



BANK OF ENGLAND

News release

Press Office

Threadneedle Street

London EC2R 8AH

T 020 7601 4411

F 020 7601 5460

press@bankofengland.co.uk

www.bankofengland.co.uk

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Collective Action Clauses (CACs): An Analysis of Provisions Included in Recent Sovereign Bond Issues

The Bank has today published a paper (by John Drage and Catherine Hovaguimian) that 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 debt.

The paper looks at the clauses that have been included in bonds issued under New York law since February 2003, which is when the change in market practice occurred, and considers the extent to which they meet three objectives identified in a report on contractual clauses completed in September 2002 by a G10 Working Group. These were:

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

The broad conclusion of the paper is that the changes in contractual clauses included in New York issues since February 2003 achieve the second objective - effective means for creditors and debtors to re-contract - but that only modest progress has so far been made in respect of the other two objectives of fostering dialogue, coordination and communication, and of avoiding disruptive legal action.

The authors consider that the widespread adoption of majority amendment provisions is very significant and welcome progress - the G10 Working Group had considered this to be the most critical of their recommendations. But, that said, it is doubtful whether the clauses so far adopted will by themselves be sufficient to address all the problems associated with sovereign restructurings. They hope that, over time, private sector investors as well as issuers and their advisers will come to accept that it is in all their interests to include a wider range of provisions in sovereign bond documentation. In particular, they think that making provision 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 - would be a significant further step towards creating a more orderly framework for the resolution of sovereign debt crises. They also note that a voluntary set of principles - achieved through a process of consultation between major sovereign issuers and private sector trade associations (that represent the interests of both the sell and buy sides of the market) - could be a complementary means of helping to achieve the objective of developing a more orderly system for restructuring sovereign debt.

Background

While, historically, collective action clauses (CACs) have been common in some jurisdictions where foreign currency sovereign bonds are issued (like England, Luxembourg and Japan), prior to February 2003 they were relatively uncommon in sovereign bonds issued under New York law.

In 1995 in the wake of the Mexican crisis the G10 established a working party to consider the complex set of issues arising with respect to the orderly resolution of sovereign debt crises. The Working Party, chaired by Jean-Jacques Rey of the National Bank of Belgium, concluded that incorporating clauses into sovereign bond contracts that would provide for the collective representation of debt holders in the event of a crisis, allow for qualified majority voting to alter the terms and conditions of bond contracts, and require the sharing among creditors of assets received from the debtor, could be helpful in facilitating the resolution of future sovereign debt crises. The Rey Report was published in May 1996 but subsequently there was little change in market practice.

Given the number of sovereign debt problems in the intervening period, in 2002 the Ministers and Governors of the G10 group of countries established the G10 Working Group on Contractual Clauses under the chairmanship of Randy Quarles of the US Treasury with the mandate to consider how sovereign debt contracts could be modified in order to make the resolution of sovereign debt crises more orderly. The Group finished its work in September 2002 and in February 2003 Mexico issued a bond under New York law that included some of the more significant of the Quarles' Group's recommendations. Since then the vast majority of foreign currency sovereign bonds issued under New York law have included collective action clauses.

Key Resources

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John Drage and Catherine Hovaguimian

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<http://webarchive.nationalarchives.gov.uk/20100114080129/http://www.bankofengland.co.uk/publications/fsr/2004/fsr17art7.pdf>