant that exit, when possible, was at a substantial cost. In this context, the provision of officially financed collateral often acted as a “sweetener” to clinch the deal. As a result, the effective use of guarantees in these operations does not provide direct evidence of their value in support of new money.