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Third Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts

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THIRD PROGRESS REPORT ON INCLUSION OF ENHANCED CONTRACTUAL PROVISIONS IN INTERNATIONAL SOVEREIGN BOND CONTRACTS

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INTRODUCTION

1. **The IMF Executive Board endorsed in October 2014 the inclusion of key features of enhanced *pari passu* provisions and collective action clauses (CACs) in new international sovereign bonds.**[1] Specifically, the Executive Board endorsed the use of (i) a modified *pari passu* provision that explicitly excludes the obligation to effect ratable payments, and (ii) an enhanced CAC with a menu of voting procedures, including a "single-limb" aggregated voting procedure that enables bonds to be restructured on the basis of a single vote across all affected instruments, a two-limb aggregated voting procedure, and a series-by-series voting procedure.[2] Directors supported an active role for the IMF in promoting the inclusion of these clauses in international sovereign bonds.[3] The IMFC and the G20 further called on the IMF to promote the use of such clauses and report on their inclusion.

2. **Since that time, the IMF has published periodic progress reports on inclusion of the enhanced clauses.**[4] These reports found that since the Executive Board's endorsement, substantial progress had been made in incorporating the enhanced clauses, with approximately 85 percent of new international sovereign bond issuances since October 2014 (in nominal principal amount) including such clauses. The reports also found that there was no observable market impact on inclusion of the enhanced clauses. However, the reports noted that the outstanding stock without the enhanced clauses remained significant, with issuers showing little appetite for liability management exercises to accelerate the turnover.

3. **This paper provides a further update on the inclusion of the enhanced clauses and on the outstanding stock of international sovereign bonds as of September 30, 2017.** Section II reports on the inclusion of these enhanced provisions, finding that the vast majority of issuers are

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[1] See http://www.imf.org/external/np/pp/eng/2014/090214.pdf (the "2014 paper") and http://www.imf.org/external/np/sec/pr/2014/pr14459.htm.

[2] For descriptions of "series by series" and "two-limb" aggregated voting procedures, see paragraphs 24 and 28 of the 2014 paper, respectively. Note that with respect to a "single-limb" aggregated voting procedure, to safeguard the interests of creditors, the enhanced CAC requires all affected bondholders to be offered the same instrument or an identical menu of instruments (the "uniformly applicable" condition, see paragraphs 33-34 of the 2014 paper) and include a voting threshold of 75 percent of the aggregated outstanding principal of all affected bond series. The enhanced CAC also provides the issuer the flexibility to use the single-limb voting procedure to conduct separate votes for different groups of bond issuances ("subaggregation", see paragraph 37 of the 2014 paper). It also includes a disenfranchisement provision, which, in line with the G-10 approach, excludes for voting purposes all bonds owned or controlled directly or indirectly by the issuer and its public sector instrumentalies (see paragraph 46 of the 2014 paper) and an information covenant consistent with Fund policy (see paragraph 44 of the 2014 paper).

[3] International sovereign bonds are defined as bonds issued or guaranteed by a government or central bank under a law other than the law of the issuer (or where a foreign court has jurisdiction over claims arising under the bond), in freely traded form with fixed maturities, normally in excess of one year. Consistent with the approach taken in past papers, staff has not focused on the incorporation of the enhanced clauses in international sovereign guaranteed bonds.

[4] See http://www.imf.org/external/np/pp/eng/2015/091715.pdf (the "2015 paper") and Second Progress Report On Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts ("the 2016 paper").

including these clauses, with only a few countries standing out against the market trend. Section II also provides an update on the outstanding stock, indicating that while the percentage of the outstanding stock with the enhanced clauses is increasing, a significant percentage of the stock still does not and little action has been taken by issuers to increase the rate of turnover. Section III briefly reports on the use of different bond structures, and Section IV describes the staff's ongoing outreach efforts and next steps.

ENHANCED CONTRACTUAL PROVISIONS

A. Collective Action Clauses

Uptake of Enhanced Clauses

4. Substantial progress continues to be made in incorporating the enhanced CACs in international sovereign bond issuances (see Annex). Based on information available as of September 30, 2017, there have been approximately 350 international sovereign bond issuances since October 1, 2014, for a total nominal principal amount of approximately US$ 400 billion.[5] Of these, approximately 87 percent of the nominal principal amount of new issuances have included the enhanced CACs, as compared with 85 percent as of end-October last year (as a share of total nominal principal amount).[6] From end-October 2016 to end-September 2017, only 10 percent of issuances did not include enhanced CACs. See Figure 1.

5. Only a few issuers continue not to incorporate the enhanced CACs. From end-October 2016 to end-September 2017, these issuers were Lebanon, Korea and the Philippines under New York law and Azerbaijan, Hungary, Malaysia (sukuk)[7], and Poland under English law. Issuances by Hungary under Chinese law and Indonesia under Japanese law also did not include enhanced CACs.[8] Compared to that under English law, the uptake of the clauses under New York law is higher.[9] Of the new issuances, approximately 89 percent of the New York law governed bonds include enhanced

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[5] The figures presented in this paper are based on information available to staff through the Perfect Information database. The sample includes international sovereign bonds issued between October 1, 2014 and September 30, 2017, except: euro area sovereign issuances (as they are required by law to include euro area-specific CACs), China's domestic issuances under Hong Kong law, and GDP warrants. There may also be international sovereign bond issuances (e.g., private placements) that have not been captured by the database relied upon by staff.

[6] For purposes of this paper, "new issuances" exclude reopenings of previous issuances or take-downs under programs established prior to October 1, 2014.

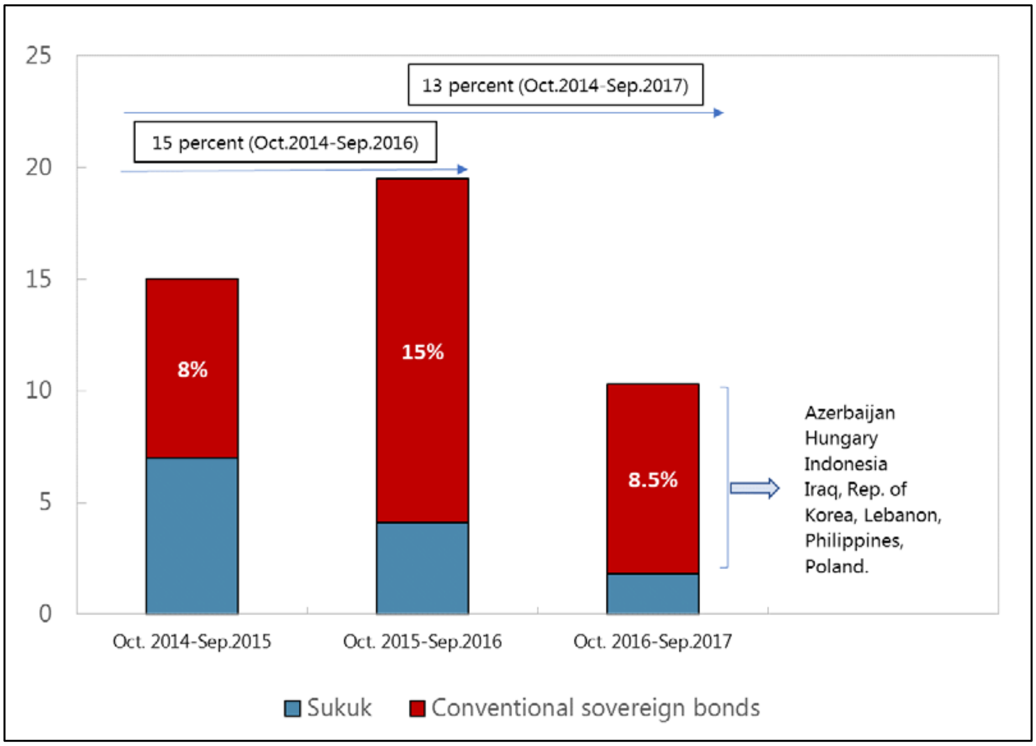
[7] Most issuers of sukuk now include enhanced CACs (e.g., Bahrain, Hong Kong, Indonesia, Oman, Pakistan, Saudia Arabia and Turkey); Malaysia is the exception.

[8] As noted in the 2016 paper, issuances by Korea and Poland under Chinese law also do not include enhanced CACs.

[9] As of September 30, 2017, of the total outstanding stock of international sovereign bonds, approximately 46 per cent are governed by English law and approximately 52 percent by New York law (as a share of nominal principal amount).

CACs, while approximately 84 percent of the English law governed bonds do (as a share of total nominal principal amount) (Table 1).[10]

Figure 1. New Issuances Without Enhanced CACs
(In percent of total issuance principal)



Sources. *Perfect Information* database and staff calculations.

Table 1. Enhanced CACs and Governing Law
(In percent of total issuances since October 2014)

	No enhanced CACs	Enhanced CACs	Total
Engish	6.5	41.3	47.8
New York	6.1	45.8	51.9
Others	0.3	0.0	0.3
Total	12.9	87.1	100.0

Source. *Perfect Information* database and staff calculation

[10] Formulation of the clauses under English law and New York law governed bonds generally track the language of their respective model clauses published by the International Capital Market Association (ICMA): http://www.icmagroup.org/assets/documents/Resources/ICMA-Standard-CACs-Pari-Passu-and-Creditor-Engagement-Provisions---May-2015.pdf.

B. Pari Passu Provision

6. The modified *pari passu* provision continues to be largely incorporated as a package with the enhanced CACs, with some exceptions. In 2014, the Executive Board endorsed a modified *pari passu* provision that explicitly states that the clause does not require the issuer to pay external indebtedness on an equal or ratable basis, thereby significantly mitigating the risk that a court would interpret the clause similarly to the interpretation given by the New York courts in the Argentine litigation. Since end-October last year, all issuances that have included the enhanced CACs also included modified *pari passu* provisions, with the exception of those issued by Sri Lanka under New York law and Bahrain, Indonesia (sukuk), Pakistan and Russia under English law (Table 2). According to English-law attorneys that advise sovereign issuers, the non-inclusion of these clauses issued under English law appears to continue to reflect the view that English courts are unlikely to interpret the *pari passu* clause as requiring that the issuer make ratable payments to creditors.[11] Several issuers—Azerbaijan (under English law), Lebanon (under New York law) and Hungary and Poland (under Chinese law)—which did not include the enhanced CACs—have included modified *pari passu* clauses in their recent issuances. Euro area sovereigns have generally not included modified *pari passu* clauses.[12] While there have been variations in the formulation of the modified clauses, they all specifically disavow the obligation to make ratable payments.[13]

Table 2. Enhanced CACs and Modified Pari Passu

(In percent of total issuances since October 2014)

	No enhanced CACs	**Enhanced CACs**	**Total**
No modified pari passu	8.7	6.6	15.2
Modified pari passu	4.2	80.6	84.8
Total	12.9	87.1	100.0

Source. *Perfect Information* database and staff calculation.

[11] The Financial Markets Law Committee (FMLC), an independent body of legal experts established by the Bank of England to examine issues of legal uncertainty in financial markets, has taken the view that the interpretation of the *pari passu* clause by the New York courts is unlikely to be followed by the English courts (see paragraph 18 of the 2014 paper).

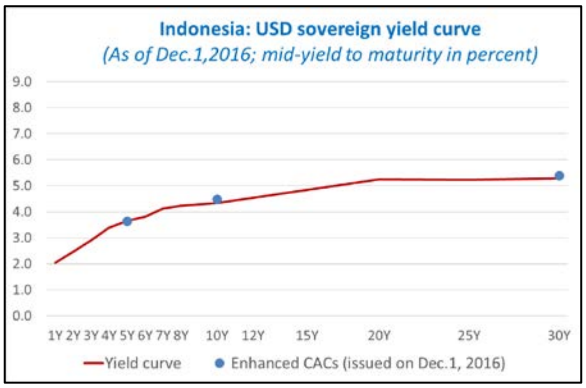
[12] For example, Finland and Lithuania have included modified *pari passu* provisions in their new international sovereign bond issuances, while Ireland and Luxembourg have not. Greece included a modified *pari passu* provision in its pre-October 2014 issuance.

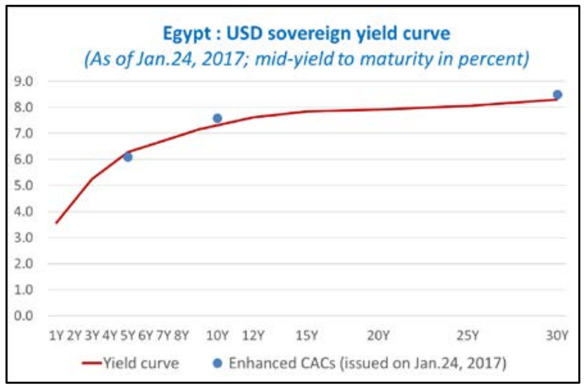
[13] ICMA published in May 2015 two different versions of the model *pari passu* clause—one for English law and another for New York law bonds: http://www.icmagroup.org/assets/documents/Resources/ICMA-Standard-CACs-Pari-Passu-and-Creditor-Engagement-Provisions---May-2015.pdf.

C. Market Impact

7. Consistent with prior observations, the inclusion of enhanced CACs does not have an observable pricing effect, according to either primary or secondary market data. As mentioned in the 2015 and 2016 papers, empirical analyses have shown little impact from the inclusion of CACs.[14] For enhanced CACs, analysis is currently limited to country case studies, given the scarcity of relevant data points. Over the last twelve months, the yields at issuance of bonds with enhanced CACs are aligned with the relevant points on their sovereign curves for both investment grade and noninvestment grade countries (Figure 2). In the secondary market, two major issuers with significant issuance were examined at recent market lows and highs.[15] Bonds with enhanced CACs did not display noticeably higher yields, even during times of stress.[16] Given the multiple market and fundamental factors at work, more systematic analysis is necessary to make definitive conclusions on this topic (Figure 3).

Figure 2. Examples of Primary Market Pricing Impact of Enhanced CACs: Yields at Issuance





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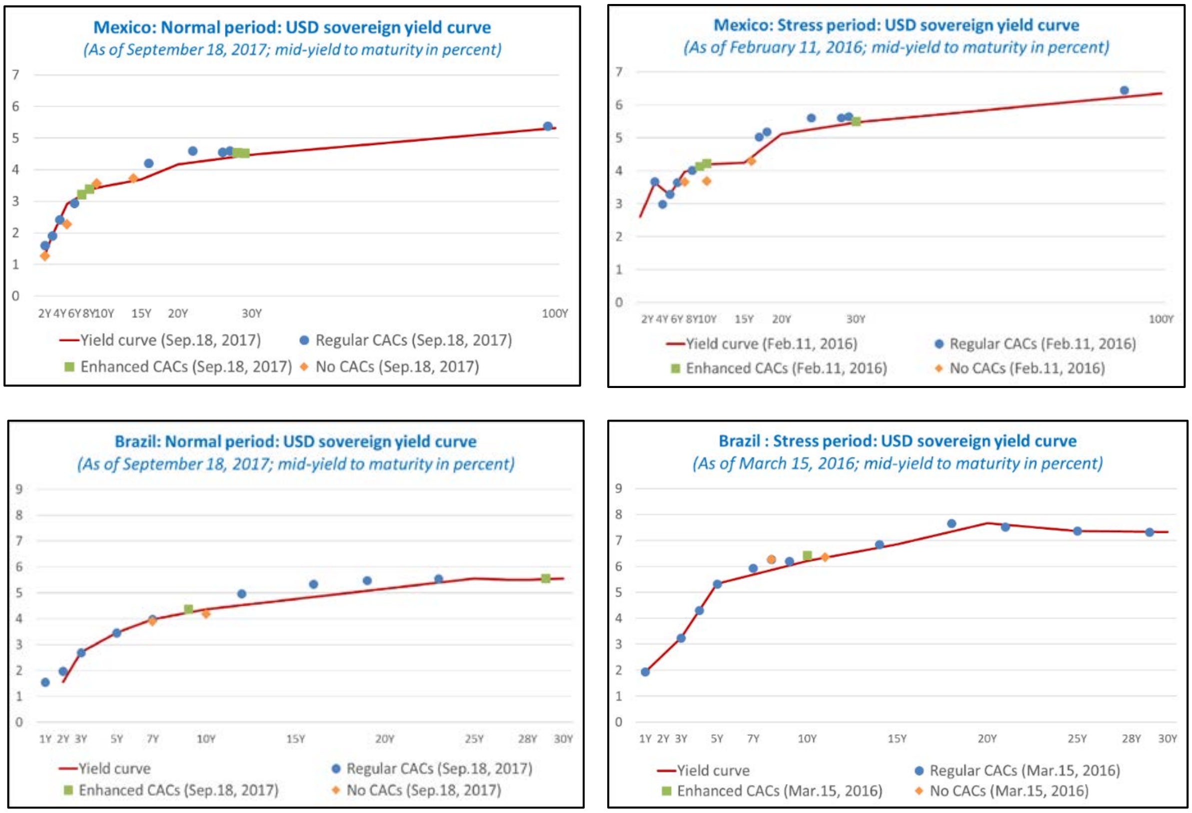
[14] See Eichengreen, Barry, Kletzer, Kenneth, Mody, Ashoka, Crisis Resolution: Next Steps, National Bureau of Economic Research Working Paper No. 10095, November 2003; Bardozzetti, Alfredo, Dottori, Davide, Collective action clauses: how do they weigh on sovereigns? Banca d'Italia, Working Paper No. 897, January 2013. Bradley, Michael, Gulati, Mitu, Collective Action Clauses for the Eurozone, Review of Finance, 2013, pp. 1-58.

[15] Dates were chosen when 5 year CDS spreads for the relevant countries were at a minimum and maximum in the period of 2014-2017.

[16] If investors expect higher recoveries on bonds without CACs, pricing divergence might be greater when the probability of default rises.

Figure 3. Examples of Secondary Market Pricing Comparison of Enhanced CACs: Normal and Stress Periods



Source. Bloomberg LP.

Note. Some non-conventional Mexico bonds are not included.

D. Outstanding Stock

8. The outstanding stock of sovereign debt without enhanced CACs continues to decline slowly, driven by recent large issuances with enhanced clauses. The share of international sovereign bonds that include enhanced CACs grew from 18 percent of total outstanding stock as of end-October 2016 to 27 percent of total outstanding stock as of end-September 2017. Large issuances by Saudi Arabia and Argentina incorporating the enhanced CACs drove this change. However, it will be a lengthy process for existing bonds without enhanced clauses to mature. Around 30 percent of such bonds are maturing in more than 10 years, and 48 percent of them are below investment grade. Of the bonds maturing in more than 10 years, 68 percent of these are governed by New York law, and may pose the highest risk of holdout behavior.[17]

[17] As discussed in the 2014, 2015 and 2016 papers, New York court decisions interpreting the *pari passu* provision in Argentine bonds may strengthen a holdout creditor position in a restructuring. However, the extent to which these decisions will apply to future sovereign bonds is not clear.

9. Sovereign interest in conducting liability management operations to accelerate the incorporation of enhanced CACs has been limited. As mentioned in the 2015 and 2016 papers, this reluctance seems largely attributable to the associated transaction costs. While no issuer has engaged in liability management exercises for the sole purpose of accelerating the incorporation of enhanced CACs in their debt profile, since 2016 the Mexican authorities have conducted an active liability management strategy that, among other benefits, has helped them to substitute part of the outstanding legacy bonds, including those without CACs (pre 2003) and those with series-by-series CACs (pre 2014), into securities that include the enhanced clauses. From August 2016 to October 2017, Mexico has executed four debt neutral (no new net indebtedness) liability management transactions in the international markets that have increased the ratio of bonds with enhanced CACs in its external debt market portfolio, from 18 percent at the end of 2015 to 42 percent at the end of October 2017.[18]

BOND GOVERNANCE STRUCTURES

10. The 2015 and 2016 papers reported on the increasing use of trust structures in New York law-governed bonds. International sovereign bonds are typically issued under either fiscal agency agreements (FAAs) or trust structures.[19] Under an FAA, the fiscal agent serves as an agent of the issuer, and its main responsibility is making principal and interest payments to the bondholders. Under trust structures, a bond trustee acts on behalf of, and has a number of responsibilities to, bondholders as a group. Trust structures provide additional protection against holdout creditors, including limitations on individual creditor enforcement actions and the pro rata distribution of the proceeds of litigation among all bondholders, which disincentivize minority holders to take enforcement actions to disrupt an orderly restructuring.[20] The 2015 and 2016 reports noted that, in light of this additional protection, a number of large emerging market issuers, such as Mexico and Chile, had switched to trust structures from fiscal agency agreements.

11. Staff has continued to monitor the use of trust structures and has noted no marked change. Data show that the percentage of issuances using trust structures is slightly lower than last year: approximately 42 percent (in nominal principal terms) of international sovereign bond issued between October 1, 2014 and September 30, 2017 have used trust structures, compared to 45 percent reported last year, with the vast majority (over 80 percent) under New York law. Issuers under English law still appear to prefer FAAs, which may reflect lack of awareness or that many lower

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[18] The transactions had an aggregate total of approximately US $10 billion. Mexico has reduced the outstanding amount of bonds with no CACs by 25 percent, from US $9.1 billion to US $6.9 billion, and bonds with series-by-series CACs by 20 percent, from US $37.1 billion to US $29.6 billion. As of the third quarter of 2017, Mexico's external debt (including market debt and bilateral credit) represents 23.3 percent of the Federal Government of Mexico's total debt and 7.7 percent of GDP.

[19] Trust structures take the form of "trust indentures" under New York law or "trust deeds" under English law.

[20] See paragraphs 23-25 of the 2015 paper.

income countries that issue under English law may be more sensitive to the higher costs associated with trust structures.

OUTREACH AND NEXT STEPS

12. Staff has continued to promote the inclusion of the enhanced clauses in international sovereign bonds using the three-pronged approach endorsed by the Board in 2014. Staff continues to: (i) collect information on the stock of existing international sovereign bonds, including the use of CACs and *pari passu* provisions, residual maturities, and authorities' intentions regarding future issuances; (ii) engage on related issues with the membership through various fora; and (iii) inform the Board, the G20 and the public periodically on the status of sovereign issuers' inclusion of the enhanced contractual provisions in international sovereign bonds. In particular, staff presented a paper on the benefits of enhanced CACs at the IMF's Public Debt Management Forum in Mexico City, Mexico, in 2017 and liasised regularly with the relevant debt management offices and Executive Directors' offices on these issues.

13. Going forward, staff will continue to promote the inclusion of the enhanced provisions through the three-pronged approach, targeting those issuers who continue to resist including the enhanced clauses. Staff will continue to collect information on incorporation; issue periodic progress reports to the Board which will be published; and engage with the membership. Staff will continue to reach out to the debt management offices and Executive Directors' offices of those issuers who continue not to include the enhanced clauses in their international sovereign bonds. Staff will also consider additional targeted outreach at the IMF's regional training centers. Finally, staff will continue to monitor and assess the viability of liability management operations to address the outstanding stock challenge.

Annex I. Incorporation of Enhanced Sovereign Bond Clauses

International Sovereign Bond Issuance Since October 2014

(in billions of USD)

	Not included enhanced CACs	Included enhanced CACs		**Not included enhanced CACs**	Included enhanced CACs
Albania		0.5	Korea	**1.5**	
Angola		1.5	Kuwait		8.0
Argentina		31.6	Lebanon	**7.8**	
Armenia		0.5	Macedonia	**0.8**	
Azerbaijan	**3.3**		Malaysia	**3.0**	
Bahrain		7.8	Maldives		0.2
Belarus		1.4	Mexico		25.0
Bermuda		0.7	Mongolia	**0.7**	0.6
Bolivia		1.0	Montenegro		0.8
Brazil		4.0	Mozambique		0.7
Bulgaria		6.5	Namibia		0.8
Cameroon		0.8	Nigeria		1.8
Chile		8.6	Oman		11.0
China		0.5	Pakistan	**1.0**	1.5
Colombia		9.3	Panama		3.8
Costa Rica		1.0	Paraguay		1.1
Côte d'Ivoire	**1.0**	2.0	Peru		3.6
Croatia		2.9	Philippines	**6.0**	
Dominican Rep		6.7	Poland	**12.8**	
Ecuador		6.3	Qatar		9.0
Egypt		12.7	Romania		7.7
El Salvador		0.6	Russia		9.9
Ethiopia		1.0	Saudi Arabia		26.5
Fiji		0.2	Senegal		1.1
Gabon		0.7	South Africa		6.8
Ghana		1.8	Sri Lanka	**3.7**	1.5
Grenada		0.2	Suriname		0.6
Guatemala		1.2	Sweden		2.8
Honduras		0.7	Tajikistan		0.5
Hong Kong	**1.0**	1.0	Trinidad and Tobago		1.0
Hungary	**0.3**		Tunisia		2.9
Indonesia	**5.6**	22.0	Turkey	**2.0**	12.5
Iraq	**1.0**	1.0	UAE	**0.5**	
Israel		3.4	Ukraine		16.1
Jamaica		2.9	Uruguay		2.6
Jordan		2.0	Vietnam		1.0
Kazakhstan		6.5	Zambia		1.3

Sources. *Perfect Information* database and staff calculations.