Report of the Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution

PRINCIPLES FOR STABLE CAPITAL FLOWS AND FAIR DEBT RESTRUCTURING & ADDENDUM

OCTOBER 2012

TRANSPARENCY COOPERATION GOOD FAITH FAIR TREATMENT

Report of the Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution

CONTENTS

Report of the Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution 3

Annex I

Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution 17

Annex II

Principles for Stable Capital Flows and Fair Debt Restructuring 19

Addendum to the Principles for Stable Capital Flows and Fair Debt Restructuring 23

Report of the Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution

I. BACKGROUND

The ongoing sovereign debt crises in the Euro Area over the past two and a half years, including the Greek voluntary debt restructuring, are the first sovereign debt crises in mature market countries in recent decades. They reflected essentially a range of factors, including underlying weaknesses in fiscal positions, inefficiencies in public sectors, unsustainable public debt, unsustainable bank credit expansion, deteriorating competitive positions, structural rigidities, weak growth potential, and, in many cases, housing price bubbles—many of which have been amplified by some design flaws of the European monetary union. Some of these underlying vulnerabilities were magnified in the aftermath of the major financial crisis of 2008–09 that has led to persistently weak economic growth in mature market countries and bouts of market turmoil. While exhibiting unique features, these vulnerabilities are reminiscent in several respects of the experience with debt crises in Latin America and other emerging markets over the previous three decades. The *Principles for Stable Capital Flows and Fair Debt Restructuring* were in fact conceived and launched in the aftermath of the sovereign debt crises in Latin America and Eastern Europe and influenced by the experience of the Asian crisis, and it was in late 2010 that the Group of Trustees of the *Principles* endorsed a recommendation by a special Principles Consultative Group (PCG) Working Group on the Applicability of the *Principles* to essentially extend the applicability of the *Principles* to all sovereign debtors and to the debt restructurings by banks or other non-sovereign entities in which the sovereign plays a major role in setting the legal framework.

The guidelines stemming from the *Principles* have usefully contributed to the development of the modalities for engaging with the private sector (summarized in the March 2011 "Term Sheet") of the European Stability Mechanism (ESM), the permanent institution set up for the channeling of Euro Area financial assistance to member countries facing sovereign debt difficulties, which has replaced the European Financial Stability Facility (EFSF) established in June 2010. Besides the EFSF/ESM, the Euro Area sovereign debt crisis management framework encompasses a range of other initiatives, including reinforced regional surveillance (new macro-imbalances procedures at the European Union level) and fiscal discipline (especially under the strengthened budgetary surveillance framework at the EU level—"six-pack" and "two-pack"—and the fiscal compact at the member country level), which complement stepped-up reform measures taken by individual member countries.

The *Principles* have also served as a guiding framework for the good-faith negotiations between the private creditor representatives and Greece, in consultation with the official sector, on a voluntary exchange of the outstanding Greek public debt held by domestic and foreign private creditors, from the outset of these discussions in June 2011 until the eventual execution of the debt exchange in March/April 2012.

In the discussions on the private sector involvement in Greece (PSI), private creditors were initially represented through an IIF-led Task Force on Greece during June–October 2011, and subsequently through the Steering Committee of the Private Creditor–Investor Committee (PCIC) for Greece during November 2011–April 2012. The debt exchange was concluded during March–April 2012. The dialogue with the Greek authorities and the official sector in general, the negotiations with Greece over the terms and conditions of the debt exchange, and the concessions made both by private creditors and the official sector were instrumental in facilitating the successful conclusion of the voluntary PSI deal with a very high private creditor participation rate—amounting to 83.5% and to almost 97% with the activation of Collective Action Clauses (CACs).

The successful conclusion of the voluntary debt exchange for Greece has provided Greece with a major upfront nominal debt reduction and cash-flow benefits. It has also given Greece some breathing space to enable it, together with the large official financial support, to be in a position to effectively implement the needed economic reforms in order to correct present imbalances and attain over time renewed growth and debt sustainability. The PSI was instrumental in facilitating the second program for Greece.

The experience with the protracted negotiations—which were partially the result of the complexities of Greece being a member of a currency union that explicitly prohibited exceptional assistance for its members, the complex decision-making procedures within the Euro Area, as well as the initial absence of any assistance mechanism—and the scope and spillover effects of the Greek debt exchange have given rise to a number of broader issues that go well beyond the impact of the debt exchange on Greece itself. They have major implications for sovereign debt crisis management policies and the existing framework for preventing and resolving sovereign debt crises, as embodied in the guidelines underlying the *Principles.* It is vital that this experience be assessed to draw appropriate lessons for policymakers at the country and regional levels, as well as relevant international financial institutions and the private investor community.

Notable features of the Greek sovereign debt crisis resolution include the following:

- It was the first sovereign debt crisis and resolution in modern history in a mature market economy and in the Euro Area;
- It was the largest debt exchange in history, covering €206 billion of government debt and the largest sovereign debt restructuring (including on a pre-default basis), entailing significant debt relief aimed at achieving a revival of growth and debt sustainability;
- It involved government bonds and not just loans, and a very broad range of domestic and foreign private investors, not just banks;
- It had significant contagion risks for other countries in the Euro Area and the regional banking system, and the world economy as a whole;
- It required contributions by both official and private creditors;
- It entailed formal negotiations between private creditors through their representative committee with the Greek authorities, and extensive consultations with the official sector. This involved complex coordination issues both among private creditors and among Euro Area member countries;
- It has clearly demonstrated that a voluntary, market-based approach is more effective and appropriate than a unilateral, top-down approach to debt restructuring (as mooted during the debt restructuring negotiations);
- It has influenced the evolution of the Euro Area sovereign debt crisis management framework, which was not in place when the Greek debt crisis erupted, and has given rise to policy issues that continue to dominate the policy debate; and
- It had a major impact on the Greek banking system, necessitating Euro Area official support for its recapitalization.

Moreover, the emergence of the Greek sovereign debt difficulties and the actual modalities pursued for the resolution of the debt crisis have revealed a number of weaknesses. The issues that have been identified related broadly to several weaknesses in crisis prevention, notably inadequate policies and data and policy transparency, inadequate risk management, and underestimation of the credit and sovereign risks by the private sector of investments in sovereign bonds of mature market countries. Other issues emphasized by private investors included the too frequent changes in the macroeconomic framework for the debt exchange, which, in their view, had an adverse impact on market sentiment and expectations; the apparent focus on fixed quantitative objectives of the debt sustainability methodology, with high prominence given to the nominal public debt/GDP ratio relative to the potential positive effects of a lengthening of the maturity profile and cash-flow debt relief; the protracted negotiating process between Greece and its private creditors on the one hand and between Greece and its official creditors on the other; the subordination of private creditor claims;

and the retroactive modification of the governing legal framework to introduce a collective action mechanism (similar to CACs) in Greek government bonds (GGBs) issued under domestic law.

Overall, the combined developments in these areas have posed at times some challenges to the adherence to the guidelines for the behavior of private creditors, sovereign debtors, and other official bodies underlying the *Principles*—namely, open dialogue, transparency, good faith negotiations, and the fair and comparable treatment of all creditors. At some instances, the multiplicity of official statements at the member country level included suggestions to resort to a unilateral, top-down approach to achieve the desired debt relief, but eventually a voluntary, consultative approach was followed. The extensive experience with the handling of the Euro Area sovereign debt crises has highlighted the potential costs to creditors, debtors, and the financial system as a whole from deviations from the *Principles*. In a broad sense, non-adherence to the guidelines advocated by the *Principles* could result in a debt resolution process that is inefficient and sub-optimal, with major risks to the normalization of market access and the promotion of financial stability.

II. FORMATION AND TERMS OF REFERENCE OF THE JOINT PUBLIC–PRIVATE SECTOR COMMITTEE

Against the above background, the four Co-Chairs of the Group of Trustees[1] of the *Principles* agreed in mid-March 2012 with the two Co-Chairs of the IIF Special Committee on Financial Crisis Prevention and Resolution on the formation of a Joint Public–Private Sector Committee to assess the recent experience with sovereign debt crisis prevention, management, and resolution in the Euro Area and elsewhere,[2] draw appropriate lessons, and make recommendations on the strengthening of the existing framework for sovereign debt crisis prevention and resolution as embodied in the guidelines of the *Principles*.

The key objectives of the Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution were:

- To assess the recent experience with sovereign debt crisis prevention at both the country and regional levels, draw lessons, and identify measures to strengthen the framework for crisis prevention—data transparency, open dialogue between the sovereign debtor (and other related authorities) and private creditors on current and future policy plans, and investor relations.
- To assess the recent experience with sovereign debt crisis resolution in Greece, taking into account the role played by Euro Area authorities (both country and regional) and international and European institutions and identify measures to strengthen the framework for debt crisis resolution: the role played by the Euro Area debt crisis management framework, the effectiveness of the decision making process, the role played by the IMF, the European Commission, and the ECB in defining the macroeconomic framework and debt sustainability parameters, the effectiveness of creditor committees and the role they should play in contributing to the policy dialogue, and the importance of facilitating the regaining of market access for sustained economic growth.
- To analyze the current and prospective implications for private creditors from actual and potential changes in the seniority of their existing and future claims resulting from official actions and for the debtors themselves (resulting from the Greek debt restructuring and the ESM Treaty provisions), particularly

[1] The Co-Chairs of the Group of Trustees include Governor Agustín Carstens of Banco de México; Governor Christian Noyer of Banque de France; Governor Zhou Xiaochuan of the People's Bank of China; and former Governor of the Bank of Japan Toshihiko Fukui.

[2] In parallel with the debt exchange for Greece, in March 2012, St. Kitts and Nevis, a small island in the Caribbean, concluded a comprehensive voluntary restructuring—consistent with the *Principles*—of its public debt held by domestic and foreign private creditors, as well as official bilateral creditors, with a participation rate of 97% and 100% after the activation of CACs.

as it regards the potential volume and terms of future private creditor financing.

- To evaluate the need and make recommendations for the amplification of the existing guidance for applying in practice the *Principles*, including through the possible issuance of an Addendum to the *Principles*, for the consideration of the Group of Trustees at their meeting on October 14, 2012, on the occasion of the IMF/Work Bank and IIF Annual Meetings in Tokyo.

The Joint Committee was co-chaired by **Jean Lemierre**, Senior Advisor to the Chairman, BNP Paribas, and Co-Chair of the IIF Special Committee on Financial Crisis Prevention and Resolution; **Thomas Wieser**, President, Eurogroup Working Group; **David Mulford,** Vice-Chairman International, Credit Suisse Group; and **Gerardo Rodríguez Regordosa**, Undersecretary of Finance and Public Credit, Mexico. The Joint Committee also comprised 35 prominent representatives from the public and private sectors with extensive experience in sovereign debt restructuring in the Euro Area and elsewhere (the membership of the Joint Committee is shown in Annex I). IIF staff served as secretariat to the Joint Committee. To address its agenda, the Joint Committee held several conference calls and three physical meetings in Washington, DC in April and in Paris in June and September 2012.

III. JOINT COMMITTEE FINDINGS AND RECOMMENDATIONS

1. Overall Assessment

The guidelines underlying the *Principles for Stable Capital Flows and Fair Debt Restructuring* remain an appropriate, relevant, and effective framework for sovereign debt crisis prevention and resolution. Their fundamental emphasis on sound policies and data and policy transparency by debtors is of critical importance in crisis prevention. Moreover, the underlying guidelines for voluntary, cooperative, market-based procedures for debtor-creditor dialogue and good-faith debt restructuring negotiations remain an essential cornerstone of sovereign debt crisis management and resolution and should continue to guide the interactions between sovereign issuers and their creditors. Such a cooperative approach would facilitate an early restoration of market access, which is of critical importance in achieving debt sustainability over time, and allow the official sector to gradually reduce its exceptional financial assistance to the countries under official sector–supported reform programs.

The support by the official sector of a voluntary debt exchange agreement for Greece reached through negotiations with private creditors has demonstrated and underscored the validity and usefulness of resolving even the most difficult sovereign debt problems in a manner consistent with the cooperative, market-based guidelines established by the *Principles* with major benefits not only for the parties directly involved, but also for the Euro Area as a whole and global financial stability in general.

However, while the voluntary overall framework of the Greek PSI negotiations was broadly consistent with the *Principles*, some aspects of the process through which the actual debt exchange deal was reached and some specific features of the coverage and terms of the deal raise concerns going forward. As regards the process, there have been at times uncertainties about the official sector commitment to a voluntary approach and, especially in the last critical stage of the negotiations, limited transparency of information on the details of Greece's future policy plans, specific policy targets, and likely macroeconomic outcomes and the associated determination of the volume and terms of the contribution of private creditors. The multiplicity of statements often at member state level in the context of domestic political debates has often created confusion for the private sector. The complexity of the Euro Area decision-making process and the fact that Euro Area authorities needed some time to develop the required response to the crisis complicated the situation significantly.

As regards specific features, the exclusion of bonds held by EU official entities (such as the ECB, national central banks, and the European Investment Bank [EIB]) from the debt exchange has raised concerns about equal treatment of creditors holding similar paper and the subordination of private investors, with possible lasting adverse effects on the demand for Euro Area sovereign debt in general. It is worth noting in this context that the EIB continued to extend credits to Greece during the crisis and the ECB undertook sovereign bond purchases under its Securities Market Program (SMP) to stabilize financial markets. In addition, the retroactive modification of the legal framework to introduce a collective action mechanism in the Greek government bonds issued under Greek law has raised concerns about the sanctity of contracts and questions about the future demand for sovereign securities issued under domestic law, notwithstanding its contribution to the high participation in the voluntary debt exchange (see Section 4(d) for more details).

These considerations, along with the special or unique institutional features of the Euro Area and the recent experience in sovereign debt crisis management, call for some elaboration or updating of the guidance provided by the *Principles* to make it more practically relevant to the circumstances faced by mature economies, in particular, those that are members of currency unions. The regional features include the significant contagion and spillover risks between Greece and the other troubled sovereign debtors in the Euro Area; the strong negative feedback loop observed between sovereign debt markets and the Euro Area banking system and its adverse regional macroeconomic implications; the large reliance of Euro Area countries on market financing; the broad range of private investors involved, subject to different regulatory requirements; and the added complexity of handling sovereign debt crisis management and resolution in a currency area.

The sections below highlight the Joint Committee's assessment of the recent experience and recommendations in specific areas related to the guidelines underlying the *Principles*—data and policy transparency, debtor-creditor dialogue and cooperation, good-faith negotiations, and fair treatment of all creditors. The Joint Committee's overall assessment and recommendations are summarized in the proposed *Addendum to the Principles*. The proposed *Addendum* is intended to complement the existing text of the guidelines underlying the *Principles* by providing some further amplification or elaboration of the current guidance on how to help ensure an effective implementation of the *Principles*.[3]

2. Data and Policy Transparency for Crisis Prevention

Assessment

A broad range of factors have contributed to poor crisis prevention practices in the period prior to the sovereign debt crises in the Euro Area. First and foremost, there were major weaknesses in data and policy transparency by Greece, and some countries pursued policies that contributed to the emergence of large and widening domestic and external imbalances and/or asset price bubbles and banking sector vulnerabilities. These unsustainable economic trends were not sufficiently well detected and highlighted by the existing economic surveillance procedures of regional and international institutions, or market analysts. Moreover, regulatory practices that *inter alia* treated sovereign debt as a riskless asset contributed to the weak risk management practices by financial institutions and market participants and resulted in misplaced perceptions about the default risks of countries that are members of currency unions. Investors, and in part policymakers, underestimated the credit risks involved in lending to individual sovereign issuers, notably in the Euro Area, contributing to a sharp narrowing of spreads on sovereign bonds. All these factors combined contributed to the emergence of unsustainable economic imbalances and posed contagion and systemic risks.

Major efforts and initiatives are currently ongoing to address these weaknesses. These include a strengthened framework for economic surveillance (the new macro-imbalances procedure) and fiscal discipline by Euro Area countries (notably through the "six-pack," the Fiscal Compact procedures, and

[3] The *Addendum* was endorsed by the Group of Trustees at its 2012 Annual Meeting in Tokyo on October 14, 2012.

the "two-pack" that will enter into force soon) and empowerment of Eurostat (the Euro Area statistical agency) to assess the compliance with established norms of data provision by member states. The regulatory framework and bank supervision arrangements have also been strengthened in the Euro Area and elsewhere, including the monitoring of contingent liabilities. The early warning procedures and multilateral surveillance and spillover analysis by the IMF, the G20, and private sector groups have also been intensified, including by the IIF's Market Monitoring Group. Enhanced risk management practices by financial institutions are also being implemented. But there is still a need for further progress and for continued effective implementation of agreed measures and vigilance by all parties concerned.

Recommendations

Sovereign debtors should pursue sound fiscal and growth-enhancing structural policies, consistent with macroeconomic and financial stability and public debt sustainability.

Sovereign debt issuers should ensure that they release on a timely basis comprehensive relevant data and other information related *inter alia* to their fiscal developments and debt positions (including, when appropriate, contingent liabilities) and on current and future policy plans. These data should be consistent with established accepted standards and norms (i.e. budget data should be released also on an accrual basis, not only cash basis) and verified by authorized domestic and regional agencies, especially with regard to their accuracy, comprehensiveness, and comparability over time.

Effective sovereign debt crisis prevention is a shared responsibility that requires—besides data and policy transparency and open dialogue with creditors by the sovereign debtors—sustained surveillance efforts by regional and international institutions and private sector groups; actions by regulatory agencies, accounting, and other international standard setters; as well as vigilance and enhanced risk management by private creditors and market participants in general.

The effectiveness and timeliness of surveillance by regional and international institutions of the consistency between policy plans and actual execution, and of national policies with regional commitments and undertakings for countries that are members of currency unions are critical for promoting sustainable policies and market confidence. Clarity and transparency of information on actual economic trends and prospects are essential for facilitating effective risk management by market participants and efficient functioning of sovereign debt markets.

Private creditors and market participants are responsible for formulating accurate and appropriate assessments of underlying trends in market risks, and the credit and sovereign risks of individual issuers, thus ensuring a realistic pricing of sovereign debt instruments. In this context, private creditors and market participants should undertake their own due diligence, drawing *inter alia* on all available information from the sovereign issuers themselves and the assessments by regional and international financial institutions. The assessment of current economic and financial developments and the identification of underlying or emerging risks by private sector groups such as the IIF's Market Monitoring Group can also play a useful and constructive role in this process.

Regulatory agencies should take care in setting capital and other requirements for covered financial institutions to avoid distortions in market signals and biasing risk management practices.

Responsible and realistic assessments and timely analysis by ratings agencies can also provide useful complementary information to market participants, investors, and issuers and enhance crisis prevention.

3. Close Debtor-Creditor Dialogue and Cooperation for Crisis Prevention

Assessment

Unlike emerging market issuers, the dialogue and cooperation between mature country issuers and their private creditors has traditionally been less extensive than in emerging markets, and minimal in some cases. This has reflected historical reasons and perceptions about debt sustainability risks, as well as market and institutional developments and practices. In the Euro Area, sovereign bonds have since 1999 primarily been denominated in euros and issued mainly under domestic law to all investors irrespective of residence, with limited provision for prospectuses on the underlying terms and conditions. In the case of Greece, only a small part of government bonds had been issued under international law (mainly English law) in euros or other currencies with embedded CACs. The European Stability Mechanism (ESM) envisages the inclusion of uniform and standardized CACs and aggregation clauses in all new issues of sovereign bonds by Euro Area countries from January 2013 onward. This initiative has been welcome and supported by private investors.

Recommendations

Mature market country issuers should consider implementing the best practices for investor relations that have evolved. The adherence of emerging market borrowers to these best practices are reviewed annually by the IIF and summarized in the annual Implementation Report of the *Principles* issued by the Principles Consultative Group.

Enhancement of investor relations under Investor Relations Programs facilitates timely data and policy transparency and a regular dialogue between sovereign issuers and their creditors and establishes an effective channel of communication and feedback. The experience over the past few years has demonstrated the value and contribution of IRPs in enhancing market confidence and maintaining market access even during periods of market tensions and turbulence.

Sovereign debt issuers in both mature and emerging market countries should incorporate in new bond issues, denominated in a foreign or a common regional currency, CACs with appropriate aggregation clauses, with comprehensive coverage of their terms and conditions in the bond documentation and easy access to this information by all investors. Issuers of domestic bonds denominated in local currency may also consider such arrangements. Appropriately designed aggregation clauses would allow bond holders across all outstanding issues of government securities to collectively decide on whether to accept potential offers from issuers to modify existing bond terms and conditions. The use of CACs inclusive of aggregation clauses can facilitate voluntary debt restructuring by reducing the chances of a small minority of bond holders acquiring blocking positions in a bond series and imposing demands for preferential treatment.

4. Good-Faith Actions in Cases of Debt Restructuring

(a) Voluntary Good-Faith Process

Assessment

The good-faith negotiations between the Steering Committee of the PCIC for Greece and the Greek authorities, in consultation with the official sector, were critical in facilitating a voluntary consensus on the terms of the debt exchange for Greece. The support provided by the authorities of key Euro Area countries and the leadership of Euro Area institutions to the good-faith negotiations was of critical importance in fending off efforts in some quarters to resort to a unilateral approach and/or consult only with a selected narrow range of private creditors separately rather than through the Steering Committee. The voluntary approach facilitated a consensus on a historic and unprecedented debt exchange deal for Greece that covered the largest volume of securities (both bonds and loans) and involved a large and diverse range of domestic and international creditors. The debt exchange was voluntary, in the sense that its terms and conditions were negotiated and agreed *ex ante* between the Greek authorities and the representatives of the private creditors, in consultation with the official sector, and was supported by a high voluntary creditor participation rate even before the activation of CACs, notwithstanding the major financial losses in net present value terms sustained by creditors.

With the prevailing accounting framework and regulatory requirements for regulated financial institutions to report their exposure to Greece (and other Euro Area sovereign debt), some or most of these financial losses were in fact recognized in their balance sheets as the debt restructuring was being negotiated. In fact, until they were clarified, earlier differences between the accounting practices and regulatory arrangements across jurisdictions and types of financial institutions had contributed to the complexity and time consuming nature of reaching an agreement on the PSI deal for Greece.

The reliance on a voluntary approach ameliorated the negative pressures in sovereign debt markets and the secondary market bond valuations for Greece and other troubled Euro Area countries and avoided a more adverse impact on market confidence. Nonetheless, concerns among both the official sector and private market participants and investors about the spillover risks from Greece to other Euro Area countries facing debt difficulties remained elevated. These concerns, and at times lack of clarity in the communication of the official sector, have weakened market confidence and the valuation of sovereign debt in Euro Area markets, and influenced the debt restructuring negotiations.

The debt restructuring negotiations were complicated and protracted as a result of institutional factors, collective action problems on both the official sector and private investor sides, and Greece's evolving macroeconomic circumstances and program performance. On the official sector side, coordination issues arose as Greece's financing need was fairly large, requiring bilateral contributions by its Euro Area partners. On the private creditor side, the large number of creditors involved, subject to different regulatory jurisdictions and accounting practices, complicated the decision-making process. Frequent slippages in policy implementation by Greece, against a setting of a deepening contraction in economic activity and employment and a challenging social and political environment, necessitated periodic revaluations of the program policy targets and medium-term funding needs.

The negotiating process was made more difficult and time consuming by the need for Greece to reach understandings with its official Euro Area partners and the IMF on the needed reform policies and the available volume and terms of financial assistance before advancing in its negotiations with its private creditors. Formal negotiations took place between Greece and private creditors, but extensive consultations were also held at the Euro Area official sector level, including the Eurogroup Working Group, the Eurogroup (Finance Ministers' level) and its leadership, senior European Commission officials, the ECB, and key Euro Area Leaders. The decision-making process within the Eurogroup was complicated by the need for unanimity among its members that represented 17 different democratic countries. It also reflected the fact that the Euro Area authorities needed some time to develop an intergovernmental crisis response and assistance mechanism. This also required a political reassessment and adjustment of some key principles underlying the Euro Area. Agreement on the terms and conditions of the private sector involvement was finally reached in an iterative process, once political decisions were taken on the volume and terms of the Euro Area official financial resources, and the macroeconomic framework and adjustment path were finalized by the IMF and other members of the Troika (the European Commission and the ECB).

Recommendations

Good-faith negotiations remain the most effective framework for reaching voluntary debt restructuring agreements among sovereign debtors and their diversified private creditor community, particularly in the complex cases of mature market issuers that are members of currency unions. Such a framework has proved to be efficient in facilitating appropriate agreements on crisis resolution, while containing the adverse impact on market confidence and other disruptions and concerns caused by spillover and contagion risks.

Sovereign issuers and their creditors should strive to reach and effectively implement voluntary agreements on a timely basis to help minimize adverse market reactions and contagion effects. In this context, debtors and creditors should be cognizant of the potential adverse effects of the interaction between sovereign debt and capital markets, to the detriment of the interests of

all parties. With the increased sophistication, integration, and complexity of capital markets, for both emerging market and mature economy countries, the interaction among developments in sovereign debt markets, changes in the regulatory framework, and banking system practices gives rise to major dynamics with significant implications for credit expansion, risk practices, market access by sovereign debtors, and macroeconomic developments.

The dynamics and incentives for debtors and issuers to engage in good-faith negotiations are strongly influenced by the existing accounting and regulatory standards and their interaction across types of financial institutions and jurisdictions. The standard-setting bodies responsible for accounting and supervision rules, as well as the interpretation bodies, should be cognizant of the need to minimize inconsistencies between accounting and supervision practices and conflicts across jurisdictions and types of covered financial institutions.

The early restoration of market access is of critical importance in achieving debt sustainability over time. Early re-accessing of capital markets at reasonable costs is also essential for allowing sovereign debtors to reduce and eliminate their reliance on exceptional IMF financing and financial support from their official bilateral partners, such as is the case under currency unions or regional arrangements.

(b) Debtor and Creditor Actions During Debt Restructuring

Assessment

In the context of sovereign debt restructuring, the macroeconomic framework, the debtor's adjustment policies, the debt sustainability analysis, and the timing of market access are crucial parameters that inform the negotiations between the debtor and its creditors.

In assessing the experience with the Greek PSI negotiations, private investors have held the view that there was inadequate sharing of information, especially during the last critical two–three months of the negotiations, about the way the Greek medium-term growth projections and reform objectives, including the debt sustainability analysis, were prepared and frequently adjusted by the official sector in response to the evolving economic circumstances and changing policy settings during the quarterly program review process. This was perceived by private creditors as limiting an open, informed and productive dialogue between private creditors and the Greek authorities, in consultation with the official sector. In light largely of Greece's evolving economic circumstances, program performance and implementation capacity between the regular quarterly reviews, the macroeconomic framework and policy undertakings by Greece were scaled down significantly in several stages between July 2011 and February 2012. These changes eventually necessitated *inter alia* a more substantial contribution by private creditors than envisaged in the broad understandings reached with the official sector in July and October 2011. The debt sustainability analysis and the derivation of the needed policy adjustments and financial contributions by official and private creditors carried out by the Troika tended to focus, in the view of private creditors, on rather fixed quantitative objectives about the nominal debt/GDP ratio, with insufficient weight attached to the potential positive effect from a lengthening of maturities and cash-flow relief, without an adequate exchange of views on these issues with private creditors. At times, private creditors perceived that their contribution was treated as a residual to fill identified financing gaps, undermining the prospects for restoring market access over time.

As a consequence, questions have been raised about the best ways to encourage greater data and policy transparency, a timely exchange of views, and a more open dialogue with private creditors. The IMF has played a critical role in the Greek PSI discussions, both as an advisor on economic policies and, to a lesser extent, as a provider of financial support. In view of the Euro Area's role as a major provider of financial assistance to Greece, the Euro Area institutions have also played an important role in determining Greece's macroeconomic framework within the Troika.

However, for private creditors to give up their legal rights and accept large financial losses, they need first and foremost an understanding of the changing economic circumstances and of the adequacy of the sovereign debtor's own reform efforts to address the adjustment needs of its economy. To this end, private creditors need to be adequately informed of the changed circumstances and the details of the reform program in a transparent and timely manner. Moreover, to achieve the broadest support possible for the overall macroeconomic framework, the broad fiscal targets, and the underlying output projections and debt sustainability analysis, it is necessary for private creditors to have an early opportunity to discuss these issues, through their creditor committee, with the sovereign debtor, in close consultation with the official sector. Such discussion and feedback would promote both market confidence in the reform program and, if necessary, facilitate a fair burden sharing between the sovereign debtor (undertaking the adjustment), the official sector (providing financial assistance), and private creditors (providing their contributions). A voluntary agreement on a fair burden sharing is needed to promote the restoration of market access, the resumption of satisfactory economic growth, and the attainment of debt sustainability.

Private creditors stress that it is important that the IMF play an objective role (and as far as the Euro Area is concerned, within the Troika) in finalizing together with the debtor the macroeconomic framework and the appropriate mixture of adjustment and financing, taking into account the availability of official financing, with a view to helping to support and facilitate, where necessary, an efficient, voluntary debt restructuring. It is clear that, under its own rules and practices, the IMF remains independent in preparing and presenting to its Executive Board its formal Debt Sustainability Analysis. It is important that the debt sustainability parameters be set with the benefit of a discussion with private creditors, since their commitments are essential ingredients to the debt sustainability outlook. These parameters include primarily the terms and conditions of a voluntary debt restructuring that need be agreed to in good-faith negotiations between the sovereign debtor and its creditors.

Recommendations

To facilitate good-faith negotiations, sovereign issuers, and regional institutions in case of regional arrangements, should engage in enhanced data and policy transparency and dialogue with private creditors at an early stage, should a debt resolution become necessary. The early release of information on the scale of the adjustment needs and the range and scale of the envisaged corrective policies by the sovereign issuers themselves or in the context of adjustment programs supported by the IMF and/or regional institutions would help minimize adverse market reaction and contagion risks and facilitate continued or early resumption of market access. The sanctity of contracts should be respected. Modifications to these contracts should be avoided wherever possible as a matter of principle.

In the debt restructuring process, an early discussion is necessary between the representative private creditor committee and the sovereign debtor, in close consultation with the official sector, on the overall multi-year macroeconomic framework and objectives, including the broad fiscal policy targets and the underlying outlook for output growth and public debt under alternative assumptions on the debt restructuring. Such a discussion is important in facilitating an effective voluntary debt restructuring agreement on a fair burden sharing, thus promoting high private sector participation, restored market access, renewed output growth, and debt sustainability.

It should be recognized that the attainment of debt sustainability over time is a dynamic, complex process that depends critically on the quality and market credibility of actual and prospective adjustment policies undertaken by the debtor, the direction of macroeconomic policies, the terms and volume of financial support or debt relief provided by official and private creditors, and the prospects for the continuation or resumption of market access at reasonable terms. As such, the debt sustainability analysis entails judgments and assessments that are often not easily amenable

to quantitative rules and that require revisions as macroeconomic parameters evolve. The contributions toward achieving debt sustainability by private creditors as well as other creditors should be considered simultaneously, with no one creditor group considered as a residual source of funding on an *ex ante* basis.

In this context, the IMF has a very important role to play by providing objective analysis and information on macroeconomic policies and prospects and on the sovereign debtor's medium-term funding needs, consistent with debt sustainability considerations.

(c) Creditor Committee Policies and Practices

Assessment

The representation of the private creditor community in the Greek debt restructuring negotiations was somewhat novel and took two distinct forms, reflecting the evolving thinking and views of the official sector on the desirability and depth of any debt restructuring for Greece. Initially, in June 2011, the IIF was invited by the Eurogroup Working Group to engage in a dialogue on the options for securing private creditor involvement, given the IIF's close involvement in the development and the monitoring of observance of the guidelines underlying the *Principles.* To aid this process, the IIF formed for this purpose a Task Force for Greece comprising IIF members and other holders of Greek bonds, after getting authorization from its Board of Directors (representing large financial institutions holding a large share of outstanding GGBs).[1] However, after October 2011, private creditors organized themselves in a broadly based creditor committee (PCIC), represented in the negotiations by a smaller Steering Committee, which reflected the diverse membership of the PCIC and facilitated the effective completion of the negotiations. The Steering Committee and the broader PCIC represented all principal groups of Greek government debt holders, including all major Greek banks, and a large share of the outstanding GGBs and loans covered by the debt exchange. As is common practice in sovereign and corporate debt restructurings, besides their broad representation, the Steering Committee and the PCIC derived their legitimacy and credibility through their actions and positions, which were aimed at advancing the interest of all private creditors, while also promoting financial stability. This legitimacy was confirmed *ex post* by the high degree of creditor participation in the debt exchange, including the acceptance of the retroactive CACs. Greece has agreed to reimburse the legal fees incurred by the Steering Committee.

Generally, private sector creditors should strive to form a single Creditor Committee and a coherent Steering Committee as early as possible, and to provide the Steering Committee with adequate financial and analytical resources to conduct negotiations with the sovereign borrower, in consultations with official bilateral creditors—negotiations that could be protracted.

Recommendations

Private creditors should organize themselves in a broadly based representative creditor committee as early as possible in the debt restructuring process, certainly before debt default, which should be avoided if possible. Sovereign issuers should interact and engage in negotiations with their private creditors through the representative creditor committee and should consult with the creditor committee as part of the process of fulfilling the requirement under IMF policy of lending to debtors in arrears to make good-faith efforts to reach understandings with their creditors. Such a framework would be more conducive to reaching a voluntary agreement on debt restructuring and facilitate market access.

Private creditors that are members of the creditor committee negotiating with the sovereign debtor should abide by established ethical standards and *inter alia* respect the confidentiality of any material non-public information that may become available during this process and notably

[1] Prior to that, in late 2010 and early 2011, the IIF had participated in informal consultations with the European Commission as part of the process for finalizing the modalities for the ESM.

commit not to use confidential information from the negotiations for trading purposes.

This process will be aided in cases of countries that require financial assistance from multiple official bilateral creditors, as is usually the case for countries that are members of currency unions, by the formulation of timely and effective procedures for reaching understandings on the scale, terms, and conditionality of any envisaged financial assistance from these creditors so as to facilitate the negotiations between the sovereign debtor and the private creditor committee.

In line with the evolving practice, the sovereign debtor would be expected to cover reasonable costs incurred by a single private creditor committee for the legal and financial advisor fees, consistent with agreed parameters.

(d) Tools for Debt Restructurings

Assessment

As regards the tools used in the Greek debt exchange, two special features are worth highlighting. First, the adoption, just days before the launching of the debt exchange offer, of legislation modifying retroactively the governing legal framework to introduce a collective action mechanism in existing GGBs issued under Greek law has raised concerns about the sanctity of financial contracts. Notwithstanding the contribution the activation of this collective action mechanism has made to the overall success of the debt exchange—after a voluntary PSI deal had been reached—as a matter of principle, there should not be any changes in the governing law with retroactive effect. This retroactive action was put to the approval of private creditors as an exit clause under the debt exchange offer and was in fact endorsed by a large majority (85.8%) of private holders of Greek law bonds, exceeding the needed 50% threshold, thus allowing the activation of the collective action mechanism. It also exceeded the normal 75% threshold for the activation of CACs for bonds issued under English law. Yet, as a matter of principle, the retroactive change in the legal framework governing sovereign debt instruments is worrisome and sets a bad precedent, as it could encourage investors to prefer international law bonds instead of domestic law bonds to minimize "sovereign risk," and might undermine the functioning of their sovereign debt markets. However, the retroactive introductions of CACs with terms and thresholds consistent with market practice to facilitate debt restructuring when a voluntary agreement with private creditors has already been reached can be considered.

Second, the Greek debt exchange involved a number of credit enhancements for the new GGBs issued under the exchange, intended to raise their market value and the attractiveness of the debt exchange offer. These useful enhancements comprised the use of a co-financing scheme for the servicing by Greece of the coupon and principal payments for both the new GGBs and €30 billion of EFSF financing. They also included the use of English law as the governing legal framework, the incorporation of CACs in the new GGBs, and the issuance of GDP-linked securities that provided the potential for additional coupon payments subject to certain restrictions in case of a higher-than-projected output growth performance by Greece. These credit enhancements were seen by private investors as critical in facilitating a voluntary debt exchange agreement. The issuance of the new bonds under English law was particularly welcome by private investors, who considered such practice as providing more reassurance and protection for their claims, thus helping to raise the participation rate in the debt exchange. Against this background, private investors may favor in the future sovereign bond issuance under international law, especially in cases where sovereign risk is perceived to be elevated. However, the development of domestic capital markets remains a worthwhile and desirable objective. Issuance of sovereign bonds under a legal framework that is perceived to provide protection for creditor rights may facilitate accessing capital markets at more reasonable costs than otherwise would be the case.

Recommendations

Sovereign issuers and their creditors should introduce CACs and possibly other options to enhance the credit quality of the new debt instruments used under debt restructuring

exercises so as to enhance the prospects for high voluntary creditor participation. Retroactive legal changes to unilaterally modify the terms and conditions of financial contracts may undermine the integrity of financial markets and the sanctity of contracts and should be avoided. However, in exceptional cases and after a voluntary debt exchange agreement has been reached, such modifications of the governing legal framework to introduce a collective action mechanism on a timely basis with terms and thresholds consistent with market practices may be necessary in facilitating a voluntary debt exchange and achieving a fair outcome for all bond holders.

5. Fair and Comparable Treatment of All Creditors

Assessment

In line with the *Principles*, the Greek debt exchange excluded short-term government securities (Treasury Bills)—no trade-related government financing instruments were outstanding.

However, concerns about the fair treatment of all creditors arose from two developments in the sovereign debt crisis management experience in the Euro Area.

First, under the Greek debt restructuring offer, holdings of GGBs by the ECB, national Euro Area central banks, and the European Investment Bank (EIB)—amounting to more than 20% of total GGBs outstanding—were unilaterally carved out of the total Greek government securities covered by the debt exchange without consultation with private creditors, even though these holdings by the Euro Area official bodies were identical and non-separable from the holdings of the same bonds held by private investors. The resulting subordination of private claims constituted discrimination against private creditors. Notwithstanding the claimed broad rationale for such action (namely that the Euro Area official sector collectively provided substantial new funding to Greece), this subordination and concerns about similar actions in the future by Euro Area issuers have already had an adverse effect on the perceived credit risk of sovereign debt in the Euro Area, and the relative ranking of private investor claims. As a consequence, this subordination has weakened the incentives of private investors to maintain or increase their exposure to sovereign Euro Area debt.

While the GGB purchases from the secondary market by the ECB (at a discount) undertaken under the Securities Market Program were motivated by monetary policy considerations, the GGB holdings by national central banks and the EIB reflected traditional financial investments similar to those by private creditors. In this light, the exclusion of the ECB holdings from the debt exchange could be rationalized (even though a transfer of the associated net gain to Greece could be considered), but the exclusion of the other official body holdings deviated from the normal principle of non-discrimination. It is worth noting in this context, however, that the EIB continued to extend credits to Greece during the crisis.

Second, the preamble of the ESM Treaty, which outlines the Euro Area permanent debt crisis management framework and came into effect in early October 2012, stipulates that official financial support under the ESM will have a preferred creditor status second only to that of the IMF. This provision essentially subordinates both existing and future claims by private investors in Euro Area sovereign bonds, thus undermining the current and future demand for sovereign securities. This provision needs to be clarified as soon as possible. In a welcome move, the new ECB bond purchases under the Outright Monetary Transactions (OMT) program announced in early September 2012 will be on *pari passu* terms with private holders of similar bonds.

In the long run, from the standpoint of crisis resolution, if full access to private capital markets is to be restored in line with the stated objectives of Euro Area leaders and fair burden sharing re-established, it will be important to remove both the preferred creditor status for official Euro Area lenders and the presumption that private investors will be subordinated in future financing of Euro Area members. In this context, the Euro Area leaders' decision in late June 2012 to allow a potential ESM support for Spain's bank recapitalization program to be on *pari passu* terms with private investors is welcome.

Recommendations

Sovereign issuers should treat fairly and provide comparable treatment to all creditors so as to avoid discrimination against any individual or groups of creditors. No creditor or creditor group should be excluded *ex ante* from participating in debt restructuring. Any exceptions to this principle should be discussed and agreed to among all creditors on the basis of adequate justification. Broad creditor participation in debt restructuring operations is essential to ensure a fair burden sharing, including the impact of the provision of new financial assistance, as well as to avoid any new or intensify existing subordination of the claims by some classes of creditors.

Fair treatment of all creditors is in the interest of both issuers and creditors. It lessens the burden on all creditors and, by avoiding discrimination, encourages creditors to participate voluntarily in debt resolution and minimizes any adverse impact on the investor demand for existing or new issues of sovereign debt by the issuer undergoing debt restructuring or similar debtors in the region or fellow members of currency unions. Reduced demand for sovereign debt by private investors, and/or delayed resumption of market access by the sovereign debtor due to subordination concerns, increase the potential burden on official creditors and international or regional institutions to provide financial support to the adjusting country in larger volume and/or over a longer period of time than would otherwise be necessary.

Annex I. Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution

Co-Chairs

Mr. Jean Lemierre
Senior Advisor to the Chairman, *BNP Paribas*
Co-Chair, *IIF Special Committee on Financial Crisis Prevention and Resolution*

Dr. David Mulford
Vice-Chairman International
Credit Suisse Group

Mr. Gerardo Rodríguez Regordosa
Undersecretary of Finance and Public Credit
Mexico

Mr. Thomas Wieser
President, *Eurogroup Working Group*
Chairman*, European Union's Economic and Financial Committee*

Members

Mr. Terrence Checki
Executive Vice President
Federal Reserve Bank of New York

Mr. Frank Czichowski
Senior Vice President / Treasurer
KfW Bankengruppe

Ms. Delphine D'Amarzit
Assistant Secretary for Multilateral Affairs,
Trade and Development Policies Department
French Treasury; and Co-Chair of the Paris Club

Mr. Alejandro Díaz de León
Head of Public Credit, Secretariat of Finance and Public Credit
Mexico

Mr. Christopher Drennen
Head of Strategic Marketing
BNP Paribas

Mr. Nazareth Festekjian
Managing Director, Head of Global Liability Management and Co-Head of Global Structured Finance
Citi

Mr. Spyros Filaretos
General Manager and Chief Operating Officer
Alpha Bank

Mr. Robert Gray
Chairman, Debt Finance and Advisory
HSBC Bank, Plc.

Mr. Andreas Gruber
Regional Chief Investment Officer
Allianz Investment Management

Mr. George Hoguet
Managing Director
State Street Global Advisors

Mr. Nicolas Hubert
Managing Director
Blackstone Advisory Partners

Mr. Hans Humes
President and Chief Investment Officer
Greylock Capital Management

Mr. René Karsenti
President
ICMA

Dr. Dagmar Linder
Managing Director, Regional Management,
Central and Eastern Europe
Deutsche Bank

Mr. Mauro Maccarinelli
Head of Market Risk Management
Intesa Sanpaolo

Mr. Yannis Manuelides
Partner
Allen & Overy, LLP

Mr. Daniel Marx
Executive Director, *Quantum Finanzas*
Former Secretary of Finance, *Ministry of Finance, Argentina*

Mr. Gavin McLean
Partner, Banking & Capital Markets Group
White & Case, LLP

Dr. Carlo Monticelli
Head of International Financial Relations
Ministry of Economy and Finance, Italy

Ms. Elaine Murphy
Executive Director, Head Financial Institutions and Sovereigns, Restructuring Unit
Bayern LB

Dr. Bandid Nijathaworn
Chairman, *Thai Bonds Market Association*
Former Deputy Governor, *Central Bank of Thailand*

Dr. Guillermo Ortiz
Chairman of the Board of Directors
Grupo Financiero Banorte

Mr. Klaus Regling
Chief Executive Officer
European Financial Stability Facility

Mr. Roman Schmidt
Head of Corporate Finance
Commerzbank

Mr. Christian Sewing
Chief Credit Officer, Operational Risk Management
Deutsche Bank

Mr. Jon Sigurgeirsson
Director, General Secretariat
Central Bank of Iceland

Mr. David Soanes
Group Managing Director & Head of Global Capital Markets
UBS

Mr. Carlos Steneri
Consultant
Posadas, Posadas & Vecino

Mr. Nicola Stock
President
Task Force Argentina

Mr. Gerassimos Thomas
Director, Finance, Coordination with IFIs
European Commission

Mr. Emmanuel Vercoustre
Deputy CEO of AXA Bank Europe
& Head of AXA Bank Europe Financial Services
AXA Bank Europe

Mr. Philip Wood
Head, Global Law Intelligence Unit, Special Global Counsel
Allen & Overy, LLP

IIF

Mr. Charles Dallara
Managing Director

Mr. Hung Tran
Deputy Managing Director and Counsellor

Mr. Mikis Hadjimichael
Deputy Director, Capital Markets and Emerging Markets Policy Department

Annex II. Principles for Stable Capital Flows and Fair Debt Restructuring[1] & *Addendum*

PRINCIPLES FOR STABLE CAPITAL FLOWS AND FAIR DEBT RESTRUCTURING

PREFACE

Since the mid-1990s, sovereign debtors and their private sector creditors have generally sought to put in place policies and procedures likely to promote and maintain sustained market access.

Most issuers have recognized the importance of implementing sound economic and financial policies (including monetary, exchange rate, and debt management policies), as well as developing domestic public support for those policies. Equally important are policies that preserve the rule of law and, in particular, maintain the sanctity of contracts, as well as other measures needed to advance an open investment environment. In maintaining sound policies, debtors have been guided by internationally accepted standards and codes to strengthen financial stability and to enhance transparency by providing timely economic and financial data.

For their part, most creditors make investment and lending decisions on their own merit, accept full responsibility for these decisions, and do not expect official sector bail-outs. As part of this process, creditors have sought to implement good practices in risk management, including thorough analysis of a borrowing country's implementation of sound economic and financial policies, as well as adherence to key standards and codes.

More recently in a significant step toward strengthening the resilience of the system, most debtors and their creditors have opted for the voluntary inclusion of collective action clauses (CACs) in international bond terms and conditions. These bonds have provided for amending payment terms through supermajority voting and for limiting precipitous legal actions through higher acceleration hurdles; a few bonds have also included provisions for debtor-creditor engagement.

In a growing number of cases, both issuers and creditors have pursued effective, two-way communication through robust investor relations programs (IRPs). This communication includes information and data on the issuer's key economic and financial policies and performance, with creditors providing feedback.

The *Principles* outline actions and behavior of private sector creditors and emerging market sovereign debtors to promote and maintain stable private capital flows to emerging market economies in the context of growth and financial stability. They are based on extensive and broadly based discussions among private creditors and sovereign emerging market issuers. Because individual cases will invariably involve different circumstances, the *Principles* should be applied flexibly on a case-by-case basis and are strictly voluntary. Accordingly,

[1] The *Principles* were launched in 2004 and welcomed and supported by the G20 Finance Ministers and Central Bank Governors in their meetings in Berlin, Germany, on November 20–21, 2004, and in Xianghe, Hebei, China, on October 15–16, 2005. During the annual meeting of the Group of Trustees on October 10, 2010, the Trustees agreed to broaden the applicability of the *Principles* to go beyond the traditional emerging market sovereign issuers to encompass on a voluntary basis all sovereign issuers, as well as cases of debt restructuring in which the state plays a major role in influencing the legal and other key parameters of debt restructuring, based on the recommendation of a PCG Working Group on the Applicability of the *Principles*. The Group of Trustees also agreed to drop the reference to emerging markets from the title of the *Principles*. For more details, see Annex II of the October 2010 *Report of the PCG on the 2010 Implementation of the Principles for Stable Capital Flows and Fair Debt Restructuring*.

no party is legally bound by any of the provisions of these *Principles*, whether as a matter of contract, comity, or otherwise. Moreover, nothing in these *Principles* (or in any party's endorsement thereof) shall be deemed to constitute a waiver of any such party's legal rights.

The *Principles* build on the progress since the mid-1990s to identify effective measures in order to shore up crisis prevention and encourage their continued implementation. The *Principles* promote early crisis containment through information disclosure, debtor-creditor consultations, and course correction before problems become unmanageable. They also support creditor actions that can help to minimize market contagion. In cases where the debtor can no longer fulfill its payment obligations, the *Principles* outline a process for market-based restructuring based on negotiations between the borrowing country and its creditors that involve shared information, are conducted in good faith, and seek to achieve a fair outcome for all parties. Such a process maximizes the likelihood that market access will be restored as soon as possible under sustainable macroeconomic conditions.

PRINCIPLES

1. Transparency and Timely Flow of Information

General disclosure practice. Issuers should ensure through disclosure of relevant information that creditors are in a position to make informed assessments of their economic and financial situation, including overall levels of indebtedness. Such disclosure is important in order to establish a common understanding of the country's balance of payments outlook and to allow creditors to make informed and prudent risk management and investment decisions.

Specific disclosure practice. In the context of a restructuring, the debtor should disclose to all affected creditors maturity and interest rate structures of all external financial sovereign obligations, including the proposed treatment of such obligations; and the central aspects, including assumptions, of its economic policies and programs. The debtor should inform creditors regarding agreements reached with other creditors, the IMF, and the Paris Club, as appropriate. Confidentiality of material non-public information must be ensured.

2. Close Debtor-Creditor Dialogue and Cooperation to Avoid Restructuring

Regular dialogue. Debtors and creditors should engage in a regular dialogue regarding information and data on key economic and financial policies and performance. IRPs have emerged as a proven vehicle, and countries should implement such programs.

Best practices for investor relations. Communication techniques should include creating an investor relations office with a qualified core staff; disseminating accurate and timely data/information through email or investor relations websites; establishing formal channels of communication between policymakers and investors through bilateral meetings, investor teleconferences, and videoconferences; and maintaining a comprehensive list of contact information for relevant market participants. Investors are encouraged to participate in IRPs and provide feedback on such information and data. Debtors and investors should collaborate to refine these techniques over time.

Policy action and feedback. Borrowing countries should implement economic and financial policies, including structural measures, so as to ensure macroeconomic stability, promote sustainable economic growth, and thereby bolster market confidence. It is vital that political support for these measures be developed. Countries should closely monitor the effectiveness of policies, strengthen them as necessary, and seek investor feedback as warranted.

Consultations. Building on IRPs, debtors should consult with creditors to explore alternative market-based approaches to address debt service problems before default occurs. The goal of such consultations is to avoid misunderstanding about policy directions, build market confidence on the strength of policy measures, and support continuous market access. Consultations will not focus on specific financial transactions, and their precise format will depend on existing circumstances. In any event, participants must not take advantage of such consultations to gain a commercial benefit for trading purposes. Applicable legal restrictions regarding material non-public information must be observed.

Creditors' support of debtor reform efforts. As efforts to consult with investors and to upgrade policies take hold, the creditor community should consider, to the extent consistent with their business objectives and legal obligations, appropriate requests for the voluntary, temporary maintenance of trade and inter-bank advances, and/or the rollover of short-term maturities on public and private sector obligations, if necessary to support a borrowing country's efforts to avoid a broad debt restructuring. The prospects of a favorable response to such requests will be enhanced by the commitment to a strong adjustment program, but will also depend in part on continued interest payments on inter-bank advances and continued service of other debt.

3. Good-Faith Actions

Voluntary, good-faith process. When a restructuring becomes inevitable, debtors and creditors should engage in a restructuring process that is voluntary and based on good faith. Such a process is based on sound policies that seek to establish conditions for renewed market access on a timely basis, viable macroeconomic growth, and balance of payments sustainability in the medium term. Debtors and creditors agree that timely good-faith negotiations are the preferred course of action toward these goals, potentially limiting litigation risk. They should cooperate in order to identify the best means for placing the country on a sustainable balance of payments path, while also preserving and protecting asset values during the restructuring process. In this context, debtors and creditors strongly encourage the IMF to implement fully its policies for lending into arrears to private creditors where IMF programs are in place, including the criteria for good-faith negotiations.

Sanctity of contracts. Subject to their voluntary amendment, contractual rights must remain fully enforceable to ensure the integrity of the negotiating and restructuring process. In cases where program negotiations with the IMF are under way or a program is in place, debtors and creditors rely upon the IMF in its traditional role as guardian of the system to support the debtor's reasonable efforts to avoid default.

Vehicles for restructurings. The appropriate format and role of negotiation vehicles such as a creditor committee or another representative creditor group (hereafter referred to as a "creditor committee") should be determined flexibly and on a case-by-case basis. Structured, early negotiations with a creditor committee should take place when a default has occurred in order to ensure that the terms for amending existing debt contracts and/or a voluntary debt exchange are consistent with market realities and the restoration of growth and market access and take into account existing CAC provisions. If a creditor committee is formed, both creditors and the debtor should cooperate in its establishment.

Creditor committee policies and practices. If a creditor committee is formed, it should adopt rules and practices, including appropriate mechanisms to protect material non-public information; coordinate across affected instruments and with other affected creditor classes with a view to form a single committee; be a forum for the debtor to present its economic program and financing proposals; collect and analyze economic data; gather, evaluate, and disseminate creditor input on financing proposals; and generally act as a communication link between the debtor and the creditor community. Past experience also demonstrates that, when a creditor committee has been formed, debtors have borne the reasonable costs of a single creditor committee. Creditors and debtors agree jointly what constitute reasonable costs based on generally accepted practices.

Debtor and creditor actions during restructuring. Debtors should resume, to the extent feasible, partial debt service as a sign of good faith and resume full payment of principal and interest as conditions allow. Debtors and creditors recognize in that context that typically during a restructuring, trade lines are fully serviced and maintained. Debtors should avoid additional exchange controls on outflows, except for temporary periods in exceptional circumstances. Regardless of the specific restructuring mechanics and procedures used (i.e., amendment of existing instruments or exchange for new ones; pre-default consultations or post-default committee negotiations), restructuring terms should be subject to a constructive dialogue focused on achieving a critical mass of market support before final terms are announced. Debtors should retain legal and/or financial advisors.

4. Fair Treatment

Avoiding unfair discrimination among affected creditors. The borrowing country should avoid unfair discrimination among affected creditors. This includes seeking rescheduling from all official bilateral creditors. In line with general practice, such credits as short-term trade-related facilities and inter-bank advances should be excluded from the restructuring agreement and treated separately if needed.

Fairness of voting. Bonds, loans, and other financial instruments owned or controlled by the sovereign should not influence the outcome of a vote among creditors on a restructuring.

ADDENDUM TO THE PRINCIPLES FOR STABLE CAPITAL FLOWS AND FAIR DEBT RESTRUCTURING

This *Addendum* presents the recommendations of the Joint Public–Private Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution, endorsed by the Group of Trustees of the *Principles* on October 14, 2012, at its 2012 Annual Meeting in Tokyo. The Joint Committee was set up under the auspices of the Co-Chairs of the Group of Trustees in March 2012 to assess the recent experience with sovereign debt crisis prevention, management, and resolution in the Euro Area and elsewhere; draw appropriate lessons; and make recommendations on the strengthening of the existing framework for sovereign debt crisis prevention and resolution as embodied in the guidelines of the *Principles for Stable Capital Flows and Fair Debt Restructuring*. The recommendations included in the *Addendum* complement the *Principles* and provide amplification of the practical guidance for the implementation of the guidelines underlying the *Principles* to make them more practically relevant to the circumstances faced by mature market countries, including those that are members of currency unions.

1. Overall Assessment

The guidelines underlying the *Principles for Stable Capital Flows and Fair Debt Restructuring* remain an appropriate, relevant, and effective framework for sovereign debt crisis prevention and resolution. Their fundamental emphasis on sound policies and data and policy transparency by debtors is of critical importance in crisis prevention. Moreover, the underlying guidelines for voluntary, cooperative, market-based procedures for debtor-creditor dialogue and good-faith debt restructuring negotiations remain an essential cornerstone of sovereign debt crisis management and resolution and should continue to guide the interactions between sovereign issuers and their creditors. Such a cooperative approach would facilitate an early restoration of market access, which is of critical importance in achieving debt sustainability over time, and allow the official sector to gradually reduce its exceptional financial assistance to the countries under official sector–supported reform programs.

2. Data and Policy Transparency for Crisis Prevention

Sovereign debtors should pursue sound fiscal and growth-enhancing structural policies, consistent with macroeconomic and financial stability and public debt sustainability.

Sovereign debt issuers should ensure that they release on a timely basis comprehensive relevant data and other information related *inter alia* to their fiscal developments and debt positions (including, when appropriate, contingent liabilities) and on current and future policy plans. These data should be consistent with established accepted standards and norms (i.e. budget data should be released also on an accrual basis, not only cash basis) and verified by authorized domestic and regional agencies, especially with regard to their accuracy, comprehensiveness, and comparability over time.

Effective sovereign debt crisis prevention is a shared responsibility that requires—besides data and policy transparency and open dialogue with creditors by the sovereign debtors—sustained surveillance efforts by regional and international institutions and private sector groups; actions by regulatory agencies, accounting, and other international standard setters; as well as vigilance and enhanced risk management by private creditors and market participants in general.

The effectiveness and timeliness of surveillance by regional and international institutions of the consistency between policy plans and actual execution, and of national policies with regional commitments and undertakings for country members of currency unions, are critical for promoting sustainable policies and market confidence. Clarity and transparency of information on actual economic trends and prospects are essential for facilitating effective risk management by market participants and efficient functioning of sovereign debt markets.

Private creditors and market participants are responsible for formulating accurate and appropriate assessments of underlying trends in market risks, and the credit and sovereign risks of individual issuers, thus ensuring a realistic pricing of sovereign debt instruments. In this context, private creditors and market participants should undertake their own due diligence, drawing *inter alia* on all available information from the sovereign issuers themselves and the assessments by regional and international financial institutions. The assessment of current economic and financial developments and the identification of underlying or emerging risks by private sector groups such as the IIF's Market Monitoring Group can also play a useful and constructive role in this process.

Regulatory agencies should take care in setting capital and other requirements for covered financial institutions to avoid distortions in market signals and biasing risk management practices.

Responsible and realistic assessments and timely analysis by ratings agencies can also provide useful complementary information to market participants, investors, and issuers and enhance crisis prevention.

3. Close Debtor-Creditor Dialogue and Cooperation for Crisis Prevention

Mature market country issuers should consider implementing the best practices for investor relations that have evolved. The adherence of emerging-market borrowers to these best practices are reviewed annually by the IIF and summarized in the annual Implementation Report of the *Principles* issued by the Principles Consultative Group.

Enhancement of investor relations under Investor Relations Programs facilitates timely data and policy transparency and a regular dialogue between sovereign issuers and their creditors and establishes an effective channel of communication and feedback. The experience over the past few years has demonstrated the value and contribution of IRPs in enhancing market confidence and maintaining market access even during periods of market tensions and turbulence.

Sovereign debt issuers in both mature and emerging market countries should incorporate in new bond issues, denominated in a foreign or a common regional currency, CACs with appropriate aggregation clauses, with comprehensive coverage of their terms and conditions in the bond documentation and easy access to this information by all investors. Issuers of domestic bonds denominated in local currency may also consider such arrangements. Appropriately designed aggregation clauses would allow bond holders across all outstanding issues of government securities to collectively decide on whether to accept potential offers from issuers to modify existing bond terms and conditions. The use of CACs inclusive of aggregation clauses can facilitate voluntary debt restructuring by reducing the chances of a small minority of bond holders acquiring blocking positions in a bond series and imposing demands for preferential treatment.

4. Good-Faith Actions in Cases of Debt Restructuring

(a) Voluntary Good-Faith Process

Good-faith negotiations remain the most effective framework for reaching voluntary debt restructuring agreements among sovereign debtors and their diversified private creditor community, particularly in the complex cases of mature market issuers that are members of currency unions. Such a framework has proved to be efficient in facilitating appropriate agreements on crisis resolution, while containing the adverse impact on market confidence and other disruptions and concerns caused by spillover and contagion risks.

Sovereign issuers and their creditors should strive to reach and effectively implement voluntary agreements on a timely basis to help minimize adverse market reactions and contagion effects. In this context, debtors and creditors should be cognizant of the potential adverse effects of the interaction between sovereign debt and capital markets, to the detriment of the interests of all parties. With the increased sophistication, integration, and complexity of capital markets, for both emerging market and mature economy countries, the interaction among developments in sovereign debt markets, changes in the regulatory framework, and banking system practices gives rise to major dynamics with significant implications for credit expansion, risk practices, market access by sovereign debtors, and macroeconomic developments.

The dynamics and incentives for debtors and issuers to engage in good-faith negotiations are strongly influenced by the existing accounting and regulatory standards and their interaction across types of financial institutions and jurisdictions. The standard-setting bodies responsible for accounting and supervision rules, as well as the interpretation bodies, should be cognizant of the need to minimize inconsistencies between accounting and supervision practices and conflicts across jurisdictions and types of covered financial institutions.

The early restoration of market access is of critical importance in achieving debt sustainability over time. Early re-accessing of capital markets at reasonable costs is also essential for allowing sovereign debtors to reduce and eliminate their reliance on exceptional IMF financing and financial support from their official bilateral partners, such as is the case under currency unions or regional arrangements.

(b) Debtor and Creditor Actions During Debt Restructuring

To facilitate good-faith negotiations, sovereign issuers, and regional institutions in case of regional arrangements, should engage in enhanced data and policy transparency and dialogue with private creditors at an early stage, should a debt resolution become necessary. The early release of information on the scale of the adjustment needs and the range and scale of the envisaged corrective policies by the sovereign issuers themselves or in the context of adjustment programs supported by the IMF and/or regional institutions would help minimize adverse market reaction and contagion risks and facilitate continued or early resumption of market access. The sanctity of contracts should be respected. Modifications to these contracts should be avoided wherever possible as a matter of principle.

In the debt restructuring process, an early discussion is necessary between the representative private creditor committee and the sovereign debtor, in close consultation with the official sector, on the overall multi-year macroeconomic framework and objectives, including the broad fiscal policy targets and the underlying outlook for output growth and public debt under alternative assumptions on the debt restructuring. Such a discussion is important in facilitating an effective voluntary debt restructuring agreement on a fair burden sharing, thus promoting high private sector participation, restored market access, renewed output growth, and debt sustainability.

It should be recognized that the attainment of debt sustainability over time is a dynamic, complex process that depends critically on the quality and market credibility of actual and prospective adjustment policies undertaken by the debtor, the direction of macroeconomic policies, the terms and volume of financial support or debt relief provided by official and private creditors, and the prospects for the continuation or resumption of market access at reasonable terms. As such, the debt sustainability analysis entails judgments and assessments that are often not easily amenable to quantitative rules and that require revisions as macroeconomic parameters evolve. The contributions toward achieving debt sustainability by private creditors as well as other creditors should be considered simultaneously, with no one creditor group considered as a residual source of funding on an *ex ante* basis.

In this context, the IMF has a very important role to play by providing objective analysis and information on macroeconomic policies and prospects and on the sovereign debtor's medium-term funding needs, consistent with debt sustainability considerations.

(c) Creditor Committee Policies and Practices

Private creditors should organize themselves in a broadly based representative creditor committee as early as possible in the debt restructuring process, certainly before debt default, which should be avoided if possible. Sovereign issuers should interact and engage in negotiations with their private creditors through the representative creditor committee and should consult with the creditor committee as part of the process of fulfilling the requirement under IMF policy of lending to debtors in arrears to make good-faith efforts to reach understandings with their creditors. Such a framework would be more conducive to reaching a voluntary agreement on debt restructuring and facilitate market access.

Private creditors that are members of the creditor committee negotiating with the sovereign debtor should abide by established ethical standards and *inter alia* respect the confidentiality of any material non-public information that may become available during this process and notably commit not to use confidential information from the negotiations for trading purposes.

This process will be aided in cases of countries that require financial assistance from multiple official bilateral creditors, as is usually the case for countries that are members of currency unions, by the formulation of timely and effective procedures for reaching understandings on the scale, terms, and conditionality of any envisaged financial assistance from these creditors so as to facilitate the negotiations between the sovereign debtor and the private creditor committee.

In line with the evolving practice, the sovereign debtor would be expected to cover reasonable costs incurred by a single private creditor committee for the legal and financial advisor fees, consistent with agreed parameters.

(d) Tools for Debt Restructurings

Sovereign issuers and their creditors should introduce CACs and possibly other options to enhance the credit quality of the new debt instruments used under debt restructuring exercises so as to enhance the prospects for high voluntary creditor participation. Retroactive legal changes to unilaterally modify the terms and conditions of financial contracts may undermine the integrity of financial markets and the sanctity of contracts and should be avoided. However, in exceptional cases and after a voluntary debt exchange agreement has been reached, such modifications of the governing legal framework to introduce a collective action mechanism on a timely basis with terms and thresholds consistent with market practices may be necessary in facilitating a voluntary debt exchange and achieving a fair outcome for all bond holders.

5. Fair and Comparable Treatment of All Creditors

Sovereign issuers should treat fairly and provide comparable treatment to all creditors so as to avoid discrimination against any individual or groups of creditors. No creditor or creditor group should be excluded *ex ante* from participating in debt restructuring. Any exceptions to this principle should be discussed and agreed to among all creditors on the basis of adequate justification. Broad creditor participation in debt restructuring operations is essential to ensure a fair burden sharing, including the impact of the provision of new financial assistance, as well as to avoid any new or intensify existing sub-ordination of the claims by some classes of creditors.

Fair treatment of all creditors is in the interest of both issuers and creditors. It lessens the burden on all creditors and, by avoiding discrimination, encourages creditors to participate voluntarily in debt resolution and minimizes any adverse impact on the investor demand for existing or new issues of sovereign debt by the issuer undergoing debt restructuring or similar debtors in the region or fellow members of currency unions. Reduced demand for sovereign debt by private investors, and/or delayed resumption of market access by the sovereign debtor due to subordination concerns, increase the potential burden on official creditors and international or regional institutions to provide financial support to the adjusting country in larger volume and/or over a longer period of time than would otherwise be necessary.

This report is published by the Institute of International Finance, Inc.
1333 H Street, NW, Suite 800E, Washington, DC 20005-4770
Tel: 202-682-7459 www.iif.com
October 2012