# PRINCIPLES FOR STABLE CAPITAL FLOWS AND FAIR DEBT RESTRUCTURING IN EMERGING MARKETS

## REPORT ON IMPLEMENTATION
BY THE
## PRINCIPLES CONSULTATIVE GROUP

SEPTEMBER 2006

TRANSPARENCY     COOPERATION     GOOD FAITH     FAIR TREATMENT

“As the Principles set forth key elements of a voluntary, market-based approach to crisis prevention and resolution, we believe they should be widely supported by financial institutions, investors and governments, both in emerging markets and industrialized countries.”

*Dr. Josef Ackermann, Chairman of the Board of Directors, Institute of International Finance and Chairman of the Managing Board and the Group Executive Committee, Deutsche Bank AG*

“Integrated financial institutions can also make major contributions to global financial stability by contributing to effective crisis resolution efforts, such as the development of the Principles. This initiative between private sector representatives and emerging market officials holds promise, especially, if it continues to gain broad support among all concerned parties.”

*Rodrigo de Rato y Figaredo, Managing Director, International Monetary Fund*

"The year has seen rising interest and support for the Principles from governments and private financial institutions alike. This reflects not only the pragmatic, voluntary nature of this new approach, but also recognition that the global financial system is likely entering a more challenging phase when implementation will become ever more important."

*William Rhodes, Chairman, President, and Chief Executive Officer, Citibank, NA and Senior Vice Chairman, Citigroup Inc.*

## Development and Support for the Principles

Over the past 15 years, economic and financial crises have taken a heavy toll on emerging markets and economies in transition. The impact of these crises was intensified at times by inadequate flows of information from debtors to creditors, which impacted risk assessments; sharp shifts in sentiment among investors; insufficient dialogue and early corrective action that precluded timely solutions; and failures to introduce sufficient measures to secure or restore investor confidence. Evidence from several countries shows that it often took a number of years before crisis countries were able to return to pre-crisis levels of employment and national income.

Authorities and investors in emerging markets have learned from experiences during these crises and undertaken actions both to strengthen their fundamentals and to help protect themselves from potential global uncertainties in the future. Economic performance has improved in many emerging markets, building investor confidence. Sound fiscal and monetary policies have been reinforced in some cases by structural reforms and economic liberalization which have attracted direct investment. Many emerging markets have adopted pro-active liability management strategies benefiting from an environment of global liquidity and low sovereign spreads. A growing number of emerging markets have also shifted to more flexible market-based exchange rate regimes.

Investors have strengthened their risk management practices and reinforced their capacity to differentiate across credits. There has also been growing variety in the types of emerging market debt instruments, including by currency, as well as an increase in cross-over investors for emerging markets. Together with abundant liquidity and the search for yield by investors, these factors have contributed to the robustness of the emerging market asset class in recent years. Moreover, international financial institutions such as the IMF and World Bank have intensified efforts to support the strengthening of financial systems and have advanced best practice standards through their standards and codes initiative.

Implementation of the Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets (the Principles) is already beginning to address the weaknesses that have remained in the system despite the progress over the past decade. The Principles provide a unique framework for cooperative actions by debtors and creditors to strengthen the fabric of emerging markets finance. They can contribute significantly to avoiding crises and, when necessary, facilitate a timely, orderly restructuring of debt. The Principles were developed by issuers, investors, and financial institutions as a voluntary and pragmatic approach to strengthen international credit and capital markets.

Building on progress on data transparency and investor relations, the Principles provide debtors and creditors with a framework for close dialogue and cooperation. This interaction can help to promptly restore market confidence in cases where it may be slipping and prevent full-blown crises. The resolutions of past crises have often been *ad hoc*, protracted, and complicated, involving unnecessary economic dislocation and reductions in the values of emerging market assets, especially in cases that required debt restructuring. By contrast, the Principles articulate a well-defined process for debtor–creditor negotiations on restructuring terms that can attract broad-based support from creditors; this process aims at restoring macroeconomic sustainability and market access on a timely basis. (See Page 14 for Principles.)

The Principles rely heavily on voluntary best practice standards. One of the key advantages of such standards is their flexibility to accommodate innovations in the marketplace. At the same time, the expectations they establish for behavior—in this case expressed jointly by borrowers and creditors—provide a strong source for constructive cooperation by issuers and investors for mutual benefit. Since their release in November 2004, issuers and financial firms who developed the Principles—in particular Brazil, Korea, Mexico, and Turkey and key members of the Institute of International Finance (IIF) and the International Capital Market Association (ICMA)—have been joined by others from both the issuer and investor community to advance a process for their implementation. These parties have also collaborated over the past two years to broaden support in both of their communities and beyond.

The Principles are supported by the Group of Twenty (G-20) Ministers and Governors whose November 2004 communiqué stated that these Principles provide a good basis for further strengthening crisis prevention and enhancing the predictability of crisis management both now, and as they develop in the future.

On various occasions, G7 officials and IMF management have welcomed the contributions issuers and the private sector have made to strengthen the financial architecture through the development of the Principles. Paris Club creditors have also expressed clear support for the Principles during their recent two annual meetings with private creditors.

> "The Principles are a reflection of the unique collaboration between sovereign issuers and private investors in shaping a more predictable framework for emerging markets finance. Their implementation is in the best interest of issuers and investors alike."
>
> *Ali Babacan, Minister of State in Charge of Economy, and Chief Negotiator of Turkey for European Union Affairs, Turkey*

"Institutional investors have a strong interest in supporting the Principles, which provide a sound framework for private capital investment in emerging markets. With their focus on transparency, creditor-debtor dialogue, good faith actions, and fair treatment, the Principles facilitate decision-making by investors, enhance the prospects of issuers, and promote conditions in which productive relations between the two can thrive."

*Herbert M. Allison, Chairman, President, and Chief Executive Officer, TIAA Cref*

Countries that have indicated broad support for the Principles on different occasions include the leading industrial countries and other sovereign issuers from both within and outside the G-20 membership. To date, over 30 issuing countries have voiced support for the Principles in letters and meetings, and expressed their particular interest in advancing implementation. Several issuers have underscored the significance of broad support by all market participants for implementation of the Principles given their voluntary nature.

Support is evident in actions by such diverse economies as Brazil, the Dominican Republic, Indonesia, Korea, Mexico, Morocco, Peru, the Philippines, and Turkey, all of which have bolstered their investor relations and transparency practices in recent months. The Principles have also been applied in some restructuring cases, most notably the Dominican Republic and Grenada.

On the investor side, several major financial institutions have reaffirmed their support for the Principles and are taking steps to integrate them into various aspects of their business operations. In letters of support, a growing number of CEOs have emphasized the need for all parties to implement the Principles and apply them to their daily decision-making process. Others have emphasized the useful guidance the Principles provide for crisis prevention and resolution, including their meaningful contribution to reinforcing cooperative approaches to debt restructuring. Several of these firms have stated that they act in accordance with the Principles. In addition, the IIF has been enhancing awareness and support for the Principles by highlighting them at key meetings with its membership.

Some issuers, investors, and creditors have been instrumental in advancing the implementation of the Principles through the work of the Principles Consultative Group (PCG) guided by the Group of Trustees of the Principles. (See Page 5.) This process has been characterized by the same spirit of cooperation that marked the development phase. There is a growing recognition in the international financial community that wide-spread adoption can make a meaningful contribution toward promoting investment, growth, and financial stability in the system.
The implementation process has broadened support for the Principles beyond their initial creators to other key issuers and representatives from the private sector.

"The Principles provide debtors and creditors with a clear framework for close dialogue and cooperation on both avoiding and resolving crises in emerging markets finance. They have already proven useful and are destined to become a major force in promoting global financial stability."

*Jacques de Larosière, Advisor to the Chairman, BNP Paribas Group*

## Benefits of Implementing the Principles

The Principles' overriding strength is that they incorporate voluntary, market-based, flexible guidelines for behavior and actions of all parties that have been framed cooperatively by debtors and creditors. The main potential benefit for the system as a whole is their proactive and growth-oriented focus, given that the Principles are operative not only after a crisis has occurred but mainly during times of diminished market access and early crisis containment.

The Principles also yield substantial shared benefits for emerging market issuers, creditors, and investors. They reduce vulnerabilities to economic or financial crises, as well as their frequency and severity, by promoting:

- Information sharing and close consultations between debtors and their creditors and investors to provide incentives for sound policy action in order to build market confidence.

- Enhanced creditor-debtor communication by encouraging debtors to strengthen investor relations based on market best practices and investors to provide feedback. Investor relations practices enable policymakers to make market-informed policy decisions.

- Early corrective action through sound policymaking stimulated in some cases by intensified investor relations or based on direct consultations between the debtor and its creditors and investors.

- Cooperative behavior between debtors and creditors toward an orderly restructuring based on engagement and good faith negotiations toward a fair resolution of debt-servicing difficulties. Such actions could accelerate a country's restoration of growth and market access.

Through these cooperative actions, the Principles can underpin a sustainable and healthy flow of private capital to emerging market economies, facilitating needed investment for long-term growth.

The Principles also contain a number of synergies with IMF objectives and policies. At the broadest level, the Principles support and facilitate the accomplishment of the Fund's goals to promote international monetary cooperation and enhance stability of the international financial system. In addition, the Principles provide further momentum to the IMF's efforts to improve data transparency, encourage sound policies, and facilitate cooperative solutions to debt restructurings should they arise.

"The Principles provide an excellent counterpart to collective action clauses in utilizing market-based approaches to promoting stability and growth in emerging markets."

*Francisco Gil Díaz, Minister of Finance and Public Credit, Mexico*

# Implementation of the Principles

The changing global economic environment makes broad-based implementation of the Principles a matter of priority. Buoyed by the strength of the global economy, private capital flows to emerging markets have surged to nearly $500 billion in 2005 from $120 billion in 2002. However, the powerful impact that sharply higher risk aversion and market volatility can have on emerging markets asset prices was exemplified earlier this summer, when concerns arose about economic growth prospects and the appropriate course for monetary policy in the United States. While prices of some emerging market assets have reverted to their May-June levels, the volatility has reminded market participants that remaining vulnerabilities in many emerging market economies need to be addressed, despite the significant improvements that have been made to economic fundamentals.

The possibility of a further slowdown in economic growth, especially in the United States, perhaps combined with a rise in risk aversion could pose even greater challenges for issuers and investors. Thus, all participants in emerging market finance should work together as stated in the Principles to strengthen the fabric of their interactions, as well as to fortify policies or behaviors in order to enhance the stability of the system. Reinforced policies and stronger focus on improving transparency and investor relations can be helpful to preserve the gains that many countries have made in the past few years. As important, investors should emphasize prudent risk management and consider investment decisions on the basis of economic fundamentals.

## The Principles Implementation Process

The implementation process is based on the cooperation and partnership between issuers and investors that was formed during the creation of the Principles. It is operationally centered on the PCG with technical support from the IIF secretariat. In addition, a Group of Trustees, comprised of senior leaders in global finance, provides overall guidance for the implementation of the Principles and lends credibility and objectivity to this process.

The PCG consists of 17 finance and central bank officials from emerging markets and senior representatives of the private financial community, many of whom have been instrumental in the formulation of the Principles. Representation from the private sector reflects the diversity of today's marketplace.

*"We are pleased to see progress being made by issuers and the private sector on the Principles and encourage them to build on their ongoing efforts."*

*Tim Adams, Under Secretary for International Affairs, U.S. Treasury Department*

The implementation process has four main functions:

- Evaluate how implementation is proceeding both on the issuer and the investor side;
- Facilitate the development of a continuous effort by issuers and investors to keep each other abreast of developments in emerging markets and encourage sound policies and investor support;
- Offer guidance for the restructuring process in appropriate cases; and
- Help ensure the continued relevance of the Principles in light of changing characteristics of international capital and credit markets.

IIF and ICMA leadership were consulted in the selection of these individuals from the asset management and banking community, who have been appointed to serve as initial members of the PCG. On the issuer side, senior officials were identified on the basis of the interest they expressed in the Principles, and in some cases, based on the importance to the global financial system of the economy they represent. Geographical diversity was also a factor.

Against the backdrop of the general environment for emerging markets, the purpose of the PCG is to:

- Consider specific country circumstances with a view toward providing suggestions to authorities and creditors as to how to align their policies and actions better with the Principles.
- Evaluate a wide range of country cases, including those where significant progress has been made as well as others that are facing market difficulties.

> "The importance that we place on the Principles can be seen not only from our participation in the implementation process but also in Indonesia's own efforts to enhance investor relations and data transparency."
>
> *Sri Mulyani Indrawati, Minister of Finance, Indonesia*

- Review market trends and the changing characteristics of capital and credit markets in order to ascertain if the Principles remain relevant or require amendment. Such reviews will be generally completed ahead of the annual meetings of the Group of Trustees.

The PCG is supported by the IIF which acts as a secretariat. The IIF consults with members of the PCG as well as other market participants as to which countries should be included in PCG discussions. It also prepares background material for PCG calls, providing analysis of investor relations and data transparency practices as well as economic policies of countries on the agenda. Staff from the IMF's policy and capital markets departments as well as a representative from the Federal Reserve Bank of New York join PCG discussions as observers.

The Group of Trustees is comprised of former and current leaders in international finance, with exceptional experience. The Group is co-chaired by Mr. Jean-Claude Trichet, President of the European Central Bank, Mr. Henrique de Campos Meirelles, Governor of the Central Bank of Brazil, and Mr. Toyoo Gyohten, President of the Institute for International Monetary Affairs in Tokyo, a former Japanese Vice Minister of Finance and a former Chairman of the Bank of Tokyo.

Trustees will meet as a Group once a year at the time of the IMF/World Bank and IIF Annual Meetings. The Group's mandate includes:

- Review of the evolution of the international financial system as it relates to emerging markets;

- Review of the development of the Principles, including their implementation;

- Proposals for modification of the Principles, if needed.

### The PCG Process

Since November 2005, the focus of the PCG's analysis and discussions has been on a mix of country circumstances in light of expectations for behavior set forth in the Principles. PCG members have also reflected on what feedback could be provided to authorities and creditors, and reviewed the follow-up discussions that have taken place on cases that have already been considered.

Selection of PCG cases in the first year of implementation has been relatively *ad hoc*, reflecting specific interests or concerns of PCG members as well as developments in particular economies and changes in the overall market environment. To date, only countries with significant capital market access have been discussed. Case selection has taken into account special progress or shortcomings in investor relations and data transparency. Practices in these areas were reviewed against market best practices that have been developed by the IIF.

Other cases reflect market concerns related to the overall thrust of economic performance. Countries that have made progress on a variety of fronts were also included in order to help ensure that discussion of a particular country in itself does not send a “yellow flag” to market participants.

The PCG’s discussions have taken place against the backdrop of a changing environment for emerging market finance. In early PCG discussions, participants considered potential risks to the outlook for emerging markets stemming from higher oil prices and global imbalances as well as preventative actions taken by issuers. More recently, the PCG discussed how volatility in emerging markets over the summer was viewed by investors and what steps issuers were taking to protect themselves against possible market instability in the future.

The mix of PCG cases can be grouped into three categories based on the progress countries have made with respect to data transparency, investor relations, and economic policies coupled with how these countries are performing in the market, including the development of their bond spreads.

- Cases with policy progress and positive market sentiment

- Cases with mixed policy performance and market concerns

- Restructuring cases

> “An increasing number of sovereign issuers are responding positively to the Principles–developing market-based investor relations programs, improving data transparency practices and following sound policies.”
>
> *Monika Machon, Managing Director and Head of Global Sovereign Risk, AIG Global Investment Group and Chief Executive Officer, AIGGIC (Europe) Ltd.*

“The Korean authority has made improvements fully reflecting market best practices. We will continue with our efforts for more effective communication and enhanced transparency for the good of both the investors and also Korea.”

*Tae-Kyun Kwon, Director General, International Finance Bureau, Ministry of Finance and Economy, Korea*

For the most part, implementation has focused on crisis prevention due to the absence of major debt restructuring cases. Thus, the PCG dialogue has centered on a country’s level of data transparency and quality and effectiveness of communication with investors. The PCG has also exchanged views on economic policies and performance.

The PCG has asked the IIF management to relay the Group’s perspectives to country authorities and engage in a dialogue toward implementation of PCG recommendations. The follow-up has taken place in the form of bilateral meetings, phone calls, visits, and written communication with Central Bank Governors and/or Ministers of Finance and in a few cases other senior officials. Typically, follow-up discussions have centered on providing the PCG’s views on authorities’ efforts with regards to investor relations and data transparency. In addition, these discussions have also touched on countries’ economic and financial situations. In one case, the PCG provided recommendations for how slipping investor confidence could be countered by decisive policy actions. In another case, there was an exchange of views with authorities on how they could adopt a market-friendly approach in case debt restructuring becomes unavoidable.

The general reaction of authorities to the PCG’s recommendations has been positive and the discussions have resulted in actions in a number of cases. Specific indications of progress have been observed in authorities’ efforts to strengthen data transparency and investor relations practices, in particular with respect to enhancing availability of data in an “investor-friendly” format and stepping up communication with investors in line with market best practices. In a number of cases, authorities are also taking steps to address concerns raised by the PCG, for example, by adopting policies to strengthen fiscal positions.

### Cases with policy progress and positive market sentiment

The PCG has discussed a few cases where authorities have responded to domestic or external shocks by adopting strong policies that have been well received in the market. Policy responses have included fiscal adjustment measures as well as inflation containment and stabilization of exchange rates. These measures have been reflected in sovereign ratings for these countries, which have remained stable or upgraded in some cases. Sovereign external bond spreads for these countries have either fallen or remained steady since mid-2005, with a temporary increase following the market correction in May 2006. At the same time, these countries have attracted foreign investment in external and domestic debt markets.

In some cases, authorities have been undertaking measures to attract foreign investment by instituting reforms in key sectors. Foreign direct investment has remained dampened in some cases due to investor concern regarding political prospects and the medium-term sustainability of policies and structural reforms. In some cases, policies with respect to tax collection and private investment have been noted as areas for improvement.

The PCG has also welcomed positive actions by authorities with respect to investor relations and data transparency in these countries whose practices are among the best in the group of 30 key borrowing countries assessed by the IIF in December 2005. For the most part, authorities are increasingly engaging in regular dialogue with investors. They are making information and investor relations staff accessible to investors through a variety of avenues, including official websites, non-deal road shows, and investor conferences/conference calls.

Most of the areas where needed improvements have been identified are related to data transparency, although one country would also benefit from better communication with a wider group of investors. In particular, the PCG has noted gaps in provision of time series data for central government debt and central government operations, as well as breakdowns by sector of external debt financing. None of the countries analyzed publish amortization schedules for external debt, which are important for investors to gauge future debt service payments.

> "The strength of the Principles lies in their market-based nature and their emphasis on crisis prevention measures. I am particularly pleased to see the progress made on this front. Containing financial difficulties at an early stage is far preferable than dealing with the economic consequences of a full blown crisis."
>
> *David Dodge, Governor, Bank of Canada*

“The adoption of the Principles will serve well the purpose of containing the risks through filling the gaps remaining in the areas of both crisis prevention and management and thus, ensuring stable capital flows to those countries and preserving financial stability.”

*Leszek Balcerowicz, President, National Bank of Poland*

## Cases with mixed policy performance and market concerns

The PCG has discussed a few cases where there has been a range of market concerns regarding investor relations and data transparency practices and/or economic performance and reform measures. In some cases, the PCG has identified a few key areas where improvements are necessary, while in others the recommendations were more extensive. In one case, the PCG provided guidance to authorities on adopting a cooperative market-based approach should authorities consider that they are unable to meet external financing requirements.

Most of these countries have benefited from a favorable external environment that has masked economic and financial vulnerabilities. Market concerns in these case have been linked to a series of factors such as the prospects of rising global interest rates, changes in oil prices (if the country is a net importer), shifts in the degree of risk aversion, and mixed political support for reforms, all of which could exacerbate perceptions of relatively weak economic fundamentals.

Risks have been partly evident in sovereign and local currency debt spreads for these countries as well as some ratings changes. FDI flows have reflected positive market sentiment for medium-term prospects in some countries, while in others the possible impact of external or political factors have dampened such equity flows.

In most cases, the PCG has noted areas in need of significant improvements with respect to investor relations practices. Authorities need to significantly develop avenues for investor communication such as active investor lists, conference calls and website mechanisms in order to better understand investor concerns and seek feedback.

Presentation of data in formats that can be easily used has been a particular cause of concern for investors in some of the cases. At the same time, most of the countries provide timely data on key areas of particular interest to investors such as: central government debt, central government operations, and external debt. However, the PCG has identified gaps in the provision of amortization schedules for both central government and external debt, as well as accrual-based data for central government operations. In one case, the presentation of fiscal data was found to be misleading.

### Restructuring cases

The PCG has reviewed a mix of debt restructuring cases that concluded in 2005. All of the cases were complex, involving a diverse set of market participants, instruments, and currencies. Cases included both pre- and post-default situations. Authorities took different approaches which were not in all cases seen by creditors as fully consistent with the Principles. In some cases, debtors negotiated in good faith with creditor committees to reach restructuring agreements. In other cases, debtors and their advisors preferred to consult with creditors on a bilateral basis toward the formulation of an exchange offer.

Creditor reactions to approaches taken by debtors were varied. Creditors were generally pleased with approaches involving cooperative negotiations with creditor committees. The experience with consultative cases was more varied. In one case, most creditors were satisfied with the level of consultations and transparency adopted by the debtor in order to put forth a debt exchange offer that was supported by a large majority. In another case, creditors stated that consultations with debtors and their advisors were inadequate leading to a "take-it-or-leave-it" unilateral exchange offer.

## Next Steps on Implementation

The Principles implementation process demonstrates a unique collaboration between emerging markets issuers and investors to shape a more stable framework for emerging markets finance. The PCG recognizes the novelty of this process and has proceeded gradually in order to develop a process that is mutually agreeable to issuers and investors. Over the past few months, members of the Group have gained experience working with each other within the PCG framework and have suggested improvements to strengthen the quality of the dialogue both within the Group and with authorities. Discussions benefited from cross-country comparisons and infusion of several PCG members' own experiences.

The growing awareness and support for the Principles that has resulted from the implementation process itself is encouraging. The PCG recognizes that more can be done in general to encourage more issuers and investors to embrace the Principles alike. Investor briefings and meetings between key issuers and investors are useful avenues to promote understanding and discussions of the Principles. The G-20, which endorsed the Principles at their creation, can be important to advance implementation and the policy dialogue. Continued support by the Paris Club will also be crucial in particular with respect to transparency and cooperative actions in restructuring

“I am pleased by the growing cooperation between the IMF and issuers and investors who are advancing the implementation of the Principles. I would encourage even greater collaboration in order to fully realize the synergies between the application of the Principles and the IMF’s important objective of promoting global financial stability.”

*Arminio Fraga Neto, Chairman, Gavea Investimentos Ltda. and former Governor, Central Bank of Brazil*

cases. In addition, as more debtors and creditors adopt the Principles as “modus operandus,” it is expected that the Principles will become a commonplace market feature, much the same way as collective action clauses have become over the past few years.

As the implementation process evolves, PCG members will consider rotation of its members on a staggered basis to ensure continuity while adding new perspectives. New private sector members could be nominated by organizations such as the IIF and ICMA. Issuers could be invited on the suggestions of colleagues currently on the PCG or from other senior emerging market officials. Individual Trustees could also nominate prospective PCG members. The full Group of Trustees would review and endorse any new PCG members.

On a technical level, the PCG will consider a more systematic process for country selection, building on its experience. It will broaden the group of countries it reviews beyond those countries that have significant access to international capital markets and include countries that will be seeking market access in the future. At the same time, the Group will need to ensure it remains engaged in the country cases that it has previously discussed. In the context of its country discussions, the PCG will review broader developments in international capital markets, in particular related to areas that could contribute to potential vulnerabilities in the global financial system. The PCG will also review actions by financial institutions or individual creditors/investors in light of the Principles.

The PCG’s informal assessments of a country’s performance and recommendations are provided by IIF management to authorities. Currently, assessments and discussions with authorities are not publicly released. The PCG will consider over time what aspects of its work could be shared publicly in order to better integrate information on implementation into the marketplace. The IIF reports on investor relations and data transparency practices by key borrowing countries provide a useful benchmark for assessing countries’ efforts in these areas. The PCG welcomes regular updates. The PCG will also discuss further if rating agencies should be encouraged to give focus to the Principles in the context of their overall evaluation of countries’ creditworthiness.

Some issuers and investors have considered that the Principles implementation process should be woven into the fabric of international policy discussions. In addition, in light of the IMF’s involvement in PCG calls as an observer, synergies could develop between the PCG’s discussions and the Fund’s own policy advice. Input could also be given to enhancing implementation of the Fund’s data standards, in particular in those areas that are important to investors but where adherence is not currently prescribed. Going forward, discussions could also focus more explicitly on the interface between the Principles and policies of the IMF and the Paris Club, especially in the areas of lending into arrears and comparability of treatment.

# Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets

## PREFACE

Since the mid-1990s, sovereign debtors and their private sector creditors have generally sought to put in place policies and procedures likely to promote and maintain sustained market access.

Most issuers have recognized the importance of implementing sound economic and financial policies (including monetary, exchange rate and debt management policies), as well as developing domestic public support for those policies. Equally important are policies that preserve the rule of law and, in particular, maintain the sanctity of contracts, as well as other measures needed to advance an open investment environment. In maintaining sound policies, debtors have been guided by internationally accepted standards and codes to strengthen financial stability and to enhance transparency by providing timely economic and financial data.

For their part, most creditors make investment and lending decisions on their own merit, accept full responsibility for these decisions, and do not expect official sector bailouts. As part of this process, creditors have sought to implement good practices in risk management, including thorough analysis of a borrowing country's implementation of sound economic and financial policies, as well as adherence to key standards and codes.

More recently in a significant step toward strengthening the resilience of the system, most debtors and their creditors have opted for the voluntary inclusion of collective action clauses (CACs) in international bond terms and conditions. These bonds have provided for amending payment terms through supermajority voting and for limiting precipitous legal actions through higher acceleration hurdles; a few bonds have also included provisions for debtor-creditor engagement.

In a growing number of cases, both issuers and creditors have pursued effective, two-way communication through robust investor relations programs (IRPs). This communication includes information and data on the issuer's key economic and financial policies and performance, with creditors providing feedback.

These Principles outline actions and behavior of private sector creditors and emerging market sovereign debtors to promote and maintain stable private capital flows to emerging market economies in the context of growth and financial stability. They are based on extensive and broadly based discussions among private creditors and sovereign emerging market issuers. Because individual cases will invariably involve different circumstances, the Principles should be applied flexibly on a case-by-case basis, and are strictly voluntary. Accordingly, no party is legally bound by any of the provisions of these Principles, whether as a matter of contract, comity, or otherwise. Moreover, nothing in these Principles (or in any party's endorsement thereof) shall be deemed to constitute a waiver of any such party's legal rights.

The Principles build on the progress since the mid-1990s to identify effective measures in order to shore up crisis prevention and encourage their continued implementation. The Principles promote early crisis containment through information disclosure, debtor-creditor consultations, and course correction before problems become unmanageable. They also support creditor actions that can help to minimize market contagion. In cases where the debtor can no longer fulfill its payment obligations, the Principles outline a process for market-based restructuring based on negotiations between the borrowing country and its creditors that involve shared information, are conducted in good faith, and seek to achieve a fair outcome for all parties. Such a process maximizes the likelihood that market access will be restored as soon as possible under sustainable macroeconomic conditions.

## PRINCIPLES

### 1. Transparency and Timely Flow of Information

*General disclosure practice.* Issuers should ensure through disclosure of relevant information that creditors are in a position to make informed assessments of their economic and financial situation, including overall levels of indebtedness. Such disclosure is important in order to establish a common understanding of the country's balance of payments outlook and to allow creditors to make informed and prudent risk management and investment decisions.

*Specific disclosure practice.* In the context of a restructuring, the debtor should disclose to all affected creditors maturity and interest rate structures of all external financial sovereign obligations, including the proposed treatment of such obligations; and the central aspects, including assumptions, of its economic policies and programs. The debtor should inform creditors regarding agreements reached with other creditors, the IMF, and the Paris Club, as appropriate. Confidentiality of material non-public information must be ensured.

### 2. Close Debtor-Creditor Dialogue and Cooperation to Avoid Restructuring

*Regular dialogue.* Debtors and creditors should engage in a regular dialogue regarding information and data on key economic and financial policies and performance. IRPs have emerged as a proven vehicle, and countries should implement such programs.

*Best practices for investor relations.* Communication techniques should include creating an investor relations office with a qualified core staff; disseminating accurate and timely data/information through e-mail or investor relations websites; establishing formal channels of communication between policymakers and investors through bilateral meetings, investor teleconferences, and videoconferences; and maintaining a comprehensive list of contact information for relevant market participants. Investors are encouraged to participate in IRPs and provide feedback on such information and data. Debtors and investors should collaborate to refine these techniques over time.

*Policy action and feedback.* Borrowing countries should implement economic and financial policies, including structural measures, so as to ensure macroeconomic stability, promote sustainable economic growth, and thereby bolster market confidence. It is vital that political support for these measures be developed. Countries should closely monitor the effectiveness of policies, strengthen them as necessary, and seek investor feedback as warranted.

*Consultations.* Building on IRPs, debtors should consult with creditors to explore alternative market-based approaches to address debt-service problems before default occurs. The goal of such consultations is to avoid misunderstanding about policy directions, build market confidence on the strength of policy measures, and support continuous market access. Consultations will not focus on specific financial transactions, and their precise format will depend on existing circumstances. In any event, participants must not take advantage of such consultations to gain a commercial benefit for trading purposes. Applicable legal restrictions regarding material non-public information must be observed.

*Creditors' support of debtor reform efforts.* As efforts to consult with investors and to upgrade policies take hold, the creditor community should consider, to the extent consistent with their business objectives and legal obligations, appropriate requests for the voluntary, temporary maintenance of trade and inter-bank advances, and/or the rollover of short-term maturities on public and private sector obligations, if necessary to support a borrowing country's efforts to avoid a broad debt restructuring. The prospects of a favorable response to such requests will be enhanced by the commitment to a strong adjustment program, but will also depend in part on continued interest payments on inter-bank advances and continued service of other debt.

## 3. Good Faith Actions

*Voluntary, good faith process.* When a restructuring becomes inevitable, debtors and creditors should engage in a restructuring process that is voluntary and based on good faith. Such a process is based on sound policies that seek to establish conditions for renewed market access on a timely basis, viable macroeconomic growth, and balance of payments sustainability in the medium term. Debtors and creditors agree that timely good faith negotiations are the preferred course of action toward these goals, potentially limiting litigation risk. They should cooperate in order to identify the best means for placing the country on a sustainable balance of payments path, while also preserving and protecting asset values during the restructuring process. In this context, debtors and creditors strongly encourage the IMF to implement fully its policies for lending into arrears to private creditors where IMF programs are in place, including the criteria for good faith negotiations.

*Sanctity of contracts.* Subject to their voluntary amendment, contractual rights must remain fully enforceable to ensure the integrity of the negotiating and restructuring process. In cases where program negotiations with the IMF are underway or a program is in place, debtors and creditors rely upon the IMF in its traditional role as guardian of the system to support the debtor's reasonable efforts to avoid default.

*Vehicles for restructurings.* The appropriate format and role of negotiation vehicles such as a creditor committee or another representative creditor group (hereafter referred to as a "creditor committee") should be determined flexibly and on a case-by-case basis. Structured, early negotiations with a creditor committee should take place when a default has occurred in order to ensure that the terms for amending existing debt contracts and/or a voluntary debt exchange are consistent with market realities and the restoration of growth and market access and take into account existing CAC provisions. If a creditor committee is formed, both creditors and the debtor should cooperate in its establishment.

*Creditor committee policies and practices.* If a creditor committee is formed, it should adopt rules and practices, including appropriate mechanisms to protect material non-public information; coordinate across affected instruments and with other affected creditor classes with a view to form a single committee; be a forum for the debtor to present its economic program and financing proposals; collect and analyze economic data; gather, evaluate, and disseminate creditor input on financing proposals; and generally act as a communication link between the debtor and the creditor community. Past experience also demonstrates that, when a creditor committee has been formed, debtors have borne the reasonable costs of a single creditor committee. Creditors and debtors agree jointly what constitute reasonable costs based on generally accepted practices.

*Debtor and creditor actions during restructuring.* Debtors should resume, to the extent feasible, partial debt service as a sign of good faith and resume full payment of principal and interest as conditions allow. Debtors and creditors recognize in that context that typically during a restructuring, trade lines are fully serviced and maintained. Debtors should avoid additional exchange controls on outflows, except for temporary periods in exceptional circumstances. Regardless of the specific restructuring mechanics and procedures used (i.e. amendment of existing instruments or exchange for new ones; pre-default consultations or post-default committee negotiations), restructuring terms should be subject to a constructive dialogue focused on achieving a critical mass of market support before final terms are announced. Debtors should retain legal and/or financial advisors.

## 4. Fair Treatment

*Avoiding unfair discrimination among affected creditors.* The borrowing country should avoid unfair discrimination among affected creditors. This includes seeking rescheduling from all official bilateral creditors. In line with general practice, such credits as short-term trade related facilities and interbank advances should be excluded from the restructuring agreement and treated separately if needed.

*Fairness of voting.* Bonds, loans, and other financial instruments owned or controlled by the sovereign should not influence the outcome of a vote among creditors on a restructuring.

# Principles Consultative Group

## Members

**Mr. Tom de Swaan**
Senior Advisor to the Managing Board
ABN AMRO Bank N.V.

**Ms. Monika Machon**
Managing Director and
Head of Global Sovereign Risk
AIG Global Investment Group and
Chief Executive Officer
AIGGIC (Europe) Ltd.

**Mr. Jacques de Larosière**
Advisor to the Chairman
BNP Paribas Group

**Mr. Paulo Vieira da Cunha**
Deputy Governor, International Affairs
Central Bank of Brazil

**Mr. William Rhodes**
Chairman, President, and
Chief Executive Officer
Citibank, NA and
Senior Vice Chairman
Citigroup Inc.

**Dr. Dagmar Linder**
Director
Regional Management, Central and
Eastern Europe
Deutsche Bank AG

**Ms. Susanne Gahler**
Director, Fixed Income
F&C Emerging Markets Ltd.

**Mr. Derrill Allatt**
Managing Director
Sovereign Debt Advisory Services
Houlihan Lokey Howard & Zukin

**Mr. Robert Gray**
Chairman
Debt Financing and Advisory
HSBC Bank, Plc.

**Mr. Kwon Tae-Kyun**
Director General
International Finance Bureau
Ministry of Finance & Economy, Korea

**Mr. Alonso Garcia Tames**
Undersecretary of Finance and Public Credit
Mexico

**Mr. Sergey Storchak**
Deputy Minister of Finance
Russian Federation

**Mr. Yi Gang**
Assistant Governor
People's Bank of China

**Mr. Roberto Hoornweg**
Managing Director
Morgan Stanley International Ltd.

**Mr. Johan Krynauw**
Director, Debt Operations
National Treasury, South Africa

**Mr. Brett Hammond**
Senior Managing Director
Head of Investment Analytics
TIAA-Cref

**Mr. Ibrahim Çanakci**
Undersecretary of the Treasury
Turkey

# Group of Trustees for the Principles

This report is published by the Institute of International Finance, Inc.
1333 H Street, NW, Suite 800E, Washington, DC 20005-4770
Tel: 202-331-8183 http://www.iif.com
September 18, 2006