Towards a Code of Good Conduct
on Sovereign Debt Re-Negotiation*

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EXECUTIVE SUMMARY

Improving the involvement of the private sector in crisis prevention and resolution has been at the centre of international discussions for several years, focusing increasingly on sovereign debt restructuring. Thus far the debate on how current mechanisms for tackling sovereign debt restructuring could be improved has primarily focused on CACs and the IMF proposal (SDRM). The former approach relies, to a large extent, on the mutual consent of issuers and investors to agree on contractual mechanisms aimed at dealing with operational issues, in particular in case of default. The latter provides a comprehensive framework which has far reaching legal implications, possibly including an amendment of the IMF articles of agreement However while there is a broad consensus on the need to improve the current framework, there are still substantial divergent views on the best way forward.

This is the reason why it could be appropriate in the present circumstances to try another avenue which could take the form of a Code of Good Conduct (CGC). The latter would list carefully what is expected from each parties concerned in times of sovereign financial distress.

Taking account of the present complex situation and recognizing the need to gather support among all stakeholders, who have different standpoints and interests, a non statutory approach embedded in the CGC could provide a workable solution with the support of all parties concerned. That said, the CGC is not intended to be a substitute for the CACs which could improve substantially the present situation. A widespread inclusion of CACs will facilitate the enforcement of the principles embedded in the Code. As regards the SDRM concept, which is, in any case, a much longer term project due to its statutory and legal approach, and also due to a certain lack of consensus amongst stakeholders, the CGC does not contradict, or substitute for it. The CGC rather fills the present vacuum and offers a workable way for allowing –as pragmatically and realistically as possible- all stakeholders to optimize their present behavior and, perhaps, to accept tomorrow what they do not accept today.

The CGC is also to be thought of as a building-block that will reinforce the reforms being contemplated as regards not only the setting of clear access limits to IMF financing in times of crisis but also the IMF role in prevention and surveillance. The effective implementation of the CGC implies that countries carefully factor-in the likely consequences of the non observance of the principles of the CGC when it comes to requesting the support of official finance. Last but not least, the CGC rests on the premises that a document which embodies general principles as well as best practices will be instrumental in prompting progress in the way creditors and debtors deal with each other, particularly in times of distress. This approach may prove to be as promising as that being pursued for other standards and codes

The proposal set out below does not seek to respond to all practical issues in detail. It solely aims to identify principles and outline a process towards the definition of a code, in the design of which all stakeholders are needed to contribute.

1. The code would provide a set of principles and best practices aimed at facilitating the emergence of an orderly solution to excessive indebtedness :

- ***An early engagement with creditors*** before and when debt-servicing problems arise, whatever their nature.
- ***A fair information sharing*** among all interested parties. The CGC should specify which information is to be provided to stakeholders for them to make an informed assessment of the debtor's financial condition.
- ***A fair representation of creditors***. The organisation of this representation should be based as much as possible on existing or agreed modalities, such as those included in Collective Action Clauses (e.g. majority clauses).
- ***An expeditious and cooperative process***, possibly resorting to instruments and techniques aimed at accelerating the renegotiation process and at discouraging "holdout creditors" (e.g. a voluntary stay on litigation).

- ***A comparable treatment among creditors***. This implies agreeing on the scope of the debt to be renegotiated and on specific voting procedures to be used across a large range of situations.
- ***Fair burden sharing*** between the debtor and its creditors.
- ***Negotiating in good faith*** from all participants. Procedures will be defined ex-ante to achieve this aim (e.g. mediator or arbitrator, etc.).
- ***The debtor's financial situation should be preserved***. A number of avenues could be explored (concerted rollover; status of new money; concerted standstill, etc.).
- ***Restoring, as soon as possible, debt sustainability*** should be the ultimate objective of debt re-negotiation. The IMF program and its debt sustainability analysis will provide the various parties involved with the background information to work out a sustainable solution.

2. The Code of Good Conduct is intended to address a whole range of debt re-negotiation situations. Three illustrative scenarios are presented in the paper:

- In a first scenario ("**alleviating tensions on a sustainable debt")** characterised by a sustainable debt over the medium-term, a country faces short-term financial tensions and there are increasing expectations that the situation could deteriorate further. In order to prevent an unsustainable debt dynamic from developing, pro-active debt management or debt re-negotiation might be contemplated by the debtor. In this context, creditors and debtors could usefully implement several principles of the CGC.

- In a second scenario ("**re-negotiating unsustainable debts, while "remaining current")** characterised by an unsustainable debt, the debtor triggers a debt re-negotiation process, while still being able to service debt payments. An IMF program aiming at restoring debt sustainability over the medium term is designed. The principles and best practices of the CGC are expected to provide a comprehensive framework which would allow debtor and creditors to renegotiate expeditiously new terms and conditions, before the situation of the debtor deteriorates further.

- In a third scenario ("**renegotiating unsustainable debt under a payment standstill")** characterised by an unsustainable debt and temporary payments standstill, the main objective of the CGC is to reduce the risk of a non-cooperative debt restructuring process. Its implementation aims at ensuring debtor's good faith and a fair burden sharing among participants. The combination of an IMF adjustment program and lending into arrears is to be used as a critical instrument to reduce the severity of the crisis and ensure a fair implementation of the CGC, including the good faith criterion.

3. The CGC needs ownership and an adequate incentive structure in order to be implemented efficiently

The experience thus far with the definition and implementation of the standards and codes point to the effectiveness of an approach that relies on internationally agreed principles and best practices. The same positive results can reasonably be expected with the CGC even though, contrary to other codes, some of the best practices and principles in this area may still need to be recognised as such. That said, peer and market pressures should contribute to deterring stakeholders from deviating from the path being agreed upon in the CGC, all the more so since other incentives will be set out with a view to achieving compliance. The active participation of all parties in the design of the CGC is a key condition for a cooperative process and the effective implementation of the CGC's principles. Thus a wide range of stakeholders (public and private creditors, sovereign debtors, the financial community as a whole, IFIs) should be involved.

The CGC should be explicitly endorsed and promoted by all stakeholders: in particular the private sector, emerging countries through bond documentation, and the IMF through its LIA policy.

I. Introduction

The so-called "Prague framework" on crisis resolution and private sector involvement (PSI) is based on three main principles (IMFC Communiqué dated 24 September 2000):

- "Fund resources are limited and therefore extraordinary access should be exceptional";
- "Neither creditors nor debtors should expect to be protected from adverse outcomes by official action";
- The respective amount of IMF financing and private sector involvement "should be based on the IMF's assessment of a country's underlying payment capacity and prospects of regaining market access".

These principles are widely recognised by the private sector, and notably the IIF[1], which notes that market participants must accept full responsibility for their investment and that official funding is not expected to bail-out private creditors. Turning to the implementation of these principles, the Communiqué notes that "the involvement of the private sector would be required in the event that "the combination of catalytic official financing and policy adjustment" is not sufficient to allow the country to regain full market access quickly". Besides voluntary PSI approaches to address these problems (typically: debt reprofiling through exchange/debt swaps), the Communiqué envisages that a "comprehensive debt restructuring may be warranted to provide for an adequately financed program and a viable medium-term payments profile". In this context, the IMF financing is granted under the Lending Into Arrears (LIA) policy: "The Fund should continue to be prepared to provide financial support to a member's adjustment program despite arrears to private creditors, provided the country is seeking to work co-operatively and in good faith with its private creditors and is meeting other program requirements".

With regard to the PSI framework as such, the Communiqué notes that "[it] should strike a balance between the clarity needed to guide market expectations and the operational flexibility, anchored in clear principles, needed to allow the most effective response in each case". In addition, the Committee agrees that "the operational framework for private sector involvement must rely as much as possible on market-oriented solutions and voluntary approaches".

The Prague Communiqué reflects not only a renewed emphasis on PSI and debt restructuring but also the willingness of the international community to develop a comprehensive and clear framework for dealing with sovereign debt crises. In the past, policy measures or initiatives aimed at complementing market mechanisms in crisis situations have been adopted in several occasions by the official sector (e.g. Paris Club, Baker and Brady plans, moral suasion, and efforts to enhance Private Sector Involvement).

Nevertheless, the emphasis of the Prague Communiqué on the need for "the operational framework for private sector involvement to rely as much as possible on market-oriented solutions" seems to be warranted: the recent development of bond financing and the parallel growth of the bondholder community have not ultimately prevented countries from re-negotiating their debt, sometimes through innovative legal and financial techniques. During the last decade, in spite of a relatively high number of acute sovereign debt crises (e.g. Pakistan, Russia, Ukraine, Ecuador, Turkey), debtors and creditors have been able to handle the re-negotiation of debts without facing insurmountable hurdles - notwithstanding the pending case of Argentina-. This has even proved to be feasible in difficult cases where collective action clauses (CACs) were missing or not activated. Notwithstanding the Elliot vs. Peru case, the litigation risk involved in these re-negotiations appears to have been limited so far.

[1] See Institute for International Financial, 2002, *Action Plan of the IIF Special Committee on Crisis Prevention and Resolution in Emerging Markets*, April

However, some restructuring agreements have been difficult to reach, creating uneasiness within the international community. The following considerations may warrant the official sector's involvement in the design of a sovereign debt resolution framework:

- in some cases, the anticipated limited impact of catalytic official financing will lead the IMF to advising the crisis country to seek a partial or comprehensive debt restructuring consistent with the restoration of a viable medium-term payments profile. The IMF has therefore an obvious interest in framing procedures that will ensure an optimal restructuring process, in order to minimise the cost of adjustment for the debtor and to preserve its resources, but also to prevent contagion at the regional or systemic level. Under its LIA policy, the IMF will need to assess whether the crisis country is working co-operatively and in good faith with its creditors;
- the lack of a clear and predictable framework has been perceived as increasing the risk of difficult and protracted negotiations, against the background of subdued capital flows to emerging markets. Although in most cases the interest of private creditors is to enter into negotiations with sovereign debtors in order to protect their assets' value, creditors might delay negotiations for a number of reasons[2]. First, the heterogeneity of the creditors' group could result in coordination difficulties, complicating the task of assembling a representative group. Second, the creditors' group is made up of creditors that do not have necessarily an interest in maintaining long-term and/or commercial relationships with the debtor.

In practice, recent experience with bond restructuring suggests that the difficulty of identifying bondholders and coordinating meetings with creditors are not as severe as many had feared. However, the restructuring processes have been in some cases protracted, in part because of uncertainties about the debtor's capacity to generate sufficient resources for debt service. Against this background, the international community has sought to clarify and improve the procedural dimension of debt renegotiation, as well as its own role in this process. The ongoing discussion has been focusing primarily on two approaches, namely the inclusion of CACs in bond contracts and Sovereign Debt Restructuring Mechanisms (SDRM).

The international community has encouraged the inclusion of CACs in all bond contracts to facilitate orderly workouts, on the basis of the in-depth work undertaken by a G10 Working Group chaired by R.Quarles (US Treasury). However, even though the private sector engaged work on this topic, there is no agreement on the content of the clauses themselves. Furthermore, the dissemination of CACs in all contracts will take years, unless all existing debt contracts are renegotiated or swapped (cf. Morgan Stanley, 2001). Moreover, it is not clear whether CACs could solve alone all collective action problems associated with debt restructuring.

The limitations of CACs have led the IMF to promote a broader framework which can address the co-ordination problems raised by a complex sovereign debt structure – the SDRM-. However, this statutory mechanism is also unlikely to become operational in the short term. Besides legal implications and technical difficulties, the SDRM still lacks a broad political support. In addition, uncertainty remains about the scope of debt crises that the SDRM could address.

This is the reason why it could be appropriate in the present circumstances to try another avenue which could take the form of a Code of Good Conduct. The latter would list carefully what is expected from each parties concerned in times of sovereign financial distress.

Taking account of the present complex situation and recognizing the need to gather support among all stakeholders, who have different standpoints and interests, a non statutory approach embedded in the CGC could provide a workable solution with the support of all parties concerned. That said, the CGC is not intended to be a substitute for the CACs which could improve substantially the present situation as a widespread inclusion of CACs would facilitate the enforcement of the principles embedded in the Code. As regards the SDRM concept, which is, in any case, a much longer term project due to its

[2] IMF, 2002d, Fund Policy on Lending into Arrears to Private Creditors- Further Consideration of the Good Faith Criterion, July 30

statutory and legal approach, and also due to a certain lack of consensus amongst some stakeholders, the CGC does not contradict or substitute for it. The CGC rather fills the present vacuum and offers a workable way for allowing –as pragmatically and realistically as possible- all stakeholders to optimize their present behavior and, perhaps, to accept tomorrow what they do not accept today.

The paper also draws on the experience with the IMF Public Debt Management Guidelines, since the Code could be seen as a development of these guidelines in one particular area of debt management, namely the re-negotiation of the initial terms of debt contracts. It should be noted that the recent IMF background document to the Guidelines discussed the possibility of including CACs as a "best debt management practice". More generally, the value of the codes and standards approach hinges on its ability to provide ex-ante common terms of reference while ensuring the flexibility required for their implementation.

The present paper elaborates on conceptual and operational issues associated with the CGC. Section II describes the Code and its guiding principles. Section III presents three scenarios which illustrate the role to be played by the Code in the resolution of debt problems. Section IV deals with ownership and incentive structure as means to ensure effective implementation of the Code.

II. The CGC should provide a set of principles and best practices to facilitate debt re-negotiation

The CGC is based on a set of commonly agreed general principles while leaving flexibility to stakeholders for implementing them through appropriate specific best practices depending on the nature and complexity of the debt problem. In the light of experience, it appears easier to agree on detailed solutions when dealing with a given country debt problem than to design ex-ante a detailed framework to be referred to in all cases.

The Code could be characterised as an intermediate approach between the aforementioned contractual and statutory approaches. It is not a contractual approach as such to the extent that the Code's principles are not –and need not to be- included in debt and loan contracts. However, the CGC is likely to work all the more efficiently that it can rely on existing contractual clauses. Moreover, like the contractual approach, the objective of the Code is to solve debt-servicing problems without breaching contractual agreements. It is not a statutory approach since –by contrast to the SDRM- the debtor cannot activate a legal framework to initiate a debt restructuring process. However, like the statutory approach, the CGC seeks to address the whole array of issues involved in the restructuring of a debtor's sovereign debt.

In sum, the Code is intended to clarify a set of common principles aimed at enhancing the predictability and transparency of the negotiation process. Through ownership and appropriate incentives, it is expected to co-ordinate the actions of creditors, the debtor and the official sector so as to maximise the likelihood of success.

When reviewing the abundant literature on debt re-negotiation, a broad consensus seems to emerge around the general principles listed below. For illustrative purposes, some best practices are presented and discussed[3]:

1) Early engagement with creditors

Principle: a debtor should maintain a regular dialogue with its creditors, which is considered as a public debt management best practice [4]. In order to reduce market overshooting following the debtor's

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[3] Haldane and Kruger (2001) identify five guidelines for orderly standstill ; the IMF (2002d) proposes principles to assess the good faith during a negotiation ; while it sets out 11 principles that underpin the SDRM, the Council on Foreign Relations (2002) defines 8 principles for sovereign bond restructuring. Beranger Lachand and Eugene (2000) recall four critical principles which have paved the ground for a smooth functioning of the Paris Club

[4] See for example IMF 2002 « Public debt management guidelines »

decision to open negotiations about a potential restructuring, it is expected that a country would not wait until difficulties are looming to communicate openly. A close and ongoing dialogue with its creditors, together with the provision of comprehensive and accurate information will allow an early detection of debt servicing difficulties. It will also help to achieve a broad creditors' participation in restructuring deals at a later stage, even though the initiative of the restructuring rests with the debtor.

Best practices:

- the debtor will need to decide on the most appropriate modality for conducting a dialogue with its creditors. It would be expected, however, that a member would initiate a dialogue with its creditors prior to the member' s agreement with the Fund on a IMF-supported program.
- The debtor might contemplate the setting-up of formal collective framework. A regular dialogue between debtors and bondholders, as suggested by the Quarles group, could be organised through trustees or other structures. Parallel structures might also be useful for bank loans. Once the negotiation process is engaged, dialogue could take place under the auspices of "ad hoc steering committees" (as proposed for instance by the Council on Foreign Relations) or through standing bodies (such as the example of the Paris Club secretariat, the private sector advisory group proposed by the IIF or the sovereign debt forum proposed by R.A Gitlin (2002)).

Role of the public sector

It is likely that even at an early stage of the renegotiation process the authorities would have requested the IMF's assistance in order to design a sustainable economic program. In this context, the IMF could play a crucial role in providing its own debt sustainability assessment as well as financial support in accordance with its access policy In the context of surveillance and programs, it is already of usual practice for the IMF to advise members to maintain a close dialogue with private investors, and when members are contemplating a debt restructuring.

2) Fair information sharing

Principle: interested parties should ensure that fair information-sharing mechanisms are in place. Indeed, participants should be in a position to make an informed assessment of the economic and financial situation of the country, in particular to concur with the debtor on the unsustainability of the sovereign debt.

Best practices:

- Once the negotiation process has started, a proper framework for information sharing is required in order for creditors to form their judgement as to the seriousness of the debtor's financial situation, while preserving the confidentiality of market sensitive information. In particular, the debtor is expected to provide creditors with the following information :
  - a detailed assessment of the economic and financial circumstances that led the authorities to initiate the re-negotiation of the terms and conditions of their debt;
  - a detailed account of outstanding debt and prospects ;
  - an outline of the negotiation process (timeframe, information on the treatment of claims not included in the negotiation, etc.).
- The creditors could appoint experts to help them form their judgement on the information made available by the debtor and the need and scope for a debt restructuring. In any case, all creditors should be provided with the same level and quality of information, irrespective of whether they participate in the ad-hoc committee. Thus, they would be in a position to make their own judgement on whether a debt restructuring is necessary.

3) A fair representation of creditors

Principle: once the debt re-negotiation process has been initiated, a fair representation of creditors should be ensured. This is particularly important when creditors have to agree on the terms of a restructuring.

Best practices: The modalities for representation of creditors, as those included in standard CACs (particularly the majority clause), could be used, either when available in bond and loan contracts or as a benchmark when no CACs are available. Several key issues have to be addressed:

- There is a need to identify an appropriate level of representation. Once creditors have been consulted and have agreed to re-negotiate, their representatives should, at this stage of the process, be in a position to act on behalf of other creditors. However, the resulting terms of agreement will have to be agreed by all creditors through the agreed upon majority rules.
- The modalities for representation might differ depending on the specific constraints faced by each class of creditors. The modalities used in various fora (London Club, Paris Club), as well as CACs or experience drawn from practical restructuring cases should help define best practices in this area. As suggested in the G10 Report, one solution could be to leave the option to the creditors to choose between a qualified majority (typically 75%) with provisions to set up quorum rules, and the so-called outstanding principal approach (with a reasonable threshold of 75%).

4) Expeditious and cooperative process

Principle: Once a debt re-negotiation process has been initiated, participants should aim at achieving a timely and expeditious agreement and at ensuring a cooperative process.

Best practices:

- While, at the outset, the CGC could set a tentative deadline for closing a deal, "rolling over" of the deadline might be a pragmatic solution.
- To ensure that an agreement is reached, debtors could rely on specific financial incentives ("sweeteners") in order to broaden creditors' support, such as up-front cash, step-up options, debt equity swaps or other types of financial incentives that could encourage creditors to participate in the debt exchange or restructuring agreement. Besides, they could have recourse to legal strategies, such as "exit consents", at the end of the negotiation to finalise the process. Further work in this area is needed, since some financial techniques could have undesirable effects on the debt dynamics.
- A concerted standstill, i.e. an agreement between a debtor and its creditors providing for a suspension of debt payments, is another instrument that could prevent a cooperative process from being disturbed by a minority of "holdout creditors". It should be backed by a voluntary stay of litigation/legal action. This was a common practice during the 1980s debt crisis, with commercial banks refraining in general from taking legal action against the debtor during the negotiations. In the case of bondholders, a majority of creditors represented in the committee could agree to a stay on litigation during the negotiating process, under pre-identified procedures (provisions dealing with the modalities of initiation, duration, suspension, etc.). Specific guidelines could be designed, for example along the lines of market best practices (see IMF, 2002d).
- Some modalities of PSI, such as a concerted rollover of credit lines, could also be envisaged.

Comment:

Given the informal nature of the Code, no procedure (except contractual clauses included in bonds or loans) could bind rogue creditors to accept a deal. However by defining internationally agreed rules, the ability of rogue creditors to disturb the restructuring process is likely to be reduced. Still, as rogue

creditors' actions could not be ruled out, a statutory procedure could provide a useful back-up to the Code.

5) Comparability of treatment

Principle: Once a debt re-negotiation process has been initiated, specific procedures should ensure comparable treatment among creditors. This principle is essential since creditors will be reluctant to participate in a non-statutory cooperative process unless they are confident that free riders will not be rewarded (hence the importance of achieving a concerted stay on litigation, see Principle 4). At the same time, there is a difficult balance to strike between an uncompromising implementation of the principle of comparability of treatment and the need to foster a deal agreeable to a majority of creditors, requiring some flexibility in its implementation (see Paris Club experience). Moreover, the financing of critical activities might call for the exclusion of some categories of claims from the renegotiation process.

Best practices: To guarantee a fair renegotiating process, participants should agree on procedures that will ensure comparability of treatment among creditors.

- Some institutional devices would help implementing this principle, as well as some others some principles of the Code (e.g. fair information sharing, good faith negotiation, inter-creditor equity), by designing transparent procedures to deal with specific operational issues (computation and registration of claims, voting procedures and related conflicts). An institution designed to manage these operational questions would increase clarity and predictability as to how the Code would be implemented. In this respect, the recent proposal by the IMF (a Forum for resolving disputes arising from these operations) provides an interesting avenue to facilitate debt re-negotiations[5].
- The need to ensure comparable treatment among creditors will have a bearing on the scope of the debt under renegotiation. It is worth considering whether domestic debt should be included in the renegotiation process, even though its restructuring is in principle already addressed through domestic procedures... When the Paris Club debt is material, there is a presumption that it would participate in the burden sharing process on a case by case basis, in a manner which is consistent with its own assessment of comparability of treatment.
- It is extremely important to ensure comparability among creditors as claims have diverse statutes and features and are held by creditors that may have conflicting interests. Against this backdrop, the role of bond clauses (*Pari Passu*, cross-defaults clauses, negative pledge clauses, etc.) should be further analysed.

6) Fair burden sharing

Principles: debtor and creditors should commit themselves to seeking a fair burden sharing of debt restructuring costs.

Best practices: in order to put the sovereign debt on a sustainable path, it will be necessary to strike a balance between domestic adjustment, additional financing and debt restructuring. In some cases creditors may have to accept a reduction in the net present value of their loans/bonds, which would necessarily complicate the negotiation process. .In that respect, the experience of the Paris Club, as well as private claims restructuring experiences show that this goal can be achieved through a variety of technical solutions tailored to a specific debtor's situation. Similarly the concerns of a given class of creditors, which may face specific needs, could also be accommodated.

[5] IMF, 2002f, The design of the Sovereign Debt Restructuring Mechanism-Further Considerations, Not Published, November 27

Role of the public sector : The Paris Club experience also shows that IMF programs, including debt sustainability analyses, play a crucial role by identifying the degree of creditors' forbearance (e.g. haircut) needed to restore sustainability.

7) Negotiation in good faith

Principles: participants in the negotiation should commit themselves to negotiating in good faith. In particular, while seeking a solution to restore the sustainability of its debt, the debtor should aim at minimising the cost incurred by creditors and at maintaining contracts as long as possible. Similarly, creditors should recognise that the debt restructuring might require a writing down of their claims.

Best practices:

- While the commitment to complying with the CGC should be considered as evidence of good faith, procedures could be defined ex-ante to ensure that interested parties actually enforce the CGC. For example, the decision of creditors to agree on a concerted stay on litigation may be considered as evidence of their good faith.

- To prevent mutual suspicion, a third party could be designated to act as a mediator or an arbitrator (another alternative would be to empower the aforementioned "dispute resolution system" with this responsibility).

Role of the public sector

The IMF lending into arrears policy, which rests inter alia on the assessment of the debtor good faith, could refer to the implementation of the CGC in its assessment of the good faith criterion.

8) Preserving the debtor's financial situation

Principle: participants in the negotiation should strive to preserve the financial situation of the debtor while negotiating. The decision to engage in a re-negotiation process should not lead to a further deterioration of the country's financial situation (notably because of its signalling effect, see above) as it would jeopardise its ability to repay its debt.

Best practices: in the spirit of negotiation in good faith and in order to preserve creditors' rights, some safeguards might be necessary to preserve the debtor's financial situation. A wide array of solutions may be used depending on circumstances :

- For example new money could be granted seniority. In order to stabilise capital flows and preserve market access, a cut-off date might be set, resulting in the exclusion of new money from the renegotiation process. This question may raise legal difficulties regarding the equality of treatment between creditors, notably in the context of negative pledge clauses. The experience of the Paris Club needs also to be looked at.

- The implementation of a concerted standstill of payments, as described in 4), could avoid the depletion of foreign exchange reserves.

Role of the public sector : The IMF lending into arrears (LIA) policy has obviously a key role to play in cases of default. In order to preserve the debtor's financial situation, the LIA will not only provide additional official financing but will also help build confidence around a workable solution backed by a sustainable program.

9) Restoring debt sustainability as soon as possible

Principle: an efficient re-negotiation process should primarily aim at enhancing or restoring, as soon as possible, a country's debt sustainability over the medium term. By committing themselves to working out a long lasting solution, the creditors accept the principle that an agreement that would not restore debt sustainability is not viable and therefore that the net present value of their asset cannot be guaranteed.

Best practices: As a best practice, it should be expected that the restructuring deal will be submitted to the IMF's advise for evaluating its sustainability.

Role of the public sector : debt sustainability analysis carried out by the IMF is to play a decisive role. An IMF program framed under the lending into arrears policy will provide debtor and creditors with a set of economic and financial assumptions consistent with the restoration of medium-term sustainability. Thus, clarifying the link between debt sustainability and access policy under the LIA policy should go hand in hand with the development of the CGC. Even if the re-negotiation takes place in a country that has not requested IMF support, the IMF would need to assess whether the agreement is viable in the context of its Article IV surveillance.

III. The use of the Code of Good Conduct in the context of debt re-negotiation: three illustrative scenarios

In order to illustrate the use of the CGC in the context of debt re-negotiation, three stylised scenarios are considered (see chart in annex 1). Under scenario 1, although the debt is considered sustainable over the medium-term, the debtor faces short-term financing tensions (e.g. increasing spreads), which make it necessary to reduce the debt's sensitivity to shocks. Under scenario 2 the country's debt appears unsustainable over the medium-term, but is still serviced according to original terms and conditions. Under scenario 3 the debtor can no longer meet the original terms of its debt, which appears to be unsustainable.

The flexibility of the CGC allows for a coverage of various situations and notably cases where debt dynamics, albeit fragile, could be sustainable. This comprehensive approach seems all the more warranted that the borderline between debt sustainability and debt unsustainability is all but clear. The CGC is intended to make it possible for stakeholders to adjust their strategy to new developments along the negotiation process.

Clearly, principles will have to be applied differently depending on the situation. Part of the difficulty in designing the CGC is to reach a consensus on the best practices suitable to the diversity of cases.

- **Scenario 1 : alleviating tensions on sustainable debt dynamics**

  Even when debt dynamic is assumed to be sustainable in the medium-term, debt servicing can be under temporary stress. Pro-active debt management, for example a policy to lengthen debt average maturity, may reduce potential debt-service problems. In cases where difficulties to roll-over the debt might put the country on an unsustainable path, a debt re-negotiation could be warranted.

  Several principles and best practices embedded in the CGC (*e.g.* those related to information sharing, early engagement i.e. Principles 1 and 2) could help achieve debt re-profiling without resorting to a re-negotiation of the debt. However, in cases where a re-negotiation is needed, the process should aim essentially at reassuring creditors and at preventing further deterioration of a country's financing conditions. In this context, while no debt reduction or haircut will be necessary, creditors are expected to provide financing at sustainable conditions (Principles 8 and 9). An IMF program might be necessary should the country confront more structural balance of payments problems.

- **Scenario 2 : resolving situations where the debtor seeks to re-negotiate unsustainable debts, while "remaining current" on the original terms of debt contracts**

  A key assumption of this scenario is the recognition by the debtor and other interested parties that sovereign debt is likely to be unsustainable. If a country were to disagree with its creditors and/or the IMF on the prospects for debt repayments, it is likely to face two risks. First it may eventually default, as a result of having been too optimistic about its ability to service its debt. Second, the market sentiment of an unavoidable default may result in a self-fulfilling debt crisis. Agreement on the assessment of debt sustainability is therefore a pre-condition for minimising the cost associated with the suspension of payments.

  Once a consensus has emerged on the unsustainability of the debt, one of the main issues for the debtor is to determine whether it can remain current on the initial terms of its debt. By repaying its creditors according to agreed schedules, a country would limit the risks of additional tensions on financing conditions and would also avert litigation risks. Furthermore a country's commitment to meeting its financial contractual obligations, despite existing difficulties, would be seen as evidence of its good faith. Renegotiating the debt on the basis of the CGC guidelines could facilitate the rollover of existing exposures, the replacement of original contracts and the adjustment of their terms.

  While further work is needed, it is expected that principles and best practices designed to make co-ordination expeditious and effective would be instrumental under this scenario (Principle 4). It should also be expected that information provided to creditors would have to be more comprehensive and more accurate if a significant writing down of claims is needed (Principle 2).

  The official sector has a pro-active role to play in ensuring adherence to the recommendations of the CGC. Indeed, while debt re-negotiation could in theory take place without official intervention, this has been a rare event in practice[6]. Experience shows that successful debt re-negotiations between debtors and creditors are contingent upon an IMF program being agreed prior to the final agreement. Besides, the official sector is expected to provide its own assessment of the viability of this agreement (namely whether it is consistent with medium term-sustainability).

  In practice, the official sector intervention could take various forms:

  - *Moral suasion*. Recent experience (e.g. Brazil 1999[7]) suggests that under transparent conditions (and according to the nature of the debt problem) moral suasion and peer pressure could stabilise private lending.
  - *IMF program*. IMF financing is likely to be necessary under this scenario: it could catalyse private lending by supporting domestic policy measures taken by the debtor.
  - *Paris Club*. Its current policy as regards comparability of treatment has proved instrumental in fostering debt re-negotiations with private investors. It could be agreed that countries' debt would be eligible to the Paris Club framework, when his debt is material, provided that the CGC is endorsed and that the principles of the Paris Club are complied with.

- **Scenario 3 : resolving situations where the debtor is unable to remain current on the original terms of debt contracts**

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[6] Admittedly, Ukraine debt re-negotiation took place outside an IMF program, as the EFF had been suspended at the time the exchange offer was made. Yet, the program had been agreed prior to the initiation of the process and helped frame it.

[7] Although in the case of Brazil in 1999, moral suasion was considered mainly to stem the reduction of private credit lines.

The debtor's inability to remain current on the original terms of debt contracts raises the likelihood of non-cooperative strategies by private investors (*e.g.* risks due to holdout creditors and to weak inter-creditor co-ordination because of very complex debt structures).

Under this scenario, while all the Code's recommendations should be implemented, a key issue would be to ensure adherence to principles and best practices related to stays on litigation and concerted standstills (Principles 4 and 8). Incentives to deter non co-operative strategies should be strengthened. A more extensive use of CACs, by providing procedures to bind holdout creditors, would certainly limit the scope for non co-operative behaviour. As a matter of fact, the CGC could incorporate some market solutions (such as exit consents) that have proved successful in limiting benefits expected from non cooperative strategies.

The role of the official sector under this scenario is likely to be similar to that under scenario 2. A key difference, however, relates to IMF financing. Under this scenario, IMF support would take place through its LIA policy. Implementing the LIA policy would give the official sector the opportunity to assess the compliance of the debt restructuring process with the CGC. This in turn would possibly have consequences on the timing, the scope for, and the sequencing of official financing. For example the IMF assessment of the debtor's "good faith" could be based on the degree of implementation of the CGC's principles. The decision to grant exceptional financing in the context of the LIA could be contingent upon a debt restructuring agreement between debtors and creditors which ensures medium-term sustainability.

IV. Ensuring ownership and setting adequate incentives to ensure effective implementation of the Code

As already suggested, the need for, and the effective implementation of the CGC, relies upon a basic incentive structure, namely the early identification of debt unsustainability and a clear and strict IMF access policy (see below 3).

The experience thus far with the definition and implementation of the standards and codes point to the effectiveness of an approach that relies on internationally agreed principles and best practices. The same positive results can reasonably be expected with the CGC even though, contrary to other codes, the best practices and principles in this area may still need to be recognised as such. That said, peer and market pressures should contribute to deterring stakeholders from deviating from the path agreed upon in the CGC, all the more so since other incentives will be set out with a view to achieving compliance (see below).

Besides, a key feature of the Code, namely its co-operative nature, should ensure its effective implementation. Sections II and III have already highlighted this aspect of the CGC at the various stages of the renegotiation process. Like CACs, the Code seeks to maintain, as long as possible, the contractual relationship between the debtor and its creditors. For the debtor, this would facilitate market re-access after the crisis is over. For creditors, the CGC is expected to reduce uncertainty about the restructuring process without increasing debtor moral hazard (the Code is not a unilateral binding option in the hand of the debtor). More generally, a non co-operative re-negotiation would entail comparatively high costs for all interested parties (low recovery value for creditors and sharp economic adjustment together with loss of market access for debtors). The "market-oriented" nature of the Code and the expectation that the debtor will act according to rules agreed upon (ex-ante) should in principle reinforce market discipline; indeed, the non-cooperative attitude of the debtor, which is likely to be already sanctioned by markets, would become a deliberate breaching of best practices.

But the CGC will not be effective without the endorsement of its key principles by all stakeholders involved in the renegotiation process. Ownership, which is a common feature of other codes and standards, is seen as one of the main incentives for adhering to the Code. This has important implications for the Code's drafting process (section 1) and its endorsement (section 2). However, the

role of the official sector, notably the IMF, with regard to the endorsement and implementation of the Code remains crucial (section 3).

1) The Code's drafting process

The ongoing discussion on debt restructuring mechanisms provides ample evidence that there is strong interest in designing a new framework for orderly workouts. However, it also confirms that views diverge on how best to achieve this objective. The CGC will not be operational unless all major stakeholders recognise its potential benefits and act accordingly. Three categories of stakeholders should be involved in the design of the CGC:

- Representatives from the different categories of public and private creditors as well as other market participants or rating agencies;
- Sovereign issuers, notably emerging markets;
- The IMF which should act as a catalyst in designing the CGC, in coordination with other relevant organisations (e.g. the World Bank, BIS, FSF, etc.).

Different avenues to involve the private sector in the CGC drafting process could be explored, relying upon existing or proposed fora: the IMF has recently created a Capital Markets Consultative Group, whereas the IIF has proposed the creation of a "Private Sector Advisory Group". Alternatively a task force could be set up to work out the principles and content of the CGC, before a wider consultative process is in place (e.g. through the IMF website).

2) Gathering momentum for the CGC : endorsement and initial steps

Once adopted, the CGC will require the active support of the international community to foster its adoption and implementation.

As a first step, the code should be widely endorsed by the private sector (through existing groupings), the official community (e.g. IMFC, Development Committee, the FSF's list of standards) and sovereign issuers (through the G20 [8] or any other relevant groupings).

The endorsement of the Code will need to be followed by concrete steps to promote its effective implementation:

- Emerging countries should signal their willingness to implement the CGC; for example they could commit themselves to explicitly referring to the Code in bond documentation. A publicly available list of countries that have adhered to the CGC (as for the SDDS) could be envisaged.
- The IMF could promote the Code by referring explicitly to its adoption and implementation, for example when assessing a country's good faith in the context of its LIA policy
- The finalisation of the work on CACs could provide best practices in terms of creditors representation to be used in the context of the CGC.

3) Fostering the implementation of the CGC: the role of the official sector

More generally, the international community has an active role to play in the implementation of the CGC at all stages of the renegotiation process:

- First, IMF surveillance and financing policy should help the debtor and creditors to determine the appropriate timing for activating the Code:
  - IMF surveillance, in particular through debt sustainability analyses, is expected to play a crucial role in the activation of the Code as it would help the debtor and creditors to

[8] It is worth noting that the G20, in its November 2002, communiqué has explicitly endorsed the idea of a code of good practices

identify situations where active debt management policy or debt renegotiation might be required.

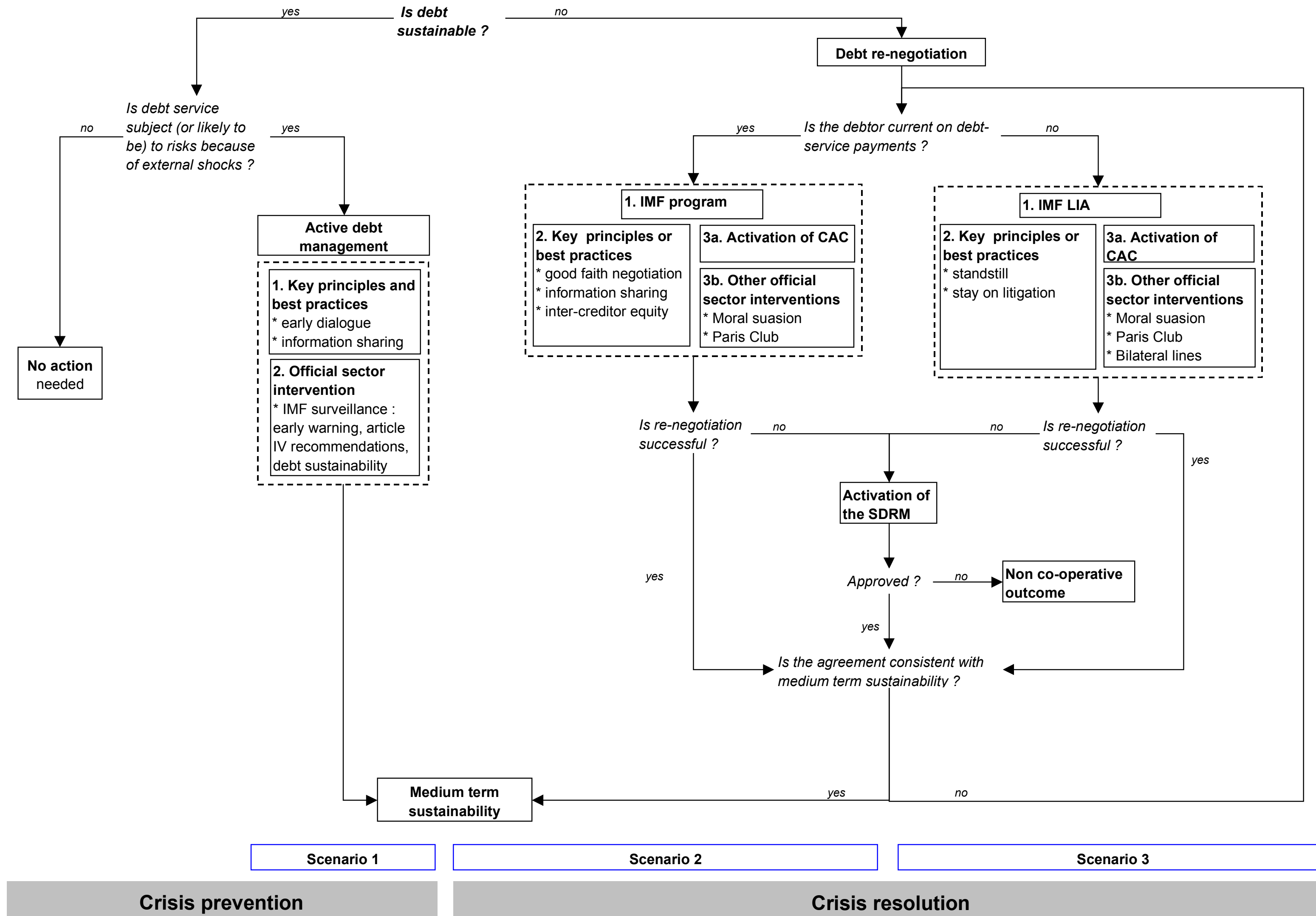
- The Code is unlikely to work properly unless the conditions for accessing IMF resources policy are clearly spelled out. Clear and firm access limits are instrumental in triggering debt re-negotiation. By the same token, the decision to grant exceptional financing in the context of the LIA policy would require an agreement between debtors and creditors on a debt restructuring consistent with the restoration of debt sustainability.

▪ Second, an IMF program is likely to be designed in conjunction with the implementation of the Code. As suggested above, this program will provide parties involved in the renegotiation process with two key "public goods": information (e.g. macroeconomic situation, financing gap, optimal debt structure) and financing. Moreover, program conditionality, notably in the context of the LIA policy, would make operational some principles and best practices listed in the Code. For example, the assessment by the Funds of debtor's "good faith" could be based on the degree of implementation of the Code principle (e.g. the need for a creditor committee).

▪ Third, the Paris Club could advise debtors to implement the Code when calling for comparable treatment by private investors.

▪ Fifth, depending on the nature of the debt crises, moral suasion exerted under transparent conditions could make the implementation of the CGC more effective.

Annex 1: Key questions for preserving or restoring medium term debt sustainability



(a) The diagram assumes the debtor country has no IMF program in place.

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