

Collective Action Clauses (CACs): an analysis of provisions included in recent sovereign bond issues (summary)

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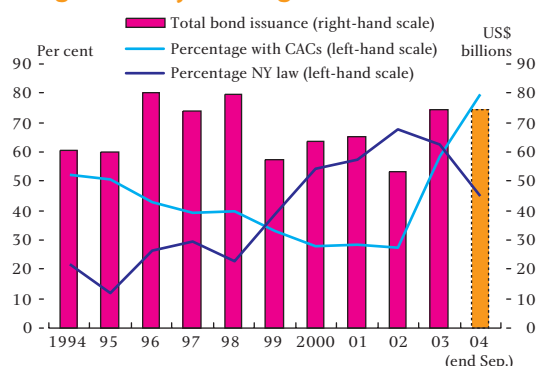
A recent Financial Stability paper published by the Bank assesses the extent to which recent contractual innovations in foreign currency sovereign bonds issued under New York law may contribute to the creation of a more orderly framework for restructuring sovereign bonds. Contractual clauses can be designed to facilitate collective agreement between all creditors to achieve a comprehensive restructuring; improve information exchange between a sovereign and its creditors; and discourage disruptive individual litigation.

A RECENT paper published by the Bank, by John Drage and Catherine Hovaguimian analyses the provisions contained in recent sovereign bond issues, focusing on the inclusion of collective action clauses. The financial stability paper is available at <http://www.bankofengland.co.uk/fsr/fsr17art9.pdf>

The proposition that the introduction of Collective Action Clauses (CACs) could improve the crisis resolution framework came to prominence in the aftermath of the Mexican crisis in 1995 through the publication of the Rey Report.¹ While CACs have been common in several jurisdictions where sovereign bonds are issued (England, Luxembourg and Japan), they were uncommon in sovereign bonds issued under New York law. And, despite the growing recognition that the framework for resolving crises was deficient, there was little change in New York market practice in the years immediately following the Mexican crisis. In 2002, G10 Ministers and Governors asked a Working Group to develop a set of model CACs for sovereign bond issues, with the aim of catalysing a change in market practice. Around the same time, seven private sector trade associations developed their own 'model features' for CACs in sovereign bonds issued under New York and English law.² Shortly afterwards, in February 2003, Mexico issued a foreign currency sovereign bond under

New York law containing CACs. Mexico's bond issue proved to be a turning point and, as Chart 1 shows, the majority of foreign currency sovereign bonds issued in New York and elsewhere now contain CACs.

Chart 1
Foreign currency sovereign bond issuance with CACs^(a)



Source: Dealogic.
(a) Central government only.

Drage and Hovaguimian analyse the clauses included in foreign currency sovereign bonds issued under New York law since February 2003, comparing them with three key objectives identified by the 2002 G-10 Working Group.³ The Working Group concluded that contractual clauses had the potential to make the process for restructuring sovereign bonds more

(1) See www.bis.org/publ/gten03.pdf for a copy of the 1996 G10 Report on The Resolution of Sovereign Liquidity Crises – the 'Rey Report'.

(2) The Institute of International Finance (IIF); the International Primary Market Association (IPMA); Emerging Markets Creditors Association (EMCA); Trade Association for the Emerging Markets (EMTA); the Securities Industry Association (SIA); the International Securities Market Association (ISMA); and the Bond Market Association (TBMA). See www.emta.org/ndevelop/Final_merged.pdf for their draft model clauses dated 31 January 2003.

(3) The Report of the G10 Working Group on Contractual Clauses was published in March 2003 and is available at: www.bis.org/publ/gten08.htm#pgtop

orderly by: (1) fostering early dialogue, coordination, and communication among creditors and a sovereign caught up in a sovereign debt problem; (2) ensuring that there are effective means for creditors and debtors to re-contract, without a minority of debt-holders obstructing the process; and (3) ensuring that disruptive legal action by individual creditors does not hamper a workout that is under way, while protecting the interests of the creditor group.

The paper shows that the most important of the three objectives, providing effective means for creditors and debtors to recontract, has been achieved through the widespread inclusion of majority action provisions (thus binding in minorities and hold-out creditors). Market standards are also evolving with regard to disenfranchisement provisions (excluding bonds held directly or indirectly by the issuer from being voted), hurdles for acceleration and deceleration, and rules for voting on non-reserved matters – all of which contribute to this objective.

However, the analysis in the paper also shows that the actual clauses adopted thus far by issuers do little to further the other two key objectives identified by the G10 Working Group: fostering early dialogue, coordination, and communication between creditors and sovereigns involved in a sovereign debt problem; and ensuring that disruptive legal action by individual creditors does not hamper a workout that is under way. Drage and Hovaguimian therefore conclude that the collective action clauses now being included in sovereign bonds issued under New York law are a most welcome step, but that there is scope for further beneficial market innovation.

The authors highlight three areas where innovation could help improve the framework for sovereign debt restructuring.

- First, the introduction of provisions for the appointment of a bondholder representative (who is empowered to act on behalf of all bondholders when requested to do so by an agreed percentage of the holders of an issue) could help to minimise the prospects of disruptive individual litigation against the sovereign and ensure the equal distribution of the benefits of any litigation to all bondholders.
- Second, given the number of bonds some countries can have outstanding simultaneously, clauses that

facilitate the aggregation of majority action provisions over a number of different issues could also help facilitate comprehensive restructurings. If achievable, aggregation could significantly contribute to the speed at which sovereign restructurings are negotiated. Thus far only the new bonds issued by Uruguay have contained limited forms of aggregation clauses.

- Third, the inclusion of some more explicit collective action provisions in the original documentation for syndicated loans could help because sovereigns also need to have ways in which to restructure their other (non-bonded) debts if the objective of creating an orderly system for sovereign debt restructurings is to be realised fully. (Although the Working Group did not address this directly, it expressed the “expectation that practices developed with respect to sovereign bonds could be implemented with appropriate modifications in other types of debt over time.”)