The Role of the Paris and London Clubs: Is It under Threat?

Chapter XXX

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When it becomes necessary for a State to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonourable to the debtor and least hurtful to the creditor.

Adam Smith, Wealth of Nations, 1776 (at 416)

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1. Introduction

"Sovereign debt" [1] is the debt owed, guaranteed or secured by the central government of a State, an agency or instrumentality thereof.[2]

States can borrow from a variety of sources. They can receive loans from international financial institutions (IMF, WB, and MDBs), foreign governments and commercial banks (either individually or as part of a syndicate), or they can issue sovereign bonds on the international capital markets.

In the 19th century and in the early years of the 20th century, most sovereign debt was in the form of bonds or loans disbursed by private banks providing mainly short-term trade financing or interbank credit lines. To deal with sovereign defaults, bondholders' committees[3] were established and, occasionally, western powers even engaged in "gunboat diplomacy" to recover debts owed to their nationals.

After World War II, government-to-government loans became the preeminent form of borrowing and sovereign debt restructurings were dealt with by the Paris Club, an informal group of official creditors.

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[1] State indebtedness may be either external or domestic. While a State's domestic debt is predominantly held by residents and is usually denominated in domestic currency, governed by national law and subject to the exclusive jurisdiction of national courts, public external debt is the debt a country owes to non-residents, including governments, international financial institutions and commercial banks. It is often denominated in a foreign currency, governed by a foreign law and subject to the jurisdiction of a foreign court.

[2] Recently, the issue of the so-called "quasi-sovereign debt" has been raised, which refers to the debt incurred by subnational political entities (provinces, municipalities and the like), and by State-owned enterprises. While State-owned enterprises are usually able to borrow externally even when the government does not guarantee its repayment, in some cases the administrative regions of sovereign States are prohibited to do so by law (for example, in the United Kingdom, but not in the United States). The global financial crisis highlighted the problems related to the debt owed by public enterprises, which in some cases was restructured on the same basis as sovereign debt, while in others was dealt with through the relevant domestic bankruptcy regime. See U. Das, M. Papaioannou, C. Trebesch, "Sovereign Debt Restructurings 1950-2010: Literature Survey, Data, and Stylized Facts" (2012) *IMF Working Paper*, WP/12/203, p. 56 ff. and A. Gelpern, "Bankruptcy, Backwards: The Problem of Quasi-Sovereign Debt" (2012) *Yale Law Journal* 121, pp. 888-942.

[3] Before World War I, when bonds were still the predominant form of sovereign borrowing, bondholders had few legal remedies against a defaulting State. At the time, States enjoyed absolute sovereign immunity and bond investors (mainly banks) could recover their investment only by seeking diplomatic protection or through negotiations. To this end, committees were established in the United Kingdom and in the United States to represent the interests of bondholders and to lobby their own governments, but with negligible effects. In 1868, in the UK, a consortium of loan houses and brokers created the Corporation of Foreign Bondholders. In the United States, the Foreign Bondholders Protective Council was established in 1933 under the Roosevelt administration to protect the interests of holders of foreign bonds and to negotiate with governments that defaulted on their debts. See P. Mauro and Y. Yafeh, "The Corporation of Foreign Bondholders" (2003) *IMF Working Paper*, WP/03/107; M. R. Adamson, "The Failure of the Foreign Bondholders Protective Council Experiment, 1934-1940" (2002) *The Business History Review*, Vol. 76, No. 3, pp. 479-514.

It was only in the 1970s that States started to borrow from international commercial banks through long-term syndicated credit agreements.[4] During the 1980s, however, the majority of emerging countries defaulted on their bank loans, which had to be restructured by small banks' committees, collectively referred to as the London Club.

During the 1990s, bank lending to emerging economies declined as compared to sovereign bond financing and nowadays the external debt of sovereigns is mainly held in the form of bonds. Sovereign bonds are actively traded in secondary markets and held by a broad community of investors. Current bondholders include many categories of creditors, both domestic and foreign, which range from retail to institutional investors (banks, investment funds, hedge funds, pension funds, and insurance companies), also encompassing sovereign wealth funds, central banks, the IMF and similar international organizations, as well as supranational institutions like the European Central Bank and the European Investment Bank. Bond investors, however, are usually not represented in bondholders' committees, and restructurings take the form of sovereign bond exchanges.

It is clear from the above that, over the past sixty years, the features of sovereign debt restructurings have been shaped by the type of creditors and by the nature of the debt. Debt restructuring vehicles therefore change according to the category of creditors involved: (a) official bilateral debt is renegotiated under the Paris Club umbrella; (b) commercial bank debt is restructured through the so-called London Club process or Bank Advisory Committees; and (c) bond debt is restructured via exchange offers.

The purpose of the following chapter is to assess whether, in light of recent developments, the Paris and the London Clubs can still play a leading role in sovereign debt restructurings.

[4] During the 1970s, bank lending to emerging market countries usually took the form of a syndicated loan, a club loan or a single-bank loan. Under a syndicated credit agreement, the borrowing country selects one or several commercial banks to act as arranger or co-arrangers against the payment of a fee. The arranger agrees to provide a share of the loan, prepares the terms of the syndicated credit agreement and sells portions of the loan to other participants. To facilitate the process of administering the loan on a daily basis, one bank from the syndicate is appointed as agent. Principal and interest payments are made by the borrower to the agent, which is responsible for their transfer to each syndicated member according to its share of the loan.

After an analysis of the Paris and the London Clubs, which developed as the preferred *fora* for the restructuring of debts owed by a State to homogeneous groups of creditors (other States and commercial banks respectively), this study will focus on the creditor structure of sovereign bonds.

It is argued that the fragmentation of the bondholders' profile can pose a host of complex issues to the development of a dedicated workout mechanism for the restructuring of sovereign bond debt. In particular, the challenges posed by supranational bondholders are yet to be carefully addressed, while the principles and practices developed by the Paris and the London Clubs can only be of a limited use.

2. The Paris Club

2.1 Origins and nature of the Paris Club

The Paris Club is the leading intergovernmental forum to restructure official bilateral debt, which is debt owed by – or guaranteed by – a national government to other countries.

The Paris Club gathered informally for the first time in 1956 to deal with Argentina's default and its creation is seen by many as stemming from the spirit of multilateralism in international relations prevailing in the aftermath of World War II. Its predecessor was the Club of The Hague, set up in 1955 by six European countries seeking a common approach to the renegotiation of the Brazilian debt.[5]

In its current configuration, the Paris Club is composed of 22 permanent members (with South Korea and Brazil joining in 2016[6]). They represent a group of countries with common interests and large credit exposure to other States.[7]

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[5] The aim of the Club of The Hague was to avoid the creation of unfair preferences among creditors, which were considered against the spirit of cooperation of the members of the Organization for European Economic Cooperation (OEEC). The IMF, the IBRD and the OEEC took part in the negotiations as observers.

Brazil had to reschedule its debt within the Club of The Hague a second time in 1961 and a third one in 1964. After the third debt agreement with Brazil, the Club of The Hague ceased to exist.

[6] The sharp rise in emerging market borrowing in the aftermath of the financial crisis encouraged official creditors to expand the Paris Club membership amid the re-emerging threat of debt crises in poorer nations.

[7] The twenty-two permanent members of the Paris Club are: Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Italy, Japan, South Korea, the

Other official creditors may attend the Club negotiation sessions as *ad hoc* participants, subject to the agreement of the permanent members and of the debtor State.[8]

Usually, both permanent members and *ad hoc* participants are represented by senior officers from the Ministry of Finance.

Since 1961, representatives of the IMF and the IBRD are invited to Club meetings as observers, to provide information and technical advice.[9] The OECD, the UNCTAD,[10] the European Commission and four multilateral development banks (the African Bank of Development, the Asian Bank of Development, the European Bank for Reconstruction and Development, and the Inter-American Development Bank) also attend negotiation meetings.

During the Latin American debt crisis of the 1980s, the Club underwent a process of progressive institutionalization. The increased administrative needs led to the establishment of a permanent Secretariat. Based at the French Treasury, which also provides the staff, the Secretariat is granted independence from France, but it does not have the power to act independently from member States.

Today, the Paris Club remains an informal group of creditor countries and its functioning is regulated neither by a treaty, nor by any attribution of competences. In fact, the Club becoming a proper international organization would have made debt restructuring an ordinary operation to be performed at a multilateral level, rather than an exceptional event justified only by extreme circumstances.[11]

Netherlands, Norway, the Russian Federation, Spain, Sweden, Switzerland, the United Kingdom and the United States. Apart from Brazil and the Russian Federation, all the other countries are OECD members.

[8] Other creditors that have participated in *tour d'horizon* meetings (on which see *infra*) or in negotiations with specific debtor countries include: Abu Dhabi, Argentina, China, Kuwait, Mexico, Morocco, New Zealand, Portugal, South Africa, Trinidad and Tobago and Turkey. Before joining the Club, Brazil participated on an *ad hoc* basis in a number of negotiations related to the debt of African countries debt.

[9] The IMF and the IBRD are recognized preferred creditor status (on which see *infra* par. 4.1) by Paris Club members. During Paris Club negotiations, they only have the role of observers.

[10] Since 1978, UNCTAD has been providing its technical assistance to debtor countries taking part in debt renegotiations within the Paris Club (see UNCTAD Trade and Development Board (TDB) Resolutions 165 (S-IX) and Resolution 222 (XXI). Part B of TDB Resolution 222 (XXI) contains the "Detailed Features for Future Operations Relating to the Debt Problems of Interested Developing Countries" that applies to bilateral debt only.

[11] A. Rieffel, *The Paris Club, 1978-1983*, in *Columbia Journal of Transnational Law*, 1984, p. 84. On the nature of the Paris Club, see among others A. Reinisch, *Debt Restructuring and State Responsibility Issues*, in D. Carreau – M. N. Shaw, *La dette extérieure*, Dordrecht-London-Boston,

Furthermore, this would have entailed admitting debtor States in the organization, something that at the time was not considered desirable by creditors, who feared losing power.

With the number of negotiations soaring during the 1980s, the need for a set of codified principles and procedures arose. Since 1982, the Paris Club started to convene monthly in *tour d'horizon* meetings to discuss the overall debt situation of developing countries and methodological issues.

2.2 The negotiation process and the Agreed Minutes

The Paris Club restructuring process is initiated by a debtor State unable to service its external debt, which submits a formal request for the opening of negotiations to the Secretariat of the Club.

Negotiations are attended by permanent members (acting as participating creditors if they have claims towards the debtor country or otherwise as observers) and *ad hoc* participants.[12] In practice, the Club has a variable geometry that depends on the State requesting a renegotiation.

A negotiation meeting begins with a plenary session where the statement of the debtor country is presented. This statement is intended to prove a State's need for debt relief and contains data on the balance of payments situation and on debt unsustainability, together with economic performance forecasts.

Data is also presented by the IMF, which provides an assessment of the debtor's economic situation. Notably, the Paris Club will only consider entering negotiations if the debtor is pursuing a macroeconomic adjustment programme supported by the IMF.

Once the plenary session is concluded, the debtor country and the observers – with the exception of the IMF – are requested to leave the meeting. Creditors gather to establish the terms to be offered to the debtor. The proposal has to be agreed upon by consensus. The debtor may suggest modifications that are always conveyed

1995, pp. 544 ff. and C. Holmgren, *La renégociation multilatérale des dettes: le Club de Paris au regard du droit international*, Bruxelles, Bruylant, 1998, p. 184 ff.

[12] *Ad hoc* participants share data with permanent members based on reciprocity and fully commit to respect the solidarity principle.

to the group of creditors by the Chairman of the Paris Club. Commitments on new lending are not discussed within the Club.

The outcome of the negotiations is a document called Agreed Minutes, which is signed by the creditors' representatives, the minister representing the debtor country and the Chairman of the Club. The Minutes amount to a gentlemen's agreement, which each government is expected to honour in good faith, but *per se* are not legally binding.[13]

The Agreed Minutes, in fact, "are signed 'ad referendum' by the heads of the participating delegations, who thereby agree to 'recommend to their Governments… that they provide relief… on the following terms'".[14]

To give legal effect to what has been established during the negotiations, the terms formalized in the Minutes have to be transposed in bilateral agreements. The latter also set the applicable interest rates on the restructured debt.

There are five principles spelling out the general terms of all Paris Club debt treatments: (1) Paris Club decisions are taken on a case-by-case basis to tailor debt treatments to each debtor's specific situation; (2) all decisions are reached by consensus among participating creditors (both permanent members and *ad hoc* participants); (3) debt restructuring can be negotiated with the Paris Club only by countries clearly in need of debt relief, which are implementing – or committed to implement – an IMF programme and its attached conditionality; (4) solidarity is requested in the sense that all creditors undertake to implement in good faith the terms agreed; and (5) the Paris Club demands comparability of treatment to ensure that an equal burden is shared among all external public or private creditors of the debtor.

The latter is a key clause, according to which the debtor country should not consent to a treatment on less favourable terms from its external private creditors

[13] The Agreed Minutes are signed by the parties involved, but they are not ratified afterwards. This shields the common agreement reached within the Paris Club from being the object of debate in national parliaments. According to some Authors, the Agreed Minutes can be considered treaties concluded by using the simplified procedure. See C. Holmgren, *La renégociation multilatérale des dettes*, cit., pp. 217-230. See also A. Rieffel, *The Role of the Paris Club in Managing Debt Problems*, in *Princeton Essays in International Finance*, n. 161, December 1985, p. 18; M. Megliani, *Sovereign Debt: Genesis, Restructuring, Litigation*, 2015, Springer, New York, p. 291 and fn. 109.

[14] See L. Rieffel, *Restructuring Sovereign Debt: The Case for Ad Hoc Machinery* (Washington DC, Brookings Institution Press, 2003), p. 91.

and other official bilateral creditors.[15] In other words, the debtor undertakes to seek from creditors that do not belong to the Club a treatment comparable to the one granted in the Agreed Minutes. This is understood to apply to States not represented in the Club, international organizations and private creditors, the only exception being the recognition of preferred creditor status to the IMF, the World Bank and multilateral development banks (on this matter see *infra* paragraph 4.1).

Breaching the comparability principle would entail the cancellation of Paris Club debt relief, thus impairing also the implementation of a country's IMF supported programme and its prospective negotiations with commercial banks or bondholders, which might be underway. A "pullback clause" ensures in fact that if the debtor agrees better terms with its non-Paris Club bilateral creditors, the participating countries will declare the provisions set forth in the Agreed Minutes null and void.

The variety of creditors, however, makes an assessment on comparability of treatments complex. This occurs, for example, when the Paris Club grants flow treatment while the London Club is restructuring a country's entire stock of debt, or when bondholders are offered a debt swap.

Moreover, the Paris Club does not acknowledge the validity of the "reverse comparability principle"; in fact, public creditors do not feel bound by a haircut agreed by the private sector.[16] The rationale behind this stance is that, unlike private

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[15] Lee Buchheit gives an example of a clause: 'In order to secure comparable treatment of its *debt due to all its external public or private creditors*, the Government of the Republic of Ruritania commits to seek promptly from all its external creditors debt reduction and reorganisation arrangements on terms comparable in net present value to those set forth in the present Agreed Minute for credits of comparable maturity. Comparability of treatment for debt reduction in net present value is assessed not only on the basis of the reduction in the face value of the debt but also on the terms of repayment of the debts not cancelled. Consequently, the Government of the Republic of Ruritania commits to accord all categories of creditors – and in particular creditor countries not participating in the present Agreed Minute, commercial banks and suppliers – a treatment not more favourable than that accorded to the Participating Creditor Countries'. (L. Buchheit and E. L Daly, "Minimizing Holdout Creditors: Carrots", in R.M. Lastra and L. Buchheit (eds.), *Sovereign Debt Management*, Oxford, 2014, p. 9-10).

Olivares Caminal gives another example explicitly mentioning bondholders: "In order to secure comparable treatment of its debt due to all its external public or private creditors, the Government of the Islamic Republic of Pakistan commits itself to seek from … bond holders the reorganization of bonds" (R. Olivares-Caminal, *Debt Restructuring*, Oxford, OUP, 2011, p. 423).

[16] T. Lambert, "Debt Restructuring Experience: the Paris Club" (2011), p. 4, paper presented at the conference "The missing link in the international financial architecture: sovereign debt restructuring" organized by Ministerio de Economía y Finanzas Argentino, Buenos Aires, 7 December 2011, available at http://www.mecon.gov.ar/finanzas/deuda%20soberana/lambert.pdf, last visited 10 June 2017.

creditors, public creditors do not lend for profit purposes. Consequently, an effort made by private creditors cannot be a benchmark for the public sector.

Two types of debt relief treatments[17] may be granted by the Paris Club, based on the financial situation of the debtor: flow-of-payment and stock-of-debt treatment.

Flow treatments aim at halting the country's liquidity problems identified by the IMF in its debt sustainability analysis.[18] If the IMF determines that the country suffers from a temporary liquidity problem, debt payments owed to Paris Club creditors and falling due within a given period of time (the consolidation period) are rescheduled to help the country close its financing gap.

If the country is also affected by debt sustainability problems and it lacks the long-term resources to meet its debt obligations, it is eligible for the second kind of treatment. The concerned stock of debt is rescheduled at concessional terms to address the debtor's solvency problem, thus providing the country with a final "exit treatment". This treatment, however, is only provided in the context of the Heavily Indebted Poor Countries initiative (HIPC) and on a case-by-case basis.[19]

Before the 1990s, the Paris Club never granted debt cancellation and its rescheduling treatments were often insufficient to restore debt sustainability and the creditworthiness of the country.[20] On many occasions rescheduling had to be repeated more than once. This led the Paris Club to grant longer repayment periods (up to 40 years for Official Development Aid loans,[21] including a grace period of 16 years[22]).

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[17] The term debt relief is comprehensive of any form of debt treatment that reduces the overall burden of debt for a given country, either by refinancing, rescheduling, reduction or conversion.

[18] The flow treatment is usually based on the financing gap identified in the IMF adjustment programme and the consolidation period coincides with the period when the IMF arrangement shows a need for debt relief.

[19] This treatment was granted for the first time in 1994 under the Naples Terms according to which stock treatment could be implemented on a case-by-case basis for countries with a satisfactory track record with both the Paris Club and the IMF.

[20] Between 1956 and 1980, rescheduling granted to debtors was at market rates with a repayment profile negotiated on a case-by-case basis (usually a ten-year repayment period, which included a three-year grace period).

[21] Official Development Aid (ODA) debt is usually restructured on more favourable terms than non-ODA debt. The OECD defines ODA as those flows that are "provided by official agencies, including state and local governments, or by their executive agencies; and ii. each transaction of which a) is administered with the promotion of the economic development and welfare of developing countries as its main objective; and b) is concessional in character and conveys a grant element of at least 25 per cent (calculated at a rate of discount of 10 per cent)."

[22] A grace period during which no repayments of the debt falling due has to be paid is often granted.

The Paris Club first agreed on a partial reduction of the outstanding debt of least-developed countries in 1988.[23] Since then, debt reduction has been increasingly resorted to, raising the level of cancellation to up to 90 per cent in the framework of the HIPC Initiative. By introducing new terms of treatment, the Paris Club turned in the last 60 years from a mere debt collector into a provider of sequential debt relief, thus incorporating a development assistance element among the objectives of its activities. [24]

Paris Club creditors have often agreed to offer a pre-defined treatment to specific categories of debtor countries. The current Paris Club standard treatments, ranking in degree of concessionality, are: Classic Terms, the standard terms available to any country eligible for Paris Club relief; Houston Terms,[25] for highly-indebted low to mid-income countries; Naples Terms, for highly-indebted poor countries; Cologne Terms, for countries eligible for the HIPC Initiative.

Classic and Houston terms only offer debt rescheduling, while Naples and Cologne terms provide also for debt reduction.

The Paris Club also offers creditors the possibility to voluntarily engage in debt swaps and to buy back their debt ahead of schedule (the same conditions should be offered to all Paris Club creditors which, however, are free to individually decide whether to take part in the operation).

In order to be eligible for the restructuring, loans must have been taken before a cut-off date, which is usually established the first time a debtor meets with the Paris Club. Short-term debts, falling due within a year, are not treated by the Club.

Having been temporarily relieved from the payment of loans taken prior to the cut-off date, the debtor is given the possibility of restoring its creditworthiness and regaining access to new credit.

[23] Under the so-called Toronto terms, between 1988 and 1991, 20 countries obtained a 33.33 per cent cancellation of their non-ODA debts.

[24] See also Gong Cheng, Javier Diaz-Cassou, Aitor Erce, From Debt Collection to Relief Provision: 60 Years of Official Debt Restructurings through the Paris Club, ESM Working Paper Series 20, 2016.

[25] Most of the denominations of the standard Paris Club terms come from the G7/G8 meetings in which they were agreed upon.

Loans granted after the cut-off date can be renegotiated with the Paris Club only on an exceptional basis, when it is demonstrated that debt relief was not sufficient to restore the payment capacity of the country.

2.3 Is the Paris Club at the end of its cycle? Life after the HIPC and the Evian approach

At the end of the 1990s, the Paris Club resolved on the adoption of two different approaches, tracing a distinction between HIPC and non-HIPC countries.

The HIPC Initiative was launched by the IMF and the World Bank in 1996 (and enhanced in 1999), when the seriousness of the external debt situation of a large number of low-income countries was finally understood. The initiative called for a coordinated action by the IMF, the IDA and other multilateral institutions, together with official bilateral creditors and commercial creditors.[26] The aim was to bring the debt of HIPC countries down to sustainable levels, channelling the freed resources towards poverty reduction priorities.[27]

To be eligible for the HIPC Initiative, a country had to be burdened by an unsustainable debt situation even after the application of the traditional debt relief mechanisms (like a preliminary flow treatment granted by the Paris Club under the Naples Terms[28]). Furthermore, the country had to be eligible for borrowing under highly concessional terms from the IDA and the IMF, and it had to implement a Poverty Reduction Strategy (PRS).

Decision Point was reached when a country still suffered from unsustainable debt, despite satisfactorily implementing its IMF/IDA-supported programme. At decision point, the IMF/IDA Executive Boards formally decided whether a country

[26] Non-Paris Club official bilateral creditors and commercial creditors, however, delivered only a small share of their expected debt relief.

[27] It is interesting to note that the HIPC Initiative was designed to preserve the preferred creditor status of the IFIs, without exempting them from taking part in debt relief operations. Despite the common understanding, under the HIPC Initiative, IFIs are still repaid, only not by the debtors, but by drawing on special funds largely raised from the major creditor countries: for instance, the IMF's costs of HIPC debt relief were financed by bilateral contributions and the investment income on the proceeds from off-market gold sales in 1999.

[28] Under the Naples terms, 67 per cent of eligible non-ODA credits are cancelled, the remaining amounts are rescheduled over 23 years with a 6-year grace period. ODA credits are rescheduled over 40 years with a 16-year grace period.

qualified for debt relief and determined its extent. The Paris Club usually granted interim relief under Cologne terms (flow treatment).[29]

Completion Point was reached once the country had achieved macroeconomic stability under a Poverty Reduction and Growth Facility supported programme and it had carried out structural and social reforms, successfully implementing a PRS for at least one year. At completion point, the country "graduated" from the HIPC Initiative, receiving the assistance still necessary to reach debt sustainability. The Paris Club granted stock treatment on the condition that the other creditors provided comparable treatment.

In 2005, to help accelerate progress towards the United Nations Millennium Development Goals (MDGs), the HIPC Initiative was supplemented by the Multilateral Debt Relief Initiative (MDRI). The MDRI allowed for 100 per cent cancellation of the eligible debts by the IMF, the IDA, the African Development Fund and the Inter-American Development Bank for those countries having reached completion point under the HIPC Initiative.[30]

Through the HIPC and MDRI initiatives, between 2000 and 2014 the international financial community cancelled debts with a total face value of USD126 billion.[31] Paris Club creditors accounted for approximately a quarter of the total financial effort. On average, external public debt was reduced from 119% of GDP in the year prior to the decision point to 33% of GDP two years after the completion point.[32]

At the end of 2017, out of the 39 countries eligible to receive debt relief under the HIPC Initiative, 36 countries reached the completion point, receiving stock of debt treatment by Paris Club creditors. The remaining 3 countries which were identified as potentially eligible for assistance – Eritrea, Somalia and Sudan – have not reached the decision point yet.

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[29] Under the Cologne terms, non-ODA credits are cancelled up to 90 per cent or more if necessary. The remaining amounts are rescheduled over 23 years with a 6-year grace period. ODA credits are rescheduled over 40 years with a 16-year grace period.

[30] On the HIPC and MDRI initiatives see, among others, T. A. Duvall III, "Debt Relief for Low-Income Countries", in R.M. Lastra and L. Buchheit (eds.), *Sovereign Debt Management*, Oxford, 2014, p. 69-84.

[31] See IMF, "Heavily Indebted Poor Countries Initiative and Multilateral Debt Relief Initiative - Statistical Update", 2014.

[32] Source: World Economic Outlook, IMF, April 2015.

For what concerns the debt problems of non-HIPC countries, in 2003 the Paris Club adopted the so-called Evian Approach, shifting from the provision of short-term debt relief to a long-term debt sustainability approach.

Through the Evian approach, the Paris Club extensively relies on debt sustainability tools to adapt its response to the financial situation of the debtor countries. However, while formally acknowledging that even non-HIPC countries may face solvency problems, no new terms of treatment have been applied and the Paris Club continues using a combination of standard terms adapted to each debtor's financial situations. A comprehensive debt treatment (flow treatment, stock reprofiling, stock reduction) is offered to non-HIPC countries only if they establish a satisfactory track record in implementing an IMF programme and in reimbursing Paris Club creditors. Debt reduction, either through principal or NPV reduction, is provided only in exceptional cases. Between 2009-2015, Paris Club concluded five agreements under the Evian Approach.[33]

Certainly, the Paris Club has played a crucial role in the restructuring of official debt, reaching since its establishment 433 agreements with 90 different countries.[34] By freeing resources for poverty reduction, it ~~certainly~~ contributed to the improvement of the socio-economic situation of developing countries.

However, since the 1990s, the Club's share of developing countries' debt and financing flows has been steadily declining and, currently, a significant number of countries (even post-HIPC countries) are accumulating new debt at a rapid pace and are at risk of returning to unsustainable debt levels.

In fact, after the 2008 financial crisis, several middle- and low-income countries have turned to international bond markets to finance their development needs. Many are first-time issuer of sovereign bonds (among HIPC countries: Ethiopia, Ghana, Rwanda, Senegal, Tanzania and Zambia).[35] The risks they incur are heightened by the fact that their sovereign bonds are usually denominated in foreign currency and their terms do not include the latest boilerplate provisions promoted

[33] See Paris Club, *Annual Report 2016*, p. 9.

[34] In the period 1950-2010, "the number of official debt restructurings by the Paris Club far exceeds the number of private debt restructurings with commercial banks or bondholders, with nearly double as many deals" (U. Das, M. Papaioannou, C. Trebesch, *op. cit.*, p. 33).

[35] See A. Guscina, G. Pedras and G. Presciuttini, "First-Time International Bond Issuance - New Opportunities and Emerging Risks" (2014) IMF Working Paper WP/14/127.

by the IMF and the International Capital Market Association (ICMA) to counter vulture funds' strategies.[36]

Moreover, an increasing share of official bilateral financing is provided by new lenders – like China, India, Kuwait and Saudi Arabia – which are not permanent members of the Paris Club, nor do they seem interested in joining it. This situation might give rise to creditor coordination problems and eventually to holdout behaviours among official creditors.

In contrast to traditional lenders, new lenders tend not to assess the long-term sustainability of the borrower's debt and apply a non-interference policy, showing a strong preference for lending without conditionality.[37] Besides, they offer loans to developing countries "with non-traditional financial structures (including implicit or explicit collateralization, foreign exchange clauses, and variable fees)".[38]

Moreover, data shows that, in recent years, the application of the comparable treatment principle by non-Paris Club creditors has fallen short of expectations. New lenders provided "less than half of the total debt relief expected"[39] to HIPC-countries and a similar behaviour was observed with regard to non-HIPC countries.

A broader inclusion of emerging creditors is therefore essential for the Paris Club to preserve its role as "the principal international forum for restructuring official bilateral debt".[40] To this end, Korea's and Brazil's accession to the Club as well as China's regular participation in *tour d'horizon* meetings since 2014 (even if on an *ad hoc* basis) are noticeable.

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[36] Source: N. Bertin, "Economic risks and rewards for first-time sovereign bond issuers since 2007", Trésor-Economics, N. 186, November 2016. The typical bond of first-time issuers is a USD denominated bond governed by English law and issued on the New York market. Most are "bullet bonds": the entire principal is repaid all at once at maturity date.

[37] See N. Nkunde Mwase and Y. Yang (2012), "BRICs' Philosophies for Development Financing and Their Implications for LICs" (2012) IMF Working Paper, IMF WP/12/74, p. 3.

[38] IMF, "Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief", November 2006, p. 8. Little is known about the terms of this new lending.

[39] IMF, "Reforming the Fund's Policy on Non-Toleration of Arrears to Official Creditors", IMF Policy Paper, December 2015, p. 12.

[40] As recognized in 2016 by the G20 (see G20 Finance Ministers and Central Bank Governors Communiqué, Chengdu, China, 24 July 2016, par. 8 and G20 Leaders' Communiqué, Hangzou Summit, 5 September 2016, par. 17).

To avoid seeing debt relief efforts undermined by free riding, the Paris Club should build a framework for an enhanced dialogue with emerging creditors with a view to ensure information sharing, coordination and comparable treatment.[41]

To this end, since October 2013, the G20 and the Paris Club have been hosting on an annual basis the Paris Forum to discuss emerging trends and challenges in official financing and to promote inclusiveness and dialogue between sovereign debtors and creditors.[42] It is in this context that, for instance, the G20 Operational Guidelines for Sustainable Financing were first discussed.[43]

Initiatives have been taken also within the IMF, in particular in relation to the Fund's Policy on Non-Toleration of arrears to official bilateral creditors (NTP), which long relied on the Paris Club practices and processes.

The NTP policy prevents the IMF from lending to countries if they owe unresolved arrears to official bilateral creditors, unless the arrears are covered by a Paris Club agreement or each creditor consents to the Fund financing. When there is a formal Paris Club Agreed Minute, also arrears to non-Paris Club countries are deemed resolved because the Fund relies on the observance of the Club's comparability of treatment principle.

In 2015, in the light of the increasingly important role played by new official bilateral lenders and of recent difficulties in ensuring their comparable participation

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[41] See IMF, "Sovereign Debt Restructuring: Recent Developments and Implications for the Fund's Legal and Policy Framework", April 2013, p. 34. See also H. Reisen and S. Ndoye, "Prudent versus Imprudent Lending to Africa: From Debt Relief to Emerging Lenders" (2008) *OECD Development Centre Working Paper No. 268*.

[42] The 5th annual conference of the Paris Forum gathered in Paris in November 2017 the Paris Club's 22 permanent members, G20 members which are ad hoc participants in the Club (in 2017 only China, but in 2016 also South Africa attended), G20 members not participating in the Club (Argentina, Indonesia, Mexico and Saudi Arabia), other members of the European Union (Czech Republic and Poland) and developing countries (Antigua and Barbuda, Cameroon, Chad, Comoros, Côte d'Ivoire, Democratic Republic of Congo, Egypt, The Gambia, Jordan, Niger, Senegal, Sri Lanka and Vietnam). The IMF, the World Bank, the African Development Bank, the Asian Development Bank, the UNCTAD, the OECD, the European Commission, the ECB and representatives of NGOs and of the civil society also participated in the Conference.

In December 2017, the Paris Forum held its first regional conference for Southern Africa in Namibia.

[43] The G20 Operational guidelines for sustainable financing adopted at Baden Baden on the 17th of March 2017 are available at http://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Schlaglichter/G20-2016/g20-operational-guidelines-for-sustainable-financing.pdf?__blob=publicationFile&v=2, last visited 10 January 2018. The G20 however failed to mention the significant body of work recently undertaken by the UN General Assembly and by the UNCTAD on the issue.

to the provision of debt relief, the Fund considered a reform of the NTP policy necessary.

According to the new policy, 1) where the majority of the arrears are owed to non-Paris Club countries and the latter is therefore not adequately representative of the creditor base or 2) where the creditors are not members of the Club and an agreement cannot be reached bilaterally or under alternative groupings, the Fund will lend into arrears only if it satisfies itself that the debtor is making good faith efforts to reach a debt restructuring agreement and that its absence is due to the unwillingness of the creditor.[44]

While the IMF policy is still primarily centred on the Paris Club process, it is acknowledged that in the future a new representative forum for the official sector involvement may emerge. In the meanwhile, the Fund continues to encourage new lenders "to participate in the Paris Club negotiations on an *ad hoc* basis".[45]

As a last remark, it is worth noting that every year the Paris Club and the Institute of International Finance[46] (IIF) jointly organize a meeting among official and private creditors, with the IMF and the World Bank also attending.[47]

3. The London Club (or the Bank Advisory Committee) process

3.1 Origins and nature of the London Club process

In the 1970s, developing countries borrowed heavily from commercial banks, mainly in the form of syndicated loans. Debt owed by a government to commercial banks was restructured through bank advisory committees. The first instances in which this form of debt restructuring was adopted were the negotiations with Zaire, Peru, Turkey, Sudan[48] and Poland in the period between 1976 and 1981.[49]

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[44] See IMF, "Reforming the Fund's Policy on Non-Toleration of Arrears to Official Creditors", cit., p. 15-16.

[45] *Ibid*.

[46] The IIF is a global association of financial institutions. Its members include most of the world's largest commercial banks and investment banks, as well as a growing number of insurance companies, investment management firms, hedge funds, and sovereign wealth funds.

[47] The last meeting of Paris Club and the IIF with representatives of the private sector took place in Paris on 21 June 2017.

[48] It is worth noting that in January 2017 a group of commercial creditors formed the Sudan London Club to start negotiations with the country. To our knowledge this is the most recently established BAC.

[49] See L. Rieffel (1984), *op. cit.*, p. 102 ff.

The process was replicated in subsequent defaults and it was labelled "London Club" in a somehow misleading way, since the negotiations were not always conducted in the City, but also in Paris and New York.[50] The term is used to refer to meetings held between commercial creditors and a debtor State by establishing an *ad hoc* Bank Advisory Committee, a Steering Committee or a Creditor Committee.

Bank Advisory Committees (BAC) were defined as "a communications link between the sovereign borrower and the international banking community".[51] They are typically composed of 10 to 20 senior representatives of the banks with the largest credit exposures to the debtor country. Members of the committee negotiate only on behalf of the banks participating in the syndicate: they do not represent other banks or other categories of creditors.

The London Club process is even less institutionalized than the Paris Club: not only is it not established by a treaty, but there are no Secretariat or fixed venues, and the costs of its meetings are usually borne by the debtor.

Moreover, unlike the Paris Club, there are no permanent members and the composition of a BAC changes greatly according to the debtor.

3.2 The restructuring of sovereign debt owed to commercial banks

The debt restructuring process is usually triggered by a country's default and its subsequent incapacity to borrow on international capital markets.

The BAC is voluntarily established by the country, which mandates one of its largest creditors to arrange a committee. When the debt is in the form of a syndicated loan, like in the 1980s, the arranger of the loan usually chairs the committee. Together with the chief negotiator for the debtor country, the chairperson invites other leading banks to participate. The composition of the creditor committee and the appointment of its chair are very sensitive issues, but

[50] The first mentioned renegotiations took place in London, but during the 1980s-1990s a large number of negotiations with Latin American countries took place in New York. Occasionally, creditor committees also met in Paris.

[51] L. C. Buchheit, "Advisory Committees: What's in a Name?" (1991) 10 *Int'l Fin. L. Rev*. 9, p. 9. See also M. Megliani, *cit*., p. 331 ff.

the advantage of a lean process is that the debtor is provided a single negotiation lane.

It has to be underlined that BACs do not operate under any formal set of rules or procedures and their formation is "without legal recognition, either as a matter of contract or as a matter of law".[52] Moreover, the formation of a BAC has no consequence on the contractual relationships between the debtor and its creditors. In fact, a debtor request for a debt standstill is unusual and typically there is no "cooling off period" during which payments would be temporarily suspended or deferred and creditors would be prevented from initiating litigation.

Although the course of action derives from practice, there is less reliance on precedents than in the context of the Paris Club. A BAC is typically mandated to: (1) adopt the procedures it considers most appropriate; (2) verify the financial data presented by the debtor to support its request for a restructuring or for new lending; (3) perform a recognition survey on the various categories and amounts of the outstanding debt; (4) assess the adequacy of the country's adjustment plans and reform efforts; (5) negotiate the terms of the restructuring, which may also include new financing; (6) draft all the legal documentation; (7) sign a confidentiality agreement; (8) endorse the final outcome of the negotiations and promote its acceptance among non-committee creditors to achieve critical mass.[53]

At the first meeting, the debtor's chief negotiator submits to the BAC an economic programme and a restructuring proposal. The country's Minister of Finance or the Governor of the central bank usually attends the meeting.

BAC members meet separately to prepare a counteroffer. Unlike Paris Club members, they are not bound by foreign policy objectives and restructurings are always market oriented, the goal being to limit losses.

As for conditionality, a country is usually requested to pay interest arrears and might be induced to enter an IMF-supported programme before the conclusion of the negotiations.

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[52] On this point see A. Mudge, "Sovereign Debt Restructure: A Perspective of Counsel to Agent Banks, Bank Advisory Groups and Servicing Banks" (1984-1985) 23 *Colum. J. Transnat'l L.* 59, p. 64.

[53] In practice, when the package is finalized by the BAC and the debtor country, the available choices for creditor banks not taking part in the committee are only to sign or not to sign the deal.

An economic subcommittee is appointed to collect and study the data presented by the debtor, as well as that provided by the banks and the IMF, in order to independently assess the country's debt sustainability. A legal subcommittee is established to draw up all the documentation.

At the end of the process, the BAC and the debtor sign the "term sheet" – also called "heads of terms" or "agreement in principle" – which is submitted to all the members of the syndicate for approval.

For the agreement to become valid, unanimity is usually required, or acceptance by banks holding at least 95 per cent of the outstanding debt. Usually, each material element of a restructuring package has to be agreed upon by the members of the BAC.

Unanimity was generally easy to achieve during the debt crisis of the 1980s, but in the following decade – together with other technical and legal issues – it caused lengthy negotiations that in the case of Russia, for instance, lasted three years (1998-2000).

Unlike the Agreed Minutes of the Paris Club, the agreement reached at the end of the BAC process, once formally ratified, is final and legally binding upon all the members.[54]

The agreement designates a servicing bank to receive payments from the debtor and to distribute them to the participating creditors.

BACs have often addressed both the liquidity and solvency problems of sovereigns in distress.[55] There are no standard terms of treatment and every workout is tailored on the specificities of the individual debtor country and on the structure of its debt. In fact, within the London Club process, "the full spectrum of crisis resolution measures is negotiable, including the provision of new financing, short-term liquidity support via rollovers or credit lines, as well as the restructuring of loans with maturity prolongation and/or outright reductions in face value".[56]

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[54] In a few cases, "major creditors also refused to participate in agreements arranged by a representative group (e.g., Bankers Trust in Algeria in 1992, Lloyds bank in Argentina in 1982, Citibank in Chile in 1987 and in the Philippines in 1986)" (U. Das, M. Papaioannou, C. Trebesch, *cit*., p. 17).

[55] In the early 1990s, stock-of-debt treatments and debt reductions were agreed by BACs to middle-income countries despite the Paris Club's refusal to do the same.

[56] U. Das, M. Papaioannou, C. Trebesch, *cit*., p. 17.

Typically, the deal provides for a deferral of the payments terms of the debt falling due within a specific period of time and sets a single (adjustable) interest rate to all of the restructured debt.[57]

During the restructuring process new loans may be granted, subject to the approval by a supermajority of the holders of the outstanding debt. Creditors not agreeing, however, refused in some occasions to offer new loans alongside the majority.[58] This was the main cause of disagreement between participating banks during the Latin American debt crisis: large commercial banks in the United States were willing to provide new loans to their debtors, with the goal of avoiding defaults and continuing doing business, while smaller banks were less interested in granting bridge loans to countries in distress.[59]

In the 1980s, BACs usually agreed to let debtor countries stay current on their obligations to bondholders, thus not requesting comparability of treatment.[60]

3.3 From the London Club process to bondholders' committees

Until the end of the 1980s, most sovereign debt was in the form of bank loans and the London Club was the leading process for the restructuring of sovereign debt towards commercial banks. In the following decade, however, the return of bonds as the predominant form of sovereign borrowing signalled a change.

Nowadays, instead of a small group of commercial banks, sovereigns in distress face tens of thousands of diverse and unknown bondholders which include banks and institutional investors as well as retail investors. Restructurings have taken the form of sovereign bond exchanges.

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[57] Interest on rescheduled commercial bank debt is set at market rate with reference to LIBOR. Any rate below LIBOR is considered concessional in nature and therefore inconsistent with commercial practices.

[58] In this case "The *pari passu* clause provided assurance that large creditor institutions, which were negotiating these agreements [i.e. new loans] and often had differing motivations because of their physical presence in the borrowing country, would not receive an unfair advantage in debt repayment over the smaller banks that lacked such negotiating leverage" (H. Tether, "Courts Are Right to Hold Argentina to Equal Debt Treatment", *New York Times*, 18 January 2013).

[59] See I. Wong, *Sovereign Finance and the Poverty of Nations: Odious Debt in International Law*, Cheltenham, UK, 2012, p. 45-46.

[60] L. Rieffel (1984), *cit*., p. 110.

With the diffusion of collective action clauses (CACs),[61] some academics and government officials[62] recommended that sovereign bond contracts included a representation clause envisioning a single committee, either for the coordination of creditors of a specific bond issue or of all bondholders of a State.[63]

In 2002, the G-10 Working Group on CACs "considered the need to promote a collaborative sovereign restructuring process by providing a mechanism for the election of a special bondholder representative, empowered to engage in restructuring discussions with the debtor without undue delay".[64] Any amendment to the terms of the contract, however, would have to be approved by the bondholders themselves. Moreover, the mandate of the bondholders' representative was limited to the coordination of creditors within a single bond issue.

Similar initiatives followed. In the aftermath of the Argentina's debt crisis, in fact, market actors proved ready to consent to the establishment of different codes of conduct to counter proposals on a statutory regime for sovereign debt restructuring.

In 2004, the International Primary Market Association (IPMA) adopted standard CACs for fiscal agency agreements under English law that recommended the appointment of a single "Noteholders' Committee". In 2015, the International Capital Markets Association (ICMA) updated said provisions.[65] The new clauses

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[61] On CACs see Chapter xxx by Giuseppe Bianco. Among others, see S. Häseler, "Collective Action Clauses in Sovereign Bonds", in Kolb, R.W. (ed.), *Sovereign Debt: from Safety to Default*, Hoboken, NJ, Wiley, 2011, pp. 235-243

[62] See A. Gelpern and M. Gulati, "Innovation After the Revolution: Foreign Sovereign Bond Contracts Since 2003" (2009) *Capital Markets Law Journal*, vol. 4, n. 1, pp. 85-103, at 94. Reference is made in particular to: John B. Taylor (US Under Secretary of Treasury for International Affairs), "Sovereign Debt Restructuring: A US Perspective", speech at the conference "Sovereign Debt Workouts: Hopes and Hazards", Institute for International Economics, 2 April 2002, as well as to the Sovereign Debt Restructuring Mechanism proposal of 2003. According to the SDRM proposal – which was mainly designed for bondholder debt –, a representative creditor committee would be given the role to address both debtor-creditor and inter-creditor issues (see IMF, "Proposed Features of a Sovereign Debt Restructuring Mechanism", 12 February 2003, p. 25). See also L. C. Buchheit and M. Gulati, "Sovereign Bonds and the Collective Will" (2003) 51 *Emory L J* 1317.

[63] In the latter case, challenges similar to those related to the aggregation of bonds across different issues for voting purposes arise.

[64] Group of Ten, "Report of the G-10 Working Group on Contractual Clauses, 26 September 2002, p. 3.

[65] In July 2005, IPMA merged with the International Securities Market Association (ISMA) to form the International Capital Market Association (ICMA). See ICMA, "Standard Aggregated Collective Action Clauses for the Terms and Conditions of Sovereign Notes Governed by English Law – Meeting of Noteholders; Written Resolutions", May 2015, available at http://www.icmagroup.org/resources/Sovereign-Debt-Information, last visited 7 January 2018.

"allow the aggregation of debt across multiple series of debt securities to meet the requisite threshold to form a committee, and, in instances where multiple creditor committees are formed, require that a simple steering committee interfaces directly with the debtor".[66]

Early negotiations with a creditor committee in cases of default on debt owed to private creditors and investors are also supported by the IIF in its Principles for Stable Capital Flows and Fair Debt Restructuring.[67] According to the Principles, if a creditor committee is appointed, it should adopt its own rules and procedures, coordinate across affected instruments and with other affected creditor classes, with a view to form a single committee to act as a communication link between the debtor and the creditor community. A high level of confidentiality by committee members, especially on sensitive business information, is prescribed.

In addition, the IIF Best Practices for Formation and Operation of Creditor Committees[68] contain indications on the initial formation of the committee, on its representativeness and diversity, on its members' required expertise as well as on confidentiality and costs.

After their last amendment of 2017, the IIF Best Practices recommends the use of creditor committees not only when a country defaults on its private external debt, but also in pre-default cases where a restructuring or reprofiling is needed.[69] Besides, references to aggregated CACs have been added.

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[66] IIF, "Principles for Stable Capital Flows and Fair Debt Restructuring: Report on Implementation", October 2017, p. 53.

[67] The IIF Principles for Stable Capital Flows and Fair Debt Restructuring (in Emerging Markets) were adopted in 2004 and revised in 2010. They adapt the established practices of traditional bank advisory committees to the world of capital markets. In 2012, the IIF Group of Trustees endorsed an Addendum to the Principles to take into account recent experiences with sovereign debt crises, in particular the Greek one.

On the IIF Principles see A. Gelpern, "Hard, Soft, and Embedded: Implementing Principles on Promoting Responsible Sovereign Lending and Borrowing", in C. Esposito, Yuefen Li, J.P. Bohoslavsky, *Sovereign Financing and International Law: The UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing* (Oxford, OUP, 2013), pp. 374-376.

It is worth noting that, on the contrary, the 2012 UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing do not advocate for the formation of creditor committees, but only for a prompt, efficient and fair debt restructuring (Principle n. 15).

[68] The IIF Best Practices for Formation and Operation of Creditor Committees were adopted in 2007 and last updated in 2017. For the text of the Best Practices, see IIF, "Principles for Stable Capital Flows and Fair Debt Restructuring: Report on Implementation", Annex VI, October 2017, p. 49, available at www.iif.com.

[69] See IIF, "Principles for Stable Capital Flows and Fair Debt Restructuring: Report on Implementation", October 2017, p. 14.

Despite being supported by many, there is still no consensus on the benefits of creditor committees. In recent years, debtors expressed their preference for bilateral negotiations or no negotiations at all; questioned creditor committees' representativeness; decided not to be involved in a creditor committee whose members had competing interests or were not considered able to keep confidentiality; were reluctant to serve on a creditor committee "if the price of doing so is an undertaking to retain their exposure until the end of the restructuring process";[70] considered the entire process costly and time-consuming; were unable to join a creditor committee because they did not have the proper corporate structure or because unable to pay the costs.[71]

As recently as April 2013, the IMF too questioned the representativeness of creditor committees while reviewing its policy on lending into arrears (LIA).[72] Despite encouraging debtor countries to engage in a collaborative process with their creditors and provide them with an early opportunity to give input on the design of the restructuring strategies and instruments,[73] the Fund expressed doubts as to creditor committees' ability effectively to represent the wide diversity of interests at stake, due to the increased complexity of the creditor base.[74]

In fact, "over the years, creditors have increased in number and become more dispersed, while having different accounting rules (e.g., book value versus mark-to-market) and holding patterns and incentives (e.g., short-term creditors versus

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[70] L. C. Buchheit (2009), *op. cit.,* p. 212.

[71] For a discussion on potential drawbacks or benefits of establishing creditor committees see L. C. Buchheit, "Use of Creditor Committees in Sovereign Debt Workouts" (2009) 10 (3) *Business Law International*, p. 208 and T.B. De Sieno, "Creditor Committees in Sovereign Debt Restructuring: Understanding the Benefits and Addressing Concerns", in M. Guzman, J.A. Ocampo, J.E. Stiglitz (eds.), *Too Little, Too Late: The Quest to Resolve Sovereign Debt Crises*, New York, 2016, pp. 175-186.

[72] Under the LIA policy, the Fund may lend to a member despite its arrears to external private creditors only under certain conditions: most notably, only when 1) Fund's support is considered essential for the successful implementation of the member's adjustment program, and 2) when the member is pursuing appropriate policies and is making a "good faith effort" to reach a collaborative agreement with its private creditors. The good faith criterion was interpreted to include a sovereign's good faith efforts to enter into negotiations with a sufficiently representative creditor committee formed in a timely manner in circumstances where this organized negotiating framework is justified by the complexity of the case. See also IMF, "Fund Policy on Lending into Arrears to Private Creditors – Further Consideration on the Good Faith Criterion", July 2002, p. 15 ff.

[73] IMF, "Sovereign Debt Restructuring: Recent Developments and Implications for the Fund's Legal and Policy Framework" (2013), *cit.*, p. 40.

[74] Ivi, p. 36. For instance, the interests of investors who purchased credit default swaps or other protections differ from those of unsophisticated retail investors who purchased the bonds on the secondary market.

those holding to maturity), especially when creditors enter the debt market at different prices".[75]

In practice, even if creditor committees might help build inter-creditor consensus, thus minimizing holdout problems, they have rarely been formed. On the basis of available data, since 2000, creditor committees were established only in the following cases: Argentina (2004), the Dominican Republic (2005), Grenada (2005 and 2013), Belize (2007, 2012 and 2017), the Seychelles (2008), St. Kitts and Nevis (2012) and Greece (2011).[76]

In the case of Argentina, the government refused any formal contact with the Global Committee of Argentina Bondholders, which spontaneously formed in 2004 and claimed to represent approximately 75 per cent of Argentine bonds held abroad[77]. In the case of Grenada and Belize, although more than 50 per cent of the outstanding bonds were represented in creditor committees, these were composed of just few major financial institutions. For the Dominican Republic, the Seychelles and the St. Kitts and Nevis committees, creditor representation was limited.

The Greek sovereign debt crisis was peculiar in many instances. Not only was it the first pre-default debt restructuring in a developed economy in decades, but it also introduced many novelties in the way the restructuring was managed. It is interesting to note that, during 2012, informal discussions[78] on the so-called private sector involvement agreement (PSI) were conducted by a Steering Committee made up of 13 major private creditors, acting on behalf of a larger group of 32 creditors

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[75] IMF, "Sovereign Debt Restructuring" (2013), *op. cit.*, p. 36.

[76] The dates in brackets indicate the formation of each committee. Information on the listed creditor committees can be found in U. Das, M. Papaioannou, C. Trebesch, *cit.*, pp. 24-25. see also IMF, "Belize Staff Report for the 2013 Art. IV Consultation", 5 June 2013, p. 33; BroadSpan Capital Press Release, "Grenada Steering Committee and Ad-Hoc Committee Announce Formation", New York, 3 May 2013; T. Asonouma et al., "Sovereign Debt Restructurings in Belize", IMF Working Paper, WP/14/132, July 2014; T. Asonouma et al., "Sovereign Debt Restructurings in Grenada", IMF Working Paper, WP/17/171, July 2017.

On committees established before World War I, when bonds were still the predominant form of sovereign borrowing, see *supra* footnote 3.

[77] The Global Committee of Argentina Bondholders consisted of the Task Force Argentina, the Argentina Bondholders Committee, Bank of Tokyo-Mitsubishi, Shinsei Bank. Institutional and retail investors were represented in the General Membership category. Deutsche Bank, DZ Bank, the Swiss Bankers Association and the Argentine Bond Restructuring Agency participated as observers.

[78] As recognized by the Greek Council of State in its Judgment No. 1116/2014 on the legality of the sovereign debt restructuring, discussions with the PCIC "were absolutely informal and no binding commitment for any investor has come out of them".

forming the Private Creditor-Investor Committee (PCIC). The Steering Committee and the PCIC represented the main categories of debt holders: financial institutions, banks, insurance companies and asset managers, many of which were also members of the IIF. The Greek Steering Committee was co-chaired by two senior IIF officials and undoubtedly it was the most important bondholders' committee to be established since the 19th Century.[79] In the case of Greece, the IIF demonstrated to be extremely active in promoting adherence to its Principles, which more recently also served as a framework for the negotiations with Belize.

At this point of our analysis, the following conclusions can be drawn.

(1) Bondholders' committees, modelled on the London Club process, might be a useful vehicle for negotiations: they can streamline the restructuring process and build inter-creditor consensus, redress information imbalances and, above all, minimize holdout creditor behaviour.[80]

(2) Most of them are self-appointed, their bargaining power entirely depending on their credibility and on acknowledgement and acceptance by both the sovereign debtor and bondholders. Even if the bond contract does not provide for the establishment of a committee, nothing prohibits bondholders to spontaneously form one. In the case of Belize, the initiative was taken by the government, which announced that it was prepared "to recognize and deal with a formal creditors' committee on the terms set out in a memorandum captioned 'Belizean Creditors' Committee'".[81]

(3) Creditor committees adopt at their discretion the rules they consider more appropriate for their proceedings. In fact, important aspects of creditor committees' operations have yet to be clarified through the adoption of best practices or a code of conduct dealing with their formation and representativeness, with confidentiality

[79] See IIF, "Report of the Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution", October 2012, p. 12-13 and p. 52; J. Zettelmeyer, C. Trebesch, and M. Gulati, "The Greek Debt Restructuring: An Autopsy", Peterson Institute for International Economics Working Paper, WP 13-8, August 2013, p. 9; P. R. Wood, "How the Greek Debt Reorganisation of 2012 Changed the Rules of Sovereign Insolvency" (2013) *Business Law International*, vol. 14, n. 1, p. 11-12.

[80] On these points see T.B. De Sieno (2016), *cit*., p. 176-178.

[81] See L. C. Buchheit (2009), *op. cit.,* p. 213 ff.

and expenses as well as with other important features such as standstills on litigation or a moratorium on the trading of bonds.[82]

It is noteworthy that Belize and its bondholders' committee agreed on a 30-day moratorium on the trading of bonds, together with a confidentiality agreement.[83]

(4) In recent times, the unanimity rule has not been applied. In the case of Belize, for instance, 75 per cent of the total amount of debt held by all committee members was sufficient for the adoption of decisions. This qualified majority rule is in line with the rationale behind CACs.

(5) In most of the cases, the outcome of the negotiations was an exchange offer formally put forward by the debtor State and endorsed by the creditor committee, that needed acceptance by a critical mass of creditors to become binding. Remarkably, the Greek debt restructuring was a hybrid between a creditor committee process and a unilateral take-it-or-leave-it exchange offer.[84] In 2017, since the bonds to be restructured included a collective action clause, Belize used a consent solicitation instead of an exchange offer.

The next paragraphs will be devoted to analysing how recent developments and the wide diversity of sovereign bondholders are going to affect the role of the Paris and London Clubs as the "leading" vehicles for sovereign debt restructuring.

4. Recent Developments in the Identity of Bond Investors: The Issue of Supranational Creditors

To better assess what role is left to the Paris and London Clubs, it is essential to have a clear picture of how the identity of sovereign creditors has changed over time, shifting from homogeneous groups with similar standing to a composite landscape of different actors.

Currently, sovereign bondholders consist of a heterogeneous group of investors, ranging from individuals to commercial banks, including institutional investors and public-sector entities. Bondholders have become increasingly diverse, numerous, anonymous and difficult to coordinate. To further complicate a common course of

[82] On these points see T.B. De Sieno (2016), *cit*., p. 180 ff.

[83] Institute of International Finance, "Report of the Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution", October 2013, p. 11.

[84] On which see *infra* paragraph 4.2.

action, they might have conflicting interests, different incentives and bargaining power, different accounting rules and holding patterns as well as significant information asymmetries.

The challenges posed by the fragmentation of bondholders are particularly pronounced when it comes to "supranational creditors". This term is here used to describe international organizations (the IMF and the IBRD) and supranational institutions (like the ECB and the EIB) when they purchase sovereign bonds on the secondary market. Supranational bondholders are halfway between private investors pursuing pure economic interests and multilaterals pursuing their public-sector objectives.

It is a consolidated practice for some international organizations (IOs) to invest part of their resources in debt instruments issued by advanced economies with high credit ratings. Before the global financial crisis, these were considered safe investments. Recent events, however, demonstrate that even IOs might find themselves exposed to a sovereign credit risk. An important question therefore is whether international organizations should be entitled to claim a preferred creditor status granting them seniority over ordinary bondholders. Neither bond contracts, nor international law contain clear indications on the issue at stake.

4.1 International financial institutions as bondholders: do they enjoy preferred creditor status?

The Fifth Amendment to the IMF Articles of Agreement (which entered into force in February 2011) broadened the investment mandate of the Fund.[85] The purposes of the changes introduced were to ensure the long-term sustainability of the Fund's finances, and to make it less dependent on borrowing from member States and on earnings deriving from its lending activities.

[85] In particular, the Fifth Amendment modified Art. XII, Section 6(f)(iii) of the Articles of Agreement. See the IMF Executive Board Resolution No. 63-3: 'Proposed Amendment of the Articles of Agreement of the IMF to Expand the Investment Authority of the IMF', 5 May 2008 in IMF, *Summary Proceedings of the Sixty-Second Annual Meetings 2008*, Washington DC, p. 209-211. On the IMF new income model see B. Steinki and W. Bergthaler, "Recent Reforms of the Finances of the International Monetary Fund: An Overview" in C. Herrmann and J.P. Terhechte (eds.), *European Yearbook of International Economic Law* (EYIEL), Vol. 3 (2012), European Yearbook of International Economic Law 3, pp. 635-666; S. Hagan, "Reforming the IMF", in IMF, Current Developments in Monetary and Financial Law: Restoring Financial Stability – The Legal Response, vol. 6, Washington DC, 2012, p. 253 ff.

Under the new income model, the Fund is allowed to invest part of its resources in fixed-income securities and cash instruments to generate returns exceeding the SDR interest rate.[86]

However, the prudent risk profile of the Fund enables it to invest only in a limited group of assets which include: (a) fixed-income securities issued by national governments of member States, their central banks and official agencies; (b) fixed-income securities issued by international financial institutions; (c) obligations of the Bank for International Settlements (BIS); all of which denominated in currencies included in the SDR basket (or denominated in SDR).[87]

Credit risk is further minimized by restricting investments to financial instruments with a credit rating at least equivalent to A, based on the Standard & Poor's rating scale.[88] The consequence is that the Fund's external investment managers[89] will be compelled to sell financial instruments in their portfolio as soon as these go below the rating threshold. This rigidity is even likely to increase the chances of the organization to bear losses.[90]

While the IMF has only recently started to play an active role as an investor, the IBRD has a long history of buying and selling securities on the international capital markets for investment purposes.

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[86] IMF, "Rules and Regulations for the Investment Account", as lastly revised by the Executive Board the 29 July 2016, https://www.imf.org/en/Publications/Policy-Papers/Issues/2016/12/31/Rules-and-Regulations-for-the-Investment-Account-PP4734, last visited 9 June 2017. The Investment Account (IA) of the IMF is divided in different subaccounts (the Fixed-Income Subaccount and the Endowment Subaccount). It holds resources transferred from the General Resources Account (GRA), which are to be invested to broaden the IMF's income base. The earnings generated by the IA may be retained in the IA or transferred to the GRA to help meet the expenses of conducting the business of the IMF.

[87] These assets are eligible both for the shorter-duration Tranche 1 and the longer-duration Tranche 2 types of investments. Under the revised rules adopted in 2016, eligible investments in Tranche 1 now also include fixed-income securities issued by subnational governments, corporate bonds, mortgage-backed and other asset-backed securities, and cash instruments.

[88] If the rating threshold is breached, assets shall be divested within three months from the rating downgrade.

[89] The assets in the IMF Investment Account are managed by external operators with a clear separation of responsibilities from the IMF management (the IMF Managing Director and the Executive Board).

[90] Rutsel S. J. Martha, "International Organizations Sovereign Bondholders: An Unexplored Dimension of the Sovereign Debt Crisis" (2013) *Manchester Journal of International Economic Law*, vol. 10, pp. 2-18, at 3. Besides, the World Bank Treasury currently manages the investment of over USD 100 billion in high-grade fixed-income portfolios in US dollars, Euros, Sterling and Yen for several types of institutions, including other IFIs, donor trust funds and central banks of its member States.

The IBRD, though, has a less prudent investor profile. Pursuant to Art. IV, Section 8 (iv) of the Articles of Agreement, the IBRD can buy and sell such other securities as the Directors may deem proper for the investment by a three-fourths majority of the total voting power.[91] In its Liquid Asset Portfolio, the IBRD holds principally high-grade fixed-income securities like government and agency obligations.[92] Only obligations rated AA- or more, issued or unconditionally guaranteed by a member country or by a multilateral organization, are eligible for IBRD's investment. However, if they are denominated in the currency of the issuing State, no rating is required. Besides, the IBRD can also invest in corporate and asset-backed securities, time deposits and other unconditional obligations of banks and financial institutions and other instruments.

In light of the above, it should be observed that, by investing on the sovereign bonds markets, the two Bretton Woods institutions are exposed to the risk of losses.[93] In case of a country's default, the question as to whether these "supranational bondholders" should be shielded from a debt restructuring remains open.

The preferred creditor status of the IMF, the World Bank and multilateral development banks (MDBs) might be relevant to solve this issue.

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[91] The IBRD is also one of the major borrowers on the financial markets and raises most of its funds from the issuance of bonds (which carry an AAA rating because their repayment is guaranteed by its member States).

[92] Government and agency obligations amount to 60 per cent of the IBRD Liquid Asset Portfolio, which at the end of June 2016 was valued 50.5 billion USD. Source: IBRD Information Statement 2016, available at http://treasury.worldbank.org/cmd/pdf/InformationStatement.pdf, last visited 16 June 2017.

[93] This risk is well illustrated by the Hypo Alpe Adria case. In FY07 the IBRD had invested around 190 million USD in subordinated debt instruments of the Austrian bank, Hypo Alpe Adria, which was fully guaranteed by the State of Carinthia. In 2009, after years of high-risk project financing, mismanagement and corruption, the Austrian government nationalized the bank to avoid its insolvency. In August 2014, the Federal Law on the Reorganization of the Hypo Alpe Adria bank (HaaSanG) entered into force. The HaaSanG went well beyond a simple bail-in of HAA debt, it also cancelled the guarantee provided by the State of Carinthia. However, the applicable EU law – the Bank Recovery and Resolution directive (BBRD) – contains no basis for cancelling a guarantee by a third party. To the contrary, according to the BBRD, a regulatory resolution of a financial institution should leave creditors no worse off than they would have been under an insolvency proceeding. In July 2015, the Austrian Constitutional Court deemed the HaaSanG unconstitutional as in violation of the right to property and, accordingly, the security and related guarantees were reinstated (see VfGH Decision No. G 239/2015 ua, VfGH Press release 7/28/15). In October 2016, the IBRD eventually accepted a tender offer to exchange its bond for a new zero coupon bond maturing over 18 years. This zero coupon bond was later sold on the market for 79 million USD.

In the Articles of Agreement there is no explicit reference to the Fund's preferred creditor status (PCS),[94] nonetheless this privilege is recognized internationally by G20 countries and in the practice of the Paris Club.[95]

In the 1980s, some authors expressed the view that the PCS of the IMF came from an international customary law norm.[96] Others, however, contended that a general international law rule to this end had not arisen yet and that "decisions by some creditors [Paris club members] to extend *de facto* preferential status to IFIs […] differ fundamentally from a legal right of being exempt, even though the private sector has often acquiesced".[97]

In the context of the so-called 'protracted arrears crisis' of 1983-1992,[98] the same IMF had to acknowledge the feeble legal grounds for its preferred creditor status and it "urged all members, *within the limits of their laws*, to treat the Fund as a preferred creditor" (emphasis added).[99]

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[94] See K. Raffer, 'Preferred or Not Preferred: Thoughts on Priority Structures of Creditors' (2009), paper prepared for discussions at the 2nd meeting of the ILA Sovereign Insolvency Study Group, 16 October 2009, available at http://homepage.univie.ac.at/kunibert.raffer/ila-wash.pdf (last visited 10 June 2017).

[95] See Rutsel S. J. Martha, 'Preferred Creditor Status under International Law: The Case of the International Monetary Fund', 39 Int'l and Comp L. Q., 1990, p. 814 ff.. At the October 2011 meeting of Cannes, the G20 Finance Ministers and Central Bank Governors endorsed a document entitled Principles for Cooperation between the IMF and Regional Financial Arrangements. This soft law instrument acknowledges the importance of cooperation between the IMF and RFAs to promote regional and global financial and monetary stability. The G20 Principles do not establish a hierarchy between the IMF and the RFAs, if not for the preferred creditor status that is recognized to the IMF. This is also acknowledged by the European Stability Mechanism Treaty (ESM): "the ESM loans will enjoy preferred creditor status in a similar fashion to those of the IMF, while accepting preferred creditor status of the IMF over the ESM" (Preamble of the ESM Treaty, n. 13). Therefore, under normal practice, the debtor country will first repay the IMF, then the ESM, and last its private creditors (A. Mody, "Sovereign Debt and Its Restructuring Framework in the Euro Area", (2013) Bruegel Working Paper 2013/05, p. 20-21).

[96] D. Carreau, 'Le rééchelonnement de la dette extérieure des Etats' (1985) 112 Journal du droit international 5, 15.

[97] See R.S.J. Martha, *cit*., (1990), at 825.

[98] By 1988, 13 countries were in protracted arrears (of six or more months) with the Fund. Arrears amounted to nearly 14 per cent of the outstanding IMF loans.

[99] 'IMF Survey', 17 October 1988, p. 326. See also Report of the Executive Board to the Interim Committee of the Board of Governors on Overdue Financial Obligations to the Fund, EBS/88/166, Rev. 2, 9 September 1988, p. 3: "Executive Directors have stressed the unique position of the Fund as an international cooperative institution, its role in the international monetary system, the revolving nature of its resources, and the consequent need for all members, creditors and debtors alike, in practice, to treat the Fund as a preferred creditor. Accordingly, all members should accord the highest priority to the settlement of financial obligations to the Fund". For a comment and the text of this document, see J. M. Boughton, *Silent Revolution: The International Monetary Fund 1979-1989* (2001), Washington, DC, IMF, p. 820-21 and 832.

It is however undisputed that, when the Fund provides financial assistance to a member State, its claims are *de facto* senior to those of all other creditors.

It was also argued that, without preferred creditor status, the IMF would greatly limit its lending activities, especially in the case of countries struck by a debt crisis.[100] In this sense, preferential treatment is considered essential to ensure that the IMF's reserve assets remain risk-free. This 'adequate safeguard' (within the meaning of IMF Art. V, Section 3) reflects the global public good nature of the IMF financing, which is intended to restore the recipient country "external viability, thus also ensuring that the other creditors will have their restructured claims repaid".[101]

What seen for the IMF's preferred creditor status applies also to the IBRD, IDA and MDBs.[102] Their statutes do not contain a legal basis for preferential treatment, nor does general international law. Though, since they provide development financing, they are granted *de facto* priority. [103]

As stated above, when providing financial assistance, the IMF/IBRD preferred creditor status has rarely been challenged. The question is whether the same should apply when they act as mere investors in the capital markets.

On the one hand, it could be argued that, when buying bonds on secondary markets (moreover through external managers), the IMF and the IBRD are

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[100] S. Schadler, 'The IMF's Preferred Creditor Status: Does It Still Make Sense after the Euro Crisis?', CIGI Policy Brief n. 37, March 2014. The Author concludes: "Ultimately, the case for or against PCS for the IMF comes down to how members wish to maintain discipline over IMF lending. There are two choices: discipline through rules, that is, a clear framework specifying minimum standards for the credibility that IMF programs will return a country to market access, or discipline through market forces, that is, subjecting IMF loans to the same risks of default or restructuring as private market lending".

[101] IMF, 'Review of Fund Facilities: Analytical Basis for Fund Lending and Reform Options', 6 February 2009, 8.

[102] On this point see K. Raffer, *cit*. (2009), and K. Raffer, *Debt Management for Development: Protection of the Poor and the Millennium Development Goals* (2010), Cheltenham, 221 ff. The Author argues that, on the contrary, the IBRD founders wanted to subordinate the bank's claims.

[103] It should be noted that even in the context of the HIPC initiative, the IMF and the IDA maintained their preferred creditor status. Debt relief was in fact provided in a way to formally guarantee that payments to the IMF/IDA were made as they became due. In practice, much of the debt relief was provided by a special Debt Relief Trust Fund, financed from income of the IBRD, or by special ESAF grants provided by the IMF; a portion of HIPC debt was also attributed directly to member States of the IDA as part of their IDA replenishment contributions. These funds were used to buy back or repay portions of the debt owed by HIPC countries to the IDA and the IMF; alternatively, the Trust Fund committed to pay a portion of the future debt service owed to multilateral creditors as it became due. See Leonie F. Guder, *The Administration of Debt Relief by the International Financial Institutions: A Legal Reconstruction of the HIPC Initiative*, Berlin, Springer, 2009, p. 49 ff.. See also IMF, 'HIPC Initiative and MDRI: Statistical Update', 19 December 2013.

comparable to private investors. Hence, in the case of a debt restructuring, they will have to share an equal burden with any other bondholder. Since the commercial nature of the investment activity prevails over their public function, the IMF/IBRD should not be treated in a more favourable way than other private creditors. Therefore, the IMF/IBRD cannot avail themselves of the preferred creditor status they enjoy when they provide financial assistance to a member country.

On the other hand, the opposite can be contended if one focuses on the purpose of the IMF/IBRD's investments, which is to ensure the proper financing of their activities in the long run. In general, IFIs and MDBs do not approach liquidity investing in a commercial manner: their key goal is to preserve principal and maintain the ability to meet their public policy mandates, rather than income generation. Substantial amounts of liquidity are held by these organizations in order to be able to play a countercyclical role in times of financial turmoil.[104] In this sense, it can be argued that even while engaging in a private sector activity, the IMF/IBRD are still pursuing their public-sector objectives and that consequently they should be granted preferred creditor status. If we agreed with this view, the bonds held by the IMF/IBRD could be rightfully exempted from a debt restructuring.

This is precisely what happened to the bonds held by the ECB, the Eurosystem national central banks and the EIB in the context of the March 2012 Greek exchange offer, even if none of these supranational institutions has ever been acknowledged preferred creditor status.

4.2 The exemption of the ECB, Eurosystem NCBs and the EIB from the Greek sovereign debt restructuring

The IMF/IBRD investor status is indeed different from the one of the ECB, which purchased European sovereign bonds in the exercise of its monetary policy mandate and responding to public interest considerations.

In May 2010, the ECB and the Eurosystem national central banks (NCBs) started to make outright purchases of sovereign bonds issued by governments of the Euro area on the secondary market (i.e. from banks and at market prices). These

[104] Besides, large liquidity holdings are also kept in order to satisfy the requirements for AAA ratings.

interventions were made under the legal framework of the Securities Markets Programme (SMP),[105] a monetary policy instrument adopted due to the exceptional circumstances that were hampering the monetary policy transmission mechanism in the Euro area.[106]

As a result of the SMP purchases, in February 2012 the ECB was the single largest holder of Greek sovereign bonds, with 16.3 per cent of the total, amounting to €42.7 billion. Notably, purchases were made at a discount: spending about €40 billion for bonds having a face value of €55 billion.[107] The Eurosystem NCBs held around 5 per cent of the total Greek bonds, amounting to €13.5 billion, while the European Investment Bank (EIB) had invested for just 0.1 per cent of the total, amounting to €315 million. Their cumulative holdings amounted to more than 20 per cent of the total outstanding bonds.[108]

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[105] The SMP programme was discontinued in September 2012, when the ECB announced the introduction of the new Outright Monetary Transactions programme (OMT) under which secondary market purchases of public debt instruments will be carried out only if the sovereign concerned agrees to a EFSF/ESM financial reform programme and its attached conditionality. See ECB Decision of 14 May 2010 establishing a securities markets programme (ECB/2010/5), OJ L 124/8, 20.5.2012. See also ECB, 'The ECB's Non-Standard Measures – Impact and Phasing Out' (July 2011) Monthly Bulletin 66; D Zandstra, 'The European Sovereign Debt Crisis and Its Evolving Resolution' (2011) 6 Capital Markets Law Journal 285-316, at 291. On the OMT, see ECB Press Release, 'Technical Features of Outright Monetary Transactions', 6 September 2012, www.ecb.int. The ECB Governing Council has not yet adopted a decision detailing the legal framework for the OMT programme.

The SMP/OMT programmes were object of strong criticisms and they were challenged in front of the German Federal Constitutional Court (GFCC). On 14 January 2014, the GFCC separated from the proceedings related to the ESM and to the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (the so-called Fiscal Compact) the matters related to the SMP and the OMT programmes. The proceedings related to the SMP/OMT were stayed and a referral for a preliminary ruling was submitted by the GFCC (for the first time in its history) to the Court of Justice of the European Union asking the CJEU to assess whether the OMT programme is covered by the monetary policy mandate of the ECB and whether the SMP/OMT programmes are consistent with the prohibition of monetary financing enshrined in Art. 123 TFEU. In the *Gauweiler* case, the Court ruled in favour of the compatibility of OMTs with Art. 123 TFEU (ECJ (Grand Chamber), Case C-62/14 *Gauweiler and others*, ECLI:EU:C:2015:400). On *Gauweiler* see, among others, the special section of the German Law Journal vol. 16, n. 4, 2015, pp. 917-1072 and the special issue "The European Court of Justice, The European Central Bank, and The Supremacy of EU Law" of the Maastricht Journal of European and Comparative Law, vol. 23, n. 1, 2016. The saga ended in June 2016, when the GFCC accepted the requirements set forth by the ECJ to restrain the OMT programme, should it become operational (BVerfG, Judgment of 21 June 2016, 2 BvR 2728/13.

[106] See Recital 2 of the ECB Decision of 14 May 2010 establishing a securities markets programme (ECB/2010/5), OJ L 124/8, 20.5.2012.

[107] See IMF, "Euro Area Policies: 2012 Article IV Consultation - Selected Issues Paper", IMF Country Report No. 12/182, July 2012, p. 47.

[108] Sources: J. Zettelmeyer, C. Trebesch, and M. Gulati, *op. cit.*, p. 10. See also Morgan Stanley, "Trading After the PSI", 8 March 2012.

During the restructuring, these supranational creditors were shielded from bearing any losses: in mid-February 2012, shortly before Greece launched its exchange offer, they swapped their "old" bonds for "new" bonds with identical nominal value, payment terms and maturity dates, but different ISIN serial numbers.[109]

This was the only way to single out and aggregate bonds issued under different series. The new bonds were in fact protected from the debt swap that was carried out under the so-called private sector involvement (PSI) and performed by means of retroactive collective action clauses.[110]

The Greek exchange offer in fact did not extend to bonds held by the ECB, Euro area NCBs and the EIB, but it did extend to retail and institutional bondholders as well as to other non-European sovereign bondholders and central banks.[111] For instance, the Norwegian Government Pension Fund Global had to suffer a huge loss after having stocked up on Greek debt (and on bonds of Portugal, Spain and Italy) and having started to downsize its portfolio only at the end of 2011.[112]

The exemption of supranational bondholders led to the development of a very unusual ladder of priorities among creditors and it was considered discriminatory in nature.[113] The result was that the claims of these European official sector institutions were *de facto* given priority, to the detriment of both retail and institutional investors.[114]

While bondholders agreeing to the exchange offer received bonds maturing between 2023 and 2042 and suffered a huge haircut (53.5 per cent on their principal),

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[109] The new bonds with different ISIN numbers (International Securities Identification Number) were kept outside the remit of the Greek Bondholder Act and therefore were not involved in the application of retroactive CACs. See IMF, "Euro Area Policies: 2012 Article IV Consultation - Selected Issues Paper", IMF Country Report No. 12/182, July 2012, p. 47.

[110] On 23 February 2012, the Greek Parliament introduced Law 4050/2012 on Rules on the modification of titles issued or guaranteed by the Greek state with the Bondholders' agreement (published in Government Gazette A 36/23.02.2012 of the Hellenic Republic), by which CACs were to be retroactively introduced on all Greek bonds issued before 31 December 2011.

[111] P. R. Wood, *op. cit*., pp. 3-50, at 5.

[112] Data on the Norwegian Government Pension Fund's annual holdings from 1998 to 2016 are available at http://www.nbim.no/en/Investments/holdings-/, last visited 9 June 2017.

[113] According to the IIF Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution, "the exclusion of the ECB holdings from the debt exchange could be rationalized […], but the exclusion of the official body holdings [NCBs and EIB] deviated from the normal principle of non-discrimination" (IIF, "Report of the Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Restructuring", October 2012, p. 52).

[114] P. R. Wood, *op. cit*., p. 34.

the maturity dates of the bonds held by the ECB and the other supranational bondholders remained unvaried.

The ECB would in fact receive the full face value of the Greek bonds it had purchased at significantly below par value in 2010 and it would also benefit from coupon payments, thus receiving preferential creditor status.

The decision to grant preferential treatment to the ECB resulted in an aggravated sense of grievance on the part of the disfavoured creditors and it was harshly criticized.

On the issue, it was observed that: "The larger the share of the privileged creditors becomes (protected against losses in case of a debt cut), the higher the default risks for the underprivileged (private) creditors rise".[115]

Furthermore, the fact that part of the money disbursed to Greece by the IMF and Euro area members was used to repay the ECB provoked a flood of indignant reactions.[116]

Initially, the ECB argued that its exemption from the PSI was "special" and justified on the grounds that it had intervened on the bond markets solely for monetary policy purposes.[117] In a second moment, however, the ECB declared that in similar situations it would be ready to be *pari passu* with private lenders.[118]

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[115] K Schneider, 'Questions and Answers: Karlsruhe's Referral for a Preliminary Ruling to the Court of Justice of the European Union' (2014) 15 (2) German Law Journal 234.

[116] A first group of bonds held by the ECB matured at the end of August 2012. While struggling with the austerity measures and spending cuts required by the Troika, Greece had to repay €3 billion. This, however, was only a fraction of the €55billion face value Greek bonds held by the ECB and by Eurosystem NCBs.

[117] According to Mario Draghi 'the SMP was a monetary policy instrument. So the purchases of Greek bonds done under that program responded to public interest policy – general policy considerations. And as such, they deserve protection.' (M Draghi, President of the ECB, 'Transcript of the Press Conference', 8 March 2012, available at http://www.ecb.int/press/pressconf/2012/html/is120308.en.html).

[118] This will apply to sovereign bond purchases made via the OMT programme.

It is worth mentioning that in *Gauweiler*, *cit.*, par. 126 the ECJ ruled that "although the lack of privileged creditor status may mean that the ECB is exposed to the risk of a debt cut decided upon by the other creditors of the Member State concerned, it must be stated that such a risk is inherent in a purchase of bonds on the secondary markets, an operation which was authorized by the authors of the Treaties, without being conditional upon the ECB having privileged creditor status".

A few months later, however, in the *Accorinti* case (see below), the General Court of the European Union held incidentally that "in so far as a rule which imposed the *pari passu* principle would entail equal treatment for creditors without taking into account the distinct situations of, in particular, private investors, on the one hand, and the Eurosystem central banks, acting in the exercise of their tasks pursuant to Article 127 TFEU and Article 18 of the Statute, on the other hand, the recognition of such a rule in the EU legal order might well be incompatible with the principle of equal treatment". Case T-79/13 *Accorinti and Others v. ECB*, ECLI:EU:T:2015:756, par. 100.

Strong criticism was also raised over the fact that part of the money provided by the IMF and through the Greek Loan Facility set up by Euro area member States was to be used to repay the ECB.[119]

This led the ECB to commit to return any profits on its Greek bond holdings to its shareholders on the basis of their capital subscription (i.e. both Euro and non-Euro area NCBs, with the latter receiving a smaller percentage).[120]

More recently, the General Court of the European Union[121] held that in the wake of the Greek PSI the ECB was exclusively guided by public interest objectives and, particularly, by the goal of maintaining price stability and the sound administration of monetary policy. Therefore, private investors – who purchased Greek bonds pursuing a "purely private interest, namely obtaining a maximum return on their investments"[122] – and the ECB were not in a comparable situation and the general principles of equal treatment and non-discrimination could not apply.

4.3 The application of collective action clauses to supranational bondholders

For the purposes of our research, it is interesting to discuss whether, for the activation of collective action clauses (CACs), supranational bondholders should be assimilated to private bondholders.

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[119] A first group of bonds held by the ECB matured at the end of August 2012. While struggling with the austerity measures and spending cuts required by the Troika, Greece had to repay €3 billion.

[120] Later, in November 2012, Euro area member States undertook to transfer on a segregated account established in the Bank of Greece "*an amount equivalent* to the income on the SMP portfolio accruing to their NCBs". See Eurogroup Statement on Greece, 27 November 2012, available at http://www.eurozone.europa.eu/media/367646/eurogroup_statement_greece_27_november_2012.pdf, last visited 9 June 2017. See also ECB Monthly Bulletin, December 2012, p. 44. Transfers under this scheme were made conditional on the implementation by Greece of austerity measures and the requirements and objectives of the adjustment programme. Euroarea Member States receiving financial assistance by the EFSF/ESM were not required to participate in the scheme. The segregated account can be exclusively used for debt service payments and to redeem maturing bonds.

[121] EU General Court, Case T-79/13 *Accorinti and Others v. ECB*, ECLI:EU:T:2015:756, par. 88, 91, 93 ff.. See also EU General Court, Case T-749/15, *Nausicaa v. ECB*, ECLI:EU:T:2017:21, par. 108 ff. See among other O. Heinz, "Issues and Possible Reforms in the Context of a Euro Area/EU Sovereign Insolvency Framework" in ESCB Legal Conference 2016, Frankfurt-am-Main, January 2017, p. 99 ff.

See also ECtHR, *Mamatas and Others v. Greece*, Judgement of 21 July 2016, Application Nos. 63066/14, 64297/14 and 66106/14.

[122] *Accorinti*, *cit*. par. 91.

CACs are based on the presumption that all bondholders are to be treated equally and that there is no ranking amongst the holders of the same bond issue (or of the aggregated bond series).

CACs are contractual provisions allowing a supermajority of bondholders to modify the features of a bond issue, including its payment terms, and make the amendments binding also for dissenting minorities. In principle, no distinction is made among the various categories of investors. Therefore, the difficulty resides in achieving a common position and defining who is entitled to vote.

Some market players have expressed the concern that a sovereign could take advantage of majority amendment clauses, by buying back – either directly or through entities under its control – a sufficient amount of a bond issue to vote for a more favourable restructuring, to the detriment of the other bondholders.

To prevent this scenario, a so-called "disenfranchisement provision" is sometimes included in sovereign bond contracts to protect ordinary creditors, and especially retail investors, from a manipulation of votes.[123] Pursuant to this clause, bonds directly or indirectly in the hands of the issuer are excluded from the quorum required to amend the terms.

The question is whether supranational bondholders should be disenfranchised. The public policy objectives they presumably pursue – in conformity with their treaty or statute obligations – differ from those of both the debtor State and of private bondholders. However, provided that bondholders are not directed by the issuer's will, their motivations are irrelevant and therefore also supranational bondholders should be enfranchised.[124]

While developing a EU CAC Model,[125] the view was expressed that "neither an investor's interests or motives, nor the predictability of an investor's vote for or

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[123] See K. Drake, "Disenfranchisement in Sovereign Bonds" (2012) *Duke Law Working Paper*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2007294.

[124] C. Hofmann, 'Sovereign Debt Restructuring in Europe Under the New Model Collective Action Clauses' (2014) 49 Texas International Law Journal 407.

[125] In 2011, the EFC Sub-Committee on EU Sovereign Debt Markets started working on a standardized CAC to be included in new sovereign debt instruments issued by EU member States. See EFC, 'CACs Common Terms of Reference', 17 February 2012, europa.eu/efc/sub_committee/pdf/cac_-_text_model_cac.pdf, as well as EFC, Supplemental Provisions, 17 February 2012, europa.eu/efc/sub_committee/pdf/cac_-_supplemental_provisions.pdf. On this point see Chapter xxx by Giuseppe Bianco. According to the Treaty establishing the European Stability Mechanism (Art. 12.3), all new euro area government securities with maturity above one year and issued after January 2013 should include a CAC.

against a proposed modification, constitutes adequate grounds for disenfranchising an investor. […] the litmus test remains: is a bondholder acting in its own interest? If so, the bondholder should be enfranchised".[126]

The final EU CAC Model grants voting power to the holders of bonds with autonomy of decision from the issuer "since, under the applicable law, [they are] prohibited from taking, directly or indirectly, instructions from the issuer on how to vote on a proposed modification".[127]

It should be underlined that this provision was discussed when the SMP programme was in force and contains an implicit reference to the ECB and the Eurosystem NCBs. Since their independence is protected by the EU Treaties,[128] their disenfranchisement is not necessary.

A similar disenfranchisement provision is included in the recently amended ICMA Standard Aggregated CACs.[129]

As for the IMF and IBRD, their willingness to preserve their preferred creditor status might direct them to vote against any proposed restructuring of the bonds they hold. Even in this case, however, they will retain complete autonomy of decision from the issuer and therefore, according to the actual CACs rationale, they will be enfranchised.

5. Conclusions

Over the years, the features of sovereign debt restructuring have been shaped by the nature of the debt and of its creditors.

Both the Paris and the London Clubs were formed to restructure debts owed by a State to a homogeneous group of creditors: respectively, official bilateral creditors and commercial banks.

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[126] See EFC Sub-Committee on EU Sovereign Debt Markets, "Model Collective Action Clause Supplemental Explanatory Note", 26 March 2012, available at http://europa.eu/efc/sub_committee/pdf/supplemental_explanatory_note_on_the_model_cac_-_26_march_2012.pdf, p. 6.

[127] Section 2.7, lett. c (x, y, z) of the European Model CAC.

[128] See Article 130 TFEU and Article 7 of the ECB Statute. They do not enjoy preferred creditor status.

[129] See ICMA, "Standard Aggregated Collective Action Clauses (CACs) for the Terms and Conditions of Sovereign Notes", lett. (i) Notes controlled by the Issuer, August 2014, available at http://www.icmagroup.org/resources/Sovereign-Debt-Information/ (last visited 10 June 2017).

At present, although most of the debt being restructured is in the form of sovereign bonds, a dedicated workout mechanism is still developing. In this new scenario, the principles and practices developed by the Paris and the London Clubs can be only of a limited use.

In fact, compared to the Paris Club rule of adopting decision by consensus and the London Club practice of deciding by unanimity, sovereign bond restructurings are currently primarily based on CACs and majority voting.

An IMF supported-programme (typically requested both by the Paris and London Clubs) is not always seen as a necessary precondition to start discussions on sovereign bond restructurings.

Representation is the main issue, as typically bondholders are not represented in a committee and only the last generation of CACs envisions their formation.

Moreover, the challenges posed by the heterogeneousness of bondholders – and by supranational bondholders in particular – are yet to be carefully addressed.

If the ECB exemption from the Greek debt restructuring of 2012 was motivated on grounds of public interest considerations, would the IMF and the IBRD be allowed to claim preferred creditor status in relation to their sovereign bonds investments?

Deference to their PCS is a likely outcome, but the establishment of a ladder of priorities among bondholders with supranational creditors at the top might threaten one of the basic tenets of the CACs approach: the equal status of bondholders.