Technical Study Group Report

Sovereign Debt Restructuring: Further Improvements in the Market Based Approach

Financing for Development Office,
Department of Economic and Social Affairs,
United Nations, New York

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Introduction

In the absence of an insolvency regime for sovereign obligors, debt crises are primarily dealt with on an individual case-by-case basis. Debtor countries seeking to normalize their financial position at such times are typically compelled to seek debt relief from their creditors in the form of an extension of the maturity of the claim, a reduction in the value of the claim and/or relief on interest payments. However, debt restructurings are often "too little too late"[2] and especially problematic pre-default and vulnerable to holdout creditors. The underlying motivation to develop a better framework for the timely, orderly restructuring of sovereign debt is the perception that the status quo increases costs on all stakeholders. Any delay to a necessary debt restructuring reduces the size of the pie and is detrimental to both the debtor country and its creditors, with the apt adage of "too much pain for too little gain." Protracted negotiations adversely affect the debtor and limits continued market access and foreign investment, often taking place in scenarios of economic recession, high unemployment and public expenditure challenges. Creditors are also harmed, as continuing uncertainty at a time of competing policy challenges for countries can lead to asset values being dissipated and balance sheets vulnerabilities persisting for longer periods; In addition, the IMF's credibility and effectiveness in assisting its members to strike a judicious balance between financing and adjustment can be impaired. And when problems occur in systemically important countries, they also portend a threat to regional or global financial stability. Since debt overhang is then often associated with large economic deadweight costs, it is appropriate for sovereigns and creditors to look for improvements to the current fragmented architecture for debt restructurings, so that future restructurings can be conducted in the most orderly, timely, predictable and efficient manner possible.

Reform proposals designed to improve the framework for restructuring sovereign debt have been under discussion on and off over the years. Notably, from November 2001 to April 2003, IMF staff proposed and developed a treaty-based framework to restructure sovereign debt—the Sovereign Debt

[1] The project on Sovereign Debt Restructuring was led by Benu Schneider, Financing for Development Office, Department of Economic and Social Affairs, United Nations with financial support from the Swiss Federal Department of Finance. It consisted of a technical study group meeting series supported and hosted by the Bank of England, Commonwealth Secretariat and the Inter-American Development Bank. This report is drafted by Benu Schneider based on inputs by members of the study group. It reflects the very useful contributions of the study group meeting participants, but is not a verbatim transcript of the discussion; rather, the key issues discussed have been integrated into a thematic briefing on the issue. The report and its recommendations are a guide to the range of issues where the market based approach to sovereign debt restructuring can be taken forward.

[2] See International Monetary Fund (2013). Sovereign Debt Restructuring—Recent Developments and Implications for the Fund's Legal and Policy Framework.

Restructuring Mechanism (SDRM). Due to a lack of consensus among all relevant stakeholders, the SDRM initiative was eventually shelved but it nevertheless spurred the acceptance by the markets and governments for a significant contract based development, the introduction of collective action clauses (CACS) in international bond contracts designed to mitigate holdout risks by allowing for bondholder majority voting within a series of bonds, should a restructuring proposal be put to the bondholder.

In recent times holdout risks, such as in the cases of Argentina and Greece, and aggressive use of litigation by holdout creditors received renewed attention. Significant improvements in contractual technology for bonds followed including, (i) improving the CACs to allow aggregation of bondholder voting (across multiple series of bonds) to further mitigate holdout risk (aggregated collective action clauses) and enhance coordination across different series of bond issuances, (ii) enhanced *pari passu* provisions to disavow the rateable payment interpretation of *pari passu* clauses, and (iii) in a few cases use of Trust structures (a potential dampener on holdout litigation). The IMF also placed attention on updating its sovereign lending policies with an increasing focus on pre-default restructurings. It is reviewing its lending in arrears policy (LIA) and has also reviewed its DSA methodologies, scrapped its systemic exemption for exceptional access lending and agreed, in certain circumstances to tolerate official sector arrears.

These developments have been an important step forward in improving sovereign bond contracts and the role of the IMF. To build-up on this progress, additional areas were identifiable in FFDO-UNDESA organised expert group meetings that needed further technical work. A technical study group was set up under the aegis of the FFDO-UNDESA with participants from the fields of academia, the legal sector, as well as some representatives from international institutions, central banks, ministries of finance, and the private sector. The aim was to identify incremental steps that can be taken to make further improvements in the market based approach to sovereign debt restructuring and follow-up on the commitment to policy actions on debt in the Monterrey Consensus, the Doha Declaration and the Addis Agenda for Action on Financing for Development. Further improvements should provide sovereign debtors with the ability to restructure or reschedule their debt (whether through seeking debt relief or by means of a liability management approach) more easily enabling them to emerge from a debt or financial crisis earlier and on a sounder footing, by lessening holdout creditor problems further; by capturing more of a country's debt which may benefit from debt treatment and by increasing understanding of the issues which need to be considered and addressed when engaging with a country's creditors. The implications of regulation of the sovereign debt asset class, on sovereigns as issuers and borrowers and the treatment of sovereign debt under relevant regulatory capital rules has not received as much attention in historic work in this area – this is relevant in terms of market efficiency and financial stability. The regulatory capital implications for banks and insurance companies especially of a sovereign debt restructuring need to be understood and considered in any proposal the sovereign may make. Finally, the group identified that many countries would benefit from capacity building in this space to better understand risks and opportunities and engagement with the private sector. Key components of this are availability of data and transparency of information as it relates to both existing stocks of debt and their commercial and legal terms and information on historic debt crises and their resolution.

The main issues covered were:

1. What needs to be done to improve information flows and would standardisation of bond and loan contracts improve the architecture for sovereign debt restructuring?

2. What further improvements can be made in provisions and clauses in bonds contracts?
3. How can the progress in bond contracts be followed by improvements in commercial bank loan contracts? Can holdouts be prevented/reduced through contractual provisions?
4. What advantages does a trust structure have vis- à-vis fiscal agent in a debt restructuring? Can trust structures reduce the likelihood of holdouts?
5. Does engagement between debtor and its creditors have to be pre-agreed contractually?
6. What are the issues in setting up a creditor committee for engagement between debtors and creditors?
7. Can contingent debt instruments such as GDP linked bonds be useful?
8. What should be the considerations in the review of the "good faith" criterion in IMF's LIA policy?
9. How does bank regulation affect sovereign debt restructuring? What are the open issues in regulation affecting sovereign debt?

Each of these issues will now be treated in turn, with recommendations based on presentations and discussions in the study group meeting series in this project.

1. What needs to be done to improve information flows and would standardization of bond and loan contracts improve the architecture for sovereign debt restructuring?

- A move to more standardisation makes sense for the foreign sovereign debt market. It saves time and money in preparing documents and endows widely-used terms with a shared public meaning, which in turn saves investors the costs of acquiring information, facilitates secondary market trading and reduces the scope for mistakes in the judicial interpretation of contract terms.[3]

- Variations from past practice and market norms must be explained in disclosure documents and through market outreach. Standardisation is not just part of the fabric of market expectations. International policy initiatives to prevent and manage financial crises rest on the assumption that sovereign debt contracts follow a generally accepted standard. Such initiatives would make no sense in the absence of significant standardisation.

- Often sovereign debt contract terms that purport to be standard are adapted in inconsistent way over decades of rote use, so that their meaning becomes obscure. Investor awareness of incomplete standardization appears to be limited, highlighting the need for statutory and judicial solutions to the problem of incomplete standardisation.

Recommendations:

- Make efforts to facilitate the ease of availability of information relating to sovereign debt in respect of both its commercial and legal terms on a standardised reporting basis. The Institute for International Finance (IIF) issues annual assessments of investor relations and data dissemination practices of the most active emerging market sovereign borrowers and the IMF has its Special Data Dissemination Standard but more could be done to ensure there is further transparency in the market as to key commercial and legal terms of sovereign debt.

- Encourage the industry standardisation of sovereign debt contracts which would be easiest to progress in the context of the sovereign debt publicly issued under English and New York law. Where debt is issued under domestic law, under auctions or based on a mixture of contractual, legislative and constitutional parameters this would be much more challenging. Nevertheless, debt management offices of each country could describe, on a more standardised basis, the applicable domestic legal framework applying to the country's debt instruments.

- Official sector and industry efforts should facilitate understanding of contract parameters that will be relevant at the time of a rescheduling/restructuring. The UN Principles on Sovereign Debt Restructuring Processes are a recent step in this direction. The IIF also has its Principles for Stable Capital Flows and Fair Debt Restructuring. The IMF has its policies on its lending arrangements and sovereign debt and its economic surveillance and debt sustainability analysis role. Could more be done to ascertain areas of commonality or is this

[3] For example, the controversy over different formulations of the *pari passu* clause, which featured in recent sovereign debt litigation.

not practicable? In reality maintaining maximum flexibility (with an awareness of relevant guidelines) may be more pragmatic and feasible.

- Create a centralised data registry, or alternatively through private market forces create a universal centralised data room. There are areas where this has been done, for example, in the area of high yield.

- Create access for stakeholders to the terms and conditions of sovereign debt contracts, including trust indentures and fiscal agency agreements, thereby creating more market transparency.

- Encourage adaptability through both innovation and standardisation**.** The current system reforms itself through acute crises necessitating a better way of getting adaptability into the system.

2. What further improvements can be made in provisions and clauses in bonds contracts?

- Recent sovereign bond reforms were implemented due to two main factors a) *pari passu* based litigations against Argentina which resulted in a risk of disrupting otherwise consensual restructurings and preventing the restoration of market access and b) holdout creditors blocking positions in individual series of bonds in the case of Greece.

- Recent reforms with respect to bonds have consisted of the publication by International Capital Market Association (ICMA) of an aggregated CACs which introduced in its options, for the first time, single-limb aggregation to facilitate sovereign debt restructuring and minimise the risks posed by litigation from holdouts as much as possible. Following endorsement by the IMF, IIF, G20 and others the aggregated CACs are now the new norm in international sovereign bonds as reported on by the IMF.

- Alongside the publication of its CACs, ICMA also published a sovereign *pari passu* clause that has been drafted with a view to avoiding the difficulties that Argentina has faced in the New York courts. The clause clarifies that under *pari passu* clauses sovereign issuers are not obliged to effect equal or rateable payments. All post-1 October 2014 issuances that have included the aggregated CACs have also included modified *pari passu* clauses.

Recommendations for bond contract reform:

- Continue recommendation to take up aggregated CACs with a single limb aggregation feature and enhanced *pari passu* clauses in international sovereign bonds. For example, some English law governed sukuks have introduced aggregated CACs with single limb aggregation, others with the less favourable two limb aggregation.

- Introduce aggregated CACs including single limb aggregation into foreign law governed instruments (as well as New York and English law which have largely already adopted). Further work could be undertaken in jurisdictions the laws of which are also used to govern documentation with respect to international bonds (e.g. German, Japanese, Swiss).

- Dealing with legacy bonds: IMF staff continue to monitor the take-up of the enhanced contractual provisions in sovereign bond documentation (aggregated CACs and *pari passu*

clauses). The IMF has explored countries undertaking liability management transactions to accelerate the take-up of the new contract reforms (estimates are that without this it will be ten years or so before the existing stock of international bonds includes the new contract reforms). However, there is little appetite for this in view of the costs involved unless a country is undertaking a liability management exercise for other reasons. If a few countries initiated such exercises it might lead to others doing so and be seen as a market neutral initiative.

- Two-limb aggregated CACs: This form of CACs in the euro area model CAC provision adopted by the euro area post the Greek crisis, allows the modification of terms with respect to more than one series of bonds with the support from a qualified majority of the aggregate principal amount of the outstanding debt securities of all affected series but also of each affected series. Voting is therefore required at two levels. Even though this form of CACs is more effective than the historic single-series CACs published in 2004, the need to obtain an approving majority within each series of bonds still leaves the risk that investors could buy a blocking percentage of particular series of bonds in order to ensure that they remain outside any restructuring agreed by other bondholders. In a further euro area sovereign debt crisis the holdout risk could still be a feature as the euro area CAC has a two-limb voting mechanism. Efforts could be undertaken to encourage the euro area member states to adopt single limb aggregation into the model euro area CAC.

- Introducing aggregated CACs including single limb aggregation into domestic law governed instruments: Each country issues domestic debt/treasuries on different terms and with varying levels of contractual complexity so the introduction of a collective action mechanism through contractual means would need to be considered in that context. Countries would need to consider carefully which stock of domestic debt to capture and undertake legal analysis under local law to ensure there are no legal or constitutional constraints that could impact on the validity of a collective action mechanism (if ever activated to effect a rescheduling or restructuring), in particular on minority creditor rights which could create legal uncertainty as to the enforceability of a majority voting mechanism. For example, work could be done to create a model aggregated CAC and model law (appropriate to both common and civil law systems) to ensure its enforceability in view of the majority cram down mechanism, for adoption into domestic law by sovereigns at the same time as the introduction of the aggregated CAC into domestic law governed debt instruments.

Recommendations for diversification of sovereign bonds

- Developing new sovereign bonds: Develop new forms of sovereign bonds to include interest deferral triggers to replicate regulatory capital instruments issued by insurers and banks. These instruments are structured to provide a form of 'quasi equity' in the balance sheets of insurance companies and banks by being both perpetual or very long-dated in duration and providing for deferral of interest payments if specified events linked to the economic and financial condition of the issuer occur. Deferred interest is either foregone altogether or only payable if circumstances materially improve. The instruments are often made more attractive to investors in applicable jurisdictions by ensuring that payments are taxed in the same way as debt, rather than equity instruments. In the U.S., equity

instruments (e.g., qualified preferreds) can obtain better tax treatment on dividends than bonds do on interest, at least in the hands of natural person investors.

- Whilst there is no comparable balance sheet or capital structure in the context of a sovereign, if acceptable trigger points could be agreed and market appetite for such products developed at a viable pricing level, then bonds including such features could become useful tools in the makeup of a sovereign's debt profile. Just as they represent a small portion of the balance sheet in the corporate field, these instruments would likely form only part of a sovereign issuer's stock of debt but they could provide it with "breathing time" to work out a negotiated solution to its debt crisis.

- Other state contingent debt alternatives could be: (i) a sovereign bond that would automatically extend its repayment date if a country received emergency liquidity assistance from the official sector, and (ii) a sovereign bond which reduces in both contractual principal and contractual interest obligations when a country's GDP shrinks by reference to a predetermined level. Further consideration could usefully be given to these forms of state contingent debt instruments with "catastrophe" features and the benefits that such instruments may provide in mitigating the impact of natural disasters.

- Successful issuance of any such instruments would require broad consultation and acceptance among market participants and relevant stakeholders and also require a number of countries to issue such instruments concurrently in order to create bond pricing dynamics and some liquidity. The recent endeavours on GDP linked securities of the Bank of England and Bank of Canada and others and the development of the London Term Sheet have not yet been taken up by a sovereign and the IMF Executive Board has not to date endorsed further work being done on state contingent debt securities.

- However, multilateral development banks have done useful work in the area of climate change and implications on financing which potentially interact with triggers tying debt relief to the occurrence of any natural disasters.[4] Consider whether instruments with inbuilt contingencies should be considered not only in instruments to be marketed to the private sector but also in financing from the official sector and/or in sovereign to sovereign lending arrangements.

[4] See also the Paris Club—Seychelles debt for nature swap and the Haiti hurricane clause.

Suspension of legal actions

- Standstills for sovereigns are not as necessary as for corporates (enforcing against sovereigns is challenging and lack of market access is more of a deterrent than legal enforcement).

- In circumstances where suspending the right to pursue claims against a sovereign (by way of litigation or arbitration) may be considered necessary, consideration should be given to the appropriate debt claims to be affected by such a suspension, the triggers for such a suspension to apply and for its reversal, the length of suspension and whether there should be any conditions attached to it. Whatever the trigger for the suspension, it needs to be recognised that consequences will follow for the sovereign debtor and its creditors. Those consequences include credit ratings downgrades, risk of triggering a credit event for credit default swaps, accounting impairment and associated regulatory capital treatment implications for regulated holders.

Sovereign immunities

- Consideration should be given to expanding the scope of sovereign immunities like immunizing payment systems, in order to deter disruptive litigation that harms both debtor countries and cooperating creditors of those countries.

3. How can the progress in bond contractual technology be followed by improvements in commercial bank loan contracts? Can holdouts be prevented/reduced through contractual provisions?

- Many emerging markets and low-income countries still use loans to raise funds. It will be useful to see how improvements made in the case of bonds (new aggregated CACs and enhanced *pari passu* provisions) can be made to loans. Could the absence of innovations in loan contracts pose more challenges i.e. lack of comparability with bond debt restructurings, need for multiple reschedulings, and greater litigation risk in the loan context? It could also raise questions of burden sharing across asset classes.

- Restructuring techniques for loans differ from those for bonds. Bonds are typically restructured through an exchange offer in which the old securities are exchanged for new instruments reflecting the amended terms. Syndicated loans, however, are usually just amended (without being exchanged) or sometimes "refinanced" (a new loan reflecting the revised terms is made to the borrower with the proceeds immediately used to repay the old loan).

- Syndicated loans contain some "syndicate democracy" provisions such as a requirement that a majority of banks (by outstanding principal) are required to accelerate the loan. On the crucial issue of modifications, however, syndicated loan agreements normally still require unanimous consent for amendments to payment terms. In other words, the collective action clause initiative, which has been the key area of focus in respect of sovereign bonds, has not penetrated into the syndicated loan market.

- In the 1980s, during which many sovereign commercial bank restructurings took place, there was no perceived need for a written set of creditor committee principles, other than

with respect to expense reimbursement. The committee functions evolved into a coherent pattern, with many of the same actors crossing over from one committee to the next. Now, however, the lack of concentration of commercial bank restructurings is such that a committee principles document could be helpful.

- There is a need for the establishment of a databank of agreements to monitor developments and assure development of best practices. As bonds are publicly traded, their restructuring is manifested in ample public documentation. The same is not true for commercial bank restructurings. It is exceedingly difficult to obtain copies of sovereign commercial bank restructuring agreements.

- The group reviewed various clauses (assignment[5], amendment, submission to jurisdiction, *pari passu*, events of default, sharing clause, immunities, good faith, set-offs[6]) and recommendations for each clause, to achieve the following goals:

  a) Stabilization during periods of stress: circumscribing the universe of creditors, carefully tailoring the assignment provisions to minimize the presence of disruptive influences; limiting the contractual rights of set-off; limiting the rights conveyed with the sale of participations; limiting cross-defaults i.e., defaults in one credit arrangement that triggers a default in others by cross-reference.

  b) Discouragement of excessive litigation: seeking to limit the submission to jurisdiction to specified courts to the exclusion of any others; tailoring the waiver of immunity from suit to correspond to the limitations on submission to jurisdictions; and clarification of the *pari passu* clause.

  c) Provision of safety valves to allow creative solutions for cooperating creditors: Seeking to lower the typical 100% vote of creditors for fundamental amendments (e.g., extending maturities or lowering interest rates); adding clauses permitting exchanges for new obligations and individual or group extensions and refinancing without the need for a unanimous vote; and clarification of the existence and scope of creditor good faith concept to permit flexible solutions.

  d) Reaching a consensual solution outside of, but in conjunction with, the agreements: promoting workable creditor committee principles and related standstill mechanisms.

Recommendations:

- Further work should also be done in the area of sovereign loans to focus reforms on sovereign loans as many countries (especially middle/low income countries) still raise funds through such loans.

- Attention should be given that inclusion of sharing clauses[7] (clauses that require proportionate sharing of recoveries among the banks) and which are a regular feature of

[5] Assignment are provisions setting forth the circumstances in which a creditor can transfer its rights and obligations to a third party

[6] Set-off rights exist both at common law and in statute, and accordingly even if credit agreements are silent, creditors nevertheless have rights. Creditors do, however, prefer to spell out their rights in contract to avoid controversy and to eliminate possible defenses such as lack of mutuality and the requirement of maturity of the obligations that are the subject of the set-off.

syndicated loans are included in loans when there are two or more lenders. Depending on how they are worded, these clauses can mitigate against individual lender holdout risk and inhibit maverick litigation because a litigating creditor would be obliged to share any recoveries realized in the litigation with the other banks. Facility Agents also play a key role in the payment mechanics set out in a loan, mostly requiring a proportionate allocation of recoveries among lenders by reference to their commitments/lending.

- *Pari passu* based litigation risk could be as relevant in the loan context. Track into loans the enhanced *pari passu* clause developed for bonds.

- Develop a market template sovereign loan. Discussions could take place at some point with the Loan Market Association and any US equivalent industry body.

- Introduce the ability to amend loans through majority provisions i.e. not require unanimous lender consent for changes to payment terms or extension to maturities.

- Consider adding as a supplement to such a clause an "Amend & Extend" clause and a "Refinancing" clause (non-European governments) or forward start clauses (European agreements).

- Refine customary "negotiations with creditors' event of default" to avoid default triggers occurring at the engagement/negotiation stage.

- Draft template assignment and transfer clauses, which give the sovereign more control over categories of potential assignees and transferees. In terms of specific clauses in the documentation, assignment clauses should define the class of acceptable assignees and explicitly state that the class is exclusive. The provision should state that any other purported assignment is null and void. The term “financial institutions” should be defined with clarity. The treatment of firms that are primarily debt traders will merit particular care. Also, attention must be given to assignees that are trusts. These vehicles open up the possibility of securitizing the credit. This could lead to an escape from the closed universe of known creditors. Adopt the practice of referring to a specific disqualified institutions list, to add specific undesirable assignees as of the outset of the credit. Require advance notice of the assignment, with details concerning the identity of the proposed assignee. Further, give the borrower the right of approval of the assignee, such approval not to be unreasonably withheld or delayed.

- Seek to limit submission to jurisdiction to the exclusive jurisdiction of specified courts for initial judgements. Ideally, this would be a single money-center jurisdiction and specified courts within that jurisdiction. A fall back would be the exclusive submission to the jurisdiction of the domiciles of the original lenders, assuming a small, club-style syndicate.

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[7] A fundamental element of a loan syndication is that all payments made by the borrower must be distributed pro rata to each syndicate member according to their individual participation percentages. This is usually achieved through the mechanism of a 'sharing clause' in the loan agreement. A sharing clause aims to: (a) prohibit the borrower from discriminating against the lenders by making payments to only some and not all the lenders under the same credit agreement; and (b) discourage a syndicate member from unilaterally enforcing its rights under the loan syndication since it will be liable to share the proceeds of the litigation. Use of trust deeds for bonds replicates to a degree such as mechanisms in bonds.

If the agreement covers borrowings in multiple currencies, it would be expected that the courts of the money center of each currency would be requested by the applicable creditors.

- Focus and tailor the cross-default clause: Set the trigger amount at a high enough level to clearly reflect a material failure to pay. Clarify whether final maturity or interim payments are covered and stipulate that the clause is triggered only on acceleration. Restrict to external debt.

- Any consent to set-off in any part of the agreement should be carefully evaluated for its consequences. Optimally from the point of view of the borrower, the consent should relate to amounts actually owed at the time of the set-off. But this is not market-standard. Consents for set-offs by holders of participations should be prohibited except in the carefully limited circumstances required to keep creditors in parity with one another in the sharing context. Waiver of immunity for set-offs should be carefully evaluated. Limit set-off clause to acceleration event, rather than default.

Bonds and Loans

- Encourage capacity building to developing know-how that explains the most important provisions in sovereign bonds and loans for debt management officers and their internal legal counsel. This will be useful in ordinary times in normal debt raising activities as well as time of crises.

4. What advantages does a trust structure have vis- à-vis fiscal agents in a debt restructuring? Can trust structures reduce the likelihood of holdouts?

- Historically, sovereign issuers have issued their international bonds under fiscal agency agreements (FAAs). A fiscal agent is the agent of the sovereign issuer, not the bondholders. The perceived benefits of using an FAA include lower costs, a quicker issuance process and the appearance of a high credit standing for the issuer.

- When a trust structure is used (in English practice), the contractual undertakings given in respect of the bonds are made by the sovereign issuer in favour of a trustee who holds these rights on trust for the bondholders. (In U.S. practice, the issuer promises to pay the bondholders through the trustee.) As a consequence, the trustee represents the bondholders and the ability to initiate legal proceedings, with some limitations, resides with the trustee who is generally required to initiate proceedings only if: (i) it is requested to do so by a requisite percentage of bondholders (typically 25 percent of the principal amount) and (ii) it has received adequate indemnification. By contrast, under a fiscal agency agreement the contractual undertakings given with respect to the bonds are made by the sovereign issuer directly in favour of the bondholders. The fiscal and paying agents are only agents of the sovereign issuer through whom payments on the bonds are made. This simpler structure means, however, that individual bondholders have the right to initiate legal proceedings against the debtor following an event of default for the amount that is due and payable. Thus despite the aforementioned benefits of a fiscal agent, this last aspect makes trust structures a useful tool to reduce the occurrence of holdouts by bond holders in a debt restructuring.

- In recent times, where the market practice had been dominated by FAAs, there has been a move toward trust structures. This switch has been motivated in part by the spectacle of holdout creditor success in Argentina and Greece. As trust structures centralize enforcement powers in the hands of a trustee (who will exercise those powers for the rateable benefit of all holders), trust structures tend to deflect the unwelcome attention of prospective holdout creditors.

- Before initiating an enforcement action, the trustee will be entitled to receive an indemnity from the bondholders for the trustee's fees and liabilities in connection with the action. Determining an appropriate amount for the indemnity, and passing the hat among the bondholders for contributions to the indemnity, can sometimes delay the commencement of an enforcement action. One solution was found in Grenada's 2013 debt restructuring. The bondholders consented to a debit to the first coupon payment on the new Grenada bonds to fund a "Contingency Account" that could be used by the trustee to pay for any enforcement action approved by the bondholders.

- As a consequence of the trustee's authority to initiate legal proceedings on behalf of all bondholders, any amounts recovered by the trustee through such proceedings are for the benefit of the bondholders as a group and, therefore, are distributed pro rata amongst them. Even if a bondholder wishing to pursue litigation has managed to acquire a sufficient percentage of bonds to enable him to request the trustee to initiate proceedings, the sharing requirement that the trustee distribute any amounts recovered through such litigation to all bondholders on a pro rata basis will reduce such bondholders' incentive to do so.

- Further, in cases where a country has very few bond issues, it may be economically viable for vulture funds or similarly minded holders to build blocking minority stakes in the context of CACs and therefore existing contract reforms may not help greatly. In such cases, the use of trust indentures or trust deeds in the context of bond issues should be helpful to ensure that individual bondholders are not able to litigate alone and that any proceeds are shared. Such mechanisms have proved important dampeners to litigation in the past. These benefits, which are likely to be considerable in times of crisis and actual payment default, need to be weighed against the modest additional ongoing annual costs associated with a trust structure.

- Finally, as noted above, the fiscal agent acts as a representative and agent of the issuer and the trustee is a fiduciary representing the bondholders. One practical difference is that payments made through a trustee cannot generally be attached by a third-party creditor of the issuer because as soon as the funds are deposited in the trustee's account they are no longer the sovereign debtor's property; the trustee holds them on behalf of (in trust for) the bondholders. Absent special features in the FAA (such as an express promise by the fiscal agent to hold funds in trust for the bondholders), an FAA may not convey this protection for the bondholders.

Recommendations:

- It is timely to promote the general use of trust indentures in the context of sovereign bond issues in order to prohibit or discourage individual bondholders from pursuing litigation. Trustee acts as a fiduciary representing the bondholders. Moreover, trust deed/trust indenture structures act as a means of dampening hold out litigation.

- The trust indenture clauses can be reviewed to standardize them for effectiveness.

- Outreach by the IMF or G20 with trustees would help in identifying steps for reconciling trustee functions in actual practice and improve their uptake by issuers.

5. Does engagement between debtor and its creditors have to be pre-agreed contractually?

- Engaging with creditors can be a key element in achieving a high participation rate, especially important where the underlying instruments include a collective action mechanism which can contractually bind a minority, and resolve crises more quickly. The engagement is beneficial not only for the debtor but also for the creditors. It is extremely important for the creditors to be able to resolve the collective action problem for themselves as well. Engagement between debtors and creditors is similarly essential to deal with the problem of "delays" in initiating a sovereign debt restructuring besides the "delay" to complete the process. A meaningful creditor engagement process is therefore often considered a key to the success of a sovereign debt restructuring. The role of the IMF in providing incentive structures for an early initiation of the process is essential for timely debt restructurings.

- In the past some effort in this direction is reflected in two private sector initiatives. The London based ICMA first published in 2004 a template for a Noteholders Committee under English law[8] Subsequently in August 2014, the ICMA published a new template version of the Noteholders' Committee provision in the form of supplementary provisions to its new model aggregated CACs and after consultations updated it in May 2015 for inclusion in sovereign debt securities issued under both English law and New York law.[9] ICMA's guidance for the creditor engagement process is the inclusion of a creditor engagement provision in sovereign bond documents, with a view to including a pre-agreed contractual obligation on the debtor to interact and engage in discussion/consultation/negotiation with its creditors through a committee. The response to this has been lukewarm and has not been

[8] The ICMA provisions are template provisions in the ICMA Handbook comprised of guidance and standard language and documentation, generally relating to offers of syndicated international bonds in the Eurobond primary market and to programmes under which such offers may be made. As one of the original trade association bodies which agreed the 2004 template CACs for inclusion in sovereign bonds following the shelving of the SDRM proposal, the ICMA has continued taking an active role in the contractual reform of sovereign bond documentation.

[9] The model aggregated CAC resulted from the work undertaken by an Expert Group convened by U.S. Treasury staff consisting of representatives from the official sector (including IMF staff), the ICMA, a number of debtor countries and buy side stakeholders, legal practitioners and academics. The Noteholders' Committee provision was not discussed by the Expert Group and is not an integral part of the aggregated CAC, but was intended to complement it. See International Monetary Fund, *Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring*, 2 September 2014.

included in the majority of international bond issues since its publication. The responses from legal experts and issuers are set out in the report below to understand why a contractual clause is problematic.

- In addition, in November 2004, the IIF launched its "Principles for Stable Capital Flows and Fair Debt Restructuring", which included a good faith principle with reference to creditor committee policies. These Principles have been refined during the course of 2010 and supplemented by an "Addendum to the Principles" in October 2013. Again, these have not been endorsed by the IMF and are subject to voluntary compliance.

- Empirical evidence on creditor committees shows no clear distinction in haircut size, duration of loss of market access, or length of negotiation period between cases where the deals were settled with or without creditor committees. Thus, the question arises, that if creditor committees are still to be pursued, how can they be made more effective and keep the interests of both debtors and creditors into account. It is advisable for sovereigns to engage with their creditors. However, it was concluded in the meeting that the approach to making the engagement a pre-agreed contractual obligation is not the best way forward.

- Additionally, while examining empirical evidence, it was recognized that estimates of recovery values in a debt restructuring have major shortcomings and need further research to develop a more robust approach. Currently, recovery values are determined arbitrarily, based on market perception of risk on a particular date around the restructuring. Market perception of risk tends to be overstated in present approaches and capture the noise around a restructuring. Cash flows from the debtor to the creditor in repayment give a better idea what is recovered by creditors. Some of the examples presented showed that investors gained more from reprofiling and restructurings than is commonly known or claimed.

- Should engagement clauses be contractual? From the issuer's perspective there appears to be no advantages in pre-agreeing to a creditor committee. The issuer can act prudently when the time comes. Conditions increase risk of other contractual breaches and putting the debtor in a worse situation. While contractual engagement clauses may possibly help to preserve a bond contract, they may also present several disadvantages for issuers. It also contemplates immediate action, which places it in an adversarial position. Moreover, while sovereigns will need to engage creditors together at some point, keeping creditors divided until the last moment has potential benefits for issuers allowing them to assess the range of within which the negotiation is possible. Also uniting creditors may shift the balance of power too heavily in favour of the creditors. Coordination problems stemming from creditor diversity can reduce the efficiency of committees, as well. The arguments are not sufficient to include engagement clauses in a bond contract. This is not to say that creditor engagement is unimportant. Indeed, one participant commented that many failings of restructuring efforts have been caused by insufficient creditor engagement and not because of litigation. However, most restructurings already involve some level of engagement, including those that are informal and ad-hoc. Some private creditors view contractual engagement clauses as a way to ensure they are included within workout discussions, and thus, support their use. In the view of some, there were advantages of committees such as their benefit of acting as a signal to sovereigns that creditors wish to be engaged with and to take this into account when forming a strategy for seeking the restructuring and delivering requisite voting thresholds.

- Principally, the benefits (for the issuer) of using a creditor committee are (i) the broader creditor universe can assume that the predicates of the restructuring terms have been stress tested by a group of similarly-situated lenders (this encourages participation in the deal) and (ii) the committee members can confirm in a public statement their intention to accept the deal (which creates instant momentum). Another usefulness of a committee is the evaluation of the value of the new securities, even though, as illustrated in the empirical evidence presented, there is a no standard formula available to value securities and more work needs to be done to choose the right discount rate for the haircut in a restructuring. The real value of creditor committees is when a debtor has imperfect knowledge of its creditors. In addition, when committees are created, there might be incentives for creditors to engage with it who otherwise might be silent and passive. But none of these advantages imply that they should be mandatory and committees can be formed on an adhoc basis or otherwise without inclusion of any pre-agreed contractual provision as to their recognition.

- People from the creditors' side also want the clause to focus on costs. From the perspective of the issuer, it is very difficult for sovereigns to pre-agree to this before a crisis. These are usually amounts that the average tax payer will find exorbitant. It is a political risk, because the issuing government has to justify these costs ex-ante to the public. For a debtor, it is also important to know if the formation of a creditor committee helps the cost of funding. There has thus far been no discussion on this.

- However, for the aforementioned reasons, pre-agreed contractual engagement clauses are not advisable. The way forward is to find a solution that encompasses a better balance of both creditor and debtor interests.

- Who in the private sector is interested in promoting a contractual engagement clause binding the debtor to engage with a creditor committee? The discussion revealed that lead managers have no keen interest and mainstream buy side investors have no interest either. It is the activist funds (litigious, co-operative) that show the greatest interest for this clause, because litigious funds are making money out of litigating or being cooperative in resolving a dispute. The cooperative ones want to make sure the other investors, who are prevented by their constitutional documents from paying the funds, stay on the table because they provide stability to the creditor group. More research is needed to identify who these investors are.[10]

- One participant suggested that maybe the way forward is to simplify the engagement clause and devoid it of any conditions other than a large majority of creditors (25 %) requiring a meeting, no good faith requirement, and no coverage of costs requirement. In the ensuing discussion, a question was raised if it is well advised to talk to the creditors when there is no big problem. In reality talking to creditors is not an issue in the majority of the restructurings undertaken. A well-advised sovereign will always talk to creditors. Sovereigns want a successful deal, and if talking to one's creditors helps achieve this then they will talk to them. But if they only speak to one creditor group and do not communicate with the rest they can face some problems such as inter-creditor rivalries and slow the

[10] It is worth noting that industry bodies such as the IIF and ICMA are sympathetic to such clauses because they are perceived to facilitate creditor engagement.

process, the sovereigns might not do it. It is not a bankruptcy regime; no one has the power to command that any creditor accept a deal, so the debtor must win people over and talking to creditors can help achieve this and advance the process. The debtor needs to win the parties to make a restructuring deal and will thus engage with creditors.

Recommendation:

- Use flexibility in the approach to creditor engagement. There are no additional benefits in extending the commitment through an engagement clause in sovereign bond contracts to engage a creditor committee. The decision to proceed with carrying out informal soundings or engaging with a creditor is based on underlying circumstances, including the composition of debt and the universe of creditors and the more flexibility sovereign debtors have the better. A decision to use the former approach does not rule out negotiating with a creditor committee as well or committees coming together.

6. What are the issues in setting up a creditor committee for engagement between debtors and creditors?

- It is likely that creditor committees will remain *ad hoc* for the near future and will be formed upon market expectations that a sovereign will be seeking a restructuring, or in the event that a sovereign defaults. The ICMA Noteholders' Committee provisions and the IIF Principles are designed to achieve creditor engagement through different channels. The ICMA approach, a contractual solution for creditor engagement, may prove problematic for it binds the issuer to a certain mode of debtor-creditor engagement *ex ante* that fails to take account of the variety of restructuring circumstances. By contrast, Guidelines such as the IIF Principles have the advantage of flexibility for the very reason that the guidelines are not binding. At the same time, they could be persuasive, and express an important yardstick in this market. A paper[11] discussed in the study group is available on un.org/desa/ffd as a guidance document on the range of issues involved in setting up creditor committees which will be informative for both debtors and creditors while negotiating the structure and terms of a creditor committee.

- When creditor committees are the desirable option, creditor diversity must be taken into account. In the event that multiple bond issues result in multiple creditor committees, investors must create an overarching group that will engage with the sovereign. This is mutually beneficial, as it prevents the sovereign from pursuing a “divide and conquer” strategy in which some investors might fall by the way-side, and it also addresses sovereigns’ concerns over the costs of having to engage with multiple committees.

- It was suggested that in order to increase the efficacy of creditor committees, information sharing and transparency should be increased. This could help shape expectations on both sides about what might be agreed to during restructuring negotiations, potentially leading to improved outcomes. Both the issuer and the CC (the Steering group) should make a good faith effort in seeking a mutually acceptable agreement on the restructuring of sovereign debt, but there should be no obligation to agree. This goes hand in hand with the issuer’s

[11] Michael Waibel (2017). Engagement between Creditors and Sovereign Debtors: Guidance on setting up Creditor Committees.

right to make proposals and reach agreements with individual creditors or all creditors via CACs even against the opposition of the CC or the Steering group. It is not feasible to give the 'good faith' standard specific content in this guidance (see the discussion on "good faith" in IMF's lending into arrears policy).

- Some possible features to include are Conflicts of Interest rules: The issuer could be entitled to discontinue engagement with the Creditor Committee (the Steering Group) until all members of the CC (Steering Committee) having conflicts cease to participate in the CC (the Steering Group).

- Majority and timeframe for establishing a CC could be 30%. The formation of CCs should not be unduly difficult. On the other hand, the CC needs to represent creditors holding a substantial amount of debt securities to be able to promote efficiency in the restructuring. The CC needs to be sufficiently representative. Furthermore, the CC does not lack legitimacy with regard to the creditors who have not joined the CC since it does not represent these creditors. If they wish, they can always join the existing CC.

- The percentage necessary to form a CC does not need to be consistent with the voting thresholds for CACs. CAC voting thresholds are high because they include minority bring along features. Requiring the same for forming CCs would be overly burdensome considering that CCs are generally conducive to a prompt and effective rescheduling or restructuring of debt. Although a CC formed by the holders of 40% or 50% of the affected debt arguably only speaks for these holders, in fact, the agreement negotiated by the CC might also encourage other, non-represented creditors to join the committee.

- The timeframe for establishing a CC could be set at 60 days from the triggering event.

- Holding CDS for the event of the issuer's partial or total default on the sovereign debt at issue should be included in the CC guidance as a conflict of interest with all the consequences that such a conflict triggers. This line of thought is also reflected in US bankruptcy proceedings, where the committee is formed of creditors of unsecured claims.[12]

- Issuer typically discloses to CCs sensitive information regarding its economic and financial position. Currently no corresponding principle is in place for the CC members. Upon request, creditors could be asked to provide information regarding the time and the price at which the CC (Steering group) members acquired the affected securities and the market value of their holdings. Timely disclosure by creditors upon the issuer's request is an important part of the CC guidance.

- It was noted that the issue of cost for creditor committees is difficult to pre-agree on, as sovereigns must justify it to taxpayers. However, creditors will want to have this at the outset. One participant suggested that the alternative might be for the creditor to spread the cost amongst its members in cases where the fees become a problem, or to help the other party construct a way to cover the costs. Under this technique, the issuer pays a portion of the committee's expenses and the balance is debited from the first coupon payment on the restructured bond. That spreads the cost of the committee across all bondholders—a fair

[12] The background note sets out the conditions under which holders of CDS participate in the restructuring.

result is if the committee is performing a service for all bondholders. In the recent Belize experience, a solution was found in accepting a lower coupon the first few times of payment with the balance between the agreed coupon and the reduced coupon to be applied towards payment of fees. Several participants expressed the opinion that committee costs should be discussed upfront so as not to slow negotiation progress at a later stage.

- In practice, the appropriate form of creditor engagement is a matter for sovereign issuers and their advisors to consider after taking into account the specific circumstances involved. However, it is worth emphasizing that creditor engagement is important both for creditors (in order to ensure that their representatives have access to necessary information and can negotiate a satisfactory resolution with the sovereign) and for debtors (in order to maximise the prospects of a successful restructuring and to reduce the risk of litigation). While creditor engagement can be organised when the need arises, arguably it is prudent to seek to put in place guidance features in the good times rather than to wait until the crisis is at hand. It was suggested that an additional IMF program that can help confirm the sovereign's creditworthiness post-restructuring to investors, should be implemented.

Recommendations:

- Debtors and creditors should examine the full range of issues before setting up a creditor committee to avoid delays and conflicts.

- Consider "Engagement between Creditors and Sovereign Debtors: Guidance on setting up Creditor Committees" for a full range of issues if the debtor decides to engage with a creditor committee. The paper is suitable for capacity development in making information publicly available on issues for consideration in setting up creditor committees.

7. Can contingent debt instruments such as GDP linked bonds[13] be useful?

- Government debt as a share of GDP is at its highest since WWII in advanced economies (109%) and since the debt crises of the 1980s in emerging markets (49%).There are growing concerns about secular stagnation, with investors in fixed income securities locked in to very low rates of return. GDP-linked bonds offer exposure to a more optimistic view of long-term economic prospects. Conversely, if fears of weak growth are realised, GDP-linked debt offers automatic debt-relief for issuing governments that could help avoid the need for protracted and costly contractual debt restructurings. GDP-linked bonds as an instrument potentially offer wider benefits for the economy and pricing of other risky assets in that scenario, and so have benefits for both investors and potential issuers.

- GDP-linked bonds are different from GDP warrants that have had an unhappy history. Warrants are complex, with multiple triggers, and no two-way risk sharing, making them difficult to price and to trade. GDP linked bonds are a simpler, standardised instrument that could offer a better alternative for debt restructurings.

- The payment structure for GDP-linked bonds have three key elements:

[13] This section draws on contributions from an *ad hoc* working group of lawyers and asset managers in the private sector and Bank of England economists. See http://www.bankofengland.co.uk/financialstability/Documents/fpc/fspapers/fs_paper39.pdf

a) First, once issued, the coupon *and* principal are both indexed to nominal GDP. There are thus both upside and downside in debt service payments over the life of the instrument with the value of redemption principal based on the cumulative performance of nominal GDP

b) Second, the bond is issued in local currency, ideally with a term of 10-20 years. Debt service is thus correlated closely with issuer's nominal repayment capacity (tax receipts) and, compared with conventional local and foreign currency debt instruments, debt service is better insulated from energy price shocks and exchange rate depreciation.

c) And third, the instrument's design is modelled as closely as possible to inflation-linked bonds, which are familiar instruments for many issuers and investors. In the model *London Term Sheet* (https://www.icmagroup.org/resources/Sovereign-Debt-Information), interest payments and redemption principal are paid with a six- month lag to match typical official data release timetables.

The instrument can be attractive for investors:

- First, there is a diversification benefit for investors, as they get exposure to labour income flows, which typically account for 60% or more of GDP.

- Second, they also gain indirect exposure to firms with equity that is unlisted and does not trade publicly. Such firms can account for a large share of corporate profits, especially in emerging markets.

- Third, GDP linked bonds would meet institutional demand for instruments correlated with labour earnings. They are thus attractive to pension funds' defined benefit plans and to defined contribution plans managed by pension funds and insurance companies.

- By design, GDP linked bonds would be treated differently in sovereign debt restructurings. The *London Term Sheet* gives the issuer the possibility of remaining current on GDP-linked bonds if conventional debt is restructured. Reservations were expressed about the possible preferential treatment of GDP linked bonds in sovereign debt restructurings, which would imply that they had legal seniority. In the discussion it emerged there was no intention to tamper with the traditional concept that all unsecured debt had equal seniority. At the same time, however, it was stressed that because GDP linked bonds would receive an automatic contractual haircut in a financial stress scenario, they needed to be dealt with differently from conventional bonds, which would not. Making GDP linked instruments a separate class of debt subject to CACs seemed to some to be a reasonable approach. The rationale here is that, in a downturn, the issuer should be more able to stay current on its GDP-linked obligations, as nominal service on them declines with nominal GDP. At the same time, unlike holders of conventional debt, investors in GDP linked bonds automatically take a hit on the value of accrued principal because of indexation but would avoid default.

- Contractually, in the *London term sheet* GDP-linked bond "cross-defaults" only to the sovereign's other GDP-linked bonds, which allows the issuer to cease debt service payments and/or restructure conventional government bonds, loans or other borrowed money without risking an involuntary acceleration of the GDP-linked bond by the creditors. The practical effect would be to create an instrument that is more likely to continue to perform when the sovereign finds itself in challenging economic circumstances. These features, in turn, should facilitate growth in the market for the new instruments. If issued in

scale, GDP linked bonds have the potential to reduce the frequency of sovereign debt restructurings going forward.

- Not surprisingly, pricing is a big issue for GDP-linked bonds as they would be new financial instruments. Theory suggests that they likely would cost more to issue than conventional bonds. Leaving aside a possible "novelty" premium for first-time issuers, the case for some embedded premium rests both on the insurance against economic shocks GDP-linked bonds provide by design and on market expectations of the future volatility of nominal GDP in the issuing country, with some offset from the lower risk of payment default relative to conventional bonds. However, how big the premium might be in practice is difficult to predict. The few academic studies that do attempt to calculate the GDP risk premium give estimates ranging from 35 to 150 basis points. Most discussants agreed that the cost is likely to turn on how quickly an international and diversified market in GDP-linked bonds develops. This strengthens the case for coordinated issuance across a range of advanced and emerging market issuers to help kick-start the market.

- There are some concerns in issuing GDP-linked bonds like the possibility that domestic banks might emerge as major investors, which could accentuate financial stability risks, but market feedback suggested that banks understood the risks of running large positions in such an instrument and, besides, regulation could discourage such situations if need be.

- On the question of motivations for sovereigns to issue GDP linked bonds in the current low interest rate, low growth environment and whether the premium on GDP linked bonds might discourage issuance, it was highlighted that the insurance element in the instrument, which could still be advantageous to some issuers, particularly ones that had, amidst the general caution about global growth, above-average growth prospects. Besides, the signalling effect of issuing GDP linked bonds could reduce the risk premium of the outstanding stock of conventional debt, which would also be beneficial to the issuer.

- Another concern raised was whether there might be a stigma attached to issuing GDP linked bonds. In particular, might the contractual possibility of debt relief built into the instrument serve to relax incentives for prudent fiscal policy? This could happen in some cases, but the disciplining effect of conventional borrowing at times was ineffectual, too. Besides, the pain from adverse shocks which automatically triggered debt relief for GDP linked bonds, while less than it might be under other adverse scenarios, would remain a deterrent against reckless policy. In any case, a generalised stigma seemed unlikely, especially if issuance became common across a range of sovereigns of varying perceived credit quality. Similar concerns were raised when collective action clauses were introduced in New York law bonds, but these proved to be misplaced as CACs were widely adopted.

- The concern related to the variable reliability of national GDP data could be resolved if at least initially, the pool of potential issuers would likely be self-selecting in the sense that first-movers would include sovereigns that attract investors already comfortable buying their conventional domestic law instruments, including inflation-linked bonds. Longer term, the success of GDP linked bonds is likely to raise standards of GDP data reporting across a broader range of countries, in turn increasing the potential issuer pool.

Recommendations:

- Explore the possibility for the instrument to be issued under domestic law by any emerging market or advanced economy issuer where investors were comfortable with the local legal jurisdiction.

- Carry out further work is on the regulatory treatment of GDP linked bonds, both for banks, as likely market makers and short- but not long-term investors, and for insurers and other asset managers.

8. What should be the considerations in the review of the "good faith" criterion in IMF's LIA policy?

- The IMF plays a unique role in assisting its member countries to resolve their balance of payments problems under adequate safeguards without resorting to measures that are destructive to national or international prosperity. Its lending into arrears policy (LIA)[14] enables it to provide financial support to a sovereign member that has fallen into arrears with its private creditors and sets the country on the path to economic recovery and a return to capital markets. Thus, the availability of IMF resources at times of debt distress can assist a country in tiding over a crisis; nevertheless, it also carries potential moral hazard issues such as: lenders may not correctly price in risk; member countries may defer needed adjustments; and banks may postpone recognizing losses on their balance sheets. Currently, as part of an IMF Executive Board endorsed review of its legal and policy framework for sovereign debt restructuring, the IMF's LIA policy is under review. The summary below traces the history of this policy; provides a critical appraisal of its evolution; and summarizes some issues for consideration in its review of "good faith."

- The IMF's arrears policy evolved over time. The policy was initially defined in 1970 not to tolerate external payments arrears. It has been guided by the two overarching principles: (i) arrears are destructive to national or international prosperity and an inadequate path to resolve a member's balance of payments problems and (ii) adequate safeguards of the IMF's own resources as set forth in Article V, 3(a) of the IMF's Articles of Agreement. This placed debtors in a weak bargaining position as private creditors acquired leverage over its debtors to provide as little relief as possible, protected in the knowledge that IMF resources were unavailable to the debtor until arrears had been resolved. Private financial institutions were also increasingly reluctant to consent to IMF arrangements and did not want to be exposed to risky behaviour from the debtors. This external "veto power'' implied "without our consent, you cannot lend." Consequently, it delayed the IMF support to the country members.

- In 1989, the IMF modified its arrears policy to remove the unintended "veto" that the private creditors had over the IMF lending and introduced—a limited exemption to the IMF's non-toleration policy of arrears known as the Lending into Arrears Policy (LIA). The requirement of resolving arrears before the IMF could approve an arrangement was removed, provided (i) prompt IMF support was judged to be essential for the successful

[14] IMF. "Reforming The Fund's Policy On Non-Toleration of Arrears to Official Creditors". *IMF Policy Paper*. December 2015 https://www.imf.org/external/np/pp/eng/2015/101515.pdf

implementation of the member's adjustment program; (ii) negotiations between the member and its creditors had begun; and (iii) it could be expected that a financing package consistent with external viability would be agreed upon within a reasonable amount of time. It represented a careful balance between the risk regarding the safeguard of IMF resources and IMF arrangements to resolve balance of payment problems. This modification balanced the bargaining power between the debtor and its creditors, as availability of IMF financing was not dependent on reaching a resolution of arrears with creditors.

- In 1998, in response to the changed landscape of financing, the policy was broadened to apply to international sovereign bonds and the term "good faith" was introduced with the expectation that it would enable to get broader creditor support in a restructuring. The concept of "good faith" was not accompanied by a clarification of its meaning. In 1999 good faith effort to reach a "collaborative agreement" with its creditors was added.

- The Good Faith principle was expanded into a full set of guiding in 2002.[15] The LIA framework was based on two criteria: (i) The prompt financial support from the IMF was considered essential for the successful implementation of the member's adjustment program and (ii) its pursuance of appropriate policies accompanied by making a good faith effort to reach a collaborative agreement with its creditors.

- The IMF Executive Board stressed the need for flexibility and recommended continuing applying a flexible framework for specific circumstances. It recognized three guiding principles with respect to creditor engagement: The debtors are expected to (i) engage in early dialogues with the creditors; (ii) share relevant and non-confidential information with all creditors in a timely manner; and (iii) provide creditors with an early opportunity to give inputs on the design of restructuring strategy and the instruments to be included in this strategy. The policy does not require such input to be incorporated in the strategy of its design, but it indicates that it would be inappropriate to give private creditors a veto over the IMF's program (this goes back to the rationale of the LIA policy). Finally, in cases in which an organized negotiating framework is warranted by the complexity of the case and by the fact that creditors have been able to form a representative committee on a timely basis, there would be an expectation that the member would enter into good faith negotiations with this committee, though the unique characteristics of each case would also be considered.

- The LIA policy has been applied in eight cases of post-default restructuring with IMF arrangements since 2002. In the eight cases where LIA policy was applied, information sharing between both parties was a routine exercise. The sharing of confidential information is limited to special circumstances—as when the creditor committee is restricted.

- Article V, Section 3(a) of the IMF's Articles of Agreement states that the IMF may only provide its resources under adequate safeguards.[16] Yet, some participants saw the LIA

[15] In December 2015, the IMF also including the toleration of arrears to official bilateral creditors in its LIA policy which permits the IMF to lend into sovereign bilateral arrears under narrowly circumscribed circumstances.

[16] IMF. "Sovereign Debt Restructuring—Recent Developments and Implications for the IMF Legal and Policy Framework". *IMF Policy Paper*. April 2013. P 45. "The legal basis of the policy is found in Article V, Section 3 which directs the IMF to adopt policies on the "use of its general resources that will assist members to solve

policy deviating from this Article over the years. They pointed out that symmetrically in 2002 the IMF asked debtors to enter into good faith negotiations with a timely formed creditor committee, provide information along with other conditions. Whether it was in the case of Ecuador, Pakistan, Ukraine or Argentina, the Board reviewed how negotiations were to be conducted. This assessment from the IMF was viewed as evidence of its increasingly costly interventions in market transactions. It went beyond its role of defining the financing envelope, including the portion that can be filled in through debt restructuring. The IMF thus became an ill-informed "referee" that could sanction the debtor but had no jurisdiction over the creditor. In other words, the bargaining power shifted to the creditor's advantage. The IMF became the arbiter of good faith behaviour but its monitoring power remained restricted to its member countries, as it had no jurisdiction over private creditors.

- Experts argued that good faith could mean one of three things: (1) it can mean genuine effort, (2) it can refer to how the agreement is reached, or (3) it can refer to the substantive positions reached in the agreement. If the aim is to safeguard resources, then the IMF needs to focus on the result, regardless of the process of debtor-creditor engagement. In their view, starting in 1989, the IMF only asked if both parties had begun the process of engagement. This was appropriate as they were protecting their resources at that time. The perception was that the IMF then moved to the substance of negotiations by specifying a transaction format rather than focusing on safeguarding its resources.

- Countervailing interests of creditors and debtors are apparent. Some private creditors would like to make engagement between debtors and creditors contractually forcing the debtor to conduct debt negotiations only with a creditor committee[17] arguing that hard coding is necessary; extension of good faith to pre-default cases is needed; and that the IMF signal is important and should push for the formation of creditor committees. The debtors, however, need flexibility to deal with debt distress and find solutions with or without creditor committees. In practice, it is problematic to make a case for making engagement with a creditor committee contractual, as it is difficult to identify cases where a debtor was not willing to engage with a creditor. From the standpoint of the debtor, the goal is to achieve a successful debt restructuring and engaging with the creditor is essential and necessary to achieve such a goal. The debtor must take sounding of its creditors, regardless of whether a committee is formed. It goes off the rails when one tries to prescribe how it should be done, because there is no one size fits all. There are situations where formal committees are not advisable. Prescription on this is problematic and does not resolve the issue. Some suggest replacing good faith criterion with a set of best practices that would guide the dialogue. Adding value for future cases would be the ability to identify 'bad practices' as indicators of breaches.

- The objective of IMF lending is to assist the member in resolving its balance of payments problem under adequate safeguards to the IMF's resources. Therefore, it was argued that the IMF's role is not to protect the creditors' rights. The IMF's role is not to monitor or oversee private contracts. However, the debtor's engagement with creditors to reach a

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their balance of payments problems in a manner consistent with the provisions of the Articles and that will establish adequate safeguards for the temporary use of the general resources of the IMF."

[17] What constitutes a representative committee? It was never defined.

consensual agreement is essential to the debtor's re-access to capital market, which would enable the debtor to repay the IMF. Given the assumptions above, the participants discussed to what extent the IMF's good faith criterion could be consistent with the existing contractual good faith obligations, and if there is any deep inconsistency between the US and English law. A few participants noted that the good faith principle is an implied covenant in the contract that attaches to express obligations. Therefore, the good faith principle need not be worded in the contract to be binding. Furthermore, some raised the issue of collective action clauses and the extent to which debtors can classify their creditors into different pools—for instance, under the New York contract law there is a good faith obligation that attaches to how debtors classify their creditors. However, the good faith principle aims to safeguard the benefit of the bargain not to protect the parties from making a poor bargain.

- The IMF advises its member countries to remain current on their debt obligation to the extent possible. Hence, a few argued that it does not make sense that creditors do not have the symmetric obligation as the debtor to act in good faith. As for property rights, creditors have already cashed in the premium of the risk when they bought the bonds and lent the money—so the risk materializes and is not a breach of the rules. They were of the view that while the IMF has no capacity to judge what private creditors do, it should consider creditors' behaviour in consideration when assessing if the good faith criterion is met.

- In the LIA review, care should be taken to ensure that the policy does not further strengthen the leverage of the private sector and maintains a power balance between debtors and creditors. Some participants pointed out that it is a bit tougher on the official sector than the private sector. The official sector would like to see a more balanced approach in the LIA policy. It would be better to focus on symmetric treatment of the two sides The main question is: are the incentives right for private sector participation in the program and if not, how can the IMF create more incentives? And to what extent is comparable treatment created with official creditors?

- From the IMF's perspective, two main factors go into the review of LIA and good faith: (1) whether the debtor has taken steps toward restructuring, which could include hiring financial or legal experts and advisors, launching of consultation with creditors, and the design of debt restructuring strategy. (2) The IMF has to judge that there are adequate assurances that debt restructuring will be successful—namely, that the level of participation of creditors is high enough to restore debt sustainability. Timing is an issue for the IMF. Usually when a country requests financing from the IMF, a debt restructuring has either not started or is in its early stages. On an average this takes about 20 months from announcement to completion. The institution cannot await the result of debt restructuring. It was noted that the evolution of LIA and its rules were only one element among others.

- Several participants mentioned emerging scenarios such as the increase in non-Paris club creditors and quasi-sovereign lenders. The IMF has different arrears policies and therefore has to classify different claims. The private sector wants clarity and predictability—which claim falls into which category and how the policy is defined. In addition, clarity is needed on the issue of coordination between different types of creditors—private vs public bilateral official creditors. The IMF does not have a formal policy in pre-default context but has established practices that also require debtor creditor engagement and sharing of

information. Since time is of essence to avoid default, there should be flexibility in terms of negotiation modality to achieve a speedy and orderly debt restructuring. This should be part of the review.

- Under U.S. state contract law, good faith is typically an implied covenant that applies to the performance of existing contractual duties. This means that (a) good faith does not need to be mentioned to apply, and (b) it is a gap-filler in an otherwise enforceable contract. In the United States, good faith does not apply to contract formation.[18]

- A common understanding of good faith is as a safeguard against extreme abuse of discretion, where a contract counterparty might be deprived of the benefit of its bargain. [the focus is on the outcome]

- Other definitions refer to abiding by relevant commercial norms, such as transparent pricing and non-discrimination among similarly situated contract counterparties.

Crucially, nothing in the concept of good faith prohibits driving a hard bargain *ex ante*, or enforcing it *ex post*.

Recommendations:

- In the IMF/sovereign debt context, good faith should be (a) a complement to sustainability, and (b) as filling inevitable gaps in the contractual approach. For example,

  a) Where bond contracts empower a subset of the creditors to call a meeting and provide for communication channels with the debtor, the latter would probably need a good reason for refusing to meet.

  b) ICMA CACs require the issuer to disclose certain information as a condition to invoking collective action clauses. Refusing to abide by the disclosure requirements merely to gain a negotiating advantage would not be sensible in most cases—and may well breach the covenant of good faith.

  c) Extreme abuse of the debtor's power to classify creditors into voting pools, so as to effectively expropriate a subset of creditors for the benefit of the others, similarly situated, would also be problematic.

  d) A creditor that refuses to meet with the debtor or participate in a workout, or one that insists on terms that are either beyond the IMF's sustainability envelope, if equitably applied to similarly situated creditors, or a creditor that seeks to recover at the expense of similarly-situated creditors, would not appear to be acting in good faith.

- What would not be a breach of good faith?

  a) A debtor that treats similarly situated creditors differently on the margins, or one that treats differently situated creditors differently, would not be in breach of good faith.

[18] The law is different elsewhere, including major European civil law jurisdictions.

b) Creditors who insist on the highest possible recovery within the IMF sustainability envelope may be driving a hard bargain, but should not be in bad faith.

In sum, treat good faith in IMF policy as a safety valve *in extremis*, to police against behaviour likely to produce unsustainable or inequitable outcomes—not as a routine test of debtor or creditor behaviour in the restructuring process.

9. How does bank regulation affect sovereign debt restructuring? What are the open issues in regulation affecting sovereign debt?

- In a survey of the legal, regulatory, accounting, tax treatment and market disclosure requirements as they relate to sovereign debt, mainly from U.S./European perspectives an expert catalogued the extensive range of legal, regulatory, accounting, tax treatment and disclosure requirements across jurisdictions worldwide that affect sovereign debt. It was noted that, except perhaps in the regulatory sphere, there was little uniformity of practice and little impetus towards convergence. Many examples were provided of disparate practices. A good example was the EU Transparency Directive, which gives existing holders of securities the right to access bond documentation but not to potential buyers of securities. This was contrasted with U.S. practice, where disclosure is publicly available to all interested parties. At the same time, disclosure requirements by sovereign bond issuers also varied, both in timing and content, and national political obstacles stood in the way of coalescing around agreed standards. Other examples mentioned include the regulation of Credit Rating Agency sovereign ratings, and tax and accounting issues, where practices vary globally. The experts concluded that a comprehensive study of these issues, much less reaching a policy consensus on how to tackle them, would be a multi-year project.

- Banks regard most sovereign bonds at most times not as investments but as a form of money. This results in a classic case of multiple equilibria. Sovereign bonds have two market equilibrium states; one as a risk-free asset; the other as a credit investment, and the gap between the price of assets in these two market states is very large. Thus in the sovereign bond market credit premiums tend not to increase linearly in line with economic and fiscal policies—they remain unnaturally low for an extended period into a downturn and then tend to spike to high levels.

- This results in three different market situations on the way into a financial crisis.

  a) At *stage one*, market prices understate risk exposure. In this state estimated expected loss on sovereign exposures will be larger than the implied risk premium derived from market prices (which may well be zero). As regards any particular issuer, the transition to stage two will be marked by a collective determination that the assets are no longer risk-free.

  b) During *stage two*, market confidence and market prices will have collapsed, and estimated expected loss will be much lower than the discount to face value envisaged in the market. The transition to stage three occurs where there is a common expectation that there will be a default either explicitly or implicitly via a debt restructuring. This is the familiar "impairment" determination. Banks are permitted to make their own determinations as to when an impairment occurs, but will tend to cluster in the making of such determinations.

c) At *stage three*, market prices and expected losses are likely to converge. Once stage three has been reached, banks are usually prepared to enter into restructuring negotiations, since they will already have taken capital charges equal to the likely losses on such restructuring.

- An optimal regulatory structure in this regard would be one which moves banks through these stages as quickly as possible, and which removes any positive regulatory incentives to disinvest at an early stage (thereby adding to a downward market spiral).

- The composition of liabilities, the structure of banks, and creditor hierarchy are all important considerations with respect to bank regulation issues. There is a systemic risk between sovereigns and banks that they may pull each other down in the event of a problem. When banks buy themselves time in resolution, sovereigns stand to suffer as the time lost results in a delayed resumption of growth and debt sustainability

- The banking and sovereign debt spheres are somewhat parallel in that they are both systemic in nature. There is in many respects a mutual dependency between the problem faced by bank regulators and the problem faced by those seeking to address sovereign default management. The more plausible and effective the sovereign default management mechanism can be made, the lower the likelihood of market collapse if that sovereign gets into difficulties, and the less concerned bank regulators should be about bank exposures to that sovereign. Sovereigns might benefit if the quick resolutions that occur in the banking world were similarly applied in the sovereign sphere.

- Banks hold large amounts of their sovereign's debt as a liquidity pool to guard against currency risk. There has been a shift where bank capital can no longer absorb losses because banks only have surplus capital above required holdings to cushion a blow. Falling below regulatory requirements will cause the bank to shut down. Thus, it was noted that increasing regulatory requirements will decreases banks' loss absorption capabilities. Current banking resolution tools have solved much of the problem by helping to better absorb losses faced by banks with large holdings of debt that become subject to a restructuring. However, incentives need to be created for banks to diversify their liquidity pools. It was suggested that having greater risk weighting on domestic debt than on foreign debt would be one way to approach this problem. There seems to be no tool in the sovereign world that functions similarly to the way total loss absorbing capacity (TLAC) does in the banking regulation realm, with close investigations of the composition of sovereigns' liabilities. In the case of the euro area, an alternative approach to diversification would be to create a single Eurobond and to allow a European bank seeking to bolster its liquidity pool, to hold bonds from the single European issuer, but not bonds issued by its respective country's treasury. Additionally, some concern was raised that, through the bank resolution authorities, it may be possible to allocate risk in a way that uninsured institutional investors carry the burden.

- The big problem with banks is also that the system of capital against risk weighted assets and assessments of riskiness is hugely procyclical. At the top of the boom when most risk is taken is when in hindsight it was riskiest and when in the depths of the recession, banks do not want to lend to anyone. They think the world is a risky place, when it's safer. That is the fundamental problem and therefore any solution should address that issue. If credit rating agencies are supposed to be one step away from the market, they are supposed to be able to

see these long running issues that the market gets caught up with and they are just as procyclical. In fact in some cases they are more procyclical than where the market is and late in their assessments.

- A key issue is to disentangle the issue of how the regulatory capital system should apply to holdings of sovereign bonds generally, and how it should apply in the case of specific sovereign bond restructuring. There are good arguments for the imposition of capital requirements in respect of sovereign exposures generally, and this discussion does not address these. However, in the case of a particular sovereign, it is important that the regulatory system does not create positive disincentives for banks to participate in sovereign restructurings.

- Basel is currently engaged in a major review of the risk capital treatment of sovereign bonds held by banks. This review was begun in the aftermath of the Greek crisis, a point where the risk of sovereign default to bank balance sheets could no longer be ignored. This review seems to be proceeding more slowly than the general review of the Basel framework which is currently under way—the proposals for revisions to the standardised approach for credit risk produced in December 2015 contained no revised proposals on sovereign risk since the issue was described as being "still under review". Policy proposals are expected in the near future.

- The old rules on impairment which applied during the sovereign debt crisis (IAS 39) will be replaced as from 1 January 2018 (IFRS 9). The key difference between the two is that under the old regime, losses were only required to be recognised where an event had occurred which made the loss almost inevitable. Under the new regime, banks are required to recognise expected credit loss (ECL) for each asset. This rule will apply to all credit assets not held on a mark to market basis.

- There remains the question of Market Abuse Regulation (MAR) for sovereigns. How will MAR work in a practical context for sovereigns? What will qualify as insider information?

Recommendations:

- From a central banking perspective the issue of collateral is extremely important i.e. the management of collateral, the valuation of collateral and the location of collateral. One of the challenges that central banks face in a crisis situation (such as in 2007) is the availability of collateral for their liquidity provisions operations and providing the public with adequate liquidity.

- Regulators should consider that in principle any instrument which can be used to obtain a currency from its central bank can continue to be used in a liquidity pool to meet obligations denominated in that currency, regardless of the credit status of the sovereign issuer.

- Consider the implications of implementing regulatory capital requirements. Focus could be placed on including transitional arrangements if capital requirements for banks change.

- Consider revising Sovereign disclosure requirements and requirement of all material information to be disclosed to investors.

- In relation to the treatment of risk weighting for bank capital, the best outcome from the Basel process would be a pillar 2 charge, designed to de-incentivise undesirable speculation in the bonds of distressed sovereigns whilst mitigating regulatory pressures on banks to liquidate assets in advance to the completion of a resolution package. The structure of such a mechanism would have to be transparent, and embedded in international standard practice and take broadly the form of the capital charge sacrifice model applied in the UK Funding for Lending scheme.[19] The proposal is to allow banks to defer recognising the capital hit arising from a prospective default until after that default had been resolved and the relevant debt restructured. Such a measure would reduce selling pressure in the markets and therefore the possibility of large mark-to-market losses and losses to pensions and other investors.

- Encourage more plausible and effective sovereign default management mechanisms to be made; the lower the likelihood of market collapse if that sovereign gets into difficulties, and the less concerned bank regulators should be about bank exposures to that sovereign.

- The Transparency Directive merits a review. As currently construed, that Directive does not give a right to the official sector, the public or a prospective investor to obtain copies of trust deeds, fiscal and paying agency agreements or the full text of an outstanding bond.

- Issues with holdings of credit default swaps by banks for insurance and regulatory purposes needs further work.

- A comprehensive study of legal, regulatory, accounting, tax treatment and market disclosure requirements as they relate to sovereign debt is needed.

The next steps:

- The report and its recommendations are a guide to the range of issues where the market based approach can be enhanced and are intended to spark a discussion on improvements and implementation.

- Different agencies and actors can be responsible for different aspects of the improvement of the sovereign debt restructuring process. Since it is the approach is market based, no additional international agreement is required to move forward in implementation. Endorsement of issues and a wider discussion on options by the United Nations General Assembly, IMF, BIS, the Paris Club, and the G20 can facilitate progress and implementation.

- Issuers of sovereign bonds can consider the recommendations on contracts, trust structures and disclosures highlighted in the report at the country level.

[19] For every dollar of negative capital impact caused by market turmoil, accounting write-off or impairment charge, the aggregate pillar 2 charge should be reduced by one dollar. It should be clear that this is a temporary concession, which would be withdrawn on a tapered basis after the relevant restructuring was completed. Thus, the effect would be to give the management of the bank time to absorb the eventual outcome of the resolution, but to make clear to them that the concession was temporary, time-limited and liable to be withdrawn immediately if there were any suggestion of deliberately increasing positions to take advantage of regulatory relief.

- Sovereigns borrowing internationally from commercial banks should consider making their loan contracts comparable to the developments in bond contracts to dampen the risk of holdouts and litigation in a debt restructuring.

- A body like the Loan Market Association (UK) and any US equivalent industry body, can review the recommendations in this report, carry out an outreach with debtors and creditors leading to a standardisation of commercial bank loan contracts.

- Debtors and creditors can consider the full range of issues in the guidance paper on creditor committees and adapt them according to individual requirements.

- ICMA and IIF can continue to play a constructive role in the evolving situation.

- The IMF can play an important role in provision of information, standardisation and setting up databases on comprehensive debt data, legal documentation, and record of restructuring agreements.

- The IMF and its members can take into consideration the recommendations in the report in its own review of "good faith" in lending into arrears policy.

- The regulatory issues can be considered for further discussion at standard setting bodies, the Financial Stability Board, the G20, and the IMF.

Annex

Technical Study Group Meeting Series
Sovereign Debt Restructuring: Further Improvements in the Market Based Approach

Organized by the Financing for Development Office, Department of Economic and Social Affairs, United Nations

List of participants

(Participants joined the meeting on an ad hoc basis depending on the theme under discussion)

Core group for background notes and presentations: Anna Gelpern, Benu Schneider, Deborah Zandstra, Lee Buchheit, Mark Joy, Mark Stumpf, Michael Waibel, Simon Gleeson, Whitney Debevoise and Yannis Manuelides.

Participant's Last Name	***Participant's First Name***	***Affiliation***
Attridge	Samantha	*Commonwealth Secretariat*
Bartholomew	Ed	*Former Inter-American Development Bank*
Beers	David	*Bank of England*
Bingham	Gavin	*Systemic Policy Partnership*
Bozidar	Djelic	*Lazard Asset Management*
Buchheit	Lee	*Cleary Gottlieb*
Buiter	William	*Citigroup*
Cailloux	Geoffroy	*Paris Club*
Chaliha	Sonia	*Bank of New York Mellon*
Clarke	Ian	*White and Case*
Chodos	Sergio	*Former Executive Director, IMF*
Canuto	Otaviano	*Executive Director, World Bank*
Debevoise	Whitney	*Arnold & Porter Kaye Scholer LLP*
DeSeino	Tim	*Morgan, Lewis & Bockius LLP*
Doyle	Peter	*Former IMF*
Dugger	Elena	*Moodys Credit Rating Agency*
Enting	Gerald	*Ministry of Finance, Netherlands*
Espinosa	Sebastian	*White Oak Advisory*
Gelpern	Anna	*Peterson Institute and Georgetown University Law School*
Gleeson	Simon	*Clifford Chance*

Goss	Lee	*International Capital Markets Association*
Gray	Robert	*Debt Financing & Advisory Group, HSBC Bank*
Griffin	Starla	*Slaney Advisors*
Haley	James	*Center for International Governance Innovation (Canada)*
Hagan	Sean	*International Monetary Fund*
Heinz	Otto	*European Central Bank*
Heinbuecher	Robert	*Deutsche Bundes Bank*
Houghton	Nigel	*Loan Market Association (European Union)*
Humes	Hans	*Greylock Capital*
Jones	Spencer	*New State Capital Partners*
Juerg	Adamek	*International Monetary Fund*
Kahn	Robert	*Institute for Foreign Relations*
Kerr	James	*Davis Polk and Wardwell LLP*
Kring	William N	*Boston University*
Kupelyants	Hayk	*University of Cambridge*
Joy	Mark	*Bank of England*
William	Ledward	*Franklin Templeton*
Lee	Harry	*HM Treasury (United Kingdom)*
Liu	Yan	*International Monetary Fund*
Lundsager	Meg	*Woodrow Wilson Center*
Makoff	Greg	*Institute for Foreign Relations*
Malik	Mehreen	*Clifford Chance*
Manuelides	Yannis	*Allen and Overy*
McGurk	Deborah	*Department for International Development (United Kingdom)*
Mitchell	Travis	*Commonwealth Secretariat*
Pedranzini	Carlos Steneri	*Former Ministry of Finance, Uruguay*
Pohlenz	Friederike	*State Secretariat for International Financial Matters (Switzerland)*
Persaud	Avinash	*Intelligence Capital Ltd.*
Tran	Hung	*Institute for International Finance*
Powell	Andrew	*Inter-American Development Bank*
Schaekermann	Thomas	*German Ministry of Finance*
Schneider	Benu	*United Nations Department of Economic and Social Affairs*
Schwan	Badirou Gafari	*International Monetary Fund*
	Solberg, KPM (Kim)	*Ministry of Finance, Netherlands*
Stumpf	H. Mark	*Arnold & Porter Kaye Scholer LLP*
Torres	R. Hector	*Center for International Governance Innovation (Canada)*
Waibel	Michael	*Cambridge University*
Wehrle	Caroline	*State Secretariat for International Financial Matters (Switzerland)*
Werner	Aviva	*Emerging Market Traders Association*
Weiss	Judith	*Deutsche Bundesbank*
Zandstra	Deborah	*Clifford Chance*