



Munich Personal RePEc Archive

Collective Action Clauses in International Sovereign Bond Contracts - Whence the Opposition?

Häseler, Sönke

Institute of Law and Economics, University of Hamburg

May 2007

Online at <https://mpra.ub.uni-muenchen.de/6314/>
MPRA Paper No. 6314, posted 15 Dec 2007 17:16 UTC

Collective Action Clauses in International Sovereign Bond Contracts – Whence the Opposition?

Sönke Häselér*

May 2007

Abstract

In the debate on strengthening the international financial architecture, which peaked in 2002 after a series of emerging market sovereign debt crises, the universal adoption of collective action clauses (CACs) was the most promising reform proposal. Academics and the official sector had been promoting CACs at least since 1995, yet market practice did not begin to change until 2003. This delay is often attributed to the opposition of investors and sovereign borrower to CACs.

This paper evaluates the publicly stated as well as the suspected private motives of the two sides to block the spread of CACs. It draws on a wide range of existing evidence and adds some new theoretical considerations to show that there is no reason to be sceptical of CACs unless bailouts exist as an alternative crisis resolution mechanism. This conclusion may be of interest purely for the sake of historical accuracy. But more importantly, it may help to better understand any potential future resistance by market participants, e.g. in the process of introducing CACs in bonds governed by German law.

* Institute of Law and Economics, University of Hamburg. I am grateful to Hans-Bernd Schäfer for the initial stimulus and valuable comments to the paper, and to Jasmine Bennöhr for proofreading.

Chapter 1 - Introduction

Problems of sovereign bond restructuring

The third wave of emerging market debt crises in the 20th century began in late 1994 with the Mexican Peso crisis and culminated in the Argentine crisis in 2002. In many instances, sovereign defaults were cured or averted through large-scale assistance from international financial institutions. For example, Mexico was given a \$ 50 billion loan from the United States Treasury, the International Monetary Fund (IMF), the Bank for International Settlements, and the Bank of Canada. Such a 'bailout' of private creditors by the official sector, though suboptimal in many respects, was seen as necessary in the absence of a viable alternative means of crisis resolution. "We lack incentives to help countries with unsustainable debts resolve them promptly and in an orderly way. At present the only available mechanism requires the international community to bail out the private creditors", said Anne O. Krueger, First Deputy Managing Director of the IMF, in November 2001.¹

This pessimistic view of sovereign default is partly grounded in history. Up until the 1930s, particularly Latin American governments issued large amounts of debt in the form of bonds sold to foreign private investors. Most of these countries defaulted on their obligations in the course of the Great Depression. Absent any pre-defined procedures for representing and coordinating the multitude of bondholders, negotiations over debt relief were lengthy, in some cases being concluded only in the 1960s.² As a result, private lending to emerging market sovereigns stopped and was replaced by loans from other governments and international development banks.

By the 1970s, commercial banks had replaced the official sector as the biggest lenders to developing country governments. The second wave of Latin American defaults set in during the 1980s and the banks were seeking to cut their losses and exit the bond market. The opportunity to do so came in the form of the Brady Plan. The non-performing bank loans were transformed into Brady bonds that were sold to international investors at deep discounts, which set the stage for a revival of the sovereign bond market.

When the Peso crisis of 1994 heralded the third wave of defaults, there was reason to expect that this time around, the chances that the private sector would be able to agree on debt relief and thereby to overcome the crisis by itself would be even slimmer than in the past. Firstly, compared to the 1930s, bond ownership was even more dispersed. Furthermore, successive changes in legislation and in the attitude of U.S. courts towards sovereign immunity had opened the doors to bondholder litigation, and thus made successful restructurings even less likely. Secondly, compared to the 1980s, the debt instruments were less flexible and the number of creditors was infinitely bigger. For the restructuring of syndicated bank loans and inter-government loans, the so-called London Club and Paris Club, respectively, provide a forum for negotiations between a relatively small number of creditors, who interact repeatedly and are therefore less likely to act opportunistically (White, 2002). No institution of that sort exists for sovereign bonds.

¹ www.imf.org/external/np/speeches/2001/112601.htm

² For a more detailed description of the development of the sovereign debt markets, see Fisch and Gentile (2004).

Indeed, as of the 1990s, it seemed virtually impossible for a sovereign debtor to obtain debt relief from its bondholders in an orderly manner. The majority of bonds outstanding contained so-called *unanimous consent clauses*, that is, the payment terms of the contract (such as maturity date and interest rate) cannot be amended unless all bondholders agree to the change. In practice, unanimous approval is impossible for several reasons.

First, there is a *communication problem*. Even the remotest bondholder would have to be informed and convinced of the proposed change of terms, however small his share of the issue may be. The holdings of international sovereign bonds are widely dispersed and bonds tend to be in bearer form, making it quite likely that some bondholders will not be contactable. Related to this is the *representation problem*. Often it was not clear who can legitimately speak on behalf of the bondholders when negotiating the restructuring terms with the debtor.

Second, the *heterogeneity* of bondholders means that, in order to achieve full approval, even the investor who is most optimistic about the repayment prospects has to give his consent.³ A restructuring that is welcomed by all bondholders is unlikely to bring any relief to the sovereign.

Third, and most importantly, unanimous consent requirements give rise to opportunistic behaviour on the part of bondholders. If all bondholders but one endorse the restructuring, the holdout investor is in a position of enormous bargaining power vis à vis his fellow investors. In theory, he could demand as a bribe for agreeing to the restructuring as much as the cumulative benefits from restructuring of all other investors and the debtor. But so could another holdout, and another. An unravelling process would ensue, resulting in an equilibrium which makes unanimous consent impossible and everyone worse off: a classic prisoners' dilemma as illustrated in figure 1 below.

		B	
		grant deferment	litigate
A	grant deferment	80/80	60/90
	litigate	90/60	70/70

Figure 1: The debt relief game

Suppose the debtor announces to its two creditors that it must suspend interest payments on the debt for a specified period. If both A and B agree to the rescheduling, the net present value of their investments falls to 80%. But given that A grants deferment, the debtor's ability to pay increases so that B will rationally hold out, accelerate its claims and, if necessary, bring action against the debtor to the detriment of A. Since neither creditor can credibly commit not to litigate, both creditors refuse the restructuring offer in the only equilibrium of the game. Wasteful litigation and delays reduce the payoffs to 70%. Thus there is a serious *collective action problem* resulting from the discrepancy

³ For the implications of creditor heterogeneity, see Fisch and Gentile (2004).

between what is rational for the individual bondholders and what is best for creditors as a group. While collective action problems exist also among banks or governments, these groups of creditors are not nearly as large, diverse, and anonymous as bondholders.

All of these difficulties have contributed to sovereigns hesitating to approach their creditors at times of crisis. If the restructuring process looks to be lengthy and uncertain, debtors are often tempted to admit default only at the last possible moment, thereby aggravating the crisis. While some argue that default must be costly in order to maintain market discipline and keep moral hazard at a minimum, most would agree that a substantial fraction of the losses incurred in disorderly debt crises constitute a deadweight loss that often falls on parties not directly involved, such as the debtor country's population.

These bleak prospects for restructuring sovereign bonds, paired with the apparent lack of alternatives, motivated the series of public-sector bailouts during the second half of the 1990s. However, the turn of the century was accompanied by a turn in the political climate. The Bush administration was much less inclined towards assisting financially troubled developing countries than the Clinton administration, and it pressed for alternatives to bailouts, in particular for 'private sector involvement' in resolving sovereign debt crises. A number of academics joined in rally against bailouts, condemning in particular the moral hazard effects.⁴

The private sector's standard reply to the ensuing reform proposals was that, contrary to Ms Krueger's statement, a possibility to restructure even bonds with unanimous consent clauses in fact already existed and worked sufficiently well. This 'ad hoc' approach revolved around exchange offers. The idea is simple: If the payment terms of the existing bonds cannot be changed, the bonds themselves have to be exchanged. Countries like Pakistan, Ecuador, Ukraine, and Russia were all able to settle their debt problems by unilaterally offering to their bondholders new securities with less stringent payment terms in exchange for the outstanding bonds. In combination with exit consents (discussed in chapter 2), exchange offers received support not only from practitioners but also from academics,⁵ hence it is surprising that they were largely ignored by the public sector despite their success record as a crisis resolution mechanism. Instead, after several years of indecision, the public sector homed in on supporting the universal adoption of collective action clauses in sovereign bond contracts as the most promising way of changing the international financial architecture for better debt crisis resolution.

⁴ See Gulati and Gelpern (2007) for the political background of the debate on CACs. See also Portes (2003): "The first and simplest principle is that big bailout packages cannot and should not continue. IMF resources are stretched, and G7 governments have little appetite for further action..."

⁵ See the literature by Lee Buchheit, a practitioner and academic, who has been credited as "The Man Who Invented Exit Consents" (Gulati and Gelpern, 2007).

Collective Action Clauses

The term collective action clauses encompasses a number of contractual provisions; there is still no consensus as to which set of clauses is best suited to improve debt restructuring. However, two particular aspects are generally thought to be central to the process, so we will speak of CACs only when a bond contract contains both types of provisions.

Majority restructuring or *majority action provisions* enable a super-majority of bondholders (typically two thirds to three quarters) to change the payment terms of the contract, and to make this change binding for all bondholders. Moreover they regulate the conduct of bondholder meetings and set quorum requirements. These provisions thus solve the collective action problem.

Majority enforcement or *non-acceleration provisions* enable a majority of bondholders to prevent an individual investor from accelerating the bond or initiating litigation in the event of default, and to reverse acceleration. Their value lies in reducing the incentives for ‘rogue creditors’ to hold out by making it more difficult to enforce the contract against the interests of the majority.

Other types of CACs that have been discussed include *collective representation clauses*, which determine the way in which bondholders are represented in consultations or negotiations with the debtor; *sharing clauses*, which postulate that any proceeds from legal action against the debtor be shared on a pro rata basis among all bondholders; and *aggregation clauses*, which regulate the aggregation of different bond issues for the purpose of voting on a restructuring.

Collective action clauses are by no means an invention of the last decade but have been a feature of international sovereign bonds governed by English law for more than a century. CACs were introduced into English corporate bonds in the nineteenth century specifically to counter the problem of holdouts, and were soon adopted for sovereign bonds (Lui, 2002). Bonds governed by the laws of Luxembourg and Japan also routinely contain CACs. Taken together, these jurisdictions accounted for around 38% of all outstanding bonds in mid-2003 (IMF, 2003b). Almost all other international sovereign bonds are governed by German (13%) or New York (49%) law, neither of which prohibits the use of CACs. However, until recently the clauses were not common in the US market⁶ and are still lacking in bonds governed by German law, although efforts are underway to promote the use of CACs in the German market.

Despite having been in existence for a long time, CACs appear to have been rediscovered for the purpose of facilitating debt restructurings only relatively recently. Eichengreen and Portes (1995)⁷ was the first of a series of publications and statements, mainly from academics and official sector representatives, that called for the more widespread adoption of collective action clauses. Examples include the G-10 “Rey Report” in 1996, the G-10 report on “The resolution of sovereign liquidity crises” in 1997, the 1998

⁶ Bonds governed by New York law have, however, traditionally contained majority enforcement clauses.

⁷ Eichengreen, B. and R. Portes (1995) “Crisis? What Crisis? Orderly Workouts for Sovereign Debtors” London, Centre for Economic Policy Research. Rogoff and Zettelmeyer (2002) cite much earlier work of the 1970s and 1980s which features reform proposals not dissimilar to the ones discussed today. However, the simple adoption of English-style CACs under New York law does not appear to have been seriously considered before the mid-1990s.

report by the G-22 Working Group on International Financial Crises, as well as a series of speeches by international financial institution officials, most notably Anne Krueger and John Taylor, the Undersecretary for International Affairs at the US Treasury. In 2002, the looming Argentine crisis brought a sense of urgency to the debate and led to the Treasury's increased efforts to find alternatives to bailout (Gelpern and Gulati, 2007).

However, the concerted support for CACs did not have any noticeable effects until March 2003. At that time Mexico made a large issue governed by New York law, but including CACs, and initiated a reversal of market practice in the U.S., where almost all subsequent bond issues have made use of the clauses. Within a year, issuing with CACs had changed from being the exception to being standard. As of February 2006, the share of outstanding bonds with CACs had already increased to 60%.⁸ Yet, the completeness of the shift cannot conceal the fact that there was a time lag of several years between the first public sector endorsement of the wider use of CACs and the first effects on market practice. In the year prior to the shift, the IMF (2002a) noted that "despite broad agreement in the official community on the merits of collective action clauses, official calls for their broader use have had little impact on market practice to date."

The time lag is often attributed to the fact that market participants were for some time strongly opposed to CACs. In particular, borrowers feared that New York law bonds with CACs could be unattractive for investors and therefore hesitated to embrace the new provisions. Investors, in turn, cited a wide range of concern and are reported to have actively tried to discourage issuers from using CACs.

This paper critically evaluates the reasons for the hostility towards CACs that has come from both groups of market participants. It adds to the literature in that to date there is no systematic analysis of the incentives and disincentives that borrowers and lenders had towards CACs. Gulati and Gelpern (2007) arrive at similar insights, but through interviews with bond market decision makers, rather than through economic theory. Contrary to these authors, we follow the more conventional assumption that the clauses have tangible economic value, rather than being merely a signal of political goodwill.

The paper is structured as follows: Chapter 2 examines a number of theoretical aspects of the position of lenders, while the subsequent chapter surveys empirical and other evidence which suggests that investors probably never had a legitimate reason to oppose CACs. Chapter 4 focuses on the position of the sovereign borrowers. The final chapter concludes with some thoughts on the role of the international financial institutions.

⁸ Gelpern and Gulati (2007)

Chapter 2 - Investors

Investor attitude

“Financial markets are hardly slow to innovate; they are criticized for many things but only rarely for their reluctance to develop new financial instruments.”⁹ Therefore inertia is not a satisfactory explanation for the fact that market practice with respect to CACs changed only in 2003, after several years of public sector pressure. At least one, if not both sides of the bond market must have had solid reasons to delay the adoption of the clauses in New York law bonds – that is, if the clauses are as beneficial as their proponents claimed.

Indeed, Jack Boorman (2002, p. 9) of the IMF recognised that “Resistance to CACs has been a persistent theme since the call in the Rey Report in 1995 to include them”. Tsatsaronis (1999, p. 22) mentions a “negative attitude [which] has been clearly documented in a survey of market participants conducted by the G-10 in 1995, as well as through recent statements in the financial press.” In a similar vein, Michael Chamberlin (2002b, p. 6), Executive Director of the Trade Association for the Emerging Markets, said: “I don’t think that collective action clauses are particularly necessary or, at least in the short to medium-term, feasible to implement.”¹⁰ Eichengreen *et al* (2003, p. 7) quote creditor spokesmen as warning that “the more widespread adoption of collective action clauses would be perceived as an erosion of creditor rights”, and that there would be “a prohibitive increase in borrowing costs”.

Naturally, these statements cannot provide a comprehensive description of investor sentiment, which has moreover changed over time. The Emerging Markets Creditors Association (EMCA), together with several other trade organisations, released their “Model Covenants for New Sovereign Debt Issues” in May 2002, which incorporated most of the provisions discussed before in the CACs debate, and signalled the Association’s active involvement in the design of the new clauses. The Institute of International Finance, previously one of the fiercest opponents of collective action clauses, issued a special committee report in April 2002, endorsing the wide-spread use of CACs. Furthermore, “late in 2002, several executives responsible for large emerging market funds contacted the official sector and offered help with getting a country to adopt CACs. They proposed a meeting to reassure high-quality issuers of their willingness to buy CAC bonds.”¹¹ By 2003, open criticism of the CACs initiative was no longer to be found, and more and more industry spokespersons had joined the ranks of the supporters of CACs.¹²

Several authors have attributed this apparent change of attitude to the emerging discussion about the so-called Sovereign Debt Restructuring Mechanism (SDRM). The

⁹ Eichengreen *et al* (2003, p. 33)

¹⁰ They were in fact implemented about eleven months later.

¹¹ Gelpern and Gulati (2007, p. 57). Again, attitudes were not homogeneous. At around the same time, the Mexican Finance Minister “went so far as to write a scathing 13-page letter to [US Treasury Secretary Paul] O’Neill in November 2002, expressing his intractable opposition to both CACs and SDRM.” (*ibid*, p. 62)

¹² See, for example, the remarks of Robert Gray, Chairman of the International Primary Market Association, in Gelpern (2003b)

SDRM was first introduced by Anne Krueger in November 2001 and was further detailed and developed in a series of speeches and papers by IMF officials throughout 2002. It envisaged a number of measures, such as a mandatory process for restructuring, standstills, and a strong role for the IMF, which threatened to encroach upon creditor rights much more than even the most far-reaching proposals for CACs ever would. Eichengreen *et al* (2003, p. 9) speculate that, “[f]aced with the possibility of a more radical solution, market participants, until recently unrelenting critics of collective action clauses, embraced them as, from their perspective, the lesser of evils.” Portes (2003, p. 13) even goes so far as to maintain that the SDRM’s purpose was mainly that of a threat, to be carried out if the private sector does not adopt CACs voluntarily: “The SDRM debate has been extremely useful but seems now to have fulfilled its role of stimulating progress towards implementation of feasible proposals, in particular CACs.” Of Gelpert and Gulati’s (2007, p. 20) interviewees, “only two said that the CACs shift might have happened without the threat of SDRM.”

While it is unclear whether the proposal for the SDRM was in fact created with the sole purpose of making CACs look market friendly, it does seem that the change in market sentiment during the year 2002 was motivated by tactical considerations rather than reflecting genuine growing enthusiasm for majority action. For instance, the issuing of the “Model Covenants” could be seen as an attempt to at least influence the debate on CACs after realising that some progress in that direction could not be avoided altogether. Besides, it has been argued that the “Model Covenants” would have made restructuring even more difficult than it is under unanimous consent clauses.¹³

The IMF effectively dismissed the SDRM as not feasible at its 2003 Spring Meeting, following the landmark Mexican bond issue with CACs under New York law. The subsequent adoption of CACs in almost all new issues seems to indicate that investors have given up any reservations against the clauses. At the very least, though, their opposition in the years prior to 2003 remains a historical fact which has not yet been fully explained.

Moral hazard

Before we embark on that explanation, it has to be stated that there are important reasons for investors to welcome the advance of collective action clauses, besides the wish to avoid having a SDRM imposed upon them. Kletzer (2003) shows that, because of more efficient lending and repayment, CACs yield a welfare gain relative to unanimous consent clauses under any realistic constellation of transaction costs.

An instance of sovereign default is by definition a period during which creditors receive no interest and / or repayment of principal. Once default has occurred, CACs are clearly valuable to investors by making it easier to reach a restructuring agreement so that

¹³ Simpson (2006), Gelpert and Gulati (2007). The “Model Covenants” set a very high voting threshold for majority action and at the same time made exit consents almost impossible, thus rendering bond restructurings even more difficult.

payments can recommence.¹⁴ If the estimated probability of full repayment during default is sufficiently low, a reduction in the principal to be repaid will benefit creditors as the expected recovery rate increases, discount rates fall, and the market value of the debt rises. Furthermore, a restructuring agreement reached after negotiations between creditors and the debtor is more likely to benefit creditors than a unilateral exchange offer, possibly reinforced with exit consents. We will discuss and analyse in turn the reasons why, according to some spokespersons, investors would rather forego these benefits.

The most often-cited objection to CACs was that they might make restructurings easier for the sovereign, and therefore more likely to happen. Creditors were, and perhaps still are afraid of opportunistic defaults, i.e. situations in which the sovereign is able, but not willing, to repay its debt, or situations in which the sovereign is squandering its credit, knowing that it will be relatively easy to obtain a partial debt relief: a classic case of moral hazard.¹⁵ According to Chamberlin (2002a, p. 8), “Sovereign bondholders are genuinely concerned that making sovereign bonds easier to restructure will make restructurings (even) more likely.” Theoretical models of debt restructuring confirm this concern, e.g. Eichengreen *et al* (2003). If “making default unspeakably horrible was a necessary counterpart to the challenge of collecting from a sovereign government, most of whose assets are inaccessible to creditors”,¹⁶ then the advent of CACs would increasingly see sovereigns voluntarily defaulting and taking the risk of attachment of overseas assets, or so some investors feared. In that sense, investors face a time inconsistency problem: *Ex ante*, they want to make default as costly as possible to the sovereign in order to minimise moral hazard. But *ex post*, i.e. when default has occurred, they would prefer to benefit from faster restructuring as afforded by collective action clauses, so that debt service can continue.

Such thinking disregards what is probably the strongest incentive a sovereign has to service its debt, namely continued market access. In a debt situation with practically no collateral and no international institution that could unconditionally enforce creditor claims, considerations of reputation are of course of utmost importance. Any sovereign who defaults will experience a sharp increase in borrowing costs, but the consequences are likely to be especially dire if market participants suspect that the default may have been opportunistic, rather than inevitable. As default becomes less costly with the introduction of CACs, sovereigns lose a commitment mechanism, and will therefore value their reputation with financial markets even more highly. Thus it is anything but certain that CACs lead to more defaults.

Esho *et al* (2004) provide some empirical evidence on the moral hazard effect of CACs, whose presence or absence is proxied by the choice of governing law. They regress the use or non-use of CACs in a sample of 2,749 corporate Eurobonds issued between 1993 and 2002 on a number of interesting explanatory variables, most notably on the use of public versus private placement. The results show that private issues are

¹⁴ Tsatsaronis (1999) reports that the recovery rate for an international bond which has been in default for two years is estimated at around 25%. This is the kind of situation in which a speedy restructuring becomes very desirable for investors.

¹⁵ This is the first type of moral hazard in a sovereign credit situation. The second type arises in the relationship between the sovereign and international financial institutions (IFIs), who may feel obliged to provide a bail-out. There exists a third type, which is not commonly recognised, namely between the IFIs and the lenders.

¹⁶ Gelpert (2003a, p. 5)

highly significant in explaining the use of collective action clauses, which the authors interpret to mean that issuers regard CACs and private placements as complements. According to their reasoning, issuers choose private placements to enable better monitoring of the borrower if a bond carries CACs which would otherwise exacerbate moral hazard.

Despite the high level of significance, there seems to be a distinct possibility that the relationship between governing law and distribution channel is spurious. The study relies heavily on the assumption that issuers make a very careful decision about governing law and collective action clauses; however, anecdotal evidence suggests that this is not the case.¹⁷ An issuer might decide to borrow in pounds sterling, which generally entails the use of UK law and thus CACs, and if private placements just happened to be more common in the UK than in other markets, the results of the study would be obtained without any underlying causation. It seems likely that a series of interviews with issuers and underwriters would in fact dispel the paper's imputation about causality.¹⁸ A more general point of criticism is that the authors repeatedly refer to the debate on sovereign debt restructuring, even though their sample consists entirely of corporate bonds. Clearly corporate borrowers and their lenders have a different view on CACs than sovereign borrowers and their lenders do, so that the importance of the study in the sovereign debt debate should not be overrated.

Majority enforcement

Part of the scepticism about collective action clauses seemed to revolve around the concern that they could lead to an erosion of creditors rights, in particular with respect to "the legitimate right of creditors to enforce their claims".¹⁹ "Contracts, even sovereign debts, should be enforceable. There is a growing perception in the bondholder community that they are not, and that creditor rights should be strengthened, not weakened", said Michael Chamberlain in 2002.²⁰

However, enforcement is largely independent of the presence of CACs, at least if we abstract from the effects of majority restructuring provisions, which are discussed below. The rules of enforcement are mainly governed by majority enforcement clauses, which have traditionally been a feature of both English and New York law bonds. Four aspects of majority enforcement are important in the context of enforcement against a sovereign

¹⁷ See Richards and Gugiatti (2003), discussed in chapter 3. It could be argued that issuers seem to have given some consideration to the questions of governing law and collective action clauses in recent years, but certainly much less so in the period covered by Esho *et al.*

¹⁸ The paper presents several other interesting, but arguably somewhat shaky results. For instance, it is found that firms with high intangible asset ratios tend to avoid CACs because, so the authors argue, a high level of intangible assets creates information asymmetries between the borrower and its lenders, and the firm will choose unanimous consent clauses to signal that it will not take advantage of these asymmetries in a restructuring. Here, again, the assumed chain of causation is rather involved, suggesting that the results may be spurious. The following explanation for the finding is much simpler and implies no causation: US firms customarily issued without CACs, and they also tend to have high intangible asset ratios purely because these ratios are usually higher in advanced economies such as the United States.

¹⁹ Chamberlin (2002b, p. 3). This was said in the context of the SDRM though.

²⁰ *Ibid*, p. 6

debtor: Acceleration, reversal of acceleration, initiation of legal proceedings, and sharing.²¹

Acceleration refers to the ability of bondholders to declare the bond payable immediately if it falls into arrears. This allows them to sue the borrower for the entire principal, rather than just the missed interest payments. Thus, absent the right to acceleration, bondholders have very little incentive, either individually or collectively, to initiate legal action against the sovereign.

If *reversal of acceleration* is possible, a qualified majority of bondholders can render any attempts by maverick investors to litigate unprofitable. Reversal of acceleration can act as an important counterbalance to prevent a ‘grab race’ where individual acceleration is possible.

Sovereign bonds also differ in their rules regarding the *initiation of legal proceedings*. This right rests either with each individual bondholder or with the representative of a certain proportion of bondholders.

Finally, a bond contract may stipulate that the proceeds of any legal action against the debtor be shared among all bondholders on a *pro rata* basis. Such *sharing* clauses are perhaps the simplest and most effective deterrent against maverick litigation.

Bond contracts often differ along these four dimensions, depending on their administrative structure. In the United States, the most common form is that of a *fiscal agency agreement*, where the fiscal agent has no relationship with the bondholders other than to make payments of interest and principal. By contrast, English law bonds are often issued under a *trust deed*. The trustee acts on behalf of the bondholders and has substantial powers to enforce their claims against the sovereign.

Table 1 shows how majority restructuring provisions are typically implemented under fiscal agency agreements and trust deeds.

	Fiscal Agency Agreement	Trust Deed
Acceleration	sometimes an individual bondholder can accelerate her own bonds; usually a vote by 25% can accelerate the entire issue	not possible individually; trustee can accelerate independently or when instructed by 25% of outstanding principal
Reversal of Acceleration	possible in most cases, 50% or 75% majority required	not possible (can be achieved with majority restructuring)
Initiation of Legal Proceedings	by individual bondholders	delegated to trustee (independently or when requested by 20-25%)
Sharing	no	yes

Table 1 – Enforcement under fiscal agency agreements and trust deeds

It is not possible for an individual bondholder to pursue legal action against the debtor under an English-style trust deed. Under a fiscal agency agreement, however, some bonds allow individual legal action and acceleration, and the bondholder is not obliged to share

²¹ See Liu (2002) and Buchheit and Gulati (2002)

the proceeds of litigation. Thus, many American investors have a marginally better standing with respect to enforcement than their counterparts under English law, but this is due to different issuing structures, not to CACs. The recent inclusion of CACs in New York law issues will have made little or no difference to investors wishing to sue a sovereign in default, although this may not have been foreseeable at the early stages of the debate. If trust structures become more commonplace in the US, as championed by the International Primary Market Association,²² the differences will become even smaller.

One may ask whether the right to individual enforcement action against a defaulting sovereign is actually in the interest of creditors as a group, as opposed to being beneficial only for the claimant and detrimental to all others. In a sense, this is a question also about economic efficiency, for if the answer is that individual action is not in the interest of creditors, it is unlikely to benefit any other concerned party, and could therefore be considered to be inefficient.

The desirability of majority enforcement provisions and in particular of limited access to legal remedies depends very much on the view one takes of sovereign default. At one extreme, default may be understood as a situation in which the debtor simply cannot raise enough finance to service its debts. The sum available for distribution is fixed so that credit enforcement is at best a zero-sum game: one creditor's gain is another creditor's loss.²³ From the creditors' perspective, lawsuits do not create value but merely result in costly redistribution. In the absence of sovereign insolvency procedures, there is the danger of a 'race to the courthouse', which benefits few investors at the expense of many. This is of course exactly the view taken by proponents of collective action clauses. If defaults are like this, then the right to individual enforcement is not just worthless to creditors as a group, it is outright harmful.

A zero-sum game may exist between a sovereign's creditors in the widest sense, but it need not exist within each creditor class. If we assume that the negative externality of one bondholder enforcing his claims are borne at least partly by other creditor classes, bondholders in aggregate may gain from the enforcement. While enforcement remains inefficient at the level of all creditors, individual groups have reason to protect their right to legal action, particularly if they are powerful relative to other groups of creditors.

Most creditors would of course strongly debate the notion that a troubled debtor only has a fixed amount of finance available for debt service. A government almost always has the option to raise taxes or to cut spending so as to increase its debt servicing capacity, up to the limit of what is politically feasible and prudent. Moreover, default may have been the result of squandering the credit, spending it on unproductive uses or simply allowing it to drain away in the debtor's bureaucracy. According to this view, which evidently underpins the reasoning of creditor interest groups, all default is to some extent voluntary and the right to individual legal action is pivotal in maintaining debtor discipline. Moreover, the costs of a creditor going to court are borne not by fellow creditors but by the debtor country's population – who, in a sense, are also creditors but are not represented in the debate in the way that for example bondholders are.

The merits of individual legal action also depend on the type of crisis. In the case of a temporary liquidity gap, a lawsuit will almost certainly reduce aggregate value. This is not least because potential new lenders may misread it as a signal of a more severe debt

²² See Gelpern (2003b)

²³ We say "at best" because debt enforcement can easily be seen as a negative sum game; see White (2002).

crisis, in which case the country could lose its market access so that the concern becomes self-fulfilling. By contrast, the case for individual action is probably stronger with respect to fundamental debt crises.

To sum up, we have seen that concerns about (presumably U.S.) investors' rights to legal remedies should not be used as an argument in the debate on CACs because these rights depend mainly on the administrative structure of a bond.²⁴ Moreover, the value of such rights to the creditor community at large is questionable.²⁵

Majority action

While collective action clauses do not impact on bondholders' recourse to legal action in principle, they significantly reduce the number of situations in which litigation is feasible. The use of the courts is especially appealing and important to holdout creditors who reject an exchange offer for a bond without CACs. Majority action provisions, by binding all bondholders to a restructuring endorsed by the required majority, preclude that course of action.

Thus another potential reason for investors to distrust collective action clauses is the dislike for being part of the minority upon whom a restructuring can be imposed. Such a situation could be particularly unacceptable to American investors who, at least until 2003, were not typically exposed to majority action. The US Trust Indenture Act of 1939 (TIA) specifies that no bondholder may be forced to cede any claims he has under a bond contract (Liu, 2002). While the TIA applies only to corporate bonds, sovereign bonds governed by the laws of New York until recently did not typically include majority action provisions, although calls to include them date back at least to the Rey Report. Buchheit and Gulati (2002), amongst others, speculate that the traditional lack of majority action provisions in New York law bonds may be due at least in part to American investors' aversion to such clauses.

However, a comparison between restructurings with and without majority action clauses shows that this attitude may be unfounded. As mentioned earlier, bonds requiring unanimous consent for a change of payment terms are usually restructured through exchange offers. The relief afforded to the debtor by an exchange offer is likely to come at a high price in any outcome: If the offer is to achieve a high participation rate, it must be so attractive to the bondholders that it cannot offer much relief to the debtor. Conversely, if the offer is designed to be more favourable to the borrower, participation will be low so that the cost of servicing the large number of remaining old-style bonds is high. Paying off the holdouts in full is unfair to the more cooperative bondholders, but to default on the remaining bonds is to risk litigation and the attachment of assets.

To reduce these costs, exchange offers are often accompanied by so-called exit consents. Exit consents can be used as a strategy by which each investor who accepts the

²⁴ One might almost say that some US investors appear to view their individual right to sue a sovereign in default in much the same light as they view their right to carry a gun: As an expression of personal freedom, without much practical use, but with the potential to cause much harm.

²⁵ Bedford (2005, p. 104): "[F]rom an efficiency perspective, coordinated litigation may be preferable to bondholders pursuing their claims individually."

exchange offer must simultaneously vote to change certain non-payment terms of the old bonds, which require only a modest majority even under New York law. These changes in the non-payment terms have the intention of sharply reducing the value of the old-style bonds held by those who resist the exchange offer. Examples include withdrawing the right to individual legal action or changing the terms in such a way that the bond can no longer be traded on the stock exchange, making it almost worthless for the dissident bondholder.

Through the use of exit consents, it may be possible for the debtor to design the terms of an exchange offer such that the participation rate is just above the level required to change the non-payment terms of the bond. If this is achieved, the remaining bondholders will be under strong pressure to also relinquish their bonds before they lose a large part of their asset value. Thus, a considerable degree of coercion exists in restructurings under either regime. The better legal standing enjoyed, and in the past sometimes fiercely defended, by most investors under U.S. law in fact has very little practical value.

Fear of abuse

Bondholder representatives have expressed the concern that majority action provisions could be abused by debtors who, either directly or through entities under their ownership or control, buy back a sufficient share of a particular issue to vote for a restructuring that runs squarely against the interest of the remaining bondholders. However, Liu (2002, p. 6) already stated that “some sovereign bonds specifically exclude the bonds held by or for the benefit of the issuer for quorum and voting purposes”. Similar disenfranchisement provisions were contained in the Model Clauses proposed by the “gang of six” trade associations and have since been a general feature of the wave of issues with CACs under New York law.

It could be argued that the exclusion of certain bonds from voting can be ineffective if the debtor is in a position to abuse majority action provisions through informal influence:

Domestic investors may hold a large portion of the principal of a specific issue with collective action provisions, either as a result of secondary market trading or heavy domestic participation in the primary market. Such investors, while not under the legal control of the debtor, may nevertheless be subject to moral suasion. This creates a risk that debtors may be able to engineer support for a restructuring which is not supported by a majority of non-resident investors.²⁶

Granted, no refinement of collective action provisions can completely rule out abuse, but then scope for opportunistic behaviour on the part of the debtor exists also under unanimous consent clauses. Moreover, to say that a debtor will jump at the chance to exploit bondholders as soon as debt contracts change is again to underestimate the disciplinary effects of reputational considerations. The benefits for a sovereign of rigging a restructuring to the detriment of the minority are limited to one bond issue at a time. By contrast, the reputational consequences for the sovereign extend not only to that issue, and not only to all classes of credit, but most likely to all its external economic relations.

²⁶ IMF (2002a, pp. 11)

Abuse is not worthwhile unless a debtor has an unrealistically high discount rate and a very unusual debt structure.

Voting thresholds and investor surplus

The publication of EMCA's 'Model Covenants for New Sovereign Debt Issues' in 2002 indicated that investor representatives no longer refused to accept collective action clauses as such, but that they objected to the standard voting threshold of 75%. For example, the 'Covenants' required a 95% majority to amend payment terms, which, in the view of the IMF (2002a, p. 14) "may effectively defeat the purpose of the majority restructuring provision." To justify such high thresholds, creditors have cited fear of abuse of the type mentioned above, as well as more general concerns of opportunistic behaviour on the part of the debtor due to increased moral hazard. Moreover, they claim, CACs can be effective even with very strict voting requirements because "some experience suggests that no more than 2 to 3% of any debtor country's bonds have been held by free-rider creditors that refused to participate in a restructuring".²⁷ "If the perceived size of the potential hold-out problem in any specific debtor country is 2-3%, there does not seem to be any justification for collective action clauses that operate with any percentage less than 90-95%. Clauses with lesser percentages would, in effect, seriously intrude on the legitimate rights of creditors not to be bound to changes in debt payment terms made against their will."²⁸

While, as discussed above, such arguments are partly unfounded, there is a more immediate reason for investors to insist on unanimous consent, or at least on very high voting requirements as a second best outcome if the first best is no longer politically feasible. Informally speaking, the higher the voting threshold, the more bargaining power rests with creditors, and therefore the better is the offer that creditors can expect to receive in a restructuring. This point can be made slightly more formally using the graphic model below.

Assume the following simple setting: A sovereign debtor encounters financial troubles and decides to make use of the collective action clauses contained in its bonds by proposing a set of amendments to the bond terms. In figure 2, the horizontal axis measures the proportion of bonds in a particular issue whose holders will support the restructuring offer. The vertical axis measures the bondholders' valuation of the bonds with the existing terms, relative to the proposed post-restructuring terms. Seen from the borrower's perspective, it denotes the bribe that can buy sufficient votes to achieve a given required majority threshold to reach a restructuring agreement.

Bondholders are ranked along the supply schedule S_1 according to their relative valuation of the old and new bond terms. At the bottom end of S_1 , we find those investors who are most enthusiastic about the new terms, or most pessimistic about the repayment prospects of the existing bonds. They would be willing to pay for the right to participate in a restructuring, or, in other words, to receive a negative bribe. For very high rates of consent, even the most reluctant bondholders would have to be persuaded – or bribed – to tender their votes. That includes investors who hope for a positive economic shock and

²⁷ Chamberlin (2002a, p. 5)

²⁸ Chamberlin (2002b, p. 6)

subsequent full repayment, or who intend to satisfy their claims through legal means. Since it is not possible to distinguish between individual bondholders with their varying degrees of willingness to agree to the proposed restructuring, every bondholder must be paid the bribe that is necessary to buy the most expensive vote.

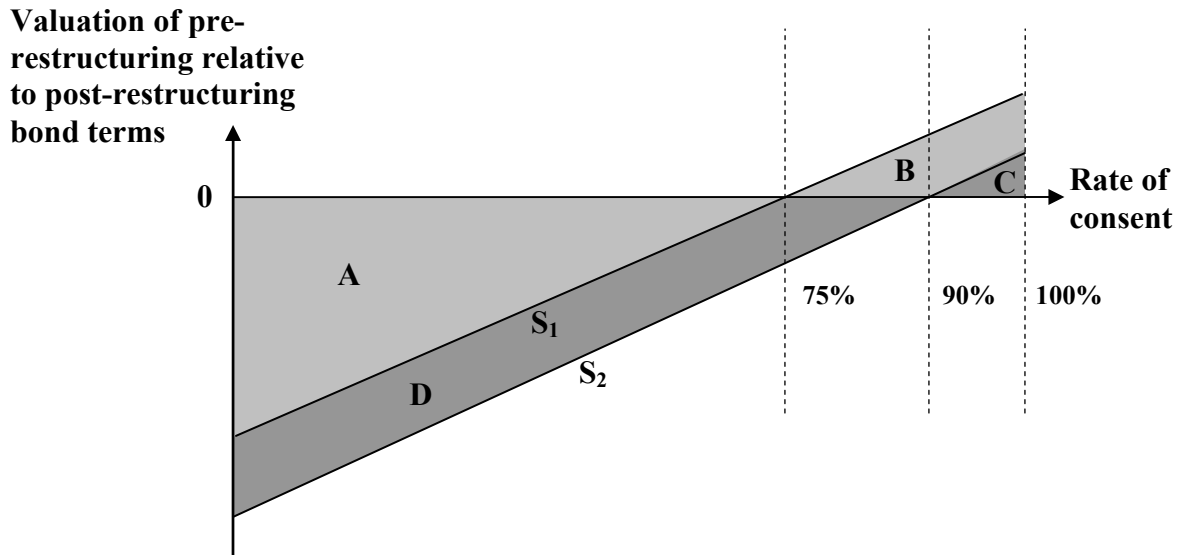


Figure 2 – Voting thresholds and investor surplus

The upward sloping supply of votes is intuitively appealing but inconsistent with standard financial market theory: In a perfect market, differences in expectations would disappear as optimistic investors buy up the claims of the more pessimistic ones. It is reasonable to assume that this will not happen in the present situation for two reasons: First, the pessimistic bondholders hope that the restructuring offer will fail and therefore do not offer their bonds to the optimists or to outside investors. Second, it is not unrealistic to think that none of the optimists are prepared to have so large a holding of this high risk debt as to buy out all of the pessimists, not least because this strategy would only pay off in the uncertain case that the restructuring goes through.

Because no bribes can be paid in an actual restructuring, the supply schedule must intersect the horizontal axis at or to the right of the required majority level. The sovereign will try to make an offer that is only just attractive enough to achieve the required threshold. To achieve 75% majority, the sovereign will propose a set of bond terms that give rise to S_1 . This leaves all bondholders up to the 75% level with a surplus – they can expect to receive a revised bond contract which they consider to be more valuable than the one they currently hold. Those beyond 75%, when bound by the restructuring agreement, will suffer a perceived reduction of wealth. Thus the ‘investor surplus’ under S_1 equals the area $A-(B+C)$. A higher voting threshold, say 90%, requires a better offer from the borrower. When the proposed terms are more attractive to the bondholders, any given level of support for the offer can be achieved with lower bribes, so the supply schedule shifts downwards to S_2 . Investor surplus is now $A+D-C$. Moving the voting

threshold from 75% to 90% increases investor surplus by B+D. Thus it is evident that investors have a strong incentive to lobby for high voting thresholds.

Adjusting yields

The initial rejection of CACs by some investors is puzzling for another, very basic reason: The more widespread use of the clauses could not be expected to have any influence on the wealth or income of bondholders. Bondholders cannot be forced to exchange their existing bonds with unanimous consent clauses for ones with collective action clauses, and the value of their existing bonds is unlikely to be affected by the advance of CACs.

If the majority of investors perceived the added risk of bonds with CACs as outweighing the benefits, efficient markets would ensure that their yields rise until the marginal investor becomes again indifferent between the two types of bonds. Those investors who do not feel adequately compensated by the higher yields can choose from an almost infinite number of assets with similar characteristics as substitutes for their bonds.

Therefore any welfare analysis of CACs can safely ignore the effects on bondholders, except for one consideration. The attitude of investors matters in the respect that their hesitation to accept CACs could lead to higher borrowing costs and / or a reduced supply of loanable funds for emerging market borrowers, to whom alternative sources of finance are not easily available. However, the evidence presented in the next chapter shows that this is not the case.

Summary

This chapter has sought to evaluate some of the main concerns investors have cited as a reason for their reluctance to embrace the more wide-spread use of collective action clauses. It has been illustrated that most of these concerns are at best only partly founded:

CACs may or may not increase moral hazard; majority action and majority enforcement clauses were feared to preclude rights which many investors do not have in the first place or which have very little value; and the ability of borrowers to abuse CACs has been significantly reduced by the voting procedures specified in recent bond issues. Investors' preference for high voting thresholds is understandable, but not for the reasons they provide, as the model of investor surplus shows. Finally, it seems likely that CACs do not materially affect bondholder wealth anyway.

Before we try to account for the deficiencies in investors' arguments in the conclusion, the next chapter examines whether bondholders 'put their money where their mouth is', i.e. whether their alleged hostility towards CACs is reflected in bond yields. If that were the case, we would expect bonds with CACs to carry higher yields, so that investors are compensated for the added risk of such bonds.

Chapter 3 – Bond Yields

Methodology

Since 1999 a number of authors have sought to establish empirically whether the presence or absence of CACs has an impact on sovereign bond yields. The most obvious way to do this is to compare the yields of bonds that typically include the clauses (i.e. mainly those governed by English law) to those that do not (New York (until 2003) and German law). The basic methodology of the regressions is usually very similar. The dependent variable consists of the yield spreads (relative to a riskless security of the same maturity) of a large sample of bonds, taken either from the primary market over a period of time or from the secondary market at a specific date. Arguments have been put forward as to why data from either type of market is superior to the other, but the results do not differ systematically.

The explanatory variables usually comprise a set of borrower-specific (such as credit ratings) and bond-specific (such as time to maturity, currency, issue size) characteristics of an issue as controls. The independent variable of interest, namely whether or not a bond features CACs, is often proxied by the governing law of the bond, for example it might be a dummy variable coded “1” if the bond is governed by laws which allow CACs, and “0” otherwise.

This chapter presents the methodology and results of the five major empirical studies on collective action clauses and sovereign bond yields in chronological order.²⁹ It discusses the implications of these results on the debate on CACs and concludes with two other types of evidence of investor sentiment.

Tsatsaronis (1999)

Tsatsaronis (1999) was the first systematic investigation into the yield effects of CACs. The sample includes 263 international sovereign bonds issued between 1990 and 1999 whose principal exceeds \$ 300m. Dummy variables for New York, English and German law are used as “rough, but informative, proxies” for the presence of collective action clauses.

The results show that the yields of New York law bonds are lower at the 10% significance level, whereas English law bonds, which include CACs, have higher spreads; however the latter coefficient is not significant. The author emphasises that the importance of the results should not be overestimated for two reasons. Firstly, a Wald test for the difference between the English and New York governing law coefficients fails to

²⁹ Two widely-cited studies are not discussed here for methodological reasons: Dixon and Wall (2000), and Petas and Rahman (1999). Both papers list a small number of cases in which a borrower issued a pair of bonds with similar characteristics, except that only one of the bonds includes collective action clauses. This is a simple but informative method of isolating the effect of CACs on bond yields. Both papers find no noticeable effects. We do not present the results in detail because they do not lend themselves to statistical tests.

reject the null hypothesis at the 5% level. Secondly, the significance of the New York law variable disappears in alternative specifications of the model.

Tsatsaronis concludes by pointing to the possibility that the debate on CACs may sharpen investors' focus on such clauses, so that clearer differences in the trading performance under different governing laws may yet arise. However, as we will see, the opposite is the case. Subsequent, more elaborate studies have tended to confirm these initial results.

Eichengreen and Mody (2000)

Eichengreen and Mody construct a sample of more than 2,000 international corporate and sovereign bonds issued between 1991 and 1999. The methodology is somewhat more sophisticated than that of Tsatsaronis (1999). Because of likely endogeneity problems involving the choice of governing law, they use an instrumental variables approach. First, the authors estimate an equation predicting the choice of governing law (New York, English, or other), then the predicted values from that regression, rather than the actual values, are used as the proxy for the presence of CACs in the yield equation. Additionally, because yields are only observed when an issue is actually made, the authors estimate a sample selection model.

The simplest version of the regression delivers a coefficient on the English law variable which is negative but not significantly different from zero. The main innovation of the paper is introduced in subsequent specifications of the model: Borrowers are distinguished according to their credit rating. This is achieved through the interaction of the rating and governing law variables. According to the results, when issuing under English governing law, a high-rated borrower can expect to pay significantly lower yields compared to governing laws which do not entail the use of CACs. Conversely, the market will demand a significant yield premium from a low-rated borrower for its use of the clauses. These effects have the same sign but are less pronounced when the sample is restricted to sovereign bonds only.

By way of explanation, the authors hypothesise that when the likelihood of default is low, the market tends to reward the benefits of faster restructuring afforded by CACs, while investors do not believe that such borrowers will be tempted by the relative ease of opportunistic defaults under CACs. By contrast, CACs are perceived as causing severe problems of moral hazard for low-rated borrowers, whereas the benefits of faster restructuring are relatively smaller.

Intuitively appealing as this reasoning may seem, it implies a very particular assumption about the way in which the costs (greater risk of opportunistic default) and benefits (faster restructuring, reduced loss of output and asset value) depend on the probability of default or credit rating.

As depicted in figure 3, both costs and benefits of CACs undisputedly increase as default becomes more likely. However, for Eichengreen and Mody's explanation to hold, the costs must rise more rapidly than the benefits, so that low-risk borrowers are rewarded for the use of CACs whereas high-risk borrowers are punished. While this is indeed a convenient explanation for the empirical findings of the paper, there is no *a*

priori reason to think that costs and benefits should vary with default risk in this fashion; the reverse seems just as plausible.³⁰

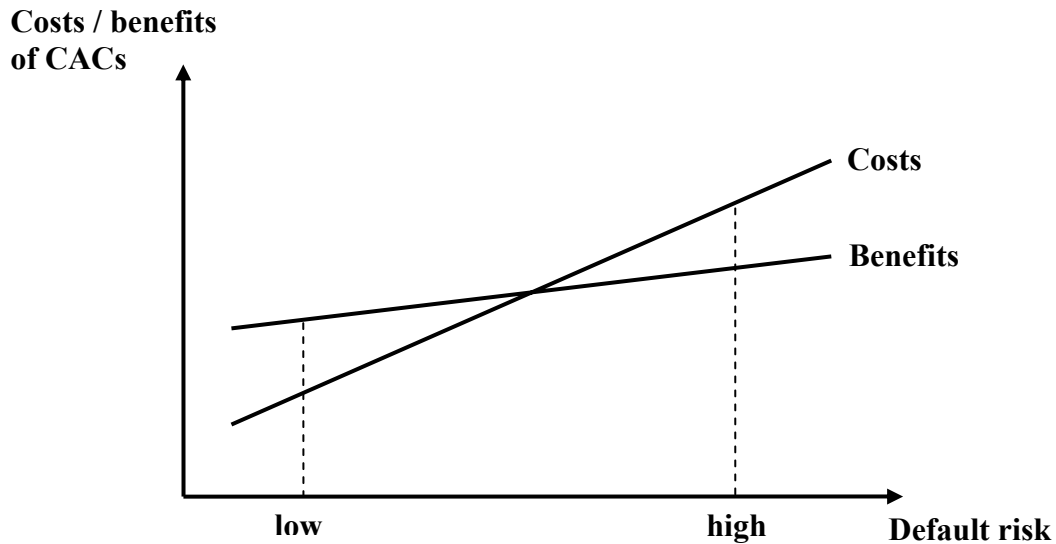


Figure 3: Costs and benefits of CACs as implied by Eichengreen and Mody (2000)

A second point of criticism relates to Eichengreen and Mody’s estimates of the quantitative effects of using CACs. According to their results, a low-rated sovereign borrower can expect to pay a premium of as much as 130 basis points on its bonds with CACs. A high-rated borrower is predicted to achieve a discount of 53 basis points. Many commentators have criticised these figures as being unrealistically large, both on the grounds of new empirical evidence and common sense – a yield difference of this size would create market outcomes vastly different from the ones we actually observe: No high-risk borrower would issue with CACs at such costs.

Becker, Richards, and Thaicharoen (2001)

Becker *et al* (2001) is the first study to use *secondary* market corporate and sovereign bonds to estimate the yield effects of CACs. The authors collected two samples, one from June 1998 and one from June 2000. The advantages over primary market data are at least threefold. Firstly, secondary market data enables the researchers to evaluate the effects of major events on market sentiment by sampling data from before and after the event. Secondly, fewer control variables are necessary because there is no need to take account of general market conditions changing over time. Finally, problems of endogeneity are arguably less prominent in secondary market data. Nevertheless, Becker *et al* also analyse some primary market data so as to allow comparisons to earlier studies. In particular, they claim that their methodology represent a substantial improvement over the one used in

³⁰ The authors subsequently provide the missing theoretical underpinning in Eichengreen *et al* (2003), see below.

Eichengreen and Mody (2000), due to higher data quality, better regression specifications and endogeneity adjustments, and additional control variables.

In the secondary market data from June 1998, Becker *et al* find that bonds governed by English law carry significantly lower yields than those governed by other laws. When a distinction is made according to the borrowers' rating (note that the cut-off in Becker *et al* is different from the one used by Eichengreen and Mody), the regression yields significantly negative effects of the use of English law for high-rated borrowers and no effects for low-rated borrowers – partly in line with Eichengreen and Mody's results.

The subsequent series of payment crises of Russia, Pakistan, Ukraine and Ecuador lead the authors to suspect that the market's perception of the possibility of default (and thus of CACs) may have changed in consequence; and the second sample from June 2000 was collected to test for this. In fact, the negative overall yield effect of CACs disappears between 1998 and 2000, possibly indicating that the market began to look less favourably towards CACs. Again splitting the sample according to credit rating, Becker *et al* find that in June 2000, high-rated borrowers paid a significant yield premium while less creditworthy borrowers were granted a significant discount – almost exactly the opposite of Eichengreen and Mody's results and also completely different from what the data revealed two years previously. As before, the size of the coefficients declines in more sophisticated specifications and signs even change, leading the authors to think that the strong correlations were largely spurious. As a final secondary market data exercise, the authors pool the 1998 and 2000 samples. The resulting coefficient on English governing law is negative but “nowhere near significance”.

The primary market sample used by Becker *et al* covers bonds issued between January 1991 and September 2000, and is thus quite similar to the samples used by Eichengreen and Mody, and by Tsatsaronis. But unlike the former, Becker *et al* do not find that high- and low-rated borrowers fare differently when issuing with CACs. The overall coefficient on English governing law is significantly negative (suggesting that investors value CACs), but the coefficient on German law is even more strongly negative (suggesting that they do not). To make matters worse, bonds issued under the laws of Luxembourg, which like those issued under English law contain CACs, pay a significant premium. Alternative specifications always yield a negative coefficient on English law, though it is not always significant. Thus, the primary market data do not allow Becker *et al* to draw any of the clear-cut conclusions found in Eichengreen and Mody.

To sum up, the three data sets examined by Becker *et al* indicate that investors seem to have a positive view of CACs, though this result is not persistent. Secondly, there is no evidence that low-rated borrowers are systematically penalised for using CACs, as found by Eichengreen and Mody. Moreover, Becker *et al* reject the large quantitative effects found by Eichengreen and Mody and attribute the size of the effects to the use of the instrumental variables correction for endogeneity, which, arguably, did not exist in the first place.

Gugiatti and Richards (2003)

In an interesting paper on the signalling effect of CACs, Gugiatti and Richards (2003) also present some additional evidence on bond yields. Following closely the methodology of Becker *et al* (2001), the authors collect secondary market data as of January 31st, 2003, in order to provide an update to the earlier results following the “extensive debate” on CACs during the year 2002.

The results are easily summarised. A negative coefficient for English law bonds is the only statistically significant outcome. However even this significance disappears when the standard interaction between rating and governing law is introduced. Contrary to Becker *et al* and Eichengreen and Mody, there is no evidence of a difference between the yields of high- and low-rated borrowers when using CACs. Neither does correcting for endogeneity through fixed effects yield any noteworthy results. The authors conclude that “[t]his pattern of variable, but almost always insignificant, estimates is exactly what one would expect if CACs have no impact on yields” (p. 20).

Yet, Gugiatti and Richards’ contribution is important in that this study is the first to recognise, and to take account of, the fact that the match between governing law and use or non-use of collective action clauses was less than perfect even before 2003, as described in more detail below.

Eichengreen, Kletzer, and Mody (2003)

The paper by Eichengreen *et al* (2003) is currently one of the latest, and perhaps most substantial contributions to the empirical debate on the yield effects of CACs. Besides some new empirical evidence, it contains a theoretical model of bond renegotiations which provides the background to the earlier findings of Eichengreen and Mody (2000), according to which low-rated borrowers are penalised for the use of CACs, whereas high-rated borrowers receive a yield discount. However, the explanation derived from the model is not entirely convincing. The model predicts that the cost of using CACs depends on the degree of moral hazard, i.e. on a borrower’s amount of private information, rather than its credit rating, although credit quality and moral hazard are admittedly related.

The empirical part of the paper is motivated by the mixed results of previous research, in particular by the many insignificant regression coefficients in Gugiatti and Richards (2003). By repeating Gugiatti and Richard’s sampling of secondary market data at four additional points in time, Eichengreen *et al* hope to obtain more robust coefficients. Moreover, the resulting pooled sample allows them to test more rigorously an earlier finding by Mody, suggesting that the point on the credit rating scale at which the use of CACs has no impact on yields shifts over time, depending on investors’ sentiments towards emerging market debt as proxied by the Emerging Markets Bond Index (EMBI). Thus, the data is gathered for four dates (in addition to the date used in Gugiatti and Richards) at which the EMBI spread was either very high or very low, so as to capture the effects of changing market sentiment.

Random effects estimation yields a coefficient on the interaction between rating and use of CACs which is significant at the 90% level, i.e., the yield penalty for low-rated borrowers increases when using CACs, although the effect is again not very strong. The

next step in the analysis is to introduce a triple interaction term, between the use of CACs, credit rating and EMBI spreads. The obtained positive coefficient suggests that when investor sentiment towards emerging market debt is negative, the point at which using CACs has no impact on spreads occurs relatively high up on the credit rating scale. In other words, when market sentiment is poor, all but the most highly-rated borrowers are penalised for the use of CACs; conversely, when investors are enthusiastic about emerging markets, the use of CACs reduces spreads for all but the least creditworthy borrowers.

Eichengreen *et al* consider these findings important because they “go some way toward reconciling previous studies of the primary market. Recall that some of those studies found that speculative borrowers face higher funding costs when using collective action clauses (Eichengreen and Mody, 2000a,b) but another (Becker, Richards, and Thaicharoen 2001) did not” (p. 24). Two aspects of this interpretation merit further thought. Firstly, it seems odd that the authors see the potential to reconcile results from the primary, rather than the secondary market. After all, the primary market samples of the two studies mentioned in the quote have an overlap of around 90%, so that the influence of changing market sentiment is minimal. Secondly, it is true that the “triple interaction effect” could explain why at times speculative grade borrowers are penalised for the use of CACs while at others they are not. However, the studies mentioned do not actually contain predictions of that sort. They merely highlight the (lack of) difference that the use of CACs makes to high- and low-rated borrowers. While market sentiment (as found by Eichengreen *et al*) may shift the point at which the effect of credit quality reverses sign and thus determines whether a yield premium exists for poor credits, it does not affect the magnitude of the effect of rating upon the yield effects of using CACs. Therefore reconciliation of the sort proposed here is not possible, not to mention that the triple interaction effect is barely significant in the Eichengreen *et al* data and the history of yield studies shows that such a promising result rarely survives the next paper.

Summary and implications for the debate

Bonds with collective action clauses do not generally carry higher yields than those without these provisions. The only result which runs contrary to this general conclusion is that of Tsatsaronis (1999), the study with the smallest sample and the lowest degree of econometric sophistication. All subsequent papers found negative and often significant yield effects of CACs. Some studies have found that, given that a country has a poor credit rating, issuing with CACs will increase its borrowing costs. It must be stressed though that this does not necessarily imply that low-rated issuers will be deterred from the use of CACs, as has been suggested, for example by Eichengreen and Mody (2000). If the overall negative yield effect of CACs is sufficiently strong to offset the rating effect, even a low-rated borrower may still be better off issuing with CACs than issuing without.

It is evident from this survey of the empirical literature that bond yields provide no evidence that investors dislike holding bonds which contain collective action clauses. This was true even in the years prior to 2002 when the resistance to CACs was at its strongest. At this level of analysis then, the bondholders’ rhetoric against the clauses,

which is at the very least a historical fact, remains a puzzle to which we will return in the concluding chapter.

Before we turn to the other side of the market though, it is worth mentioning a particularly interesting study and some more general observations, all of which caution against taking investor opposition at face value.

Richards and Gugiatti (2004)

Richards and Gugiatti (2004) examine the actual contractual terms of emerging market sovereign bonds in the Euromarket in unprecedented detail and arrive at two related findings which question the very basis of investor opposition to CACs and of the empirical literature on yield effects in general. The authors identify almost \$ 12 billion of bonds issued between 1991 and 2003 that are governed by the laws of New York but contain CACs.³¹

With respect to the yield studies this implies that governing law is a much less suitable proxy for the presence of CACs than was generally assumed. Thus all empirical studies to date have wrongly classified a number of bonds as not containing CACs while in truth they did, although Richards and Gugiatti (2003) and Eichengreen *et al* (2003) adjusted their data on governing law for the cases that were known at the time. It is unclear to what extent the results of the literature were affected by this mistake.

On the other hand, the finding shows that even before 2003, most emerging market borrowers had already issued bonds with CACs and that many US investors held those bonds. It is thus quite possible that bonds with CACs were part of the portfolios of those investors who were fighting against the ‘erosion of creditor rights’, perhaps unaware that New York governing law was never the kind of sanctuary from majority action they said it was.

Looking for a reason for the unusual pattern of New York law bond issues with CACs, Richards and Gugiatti (2004) discover that in each case, the legal advisor to the investment bank managing the issue was the London office of a New York based law firm. The authors speculate that the advisors simply used English style bond contracts from previous issues and merely changed the governing law provisions to New York to suit the preferences of US institutional investors. Correspondence with the law firms revealed that in many cases the partners were not aware that they had created an unusual combination of governing law and CACs.

The question arises, if the issuers, underwriters and legal advisors are sometimes unaware that CACs have been used, how can bondholders know the exact legal details of their securities? Gugiatti and Richards convincingly argue that it is in fact extremely difficult to ascertain the exact terms of an existing bond contract. With respect to new issues, they quote the Secretary-General of the International Primary Market Association (IPMA) as saying that “[t]here is no mechanism at present for an investor [...] to know at the time she is invited to an issue whether the issue has CACs...” (p. 2). In many cases, at that stage the legal details, including governing law, will not even have been agreed between the issuer and the underwriter. Accordingly, of the market participants

³¹ Some of these were private private placements that were not registered with the SEC, though.

interviewed by Gelpern and Gulati (2007, p. 10), “not one investor reported reading the underlying contracts.”

Although Gugiatti and Richards regard this fact as supporting the empirical studies that find no yield effects of CACs, it can also be used for strong criticism of the general literature on yields. If investors are indeed often ignorant about which type of bonds they hold, particularly in the primary market, then any yield effects found must be spurious, and models of the choice of governing law, as contained in almost all empirical papers, are superfluous.³² Furthermore, the setup described here is grossly inconsistent with investors, or any market participant for that matter, caring deeply about the presence or absence of CACs. If CACs mattered as much as some statements from creditor spokesmen would have us believe, surely investors would demand for information about the clauses to be more accessible.

To sum up, the paper by Gugiatti and Richards (2004) can be interpreted as a serious criticism of the empirical literature on CACs,³³ and it further damages the credibility of those bondholders who were strongly opposed to the clauses. If, on the other hand, the evidence presented in the paper were incorrect, a wave of protest should have come from the academics and practitioners whose research and views it contradicts.

Other evidence of investor indifference

Even prior to 2003, almost half of all international sovereign bonds had collective action clauses and their holders showed no sign of dissatisfaction. There is no comprehensive data on which groups of investors hold which types of bonds, yet it may be assumed that the portfolios of American investors are biased towards bonds governed by New York law, be this the result of preference, habit, or listing requirements (Buchheit and Gulati, 2002). However, American bondholders do also invest in English law bonds, such as those issued by Russia, Ukraine and Pakistan (IMF, 2002a). Moreover, Gugiatti and Richards (2004) have demonstrated that a substantial amount of New York law bonds included CACs even prior to 2003.

It is unlikely that investors who hold bonds with CACs differ markedly in their risk preferences from those who hold bonds with unanimous consent clauses (assuming for the sake of the argument that they even know which type they possess). Moreover, presumably a sizable number of investors hold both types of bonds, e.g. through mutual funds, which is again inconsistent with any strong views on CACs.

Finally, there is anecdotal evidence that the market pays very little attention to CACs when pricing bonds. “The sell side research of investment banks appears never to refer to

³² It is of course possible that investors make an informed guess about whether a given bond includes CACs and build their evaluation of the bond upon that guess. Yet a guess could not be the basis of a large difference in yields.

³³ Another important point of criticism is that these papers appear to assume that the presence or absence of CACs is the only factor relevant for yields which differs across governing laws. This seems unlikely. For example, English law bonds tend to use trust deeds, which are said to be more expensive than alternative mechanisms (Liu, 2002) and are not commonly used under other governing laws. There have in fact been no further empirical studies subsequent to the publication of Gugiatti and Richards (2004). One may speculate whether that is due to the revelations made in the paper, or perhaps merely because the political debate has moved on.

CACs as explaining why yields on particular bonds deviate from their fair-value yield curve. The several news services that report in detail on new issues appear never to explain the pricing of a new bond in terms of the presence or absence of CACs ... Bond ratings from rating agencies do not differ based on governing law - agencies appear never even to consider governing law as a risk factor”.³⁴ Thus, the vast majority of investors never seemed to share the view that they might be worse off when collective action clauses become more commonplace. In other words, the resistance to CACs described above was both unfounded and unrepresentative of the attitude of most bondholders. In Gelpern and Gulati’s (2007, p. 58) interviews with market participants, “many said ... that EMCA activists represented a small fringe of the investor community.”

Chapter 4 – Sovereign Borrowers

Introduction

It is the sovereign borrowers who ultimately decide whether to include collective action clauses in a new bond issue; therefore their incentives to do so merit some investigation when trying to explain the time lag between the first official calls for increased use of CACs and the change of market practice in 2003. Exactly because borrowers are free to issue without CACs, they were never compelled to voice their reservations, whereas investors had to resort to public threats if they wanted to stop the advancement of the clauses. Thus, what we know about the reasons for the emerging market borrowers’ hesitation to embrace the clauses is often based on hearsay and speculation, rather than on direct statements from borrower representatives.³⁵

This chapter examines the reasons for borrowers to delay the adoption of CACs in New York law bonds in much the same fashion as chapter 2 scrutinised the position of investors. The fact that a growing number of sovereigns have now issued with CACs under New York law suggests that the initial reservations about CACs have finally disappeared. Nevertheless, a discussion of the borrowers’ arguments with hindsight has some merit. By clearing up the debate, it may help to stimulate a more rapid change in market practice if and when the adoption of CACs under German governing law, too, comes onto the policy agenda.

³⁴ Becker *et al* (2001, p. 26)

³⁵ More generally, the number of references to investor opposition in the literature exceeds the number of available statements from market participants to that effect. There is almost a sense that nobody wanted CACs but also nobody wanted to be perceived as blocking their advance. “Issuers pointed to the bankers, bankers pointed to the issuers, everyone pointed to the investors.” (Gelpern and Gulati, 2007, p. 40)

Benefits of CACs to borrowers

Sovereign borrowers benefit as least as much as investors do from smooth and speedy debt restructurings, which can be facilitated by collective action clauses.³⁶ Again, the benefits attributed to CACs depend on the view one takes on sovereign debt restructurings. Critics have argued that orderly restructurings are also possible by way of unilateral exchange offers, perhaps using exit consents, and have denied that there is a serious collective action problem.³⁷

Yet, drawn-out restructurings and outright defaults do occur, and it is undisputed that the sovereign borrowers usually suffer enormously. The costs of default to a sovereign borrower are well documented. An overview of the literature by the Inter-American Development Bank (IADB, 2006, chapter 12) identifies five sources of costs: Loss of reputation (resulting in higher interest rates and ultimately loss of market access), direct sanctions (attachment of property or trade sanctions), damage done to the domestic financial sector, political costs, and effects on economic growth. With respect to growth, the IADB highlights the co-occurrence of defaults and recessions, but cautions that the direction of causality is not clear. Other research shows that investment tends to suffer due to a shortage of credit from domestic and foreign sources.³⁸ Eichengreen and Mody (2000) state that extended debt negotiations depress growth. White (2002) explains how a debt crisis can turn into an economic crisis.

Evidently, borrowers have good reasons to avoid defaulting on their debt. Since collective action clauses bear at least the promise to help resolve an emerging crisis before default actually occurs, it remains to be explained why borrowers did not adopt them in their New York law bond issues more readily. Furthermore, CACs could make for better investor relations. Restructuring negotiations with CACs should be much more consultative in nature, and some of the clauses implemented recently provide for extensive rights to information for the bondholders. Investors may also find that restructuring through majority amendment is more equitable since every bondholder is left with the same claim. By contrast, an exchange offer with less than full participation will often result in preferential treatment for the holdout creditors – either because the borrower voluntarily satisfies their original claims or because it is forced to do so under the threat of litigation. Restructurings done through the use of CACs should appeal to borrowers because they are the ‘cleaner’ solution, inasmuch as there will be no remaining outstanding bonds on pre-restructuring terms, as is often the case following an exchange offer. The country that moved first to adopt CACs could also expect to benefit by creating substantial goodwill with the public sector institutions (Gelpern and Gulati, 2007).

Two other important benefits to the issuer should be mentioned. First, reversing the ‘investor surplus’ analysis of chapter 2 suggests that restructuring agreements reached under CACs should be more favourable for borrowers than those reached through bond exchanges. A successful bond exchange probably requires a rate of participation that is

³⁶ Surprisingly, there does not as yet appear to exist any empirical evidence to prove that CACs actually reduce the duration of restructuring negotiations or default periods, even though the main argument for the clauses rests on this assumption.

³⁷ See, for example, the industry letter to Horst Köhler, available at www.emta.org/ndevelop/imflettr.pdf.

³⁸ See White (2002), also Arteta and Hale (2005)

higher than the required voting threshold of the clauses. The terms of the restructuring therefore have to be more attractive to investors and, by implication, less attractive to the sovereign. Being easier to restructure, bonds with CACs create a stronger bargaining position for the borrower and thus better expected outcomes.

Second, it is important to realise that CACs bring the possibility, but not the obligation, to restructure the existing bonds. The sovereign is free to ignore the option to negotiate with the bondholders and instead opt for an exchange offer, which has in fact happened in practice.³⁹ CACs enable an additional course of action without precluding any of the solutions that were previously possible.⁴⁰ The value of this option is by definition non-negative. As for the costs, we will argue below that they are probably much smaller than has sometimes been maintained.

Borrowing costs

When trying to explain the borrowers' hesitation to adopt the clauses, virtually all early publications refer to concerns about higher borrowing costs. The sovereigns were afraid, so it was generally assumed, that bonds with super-majority provisions would be less attractive to investors, particularly in the U.S. market. Investors were feared to demand higher yields to compensate them for the added risk of CACs. According to Boorman (2003), some creditor representatives used the opportunity to reinforce the borrowers' concerns: "[T]he private sector seems to be going around to emerging market countries and trying to scare the hell out of them about the fact that either the use of collective action clauses or the SDRM will lead to an increase in spreads..."

Whatever the source of the concerns, the detailed review of the empirical literature above has shown that higher borrowing costs are a myth. Not only is there no evidence of a systematic yield premium after five years of research, but there was also never a point in time since the first study by Tsatsaronis (1999) at which the available research unambiguously predicted higher yields. Several studies have even suggested that sovereigns of high credit quality could actually reduce their borrowing costs by issuing bonds with CACs.

Yet, it seems that no amount of academic research could fully dissolve the concerns of the borrowers. The main value of the studies appears to have been to provide rhetorical support for officials who needed to invalidate the private sector's arguments. Gelpern and Gulati (2007) quote a U.S. government representative in this respect: "We always cited Barry [Eichengreen]'s work ... to neutralize the bad stuff they were hearing ... If I were [an emerging markets debt manager], I would still be awfully worried." An interviewee from the buy-side expresses his low esteem for the empirical work in the following way: "Academic studies on pricing were useless as they always are ... The data sets they use would make [a quantitative analyst] cringe."⁴¹

But even if the empirical evidence did not have much sway with them, borrowers ought to have been aware of all those arguments against higher yields which were

³⁹ See Dixon and Wall (2000) for the case of Pakistan.

⁴⁰ That may be disputed. We return to the question of whether CACs preclude any courses of action in the last chapter.

⁴¹ Gelpern and Gulati (2007, p. 47)

mentioned before in the context of investors: the large stock of bonds outstanding with CACs under English law; the disregard of CACs by rating agencies, the apparent ignorance of many investors, etc.

Perhaps the strongest indication that sovereigns need not concern themselves with borrowing costs when deciding about CACs comes from the inconsistent market practice. In a sample studied by Gugiatti and Richards (2003, pp. 6), “17 of the 20 most active borrowers have switched between issuing bonds with and without CACs. [...] If] the presence or absence of CACs were a major influence on borrowing costs, we would expect borrowers to decide which type of contractual form provided the cheapest (or otherwise most appropriate) form of financing for them, and then to always use those contractual terms.” Thus, the argument of borrowing costs was never very convincing.

First mover problems

The IMF (2002a, pp. 10), amongst others, suspected that there could have been a first mover problem associated with the adoption of CAC in markets where their use was not customary: “There is a general perception that the costs of change are likely to be borne most heavily by the first issuers to include collective action clauses in their New York and German law bonds [...] Strong incentives might be needed to overcome the first mover problem.” These costs were thought to comprise higher borrowing costs, additional marketing expenses, and the costs of changing standard bond documentation. Once the first move had been made, subsequent issues under New York law with CACs would face a more favourable market so that the benefits of issuing with CACs might outweigh the costs. The tragedy of this collective action problem is, of course, that the first move is never made. Moving first would create positive externalities for the subsequent movers. The impossibility of internalising these benefits results in a market failure, such that an innovation which would yield a positive net expected value for borrowers as a group is not undertaken because the benefits cannot be redistributed to the first mover. Attempts in late 2002 by the U.S. Treasury to persuade a group of low-risk issuers to announce their adoption of CACs simultaneously show that the problem was considered to be serious in practice. Likewise, the suddenness and completeness of the change in market practice in 2003 could be regarded as practical evidence of first mover dynamics.

The first mover explanation is convincing enough, except for the key assumption on which it rests – it is unlikely that “breaking the established market practice”⁴² should have been associated with any major costs. There are several reasons.

First, the picture of market practice was never as clear-cut as it has often been drawn. We already mentioned the findings of Gugiatti and Richards (2003) and the large stock of English law bonds. Collective action clauses were more or less commonplace in every segment of the market, and investors gave no indication of being alarmed about their presence. Moreover, there exists already some practical experience with the use of CACs in restructuring situations.⁴³

⁴² Liu (2002, p. 23)

⁴³ See Dixon and Wall (2000)

Second, we have shown that bonds with CACs do not carry higher yields, and this also had to apply to the – supposedly – first issue under New York law. Indeed, when in March 2003 Mexico eventually made what was, despite the substantial number of earlier issues of that kind, widely perceived as the first move, the yield on its New York law bond with CACs was well in line with its yield curve.⁴⁴

Third, because, as was argued above, CACs appear to have been a ‘non-issue’⁴⁵ for most investors, no major extra marketing expenses should have been required to sell the bonds. In the case of the famous Mexican issue in 2003, the experience was described as such: “Instead of opening the books in the morning and closing six hours later oversubscribed, [selling the bonds with CACs required] three days working the phones.”⁴⁶ That is no too much additional effort for a very large issue.

Fourth, the legal and other expenses involved in changing bond documentation are probably small. As Richards and Gugiatti (2003) reported, such changes have often occurred as a simple copy and paste exercise, sometimes even accidentally. Moreover, as Eichengreen *et al* (2003) point out, at least two alternative sets of model collective action clauses existed as of the first half of 2002, which could have been adopted at little or no cost.

For these reasons the existence of a first mover problem seems questionable with hindsight. To what extent the concerns about costs to the first mover were justified at the time is, however, more difficult to say.

Borrower myopia

The IMF (2002a) and Eichengreen *et al* (2003) consider borrower myopia as a further potential explanation of delayed adoption of CACs. The assumed costs of introducing the clauses have to be borne at the time of issue whereas the benefits will not be realised until much later for two reasons. First, CACs are worthless until financial difficulties arise, and the expected number of years until that moment probably exceeds the length of the borrowing Finance Minister’s appointment. Besides, issuers may be tempted to publicly understate the probability of default, hoping for a positive effect on financial market sentiment.⁴⁷ Or, through wishful thinking, they may actually believe that default is impossible. In either case, the expected benefits of collective action clauses are underestimated. Second, even when financial difficulties arise, for CACs to be fully effective, it has been argued that they must be included in all outstanding bond issues, and perhaps even more generally in all outstanding debt instruments. Even if each maturing debt instrument is replaced by one which includes CACs, full effectiveness is not reached before the instrument with the longest remaining maturity is retired, which may take several decades (the transition problem).

The main limitation to this explanation, however, is again that there are probably no major upfront costs involved in introducing CACs. Yet the myopia argument may have

⁴⁴ See, for example, IMF (2003b, p. 5)

⁴⁵ Gugiatti and Richards (2004, p. 11): “The use of CACs has rapidly become a non-issue.”

⁴⁶ Gelpert and Gulati (2007, p. 64)

⁴⁷ As a borrower representative, interviewed by Gelpert and Gulati (2007), remarked: “Our scenario is not default.”

some sway. Even if the costs are low, it is plausible that elected officials may be hesitant to take an action whose benefits are uncertain and will materialise only long after the end of their term in office.

Signalling

Tsatsaronis (1999) and the IMF (2002a) consider the possibility that borrowers were concerned that adopting CACs might be perceived by investors as a signal of bad or deteriorating credit quality. There are at least two ways in which an investor could see relevant information in the adoption of CACs. First, CACs have value only in times of crisis. A sovereign that never expects to be in financial difficulty has no direct benefit from the clauses.⁴⁸ The use of CACs may thus signal that the probability of default is greater than zero. In most cases, however, such information will have almost no value to the financial markets, which are typically very well informed about the borrower's financial circumstances. Secondly, at least according to the critics, majority restructuring provisions are prone to abuse. The adoption of CACs might thus be seen as preparation for an opportunistic default. By making default easier, CACs could tip the balance in borderline cases of inability to pay. They could be a valuable (albeit negative) signal because the political willingness to honour debt obligations cannot be easily inferred from financial figures and other publicly available information. Conversely, unanimous consent provisions can act as a commitment mechanism in that they impose high costs on a defaulting sovereign.

Gugiatti and Richards (2003) provide a very interesting test of the signalling effects of CACs. Based on the fact that issuers frequently switch between the use and non-use of CACs, the authors examine whether a change in issuing policy with respect to the clauses has any impact on the price of a country's existing stock of debt. The methodology used is an event study of abnormal returns on secondary market bonds during an event window surrounding the day a new bond issue is announced. The abnormal returns are regressed on four dummy variables, one for each of the four possible policies regarding CACs: continued issuance with / without CACs, a change from use of CACs to non-use, or vice versa. If investors saw the use of CACs as a signal of deteriorating credit quality, so the authors reason, then a change from non-use of CACs to use should be associated with negative abnormal returns on existing bonds. However, none of the four dummies prove to be significant, hence investors do not value existing debt differently when a borrower changes its policies regarding CACs. This result can be interpreted to mean that the signalling interpretation of borrower hostility towards CACs, while theoretically appealing, is not confirmed by empirical evidence.⁴⁹

⁴⁸ Accordingly, John Taylor, "indicated that the United States has no plans to include CACs in U.S. government debt" (White, 2002). On the other hand, Canada and the member states of the European Union have begun to include CACs in their international bond issues despite being most unlikely to default on their debt – the intention being to stimulate progress in the adoption of the clauses by 'leading by example'.

⁴⁹ It is clear that CACs cannot have much signalling value now that they have become the market standard.

Risk aversion

Perhaps borrowers did not so much expect to be worse off when issuing with CACs but were merely unwilling to bear the uncertainty surrounding the clauses that were largely unknown to the U.S. financial markets.

A first source of uncertainty may have been the trading performance of bonds with CACs. While it was shown above that at no point did borrowers need to fear higher borrowing costs, these findings only refer to averages. Thus, even though the expected yield premium for bonds with CACs was zero, borrowers may have avoided the risk that a particular issue could be unpopular with the markets.

Secondly, there may have been legal uncertainty associated with CACs. There was, and still is, little or no experience with the treatment of restructuring agreements reached through CACs in U.S. courts. But even so, one of the main *raison d'être* of the clauses is to reduce legal uncertainty, rather than to create it. In particular the elimination of the holdout problem thanks to majority restructuring provisions should be welcomed by borrowers.

Legal uncertainty is a much more pressing concern under German law and remains the primary reason why sovereign bonds under German law do not contain CACs (Liu, 2002). Former Finance Minister Hans Eichel announced in 2003 that legislation was underway to create a more secure legal environment for the introduction of CACs⁵⁰ but as of mid-2005, market practice remained unchanged (World Bank, 2005).

Imperfections of CACs

A more general point of criticism, which cannot only be attributed to the sovereign borrowers, is that the types of collective action clauses that were in use or being proposed during the early stages of the debate were imperfect. The various subsequent sets of model clauses and the provisions that were implemented in the series of innovative bond issues with CACs since 2003 have helped to overcome some of the deficiencies, but still there is no consensus as to which set of provisions best solves the underlying collective action problems.

The transition problem already mentioned is one of the disadvantages of CACs that was often discussed, in particular in comparison to the SDRM. However this problem is, tautologically, only transitory. The sooner borrowers began to include CACs in all new issues, the sooner the clauses would become fully effective. Eichengreen *et al* (2003) find no empirical evidence of a general transition problem. The yields of newly issued bonds with CACs are independent of the proportion of a borrower's outstanding debt that includes the clauses. However, low-rated borrowers pay a slight yield premium when issuing with CACs if the majority of outstanding bonds requires unanimous consent, suggesting that less creditworthy borrowers could be rightfully hesitant to make the transition.

Another drawback (again compared to the SDRM), known as the aggregation problem, is more fundamental. Collective action clauses are in the first instance issue-

⁵⁰ Statement before the International Monetary and Financial Committee, available at www.imf.org/external/am/2003/imfc/state/deu.htm

specific; their purpose is to solve collective action problems among the bondholders of a particular issue. Once this has been achieved, the problem reappears at the next higher level. By agreeing to debt relief, the majority of bondholders of one issue improves the chances of full repayment for another, and thus creates incentives for holdouts at the level of bond issues. Assuming that collective action problems at this level can also be overcome, it crops up again in the relationship between different classes of debt, such as bank loans and inter-government debt.

These problems can only be fully solved if a mechanism is found by which votes are aggregated across the different bond issues and perhaps other classes of debt which are affected by a proposed restructuring. Such aggregation clauses or ‘super collective action clauses’ have already been implemented in an exchange offer made by Uruguay in April 2003, but their optimal design remains the subject of debate (Gelpern 2003a).

There is also debate on the size of the aggregation problem itself. “Most emerging market sovereigns have only a handful of issues in the market. Ukraine had five and Ecuador had six at the time of their respective defaults. On the other hand, Argentina had more than 80 separate sovereign issues outstanding.”⁵¹ The latter case would make it seem very difficult to devise aggregation clauses that can align the interests of such a diverse creditor base. Hence it is not surprising that the effectiveness of CACs in complicated debt restructurings has been doubted.⁵²

An empirical test of the size of the aggregation problem is again provided by Eichengreen *et al* (2003, p. 27). “If aggregation is costly, then investors will presumably demand a premium in order to hold claims on an issuer with multiple instruments in the market, especially when there is a significant likelihood that its obligations may have to be restructured.” Indeed, the authors find evidence of a “multiplicity premium”: Primary market yields increase systematically with the number of outstanding bond issues, particularly for less creditworthy borrowers.

It is important to note, however, that the failure to solve the aggregation problem could only rightfully be cited as a disadvantage of CACs relative to the SDRM. The problem has always existed, but it may just have become more obvious since CACs explicitly point towards the possibility of default. Ad hoc procedures of restructuring are just as prone to collective action problems among individual bond issues. Once workable aggregation clauses become a standard feature of CACs, what may have been perceived as a weakness should soon prove to be an additional benefit of CACs.

Summing up, collective action clauses fall short of what the Sovereign Debt Restructuring Mechanism promised to achieve with regard to transition and aggregation. In particular, even ‘super collective action clauses’ do not enable a comprehensive debt restructuring in which broad classes of debt instruments are negotiated simultaneously, as would be necessary to overcome collective action problems also at the higher levels. But the SDRM is no longer a valid point of comparison and perhaps never was. CACs represent the best course of reform that is currently available and as such should not have been resisted for their deficiencies.

⁵¹ Eichengreen *et al* (2003, p. 15). Other sources even report that Argentina had 152 different bond issues outstanding.

⁵² See, for example, Chamberlain (2002b)

Indifference

It was said at the beginning of this chapter that there is no direct indication that the sovereign borrowers were downright opposed to adopting the new clauses in New York law bond issues. The potential concerns we have been discussing are ones which third party observers, such as the IMF or academics, assumed to exist.

There is, however, plenty of evidence to suggest that many sovereigns did not give the inclusion of CACs much consideration, that the question of CACs and even choice of governing law was a matter of indifference to them, and that they were unperturbed by the repeated public sector advocacy for CACs during the late 1990s. This is confirmed by Robert Gray (2003, p. 9): „As Chairman of a trade association that represents underwriters, I would be the first to admit that the subject of CACs had not been figuring in negotiations before bond issues were mandated or even in the pre-launch negotiations. The inclusion or not of CACs was left to the issuer’s and the underwriter’s legal teams to negotiate on an ex post basis.” Underwriters in turn have “a strong home country bias” in choosing the governing law (Esho *et al*, 2004). As mentioned before, Gugiatti and Richards (2004) recall instances in which not only the issuer, but also the legal advisor was unaware of whether a given bond included CACs. More generally, they detect “a certain randomness in the particular terms and conditions included in emerging market bond issues into the Euromarket, including the use or non-use of CACs and even the governing law of bonds” (p. 11). Clearly borrowers would not leave the decision to their agents if they had any strong preferences regarding the use of CACs, and if they did, they would know the outcome of the decision.

This apparent lack of interest could be explained by the fact that borrowers tend to focus on markets and currencies, rather than on the contractual details. For example, New York law is the standard choice if the bond is to be denominated in US Dollars, and until the change in market practice, this implied unanimous consent provisions by default. Similarly, “issuance in Japanese yen is invariably under Japanese governing law and therefore inevitably includes CACs.”⁵³ Still, if the sovereign borrowers had had strong preference either for or against the use of the clauses, in the vast majority of cases there would have been no legal or other reasons to prevent them from deviating from standard issuing practice in a particular market.

⁵³ Gugiatti and Richards (2003, p. 10)

Chapter 5 – Conclusion

Summary

Ever since the publication of the “Rey Report” in 1996, public sector institutions have been emphasising the benefits of collective action clauses for more orderly debt restructurings. Yet it took around seven years for a change in market practice to materialise, due at least in part to the opposition or lack of interest of market participants. It seems to follow logically that the benefits seen by the public sector must have been matched by costs of similar magnitude that could explain the lack of enthusiasm of issuers and investors.

Our review of the empirical literature on bond yields, which finds no persistent premium on bonds with CACs, is consistent with such a balance of costs and benefits, but also with CACs being a ‘non-issue’ for investors, i.e., both costs and benefits are negligible. We have discussed a number of potential reasons for the well-documented opposition of some investor representatives prior to 2003. Individually, none of these reasons are utterly convincing, and even in the aggregate they do not seem to provide the whole picture. Thus, we are left with an explanation gap: Allegedly and plausibly, CACs have benefits, but the opposing costs are not easily identified.

A similar picture emerges from the analysis of the sovereign borrowers’ incentives. Their initial refusal to adopt CACs in New York law bonds presented a puzzle to public sector analysts. Many explanations were brought forward, but again they are not fully convincing.

The concluding chapter attempts to fill this explanation gap. It discusses two aspects of the debate on collective action clauses which we have so far ignored: Externalities, due to which borrowers do not enjoy all the benefits of CACs, and the role of bailouts, which distort the incentives of both borrowers and investors.

Externalities

If there appears to be a balance of costs and benefits of CACs, as suggested by the evidence on bond yields, but the costs are elusive, then perhaps some of the benefits take a form that is invisible to market participants. CACs likely have positive externalities, that is, they indeed have a positive impact on debt restructurings, but these benefits accrue mainly to parties other than the issuers and bondholders.

The official sector, especially the IMF, appears both as a creditor and as a third party in this context. In the former capacity, the IMF has a very immediate interest in preventing defaults to protect its own loans,⁵⁴ and in involving bondholders for ‘private sector burden sharing’ in restructuring negotiations when default is unavoidable. CACs can also reduce the pressure for new lending by the IMF, which would be very much in

⁵⁴ IMF and World Bank loans take priority over other forms of debt (White, 2002), but the IMF has generally provided assistance before the debt crisis develops to the stage where this seniority would become important.

the interest of organisations such as the G-10 or its member countries, upon whose funding the IMF critically depends.⁵⁵

This is not to say that the public sector's promotion of CACs was purely self-interested. When a Pareto-improving reform creates positive externalities, or reduces negative ones, a third party facilitator may be needed to help bring it about. For instance, CACs could reduce financial contagion by enabling the orderly resolution of a crisis before it can spread to other countries and other markets.⁵⁶ This is a benefit which borrowers will not sufficiently take into account. "[I]ndividual countries, with only weak incentives to internalise this externality, may display a reluctance to adopt CACs that is excessive from a social point of view."⁵⁷

More generally, the industrialised world has an interest in the economic wellbeing, and therefore in the sustainability of the financial systems and debt schedules, of less developed creditor countries. Speaking for the US Treasury, John Taylor (2002, p. 1) said, "Clearly we would like to see fewer crises. We would like to see a sustained recovery of investment in the emerging markets along with lower interest rates. Ultimately we would like to see the poor developing countries become truly emerging market economies." Thus, by promoting financial stability and growth, collective action clauses may create positive externalities which can explain the reluctance of many issuers to adopt the clause even in the absence of major costs.

Bailouts

There is a potential cost of collective action clauses that has not been mentioned so far. We have characterised the clauses as an option for the borrower and the majority of bondholders to take a course of action (majority amendment) that is otherwise unavailable, without ruling out any alternative paths to crisis resolution. Some market participants would probably disagree with this interpretation.

After all, going back to the very beginning of this paper, the initiative for financial market reform and in particular for CACs was partly driven by the need to develop alternatives to crisis resolution through bailouts. Many academics and official sector representatives have expressed the hope and expectation that bailouts would become obsolete once all sovereign bonds contain CACs. It is debatable whether this expectation is realistic, but the mere possibility seems to have been perceived as a serious threat by some investors and borrowers, for whom debt crisis resolution through third party assistance is a very convenient solution. Investors can obtain higher recovery rates than could be achieved without bailout. The troubled borrowers receive new credit at low interest rates, even though the loans are often conditioned on the promise of economic reform in the debtor country. Therefore, by perhaps reducing the likelihood of a bailout, CACs may impose large indirect cost on both sides of the market. The best source of support for the 'bailout' explanation of resistance to CACs is again Michael Chamberlain

⁵⁵ For Eichengreen and Mody (2000), reducing the necessity for the IMF to intervene in debt crises is the main justification for wider use of CACs, rather than the concern for the sovereign borrower and private creditors. Similar opinions can be found in Taylor (2002).

⁵⁶ See White (2002), Taylor (2002), or Weinschelbaum and Wynne (2004)

⁵⁷ Eichengreen *et al* (2003, p. 34)

(2002b, p. 5), who, in an effort to preserve the welcome financial aid, defended bailouts (“The term “bail-out” is unduly pejorative...”) while at the same time attacking CACs and the SDRM. Portes (2003, pp. 11) cites other investor representatives who make no secret of their preference for official financing over private sector involvement, and warns that “as long as the official sector provides bailout packages, there is no incentive for the markets to want CACs”. This view proved to be overly pessimistic when Mexico marketed its New York law issue with CACs, but it seems likely that the change in market practice would have occurred earlier absent the incentive effects of bailouts.

Conclusion

The intention of this paper is not to endorse the general adoption of collective clauses, but to demonstrate that many of the arguments and concerns that have been, or could be, brought to bear against them are weak for either of two reasons. First, many of them are easily invalidated on the basis of empirical evidence (e.g. the myth of higher borrowing costs or the transition problem) or on the basis of other facts, e.g. the imaginary first mover problem. The second set of arguments may have more sway, but they are immaterial from a welfare perspective. For example, differences in opinion about the optimal voting threshold have predominantly distributional effects and therefore should not stand in the way of progress. Likewise, the preference of investors for bailouts over CACs is understandable, but it should not impress policymakers.

Sovereign bonds governed by the laws of Germany are currently the last stronghold of unanimous consent. If collective action clauses are as effective and beneficial as their proponents claim, then there is no reason to stop the reform process after the recent success in the U.S. market. Once the German legislator has established legal certainty as regards the permissibility of majority amendment, the international financial community can safely ignore any resistance from investors or borrowers and apply whatever pressure they consider adequate to effect the desired change of issuing practice in the German market. In the case of New York law bonds, the threat of the SDRM arguably helped to persuade borrowers to make the transition. That threat will not work a second time. But the strongest card has not yet been played: A credible commitment to no more bailouts should help to establish collective action clauses in the sovereign bond markets once and for all.

Bibliography

- Arteta, C. and G. Hale (2005) “Are Private Borrowers Hurt by Sovereign Debt Rescheduling?” www.aeaweb.org/annual_mtg_papers/2006/0108_1300_1303.pdf
- Becker, T., A. Richards and Y. Thaicharoen (2001) “Bond Restructuring and Moral Hazard: Are Collective Action Clauses Costly?” IMF Working Paper, July
- Bedford, P. (2005) “Sovereign bond contracts: a workshop at the Bank of England” in *Financial Stability Review*, June, Bank of England
- Boorman, J. (2002) “Sovereign Debt Restructuring: Where Stands the Debate?” speech on October 17, <http://www.imf.org/external/np/speeches/2002/171002.htm>
- Boorman, J. (2003) Remarks in a Panel Discussion at the IMF Conference, “Sovereign Debt Restructuring Mechanism (SDRM)” www.imf.org/external/np/tr/2003/tr030122.htm
- Buchheit, L.C. (undated) “Sovereign Debtors and Their Bondholders” www.unitar.org/fer/sovereign.pdf
- Buchheit, L.C. and G.M. Gulati (2002) “Sovereign Bonds and the Collective Will” Bank of England, *Financial Stability Review*
- Chamberlin, M.M. (2002a) “A Casual Observer’s Commentary on the Taylor Proposal and the EMCA’s Model Covenants for New Sovereign Debt Issues” Trade Association for the Emerging Markets
- Chamberlin, M.M. (2002b) “Revisiting the IMF’s Sovereign Bankruptcy Proposal and the Quest for More Orderly Sovereign Work-Outs” remarks at the conference “Sovereign Debt Workouts: Hopes and Hazards” Institute for International Economics, Washington DC
- Dixon, L. and D. Wall (2000) “Collective Action Problems and Collective Action Clauses” Bank of England, *Financial Stability Review*
- Drage, J. and C. Hovaguimian (2004) “Collective Action Clauses (CACs): an analysis of provisions included in recent sovereign bond issues” Bank of England, *Financial Stability Review*
- Eichengreen, B. and A. Mody (2000) “Would Collective Action Clauses Raise Borrowing Costs? An Update and Additional Results” <http://ideas.repec.org/p/cdl/ciders/1008.html>
- Eichengreen, B., K. Kletzer and A. Mody (2003) “Crisis Resolution: Next Steps” IMF Working Paper, www.imf.org/external/pubs/ft/wp/2003/wp03196.pdf

- Esho, N., I.G. Sharpe and N. Tchou (2004) “Moral Hazard and Collective Action Clauses in the Eurobond Market” www.fma.org/Chicago/Papers/FMAMoralHazardandCollectiveActionClausesintheEurobondMarket.pdf
- Federal Reserve Bank of San Francisco (2004) “Resolving Sovereign Debt Crises with Collective Action Clauses” FRBSF Economic Letter 2004-06
- Fisch, J.E. and C.M. Gentile (2004) “Vultures or Vanguard? The Role of Litigation in Sovereign Debt Restructuring” *Emory Law Journal* 53:1047
- Gelpern, A. (2003a) “How Collective Action Is Changing Sovereign Debt” *International Financial Law Review*, www.iie.com/publications/papers/gelpern0804-2.pdf
- Gelpern, A. (2003b) “Sovereign Debt Crisis: Creditor’s Rights vs. Development” Institute for Intern. Economics, www.iie.com/publications/papers/gelpern0804-3.pdf
- Gelpern, A. and G.M. Gulati (2007) “Public Symbol and Private Contract: A Case Study” forthcoming in *Washington University Law Review*
- Gray, R.B. (2003) “Collective Action Clauses” remarks at UNCTAD Fourth Inter-Regional Debt Management Conference, http://r0.unctad.org/dmfas/pdfs/Gray_Dammers.pdf
- Gugiatti, M. and A. Richards (2003) “Do Collective Action Clauses Influence Bond Yields? New Evidence from Emerging Markets” www.rba.gov.au/rdp/rdp2003-02.pdf
- Gugiatti, M. and A. Richards (2004) “The Use of Collective Action Clauses in New York Law Bonds of Sovereign Borrowers” www.law.georgetown.edu/international/documents/Gugiatti.pdf
- IMF (2002a) “Collective Action Clauses in Sovereign Bond Contracts – Encouraging Greater Use” www.imf.org/external/np/psi/2002/eng/060602a.pdf
- IMF (2002b) “The Design and Effectiveness of Collective Action Clauses” www.imf.org/external/np/psi/2002/eng/060602.pdf
- IMF (2003a) “Collective Action Clauses: Recent Developments and Issues” www.imf.org/external/np/psi/2003/032503.pdf
- IMF (2003b) “Progress Report to the International Monetary and Financial Committee on Crisis Resolution” www.imf.org/external/np/pdr/cr/2003/eng/090503.pdf
- Inter-American Development Bank (2006) “Economic and Social Progress Report 2007” www.iadb.org/res/ipes/2007

- Kletzer, K. (2003) “Sovereign Bond Restructurings: Collective Action Clauses and Official Crisis Intervention”, <http://econ.ucsc.edu/~kkletzer/bondreneg5.pdf>
- Krueger, A. (2001) “International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring” speech on 11/26/01, www.imf.org/external/np/speeches/2001/112601.htm
- Krueger, A. (2002) “Sovereign Debt Restructuring and Dispute Resolution” speech on 06/06/02, www.imf.org/external/np/speeches/2002/060602.htm
- Liu, Y. (2002) “Collective Action Clauses in International Sovereign Bonds” IMF Working Paper, www.imf.org/external/np/leg/sem/2002/cdmfl/eng/liu.pdf
- Petas, P. and R. Rahman (1999) “Sovereign bonds – Legal aspects that affect default and recovery” Emerging Market Research, Deutsche Bank, May
- Portes, R. (2003) “Resolution of Sovereign Debt Crises: The New Old Framework” <http://ideas.repec.org/p/cpr/ceprdp/4717.html>
- Rogoff, K. and J. Zettelmeyer (2002) “Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976–2001” <http://ideas.repec.org/a/imf/imfstp/v49y2002i3p8.html>
- Roubini, N. (2002) “Private Sector Involvement in Crisis Resolution and Mechanisms for Dealing with Sovereign Debt Problems” <http://pages.stern.nyu.edu/~nroubini/papers/fincrisis.pdf>
- Simpson, L. (2006) „The Role of the IMF in Debt Restructurings: Lending into Arrears, Moral Hazard and Sustainability Concerns“ www.unctad.org/en/docs/gdsmdpbg2420062_en.pdf
- Taylor, J.B. (2002) “Sovereign Debt Restructuring: A U.S. Perspective” speech at the Institute for International Economics Conference ‘Sovereign Debt Workouts: Hopes and Hazards’ on 04/02/02
- Tsatsaronis, K. (1999) “The Effect of Collective Action Clauses on Sovereign Bond Yields” in ‘International Banking and Financial Market Developments’ Bank for International Settlements, Third Quarter, www.bis.org/publ/r_qt9911.pdf
- Weinschelbaum, F. and J. Wynne (2005) “Renegotiation, Collective Action Clauses and Sovereign Debt Markets” *Journal of International Economics*, 67
- White, M.J. (2002) “Sovereigns in Distress: Do They Need Bankruptcy?” *Brookings Papers on Economic Activity* 1:2002
- World Bank (2005) “International Financial Architecture: A Progress Report” Information Note, www.worldbank.org/ifa/IFA%20progress%20report%202005.pdf