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SOVEREIGN BOND CONTRACT REFORM
IMPLEMENTING THE NEW ICMA *PARI PASSU* AND COLLECTIVE ACTION CLAUSES

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ACRONYMS

CAC	collective action clauses
EMTA	Emerging Markets Trading Association
G7	Group of Seven
G10	Group of Ten
G20	Group of Twenty
ICMA	International Capital Market Association
IIF	International Finance
IMF	International Monetary Fund
TIA	Trust Indenture Act

EXECUTIVE SUMMARY

In August 2014, following an extensive consultative process, the International Capital Market Association (ICMA) published proposed standard terms for new, aggregated collective action clauses (CACs). Concurrently, ICMA released new model wording for the *pari passu* clause typically included in international sovereign bond contracts. These announcements and the commencement of issuance of bonds with these clauses are an important turning point in the evolution of sovereign bond markets.

The new CACs will make it much harder for holdout creditors to disrupt future bond restructurings or to be paid in full after the other bondholders receive haircuts. Under the new contractual form, a supermajority of bondholders can vote to force non-participating creditors into a restructuring, subject to strong protections against the abuse of minority creditors by the majority. At the same time, the new *pari passu* clause is designed to prevent the kind of rulings that lead to a disruption in payments to investors, as was the recent case with Argentina. Neutralizing holdout creditors in this fashion is of immense economic importance. It should facilitate more predictable outcomes for debtors and creditors, and fairer outcomes among creditors in situations that require debt restructuring.

However, even with the rapid issuance of bonds under the new ICMA framework, the potential for disorderly debt restructurings will remain until the vast majority of old bonds, already in the stock of debt of sovereign borrowers, have been converted to bonds that include the new clauses. This may take more than a decade. A strong case exists for the establishment of a coordinated public-private initiative that is focused on converting existing stocks of debt to the new format. While benefits to issuers and investors should provide a market force to drive the rapid uptake of the new clauses, the Group of Twenty (G20), working closely with the International Monetary Fund (IMF) and creditor groups, is uniquely positioned to give legitimacy to discussions of accelerated adoption of the new clauses, as well as discussions of further mechanisms to facilitate orderly debt restructuring.

This paper discusses the ICMA consultative process to develop the new clauses, explains the workings of CACs and the history of their adoption, analyzes the effect of the new clauses in reducing holdout activity and discusses the use of bondholder meetings and exchange offers to accelerate the conversion of outstanding debt stocks into the new format.

"The success or failure of this workout [Argentina] was likely to have more of an impact on the shape of workout machinery in the future than any further debate among the [Group of Seven] G7 architects about alternative approaches to Private Sector Involvement" (Rieffel 2003, 259).[1]

INTRODUCTION

Recent extraordinary events related to Argentina and Greece's debt restructurings have drawn attention to the vulnerability of sovereign bond restructurings to disruption by holdout creditors.

In the case of Argentina, the country recently fell back into default on $30 billion[2] of debt issued to participants on its 2005 and 2010 restructuring as a consequence of a lawsuit by a group of holdout investors. These investors obtained a favourable ruling on the interpretation of the *pari passu* clause embedded in a large number of sovereign bonds, as well as an injunction against paying on the restructured bonds without pro rata payment to the subject bonds, terms Argentina was unwilling to meet (Affaki 2014, 39–48; IMF 2014, 8-9; Moore, Mander and Cohen 2014).

Greece's 2012 debt restructuring also had problems related to non-participants. First, to avoid holdout behaviour with respect to the vast majority of bonds to be restructured, Greece relied on an ad hoc strategy; the retroactive insertion of a collective action mechanism into €177 billion of Greece's domestic law debt in anticipation of the transaction. Second, there was widespread holdout activity in Greece's international law bonds, which resulted in full repayment of €6.4 billion of bonds held by holdouts, while participants suffered present value losses in the range of 59–65 percent (Xafa 2014; Zettelmeyer, Trebesch and Gulati 2013, 13, 19 and 51).

While the holdout problem in bond restructuring had been well-known for years, the Argentine and Greek outcomes created broad-based interest among sovereign borrowers and lenders in doing something about it. At this juncture, the ICMA and the US Treasury stepped in to lead an effort to reduce the ability of holdout investors to disrupt future debt restructurings through improving the design of two important features of sovereign bond contracts: the *pari passu* clause and CACs.

1 The term "private sector involvement" refers to situations in which private sector lenders or bondholders restructure debt to help resolve a sovereign debt crisis.

2 All dollar currency figures throughout this paper are in US dollars, unless otherwise indicated.

BOX 1: CACS — A BRIEF HISTORY

The pre-history of CACs in New York law bonds begins with a 1930s-era prohibition. Enacted following a wave of corporate bond defaults in the Great Depression, the US Trust Indenture Act (TIA) of 1939 governs the issuance of corporate bonds in the US public markets. In a TIA-compliant indenture, without 100 percent support, creditors are not allowed to vote for a change in the "money terms" of a bond (such as the amount repaid, the coupon, payment dates and currency of payment) which makes contractual changes in terms virtually impossible for widely distributed securities. As a consequence, the restructuring of New York law corporate bonds relies on the powers of bankruptcy courts to legally change the terms of bonds, or in a pre-bankruptcy context on voluntary exchange offers in which holders individually participate in the restructuring. As a matter of convention rather than specific regulation (as sovereign bonds are exempt from this requirement), most sovereign bonds documented under New York law until 2003 prohibited the change of money terms via a vote, despite the absence of a backstop court-based mechanism to manage work outs. In contrast, English law bonds typically have allowed a supermajority of holders of a series of bonds to change money terms.

For a long time, the documentation of sovereign bonds was not of vast consequence, as international bank loans were the primary source of funding to sovereign borrowers in the postwar world. This lending increased rapidly in the 1970s, as international banks sought to recycle large cash deposits from oil-producing nations following the rise in petroleum prices. The boom was followed by a bust; in the early 1980s most international emerging-market borrowers defaulted on their sovereign loans as interest rates skyrocketed, commodity prices fell and growth stalled. From 1982 through 1989, sovereign borrowers and lenders worked through a series of increasingly difficult loan restructurings, culminating with the Brady Plan in which the distressed bank loans were, at the same time, reduced in present value and converted into "Brady Bonds." The banks subsequently sold these bonds into the market (Emerging Markets Trading Association [EMTA] 2009). The issuance of over $100 billion of these Brady Bonds (mostly between 1990 and 1994) created a liquid international sovereign bond market that subsequently blossomed throughout the 1990s as a result of the improved solvency issuers, low interest rates, dynamic global growth, liberalization of capital flows and reduced loan market access.

Mexico's 1994 "tequila crisis" and its resolution through a large bailout, funded by the US government and the IMF, woke up policy makers to a new reality; sovereign debt instruments (mostly issued under New York law) had become extremely hard to restructure and, to make matters worse, the sovereign creditor community had become globally dispersed and heterogeneous in character. With official bilateral lenders and international financial institutions, such as the IMF, unwilling to fully backstop recovery programs for all future sovereign crises, in 1995 the Group of Ten (G10) (which later evolved into the Group of 22 and then the G20) became the forum for the discussion of alternatives for the effective restructuring of sovereign international bonds. The G10 working group released a report that was published in 1996 in a process chaired by Jean-Jacques Rey, the Belgian Central Bank deputy, which discussed a number of mechanisms and principles for resolving crises, including the wider use of CACs in sovereign bonds (G10 1996).

The Rey report stimulated much debate on the topic among market participants and in policy circles for several years (Rieffel 2003, 220–259). However, it took Russia's default, the Asian Crisis and the sovereign debt restructurings of Pakistan (1999), Ukraine (2000), Ecuador (2000), Ivory Coast's default (2000), high financial stresses in Turkey (2001) and Argentina's 2001 default to make a compelling case for coordinated action. Consensus emerged in 2002 that the universal introduction of CACs into international sovereign bonds was the workable solution, as signalled by statements from various G7 officials and the June 2002 announcement of support published jointly by six private sector groups representing bond investors and financial institutions (EMTA 2002). Mexico issued $1 billion of bonds in February 2003 including the CACs, and other leading emerging markets borrowers quickly followed suit (Drage and Hovaguimian 2004).

The distinguishing feature of the 2003 formulation of CACs is its "single-series" voting procedure, in which to amend a bond the required majority of holders of that series bond must approve the changes. Holders of a bond have no legal ability to compel the holders of any other bond to participate in the restructuring. The 2014 formulation strengthens CACs by allowing an aggregated voting mechanism that bind holders of multiple series of bonds through a single vote of all relevant noteholders.

Before 2003, international bonds were largely restructured via exchange offers in which holders individually volunteer to accept the restructuring transaction with respect to their holdings (Das, Papaioannou and Trebesch 2012). In place of a simple vote of holders, highly successful deals were crafted through effective investor outreach and application of a combination of positive incentives and threats. Other than Argentina's 2005 restructuring, history showed many successful debt restructurings, even when CACs played a marginal role, leading some observers to highlight the importance of consensus building with creditors rather than relying on legal artillery as the key ingredient of successful debt restructurings.

Recent transactions have tested the design of CAC provisions. In 2013, Belize used CACs to fully restructure its $547 million bond (Asonuma et al. 2014, 18). In contrast, in 2012, Greece failed to reach the required majorities to activate CACs to bind in holdout investors in about half of its 36 international bonds documented under English law (Zettelmeyer, Trebesch and Gulati 2013, 53). This notable failure was paired with a powerful success; Greece restructured the terms of 100 percent of €177 billion of domestic law bonds by inserting *aggregated* CACs retroactively into these bonds by an act of Parliament in anticipation of the transaction (ibid., 26). The new ICMA model CACs have a commercial structure that closely resembles those inserted on an ad hoc basis into Greece's bonds (ibid., 42).

For more detailed information, see Buchheit, Gulati and Mody (2002) and Weidemaier and Gulati (2014)

THE CONSULTATIVE PROCESS TO DEVELOP NEW *PARI PASSU* AND CACS

The ICMA is an industry standard-setting body whose members include banks and securities dealers, market participants and securities infrastructure providers. In this role, the ICMA, working alongside a US Treasury-led working group that was established in 2013, shepherded a consensus-building process to improve the workings of sovereign bond restructurings through improving the legal clauses embedded in sovereign bonds issued into the capital markets. The working group consulted with ICMA members, issuers, investors and market makers. Officials from a number of creditor governments, the IMF and the Institute for International Finance (IIF) were actively involved.

The initiative focused, in particular, on those clauses that allow a vote of holders to amend various financial features of CACs. The central terms of CACs are the voting procedures, especially the majorities required to amend the financial terms of bonds, such as maturity, coupon or amount outstanding. The process also addressed the information provided by issuers ahead of a restructuring, how the issuer communicates or negotiates with bondholders and certain protections against manipulation of votes by issuers. A brief history of the use of CACs in sovereign bonds is contained in Box 1.

This effort resulted in the publication in August 2014 of the *ICMA Standard CACs* and the *ICMA Standard Pari Passu Provision*, which are meant to serve as models for sovereign issuers to use when documenting new bond issues going forward. This outcome was a victory, of sorts, for proponents of the "contractual approach," who believe that the international financial architecture should be improved using new provisions in sovereign bond contracts. The alternative is a "treaty-based approach," which would seek to defang holdout creditors by uploading new powers into the laws of key jurisdictions, international institutions and judicial bodies, with the objective of creating bankruptcy-type protections for distressed sovereign borrowers and their creditors akin to a Chapter 11 proceeding in the United States. Such protections could include automatic stays, lending into arrears and protection against asset seizures.[3] While we expect that implementing the ICMA model provisions will set the agenda for the next few years, and materially shift the balance of forces against holdout investors, history leads one to expect evolution in this area.

3 A detailed review of this debate and a discussion of many other issues in sovereign debt restructuring can be found in Jewett (2014, xix-xxv).

THE ICMA MODEL CAC PROVISION

The ICMA model CAC provision allows issuers to structure a bondholder vote on a debt restructuring in three ways, as discussed by Anna Gelpern (2014a):

- First, an issuer could poll the holders of each bond series in what is termed a *series-by-series* vote. If holders of three-quarters of the bonds of a series agree to the new terms, the remaining minority would be bound to participate.
- Second, an issuer could poll holders of multiple series at once, collating the results of each series in a *two-limb* vote. If at least half of the bonds of each series polled and two-thirds of all outstanding debt polled agree to the new terms, the remaining creditors would be bound to participate.
- Third, the government could poll holders of multiple series at once, collating the results into a single total across all series, making use of a *single-limb mechanism*. If three-quarters of the total approve the new terms, the remainder would be bound to participate. To prevent minority creditors from being treated unfairly, this model requires the issuer to offer all affected creditors the same restructuring terms (uniform consideration).

The uniform consideration condition, noted above, requires that an issuer offer the same set of new instruments to creditors. And such offers would be made to bondholders in proportion to the principal amount plus any accrued or past due interest. A well-known consequence of this condition is that net-present value outcomes may be unequal to holders of different series of bonds. When consideration received is of uniform value, but the value of old bonds differ, the net change in values will be unequal.

The model CAC provision also includes specific language governing bondholder votes, including notice and voting procedures. The provision requires that the sovereign borrower deliver to the bondholder several categories of background material, to allow investors to make an informed decision on casting their votes. To prevent against abuse by the issuer, the ICMA model CAC includes a disenfranchisement provision that disqualifies bonds owned or controlled by the issuer or its public sector instrumentalities from being counted as "outstanding" for the purpose of the bondholder meeting. The IMF has also noted that outside of the specific terms of the bond contracts, minority creditors benefit from legal protections in many jurisdictions, including under the laws of New York and England, against offers that discriminate against minority creditors if there is evidence of "bad faith" or "abuse of power" (IMF 2014, 28).

THE COMMERCIAL EFFECT OF THE NEW ICMA MODEL CAC PROVISION ON HOLDOUT BEHAVIOUR

Examining how the model CAC will work in practice may help clarify the above discussion. One way to gain insight into the commercial effect of the new CAC provision is to evaluate the opportunity for a holdout investor to build a blocking stake under various scenarios. To do so, this paper will take a hypothetical sovereign debt portfolio and evaluate the holdout's strategy, first assuming no CAC provision, and then assuming the various alternative CAC voting rules embedded in the new ICMA model provision.

The following stylized sovereign debt portfolio can be used to illustrate the issues when a restructuring is required to re-establish debt sustainability:

- $3.5 billion aggregate nominal principal amount of debt;
- the debt is contracted in the form of 20 separate series of bonds; and
- one of the 20 series of bonds has a nominal principal amount of $75 million.

The holdout's strategy is to build large enough stakes in specific series of bonds to block the operation of CACs that would otherwise be able to sweep these bonds into the transaction. The holdout notably hopes for a successful restructuring that makes the debtor able to service debt again. The holdout also hopes that the now-solvent issuer will simply continue to make regular payments on any small amount bonds held by holdouts to avoid a legacy of legal and reputational risks tied to the non-payment of a portion of its liabilities. But if the issuer decides to not pay non-participants, the experienced holdout creditor will be prepared to take legal action to try to compel full payment.

This example considers the holdout's required investment to block the action of CACs as a function of the type of vote that governs the restructuring of a series of bonds.

- **Restructuring bonds without CACs**: Where CACs do not exist, as was the case of bonds issued under New York law prior to 2003 (including most of the bonds defaulted on by Argentina in 2001), issuers may carry out bond restructurings via an exchange offer subject to meeting a high threshold of participation, such as 85 percent. With 85 percent participation in a debt-reducing transaction, the sovereign would regain solvency notwithstanding a small percentage of non-participants. Without CACs, the holdouts cannot be forced to participate and the issuer will probably pay them in full.
- **Bonds with single-series CAC voting with 75 percent series threshold**: CACs with series-by-series voting have been embedded in most international sovereign bonds issued since 2003 as a result of an initial effort to facilitate orderly bond restructurings. Here, the holdout could purchase $18.825 million or the more nominal principal amount of the small $75 million bond, to rest comfortably that the 25.1 percent stake in the bond series would prevent a vote to sweep the holdout into the transaction under the CAC.
- **Bonds with two-limb CAC voting, with 50 percent series threshold**: In this case the holdout might target the same small bond, but would need to purchase a $37.575 million nominal principal amount of bonds to own a 50.1 percent series blocking stake. Compared to the single-series scenario above, double the capital is needed to block the activation of the CAC for this series, but the amount is still quite manageable for the funds active in this area.
- **Bonds with single-limb 75 percent aggregate participation threshold**: In this case, the holdout would need to control 25.1 percent of the entire $3.5 billion pool of bonds, or $878.5 million of bonds, to prevent activation of the CACs that might sweep these bonds into the restructuring. This is the real game changer for holdouts: to assure a stake that blocks the effect of CACs, 46 times more capital is needed versus single-series voting, and 23 times more capital is needed versus the two-limb voting mechanism.

This example shows how the new ICMA CAC provision materially shifts the incentives against potential holdout investors. They would need to amass far larger positions in bonds to block restructurings, which should substantially increase the operational and financial risks of employing a holdout strategy. In the language of economics, the strategy of being the marginal holdout player breaks down when the holdout creditor is forced to become a major creditor in order to block a transaction.

The new CAC provision provides the issuer some flexibility in structuring deals to meet commercial objectives and limit residual holdout risk. The issuer has the option to choose which voting mechanism applies to a series of bonds, and the issuer has the option to apply single-limb aggregated voting to a subset of bonds of their choice. The grouping option will be useful, for example, in a situation where the issuer seeks to offer holders of short-dated bonds different terms than those offered to holders of longer-dated bonds. Here the issuer might opt to form two voting groups, one for the shorter-dated bonds and another for the longer-dated bonds, in each case operating under the powerful single-limb voting mechanism. Before the public launch of a transaction, a potential holdout investor will be unable to predict which voting mechanism or grouping will apply, making it harder to block a transaction.

As a test, historical data was used to confirm the utility and flexibility of the new approach, specifically looking at the 13 US dollar bonds eligible for Uruguay's 2003 offer. This offer was about 90 percent successful without the application of CACs.[4] As shown in Table 1 in the Appendix, the offer would have been about 94 percent successful with the application of single-series CACs, and would have been about 98 percent successful with the application of the new two-limb voting mechanism. A scenario can also be envisaged where pooled, one-limb voting could generate 100 percent success. This example highlights how the new CACs could eliminate the deadweight loss, or "tax," caused by non-participants in sovereign debt restructurings.

The discussion above highlights a number of consequences of the new ICMA CACs. Issuers can now better manage holdout behaviour, and debt restructurings should become much more predictable. The recapture of deadweight losses previously enjoyed by holdouts will provide financial benefits that will accrue to the issuer or participants. Issuers will be left financially stronger and haircuts suffered by participating investors may be marginally reduced.

THE NEW ICMA MODEL *PARI PASSU* CLAUSE

The new ICMA model *pari passu* clause seeks to explicitly rule out the expansive remedy developed by the US courts in the Argentina litigation. Here is the new provision in its entirety:

> The Notes are the direct, unconditional and unsecured obligations of the Issuer and rank and will rank *pari passu*, without preference among themselves, with all other unsecured External Indebtedness of the Issuer, from time to time outstanding, *provided, however*, that the Issuer shall have no obligation to effect equal or rateable payment(s) at any time with respect to any such other External Indebtedness and, in particular, shall have no obligation to pay other External Indebtedness at the same time or as a condition of paying sums due on the Notes and vice versa. (ICMA 2014a, 1)

The new provision will reduce the probability of an outcome where a judge rules that participating bondholders cannot be paid unless holdout investors also are paid. This is not to say that the old form of this clause will always lead to an Argentina-like outcome, as the specific facts and circumstances form part of the legal analysis (IMF 2014, 7–15). Despite these uncertainties, the potential profits will likely drive holdouts to seek to take advantage of future sovereign debt restructurings where the old *pari passu* clauses in New York law bonds are involved. Hence, the concern with including the new *pari passu* provision in newly-issued bonds and the importance of amending old bonds to fix this provision. And, through the power to sweep non-participating bonds into transactions, the new CACs also serve to lower the risk of legal challenges to future bonds restructurings.

ANALYSIS: THE SCOPE AND EFFECT OF THE NEW ICMA MODEL PROVISIONS

Notwithstanding the substantial benefits of the new ICMA provisions, sovereign debt restructuring will remain challenging. For one, reaching required majorities will always be a significant challenge, whether before or after a default event. Then there is the problem of scope, as the ICMA provisions are designed to apply only to international debt. Finally, current risk scenarios will persist for some time, as it will take a long time to change outstanding stocks of bonds into the new format.

Reaching Majorities will still be a Challenge

While the new ICMA model CAC provision reduces the disruptive power of holdout investors, it does not make sovereign debt restructuring easy — a 75 percent supermajority of creditors is still required to effect a restructuring. This is a high hurdle; it is not without a great effort and a convincing offer that a sovereign issuer should be able to reach this required majority.

In this context, how a sovereign works with creditors matters. Consensus building is essential to reach such high majorities. The ICMA model CAC includes a provision regarding noteholders' committees, which, if included, sets out procedures for the formation of a committee, details its powers and requires sovereign borrowers to engage with the committee and cover certain costs. With that said, consensus building may be via a formal committee process (as required in the contract or agreed at the time of restructuring) or via a more general consultative process undertaken by the sovereign borrower and its financial advisors. Practice has varied; for example, Kazakhstan included the noteholders' committee provisions in its recently issued bonds, although Mexico did not.

4 See Table 1 and the *Prospectus Supplement* (Republica Oriental del Uruguay 2003, page S–8). Note a similar calculation was previously carried out by Buchheit and Pam (2004, 31).

Should Domestic Debt also have CACs?

The new provisions do not address the treatment of domestic debt (i.e., debt governed by domestic law). Economic adjustment programs, going forward, are likely from time to time to require substantial contributions from holders of local and international debt to succeed. As such, mechanisms should be put in place to assure an orderly treatment of domestic debt.

An interesting question arises: given the vast outstanding amount of local debt, should ICMA-type CAC provisions be inserted into local law sovereign bonds? As a case in point, euro-zone government borrowers have included two-limb CACs in domestic law bonds with maturities greater than one year since January 2013. Whether in Europe or elsewhere, many argue that domestic-law bonds do not need CACs because countries may, if needed, use legislative fiat to amend domestic bond terms. Furthermore, sovereigns also have enhanced power in managing local debt burdens through moral suasion, regulation, taxation and monetary policy. But the Greek experience suggests careful evaluation is in order; legislative fiat is commercially aggressive, may create legal risks or even constitutional challenges (Zettlemeyer, Trebesch and Gulati 2013, 40–41; ibid., 2014, 28; IMF 2002, 20). Whatever the format, countries should have contingency plans for managing domestic debt in the event of a severe financial crisis, and they should consider these plans when deciding if CACs are appropriate for inclusion in their local law instruments.

Why Accelerated Implementation of the Clauses Matters

The IMF has pointed out that there are roughly $900 billion in international sovereign bonds outstanding, and that 29 percent of this debt will mature in more than 10 years (IMF 2014, 33). Many governments have issued bonds with maturities of 30 years, and even 100-year bonds have been issued. Without deliberate action, bonds with the old CACs and the old *pari passu* clauses will be around for a long time.

We may contemplate a scenario 10 or 15 years from now where an issuer has refinanced 80 percent of its debt portfolio into the new format, while 20 percent of its bonds still contain the old *pari passu* clause and do not have CACs allowing single-limb voting. The unconverted bonds will be prime targets for holdout investors in case a debt restructuring is required.

To show the financial impact of 20 percent holdout activity in a debt restructuring, assume a 50 percent haircut of the entire pool of bond liabilities is required to restore debt sustainability. If 100 percent of investors were to participate, each holder would suffer a loss of 50 percent. But the loss suffered by participants would rise to 62.5 percent if they need to make up for the losses not borne by the 20 percent who hold out. The prospect of such an unequal result among creditors should the issuer seek to pay holdouts in full — or, alternatively, the risk of unpredictable legal outcomes should the issuer seek to not pay holdouts — may make it hard for the issuer and investors to forge a successful restructuring.

In other words, the potential exists for disorderly outcomes as long as even a moderate percentage of bonds in the old format remain outstanding. As such, it would be prudent to focus on strategies to accelerate the implementation of these new provisions.

ACTIVE MECHANISMS TO ACCELERATE ADOPTION OF THE NEW ICMA *PARI PASSU* AND CAC PROVISIONS

One way to accelerate the adoption of the new contractual framework would be to use active liability management. While some have noted that such an approach would be complicated (Roubini and Ribeiro 2014; IMF 2014, 34), the potential large cost of holdout activity in the unconverted debt make reviewing the options for accelerated conversion to the new format worthwhile.

A quantity of debt may be transitioned from the old legal format to the new ICMA standard in three ways: conventional refinancing, bond amendments or exchange offers.

Conventional Refinancing is a Slow Solution

In a conventional refinancing, a sovereign issues new bonds to repay old bonds upon maturity. The new bonds could be issued in a format that includes the new ICMA CAC and *pari passu* clauses. This is a simple strategy, but may require the issuer to wait for 10 or more years for a bond to mature to carry out the change in documentation, creating interim risks.

Bond Amendments to Accelerate Adoption

Bond amendments are relatively simple for issuers and investors; the issuer delivers to bondholders a document describing the proposed surgery on the terms and conditions of the bonds, and if the required majority of holders approve the proposal, the changes will be binding on all holders. The terms of the bonds will not otherwise be changed, and bonds will not be taken out of the possession of holders during the process. Some outstanding international bonds (for example, those including the old style CACs) may allow the insertion of the new CACs and the new *pari passu* provisions via a vote of bondholders, although there may be cases where such amendments are not possible and a bond exchange offer would be required.

Bond Exchange Offers to Accelerate Adoption

In a bond exchange offer, an issuer offers investors the opportunity to exchange the holding of "old" bonds for a position of "new" bonds. In this case, the new bonds would include the new ICMA provisions and the old bonds would be cancelled. Bond exchange offers have been widely used by issuers around the world, but they are somewhat more complex to carry out than bond amendments. Bond exchange offers involve substantial documentation from an issuer, active marketing and the purchase and issuance of securities. Notably, nearly all bondholders must accept the offer if it is to achieve the target result: most bonds converted to the new format, with, at most, only a very small "stub" of old-format bonds left behind. If presented ahead of any crisis, issuers should be able to use bond exchange offers as an acceptable solution for transitioning bond documentation to the new format. Investors should be motivated to participate to avoid being left holding an illiquid stub of old bonds when they expect the vast majority of bondholders in the community to accept an offer. However, if an issuer waits until a crisis is imminent to propose such an offer, high success rates may not be possible as investors may shy away from participation and holdouts could become active.

Transaction Costs: Is an Incentive Fee Required?

Bond amendments and exchange offers require the issuer to incur legal and operational costs, and bondholder incentive fees are often paid. For sovereign issuers to incur these costs now for benefits they are unlikely to have to use, transaction costs need to be very low and outcomes of transactions highly certain. Certainty of outcome could be achieved through pre-consultation with lead investors. Bondholder incentive fees will need to be negotiated, but there is good reason to hope they will be small as sovereign issuers and bondholders have a common interest in encouraging the transition of bonds to the new format. There is a basis to argue that no, or at most a nominal, incentive fee should be paid from the issuer to bondholders to support a transaction designed solely to transition documentation.

Can the Transition of Documentation be Wrapped into Other Transactions at No Cost?

In practice, cost may depend on the transaction mechanism. A bond amendment vote in which there are no other commercial changes to the terms may justify payment of a small consent fee to encourage voting. On the other hand, the change in documentation may be effected for no additional cost in a conventional liability management transaction in which an issuer buys short-dated bonds and issues new 10- and 30-year benchmark bonds to extend maturity, lock in attractive rates and manage looming maturity peaks. Leading sovereigns around the world have been very active in carrying out exactly such transactions over the last decade, and these transactions accelerated the incorporation of 2003-era CACs in sovereign debt stocks. However, this later strategy raises the question as to the treatment of stubs of old bonds left outstanding after the transaction, given a universe of small, illiquid and legally stronger bonds would be prime targets for holdouts in future debt restructurings. Should stubs be minimized by targeting very high participation rates? Or should issuers seek to amend any non-participating bonds to the new format where allowed by 2003-era CACs?

This discussion highlights that there are a number of commercial, procedural and legal questions to be answered before issuers seek to transition their bonds to the new legal format. Therefore, it may be helpful for issuers and bondholders to extend recent discussions of the design of the new CACs into a discussion of modalities to accelerate their adoption. Strong continuing support from the leading law firms on technical issues and continuing encouragement, monitoring and support from the official sector, including the IMF, may help to speed the process by improving clarity, reducing legal risks and costs, and improving market acceptance.

THE RAPID INITIAL ADOPTION OF THE NEW ICMA MODEL PROVISIONS IN THE NEW ISSUE MARKET

New ICMA model CACs were included in bonds issued by Mexico, Kazakhstan and Vietnam prior to year-end 2014 (Gelpern 2014b). All three followed the ICMA model with regard to majority voting. With regard to majority enforcement, another important collective action feature is that all three require a creditor vote of 25 percent to make all debt due following an event of default (accelerate), albeit via different legal structures (For example, Mexico using a trust indenture, while Kazakhstan and Vietnam use fiscal agency agreements). All three have fixed the *pari passu* clause to exclude the ratable payment interpretation, but each by slightly different wording.

A STEP-BY-STEP APPROACH TO CONVERTING OUTSTANDING DEBT STOCKS TO THE NEW FORMAT

The first step to converting outstanding debt stocks to the new format is to complete the new-issue market adoption of the new clauses. As the publication of the ICMA model CAC and model *pari passu* clause under English law and New York law was rapidly followed by several new sovereign issues, this step is well under way. It is important that, over the next year, all leading sovereign bond issuers accessing the markets also embed the new provisions in their bond documentation to show a united approach in adopting the new standards. The publication of model provisions for additional legal jurisdictions commonly used for sovereign international bonds should be completed (for example, in Germany and Japan) as part of this process. Given the strong reception of the initial issuances, new issue market uptake is not expected to be an issue, although it will be important for policy makers to monitor implementation.

While the focus this year will certainly be on the new-issue market, it would be helpful for creditor and debtors to be brought together to discuss active strategies to accelerate the transition of outstanding stocks of debt to the new format over the next few years. Cost will be a key issue to discuss, but so will timing, scope and structure. Given the estimated $900 billion universe of sovereign international bonds, and the many issuers and series of bonds involved, the conversion of outstanding stocks would be quite an operational undertaking. Publication of guidelines followed by a first operation by a leading issuer to convert debt stocks to the new format, would play a helpful role in encouraging sovereign bond issuers around the world to follow suit.

Finally, while any initiative is ultimately the responsibility of countries and their creditors, leading governments should endeavour to extend the constructive environment among debtors and creditors created over the last year to support these new discussions. Because of its broad membership and central role in global economic governance and policy, as well as its visibility with markets, the G20 historically has, and should continue to play, a unique role in endorsing the overall effort to encourage active transition of debt stocks to the new format. The IMF and groups representing bond investors, underwriters and legal firms should play an active role in discussions once they commence.

CONCLUSIONS

Debt restructuring is back on the front pages. As countries around the world struggle to manage high debt levels following the global financial crisis, many have questioned whether current policies are up to the task. This has created new momentum for changes in how countries deal with financial crisis. At the same time, the much-publicized cases of Greece and Argentina have raised particular concerns about the vulnerability of sovereign bond restructurings to disruption by holdout creditors.

The publication of the ICMA model documentation for aggregated CACs and the model *pari passu* clause represents a first step in addressing these concerns and is an important milestone in the development of a more effective architecture for sovereign bond restructuring. The new CACs provide a menu of options for changing the financial terms of a bond, subject to strong creditor protections. By strengthening the contractual framework governing debt restructuring, countries will now have stronger tools for binding in minorities to the terms of a restructuring, when the proposed restructuring is supported by supermajorities of creditors. When comprehensively implemented, the new clauses should facilitate more predictable outcomes for debtors and creditors, and fairer outcomes among creditors in situations that require debt restructuring.

However, the battle is not yet won: the risk of inefficient or unpredictable sovereign debt restructurings will remain elevated until the vast majority of the stock of outstanding international bonds has been converted to the new format. An active effort — supported by lenders, sovereign borrowers and the official community more broadly — to accelerate the transition of international debt stocks to the new format is warranted. While the focus remains on changing the features of international bonds, which have been traditionally very hard to restructure, it would be prudent for countries to also systematically develop contingency plans for restructuring local debt.

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APPENDIX

TABLE 1: ACTUAL RESULTS OF URUGUAY 2003 OFFER AND HYPOTHETICAL RESULTS UNDER SINGLE-SERIES AND TWO-LIMB CAC VOTING MECHANISMS

Bond-by-Bond Results of the International Offer (1) US$ Bonds Only		Actual Results No CACs (3)		Hypothetical Example I Single-Series Voting (4)		Hypothetical Example II Two-Limb Voting (5)	
Old Bonds	**Amount Outstanding**	**Amount Tendered**	**Success Rate (%)**	**Vote Result**	**Exchanged %**	**Vote Result**	**Exchanged %**
7.875% Bonds Due 2003	191,459,000	180,783,000	94.0	Pass	100.0	Pass	100.0
New Money Notes Due 2006 (2)	74,487,000	18,979,000	25.0	Fail	25.0	Fail	25.0
8.375% Bonds Due 2006	97,460,000	95,107,000	98.0	Pass	100.0	Pass	100.0
Debt Conversion Notes Due 2007 (2)	130,588,000	103,538,000	79.0	Pass	100.0	Pass	100.0
Convertible Floating Rate Notes Due 2007	150,000,000	150,000,000	100.0	Pass	100.0	Pass	100.0
7.00% Bonds Due 2008	239,650,000	228,677,000	95.0	Pass	100.0	Pass	100.0
7.875% Bonds Due 2009	248,300,000	245,926,000	99.0	Pass	100.0	Pass	100.0
7.25% Bonds Due 2009	241,449,000	225,305,000	93.0	Pass	100.0	Pass	100.0
8.75% Bonds Due 2010	273,815,000	264,592,000	97.0	Pass	100.0	Pass	100.0
7.625% Bonds Due 2012	410,000,000	404,175,000	99.0	Pass	100.0	Pass	100.0
Collateralized Fixed Rate Notes Series A Due 2021	250,161,000	138,089,000	55.0	Fail	55.0	Pass	100.0
Collateralized Fixed Rate Notes Series B Due 2021	30,536,000	22,836,000	75.0	Pass	100.0	Pass	100.0
7.875% Bonds Due 2027	510,000,000	476,855,000	94.0	Pass	100.0	Pass	100.0
Total Principal Amount Outstanding (US$)	2,847,905,000	2,554,862,000	89.7 %		94.1 %		98.0 %

NOTES:

(1) For simplicity of presentation, this analysis excludes two Chilean peso bonds, two euro-denominated bonds, one sterling-denominated bond and a concurrent bondholder meeting of a JPY Samurai bond.

(2) Reflects original principal amount of bonds before taking into account amortization payments to date.

(3) From Republica Oriental del Uruguay (2003)

(4) The vote is denoted as a pass and exchanged amount is 100% if a 75% majority for such series is achieved; otherwise, the tendered percentage is given in this column.

(5) The vote is denoted as a pass and exchanged amount is 100% if a 50% majority for such series is achieved; otherwise the tendered percentage is given in this column.

Source: Authors' calculations.

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Malcolm D. Knight

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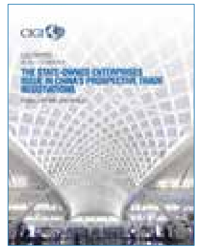

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Chinese state-owned enterprises (SOEs) are likely to be key elements in China's trade negotiations over the next few years. This paper examines some key sub-issues regarding SOEs for these trade discussions and proposes strategies to focus debate and outline possible approaches to accommodation, rather than definitively resolve the issues.

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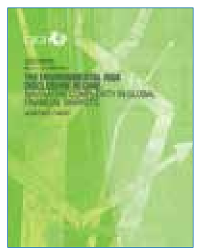
Trade analysis in the current moment is understandably focused on mega-regional negotiations, but plurilateral talks also deserve our attention. Plurilateral negotiations leading to a Trade in Services Agreement (TiSA) is the focus of this paper. Barriers to trade in services are distinct and their removal consequential; thus inviting careful consideration and, ideally, public debate. This paper seeks to illuminate developments in negotiations toward the plurilateral TiSA. Just as it has become commonplace to ask whether regional agreements advance economic and political agendas, so is it useful to explore the promise and peril of plurilateral agreements such as TiSA.



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Through minilateral efforts, the Chinese government seeks to use financial minilateralism to stimulate reform of global financial institutions, provide financial public goods for its regional neighbours and fellow developing countries, as well as directly promote China's economic and political interests. This paper examines China's minilateral diplomacy in the financial area and explores possible international reaction to China's new activism and the domestic political dynamics in China.

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