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Lending to Defaulters: The IMF Updates Its Lending into Arrears Policy

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Key Points

- The International Monetary Fund's (IMF's) willingness to lend to countries in default on their commercial debt gives member countries leverage in their negotiations with their creditors.
- The IMF conditions such lending on the requirement that the country is engaged in "good faith negotiations" with its commercial creditors to settle any outstanding defaults on external debt.
- The IMF recently made two important changes to this policy: the addition of an economic factor to the analysis and the removal of a condition that countries engage with their creditors under a formal negotiating framework, which was a point of contention during Argentina's ill-fated 2005 transaction.

Introduction

This policy brief explains one of the many formal written rules and procedures that must be followed before the IMF lends to a member country. The rule of concern is called the "lending into arrears" policy, which governs if and when the organization lends to a country in default on obligations to its commercial creditors and/or official bilateral or multilateral creditors. In the world of sovereign debt restructuring, no rule may be more important than this rule because the IMF's willingness to continue to lend to a country in default gives the country leverage to wrest a better deal from its creditors, while a cut-off in funding may force the country to take what's on offer.[1] Yet this important policy is poorly understood. Only a handful of specialists in the market understand how it works, and the IMF itself has trouble speaking clearly on the topic. For example, in May 2022, the IMF seemingly announced that what was "expected" of countries under this policy had both changed and not changed at the same time. The objective of this policy brief is to give a plain English description of the IMF's lending into arrears policy and to explain its historical origin, contention over its use during Argentina's 2005 debt restructuring, and its recent amendment.

1 See Hagan (2020) for a comprehensive discussion of the IMF's role in sovereign debt restructuring.

About the Author

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The IMF's Lending into Arrears Policy

As a formal rules-based organization, the IMF, by necessity, has detailed rules and procedures for lending to its members. As an emergency lender to countries in crisis, these rules address the scenario that countries are in default on commercial or official sector obligations. This policy brief outlines the situation in which a member country is in default on its external commercial debt — and the IMF's lending into arrears policy takes effect (Erce 2015). Perhaps "lending to defaulters" more clearly describes the policy's function because that is what the policy is designed to do: determine whether the IMF should lend to a country in default.

However, this policy brief focuses on only one condition in the set of conditions that apply when a country seeks to borrow from the IMF while in default on its commercial obligations:[2] the condition that the country is engaging in good faith negotiations with its commercial creditors (the so-called good faith criterion). The other conditions are financial and economic. To obtain a loan, the country must undertake rigorous financial reforms and "fully fund" or deliver adequate assurances that it will be able to meet all of its financing needs throughout the duration of its program. In addition, the country's debt, post-restructuring, must be sustainable according to the IMF's models. The IMF's good faith criterion may be distinguished from these other conditions because it is non-economic: it requires IMF staff to make a qualitative judgment about the manner of a country's negotiations with its creditors.

While the IMF's good faith criterion requires IMF staff to make a qualitative judgment, its reason for being has an economic origin. There is no sense in giving new money to a borrower who persists in non-payment to a group of other lenders. On a reasonable time scale, all of a borrower's arrears to all of its debt providers should be cleared up, except, perhaps, some very small amounts that may be unresolvable or subject to very lengthy negotiations. In this context, the IMF's good faith criterion can be seen as a pragmatic rule that could be verbalized in the following statement: "While

2 See IMF (2022) for a discussion of its application to official obligations.

we, as a lender, would prefer that you clean up all your defaults in advance, we will give you some time to finish the job. But, since making progress is important, we will be watching what you are doing as we monitor overall program compliance." It is an essential rule, but a delicate one, since pushing countries too hard will give the advantage to creditors, whereas letting countries slack off will make them a bad credit risk for the IMF.

A Recent History of the Good Faith Criterion

While the antecedents of the IMF's good faith criterion have a long history, for the purposes of this policy brief, the relevant policy starts in the late 1990s when the IMF board applied the policy in the format discussed above to sovereign bonds. The new policy replaced earlier policies that required a country to clean up such defaults in advance of obtaining a loan (which was very advantageous to commercial creditors) and an in-between variation that allowed loans to take place after a deal was agreed with creditors but before a deal had settled. Creditor activists were not very happy about the late 1990s policy shift because it opened the possibility of open-ended lending from the IMF to countries in default, which would undermine their bargaining power.[3] That was, in fact, the idea. The impulse for the change of policy was a conservative backlash against the bailouts of the 1990s (US Government Printing Office 2000). The Group of Twenty countries now talked about "private sector involvement" and making sure that bondholders adequately "shared the burden" when a country got into trouble (IMF 1998; 1999).

The historical context for the focus on the lending into arrears policy was the rise of the sovereign bond market and the fall of the sovereign loan market in the 1990s. After the defaults of the 1980s, the banks wanted out. During the Brady restructurings of the 1990s, the banks swapped their loans for bonds and sold them on the market. This tactic was good for the banks, which now had clean balance sheets, but it left international policy makers with a problem: how to help countries restructure their sovereign bonds when they were owned by tens of thousands or hundreds of thousands of investors all over the world. As Anne Krueger said in her famous sovereign debt-restructuring mechanism (SDRM) speech on November 26, 2001, "Private creditors have become increasingly numerous, anonymous, and difficult to coordinate" (IMF 2001a). Policy makers worked on the problem from a number of different angles. One was to promote the use of collective action clauses (Group of Ten 1996; US Department of the Treasury 2002). SDRM was another (Krueger 2002). The late 1990s shift in the IMF's lending into arrears policy was part of this same policy process.

However, the IMF's lending into arrears policy took a controversial shift in September 2002 when the board approved a new definition of "good faith" in bond negotiations — one that was first proposed by creditor lobbyists in 2000 (Council on Foreign Relations 2000, 5). Complaining that countries were abusing the leeway offered under the new policy, activists lobbied the IMF to require a specific type of negotiation to occur before countries put their bond restructurings into the market. Their complaint was that Pakistan in 1999 and Ukraine and Ecuador in 2000, had put their bond restructuring offers on the market without first engaging in formal negotiations with leading bondholders (Euromoney 2001). The source of the gripe was that some large sovereign bondholders had played an active but peripheral role in the bank advisory committee negotiations that had taken place in the latter half of the 1990s: they wanted sovereign bonds to be restructured the way sovereign loans had been restructured, but with themselves at the head of the table.[4] In September 2002, the IMF board approved the new rule proposed by the creditor activists. The IMF's good faith criterion of its lending into arrears policy now included the "expectation" that a country would negotiate with a representative creditor committee if one formed in a timely manner (IMF 2002, 3).

This shift was controversial from day one, at least in some quarters. Lee C. Buchheit, a leading lawyer in the field, criticized the policy, later publishing a piece entitled "Lending into Arrears — A Policy Adrift," with former IMF lawyer Rosa

3 See Rieffel (2003, chapter 11) for a general discussion of the history of this period.

4 Author interviews with former Emerging Markets Creditors Association members. Also see Emerging Markets Creditors Association (2000) and Chamberlin et al. (2002) for more on efforts to promote bondholder committee negotiations.

M. Lastra (Buchheit and Lastra 2007). The essential doubt was why the IMF would want to change something that was going well. The recent bond-restructuring deals achieved success rates of 99 percent for both Pakistan and Ukraine and 97 percent for Ecuador (IMF 2001b, 7, 32, 36). All three issuers had hired bankers and lawyers and had canvassed creditors before launching their deals and used this feedback in setting the terms of the offers.[5] These points were made by some board members the first time IMF staff put the Council on Foreign Relations idea up for approval in January 2001 when the proposal was rejected (IMF 2001c, 9–12). One critic (the US executive director) doubted that the IMF should give creditors a new procedural advantage when they were earning a healthy yield for the risks they were knowingly taking. According to the minutes of the meeting:

> Ms. Lissakers considered that private creditors to sovereigns had a fundamental grievance: the reality that, in that contract, there was a complete imbalance because the private creditor with a claim on a sovereign state had no effective means to enforce that contract. Lenders to sovereign states were aware that there was [no] controlling authority, and that it was very difficult to enforce a contract in a meaningful way through litigation. So, private investors looked to the Fund… to weigh in on their side and to shift the balance of power. That is part of what underlies the complaints about lack of process. That does not mean that the balance of power was currently quite right but it was a very tricky issue for an institution like the Fund…to enter into and to become the party of the private creditor vis-à-vis a member state. There were no simple answers, but the desire of private commercial creditors to have the same sort of certainty and clarity about the process that governed private-to-private claims in private-to-sovereign claims was unrealistic. Indeed, that was why there were sovereign risk premia attached on top of commercial credit risk premia. It did not appear reasonable for private creditors to want the sovereign risk premium and the legal certainty, because in a world of sovereign states that would not be possible. (IMF 2001c, 50–51)

Controversy Breaks Out during Argentina's 2005 Debt Restructuring

The challenge of using the IMF's new good faith criterion hit Argentina the following year when it moved to restructure its $100 billion[6] in defaulted bonds. Argentina's deal was hyper-contentious. The country announced in September 2003 that it wanted to pay creditors 25 cents on the dollar to resolve the default and that it would offer no compensation to cover interest that had gone unpaid since December 2001 (Smith 2003). Pakistan, Ukraine and Ecuador had asked for much smaller cuts, and the most relevant Brady restructurings of the 1990s had been done at 65 cents on the dollar, plus full payment of past-due interest (Rieffel 2003, 171). Some creditors also complained about Argentina's process for carrying it out. The dispute quickly became a *cause célèbre* in the international financial press and among IMF staff, management and board members (Beattie 2003; IMF 2004a; 2022, 22).

The dispute on process centred on Argentina's "consult-and-launch" approach to carrying out the transaction. The country announced that it would negotiate the terms of its deal, working with a dozen different consultative working groups that it had set up around the world in late 2002 and early 2003 (Nielsen 2003). Creditor activists, some of whom were the same ones who lobbied the IMF for the rule change in 2002, insisted that Argentina engage in a formal bank advisory committee-style negotiation with a committee that they had set up (Central Banking 2004). Argentina refused. The IMF had been monitoring the situation, including sending staff members to attend Argentina's investor presentations. The IMF staff felt that Argentina's entire approach, including its refusal to negotiate with the Global Committee of Argentina Bondholders (GCAB), violated the

5 Author interviews with Pakistan's and Ecuador's advisers. The author worked on Ukraine's transaction.

6 All dollar figures in US dollars.

good faith criterion as adopted by the board in September 2002. In response, IMF management chose to pull Argentina's first review off the agenda for the IMF's December 2003 board meeting (IMF 2022, 22). Argentina was deeply threatened by this move, which it saw as siding with creditors. Later that month, Argentine President Néstor Kirchner aggressively attacked the IMF in the press (*Financial Times* 2003). Under US pressure, Argentina's first review was put back on the agenda for January 2004, although the issue of compliance with the rule remained unresolved (IMF 2004a).

In evaluating Argentina's compliance with the IMF's good faith criterion, it is useful to think of the rule as a legal statute under the IMF's internal law. Compliance thus required a comparison of the facts and circumstances of Argentina's negotiations against the specific text of the new 2002 rule. This, in turn, required IMF staff, management and board members to opine on three distinct issues. The first issue was the question of exclusivity: Under the new policy, was Argentina obliged to negotiate with a single committee, or could it choose to negotiate with the multiple committees it had set up over the previous year? The second was the definition of "negotiate": Was it sufficient for Argentina to have met with various creditors between announcing its initial terms and making its final offer, or was Argentina obliged to have given concessions when it met with its creditors? The third was whether a particular investor group, GCAB, was "representative" — a topic that is addressed in Table 1 and Box 1.

The IMF's findings in 2004 were that:

→ negotiations could be non-exclusive, and that Argentina could continue to work with its many different consultative working groups (IMF 2004b, 4);

→ GCAB was a representative group (IMF 2022, 22); and

→ Argentina had failed to negotiate.

While the author has found no official IMF source to document a finding that Argentina failed to negotiate, in June 2004, US officials accused Argentina of not engaging in "give-and-take" (Gregg 2004), and a former IMF official now says that Argentina refused to negotiate (Georgetown Institute of International Economic Law 2022, 55:40). Expecting a fail at its third review for this and other reasons, Argentina lapsed its program with the IMF in August 2004, with the stated objective of carrying out its debt-restructuring deal without interference from the IMF staff (Thomson 2004).

The consequence of this contention was that Argentina's debt restructuring was sold on the market without the explicit support of the IMF and under severe attack from the leadership of the GCAB, with whom Argentina never came to terms. To succeed under these conditions, Argentina relied on aggressive legal tactics: the addition of a 10-year price-match guarantee (the so-called rights upon future offers clause), which limited the government's flexibility to deal with holdouts, and the "Lock Law," which put into law an intention to never deal with the holdouts. The outcome was suboptimal: Argentina was left with 24 percent (or $19.6 billion) in holdouts and took maximum legal risk to get its deal done. The rest, as they say, is history (Cruces and Samples 2016).

The Lending into Arrears Policy's May 2022 Amendment

On May 18, 2022, the IMF announced the results of a several-years-long review of all its policies related to lending to countries in default on their debt. The portion of the announcement devoted to the lending into arrears policy requires some unpacking. It states that: "Directors decided to eliminate the expectation that debtors would engage with creditor committees under a 'formal negotiating framework'" (IMF 2022, 3); and "Directors continued to expect that the debtor would engage with a representative creditor committee or committees" (ibid.). So, are committee negotiations expected or not expected under the 2022 revision?

Clarification can be found in the webinar that was hosted by the Georgetown Institute of International Economic Law the following week. On the call, the IMF's Tom Best said, "On creditor committees, the new policy calls on the debtor to engage with them where they're representative, which again is a case-specific judgement, but it drops some unnecessary complications that weren't really

Table 1: Representativeness of GCAB Tested against Results of the 2005 Exchange Offer

GCAB Members	Claimed Membership*	Author's Analysis	2005 Results**
Argentina Bondholders Committee	90 institutional members in the United States and Europe. $9 billion in holdings.	Credible claim as of March 2004.	82 percent acceptance rate on US global bonds. *Most US institutional investors did not follow GCAB's advice.*
Task for Argentina (TFA)	420,000 retail members in Italy. $14.5 billion in holdings.	Unclear if TFA represented Italian banks or end investors.	63 percent aggregate success rate in euros. *Proves strong TFA/ GCAB influence, especially in Italy.*
Bank of Tokyo, Mitsubishi and Shinsei Bank	40,000 retail investors holding $1.8 billion in Japanese yen-denominated bonds issued in Japan, plus an unspecified number of holders of $1.2 billion in yen eurobonds.	No evidence Bank of Tokyo or Shinsei Bank represented end investors.	95 percent success rate in Japanese yen. *Proves no GCAB influence.*
Swiss Bankers Association (observer status)	50,000 retail investors. $10 billion in holdings.	No evidence the Swiss Bankers Association represented end investors.	74 percent success rate on the one small Swiss franc bond. *No specific evidence of GCAB influence, although one may assume GCAB's activities suppressed participation by Swiss-based accounts.*
Argentine Bond Restructuring Agency (ABRA) (observer status)	35,000 retail investors in Austria, Germany, the Netherlands and Switzerland. $1.2 billion in holdings.	100 percent credible. ABRA held legally binding powers to participate in the transaction on behalf of its members (ABRA 2003).	ABRA broke with GCAB and accepted the offer (Thomson 2005).
General membership category	Unspecified number of holders. $1 billion in holdings.	Credible.	No data available.
Total	**$38.7 billion in claimed membership.**		**$19.5 billion in actual non-participants.**

Notes: *GCAB presentation dated October 4, 2004 (GCAB 2004, 5). **Author's analysis; World Bank (2006, 84–85); República Argentina (2005, 13–15).

Box 1: The "Representativeness" of a Bondholder Committee on Trial

An informal session of the IMF executive board was held in March 2004 to try the issue of the "representativeness" of GCAB, a group of investors that claimed to be a "representative group" for the purposes of the IMF's then-recently revised lending into arrears policy. According to an account in the IMF's 2022 staff paper, Argentina argued that GCAB was not a representative group because "GCAB did not include important constituencies of bondholders, there was inadequate verification of bond holdings the committee members claimed to represent, and some committee members had previously not acted in good faith" (IMF 2022, 22). With IMF staff presenting evidence against Argentina, the IMF board concluded that GCAB was a representative group because "(1) GCAB appeared to represent the creditors it purported to…[and] (2) GCAB's Steering Committee represented holders of approximately $35 billion of eligible bonds,…[and] membership was open to any major non-litigating creditors" (ibid.).

The issue of GCAB's representativeness became moot two weeks after the trial when Argentina "recognized" GCAB as one of several negotiating groups. However, the outcome of the exchange offer completed the following year suggests that GCAB's claims were highly inflated: holders of only $19.6 billion of bonds rejected the deal while GCAB claimed it controlled more than $39 billion of bonds, as detailed in Table 1. That is not to say that GCAB was not representative — it just was not as representative as it claimed to be.

used in practice. For example, the reference to… this formal negotiating framework" (Georgetown Institute of International Economic Law 2022, 14:43). For some background, former IMF general counsel Sean Hagan explained on the same call that the assumption of the 2002 change was that "if there was a representative creditors committee that they would push for formal negotiations through the sharing of confidential information because that's what happens in the corporate context. But that never happened really in the sovereign context. Argentina refused to do it, but also, interestingly, we found that creditors themselves did not want to do this because they would have to be restricted to be in compliance with securities laws" (ibid., 55:20). Under the IMF's revised policy, there is no longer an "expectation" of a formal committee negotiation with the sharing of confidential information (as takes place in the corporate context). However, countries are still expected to "engage" with their creditors. The author's plain English interpretation is that we are back to the pre-2002 "consult-and-launch" approach.[7]

However, this is not the only important change introduced by the IMF in May 2022. The IMF also introduced a new economic element into its good faith criterion. The IMF will now consider the terms of a country's offer to creditors when evaluating whether a country is "negotiating in good faith." The IMF's Best explained on the Georgetown call that "it recognizes that part of good faith is that the quantum of relief proposed needs to be appropriate in light of the debtor's circumstances… while bearing in mind that too little relief is not going to be sufficient to restore sustainability and too much could jeopardize participation in the eventual restructuring" (ibid., 16:00).

The author's acid test for evaluating a lending into arrears policy is whether it would have averted the nightmare that engulfed Argentina, its creditors and the IMF, when the country moved to restructure its debt in 2004 and 2005. By this measure, the author sees the 2022 change as a big plus.

First, without the leverage of the IMF's 2002-era formal negotiation requirement, the author believes that the GCAB leadership would have been forced to take a softer approach, which would have increased the chance that Argentina would have dealt with the group. Second, by adding a quantum of debt test to its "good faith" analysis, the IMF staff would have been forced (and empowered) to work with Argentina and its creditors on the terms of the

7 Many countries have engaged in the past (and will engage in the future) in extensive private negotiations with their commercial creditors that include the sharing of confidential information. However, the essence of the IMF's 2022 policy revisions is that this is an option, not a requirement.

offer as part of its responsibility for determining the country's compliance with the policy. A much better outcome could have followed. Of course, the outcome could still have been messy: Argentina's $100 billion default was such a fraught situation.

Conclusion

The IMF's lending into arrears policy is a critical internal policy of the IMF that can have an important impact on the outcome of sovereign debt restructurings. The policy states that a country in default must "negotiate in good faith" with its creditors to obtain a loan. As a prudent lender, the IMF must have such a policy. However, the art in carrying out such a policy is to implement it in a way that supports member countries in restructuring their debt without giving them too much leeway or giving creditors an advantage.

In May 2022, the IMF updated and streamlined this policy by making two important changes: first, the IMF reversed its September 2002 expectation that countries use a "formal negotiating framework" when engaging with their creditors before launching a deal into the market and, second, the IMF added the quantum of debt relief as a factor in its analysis of whether a member country is acting in good faith. Both of these changes comport in a healthy way with the current market-based mechanism of restructuring sovereign bonds.

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