The Minister's New Clause

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CONCLUSIONS: CONTRACT POWER AND CONTRACT ILLUSIONS
INTRODUCTION

Schemes at Shutdown

The sound of footsteps bounced along the vast empty corridors, off marble checkerboard floors imprinted with prehistoric snail fossils, across dimmed brass ceiling lamps, and up the stone spiral stairs to meet the rain knocking on the black skylights. Political paralysis had shut down the U.S. government and cleared the Treasury building of all inhabitants. Only two hubs of activity remained: the first was frantically working to avert a U.S. debt default; the second played host to the small group of finance officials, investors and experts hurrying down the hall, which would spend the next two hours debating how to make every other government’s debt easier to restructure.

Although no one had time to stop and think about it, the awkward coincidence between the U.S. government shutdown and the annual meetings of the World Bank and the International Monetary Fund in Washington had just crystallized the paradox of government debt. Governments owe over $40 trillion to private creditors worldwide, and hundreds of billions of dollars more to one another. Their debt is the core asset in national and global banking systems, the benchmark for pricing all other assets, and the preeminent savings vehicle for people, firms, and central banks. Yet it exists apart from the modern contract and statutory underpinnings of most other debt. Still-robust immunities make sovereign debt contracts nearly impossible to enforce. On the other hand, there is no bankruptcy, so the debt never goes away; it just keeps morphing and metastasizing through the ages. Despite this, and despite the long history of messy crises and defaults, creditors seem perennially content to lend more, and governments to borrow more. When the enterprise periodically runs into the ground, both sides profess shock and proceed to improvise a way out.

This book tells the story of three modern attempts to reconcile the ideal of a debt that “shall not be questioned”1 with the reality of repeated distress and default. The common thread

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1 US Constitution, XIV Amendment, Sec. 4
running through them is a set of contract terms that are supposed to make debt restructuring more orderly, less disruptive. These “collective action clauses” (CACs) had been floating around debt contracts for well over a hundred years before they were conscripted, thrice over the past two decades, to rescue governments and their debt markets, and with them, the global financial system. In the late 1990s and early 2000s, they were a tool in the hands of the world’s richest governments trying to pinch bailout pennies when poorer countries got in trouble. Less than a decade later, CACs resurfaced at the forefront of the Franco-German response to the Greek debt crisis. The European Union spent the next two years developing state-of-the-art CACs, which were unveiled just as the Greek debt restructuring and a series of court rulings in New York revealed their limitations. In response, the U.S. Treasury and the IMF launched a third initiative to fix CACs, and yet again try to rescue sovereign debt from its own dysfunctions.

Financial contract clauses are unlikely protagonists in high political drama. They are little modules in the toolkits of transaction cost engineers, picked for their capacity to allocate risks and responsibilities efficiently in a world where A agrees to pay B an amount equal to C currency units on date D. The height of excitement in this world is when C currency ceases to exist because it is absorbed in a currency union. Good lawyers are supposed to draft contracts to anticipate and address such contingencies and to keep the state (courts, regulators, legislators) out of their clients’ contracts. Smart traders are supposed to price contracts to reflect the likelihood of such contingencies, and their expected recovery. Government officials are supposed to stay out of the way, unless the markets fail and harm the public. While lawyers and traders are understood to make money from knowing what their contracts say and do, no finance minister is expected to know the difference between collective acceleration and aggregated modification.

In our research, this view of contracts turns upside down: market participants regularly profess not to know and not to care about their contracts, while heads of state and top finance officials feature contract minutiae in speeches, press briefings, and communiques. The New York Times and the Financial Times editorials sing the virtues of CACs. Government officials refuse to legislate or regulate in response to crisis, and instead take over the drafting of private contracts. A few lines of legalese are called upon to do the work of contract, bankruptcy, and macroeconomic and financial crisis response, and to preserve the asset at the heart of national
and international financial systems. CACs’ job is to keep sovereign debt credible as they make debt restructuring manageable.

Widespread adoption is evidence of contract success *per se*; it is a necessary but insufficient ingredient in policy success. By contract reform standards, CACs have been spectacularly successful, with most debt-issuing governments committing to change some or all of their contracts to incorporate CACs in just a few years. At this writing, U.S. government debt contracts are among the scant few untouched by reform. If CACs were also to achieve their policy objective, they would be revolutionary in at least two ways. First, they would create a predictable regime for sovereign debt restructuring in lieu of bankruptcy, minimizing the spillover effects of government debt distress and improving incentives for lending and borrowing. Second, CACs would help overcome a major governance challenge in international finance.

When governments intervene in domestic markets to correct market failure, they normally rely on familiar and uncontroversial tools, such as legislation and regulation. Correcting failure in the global financial markets is harder, because the available tools for government intervention are by turns cumbersome and time-consuming to put in place, nonbinding, uncertain, and prone to challenge for lacking legitimacy and accountability. Treaties, customary international law, and regulatory coordination all suffer from some or most of these defects. Voluntary contract change offers a way out: if debtors and creditors can be convinced to adopt contract terms to internalize crisis costs, the result is optimal policy and instant “hard law,” instantly legitimate simply by virtue of the parties’ consent.

Our goal in this book is to test the proposition that government-driven private contract reform can be an effective policy tool against financial crises, using the three waves of CAC reform in sovereign debt as a case study. From the start, we were skeptical: global governance by contract seems simply too easy, too good to be true. Nevertheless, the fact that smart and honest people in different governments have kept returning to contract clauses to help solve some of the hardest economic problems of our time convinced us that the subject was worthy of investigation.
As a by-product of this investigation, we also hope to paint a more complete picture of the sovereign debt universe and the role of contracts in it, at a time when the traditional distinctions between rich and poor, domestic and foreign, money and junk, are melting away. On the evening of October 9, 2013, the two groups working just doors apart in the empty U.S. Treasury building had succeeded in keeping their respective debts worlds apart. The universe is still divided into a world where debt is unquestionable and contracts are irrelevant, and a world where debt is restructured and contracts are all-important. How long it can stay that way is anyone’s guess.

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The book proceeds more-or-less chronologically. Part I describes the initiatives of the late 1990s and early 2000s in the emerging markets, which culminated in a massive market shift to CACs in 2003. Part II documents the ongoing CAC revival in Europe, which began in 2010. Part III takes us to the present day, when CACs are widely accepted – just as the old protagonists have realized that their fabulously successful contract reforms cannot possibly produce the policy outcomes they seek … and as they try again.

As the story progresses, our own place in it changes. We began as junior lawyers and policy flunkies, grateful to be flies on the wall during the crises of 1995 and 1998. We first met in 2003 at a train station coffee shop in Washington, D.C., introduced by a mutual friend (and book protagonist) who must have decided to spare our respective loved ones the annoyance of hearing us prattle on about CACs. We began by sharing our puzzlement at policy-makers’ single-minded focus on CACs, and market actors’ concomitant refusal to see their benefits. Many missed trains later, it occurred to us that the stories we were told in private were equally distant from the theories we had known and the official speeches we had heard. That was the birth of this project.

Most of this book draws on over 200 interviews begun in 2003 and continuing as we write. We have spoken with bankers, lawyers, debt relief advocates, “thought leaders” of all persuasions, and officials from over two dozen countries and international institutions involved in sovereign debt contract reform since the mid-1990s. As we lingered in this field, we were fortunate to be included in more conferences and policy gatherings where CACs were discussed.
Our joint and solo work has also figured in some aspects of reform—a point that we try to address with transparency towards our readers and interlocutors.

The journey has been both exhilarating and frustrating. It is exhilarating because the CAC story seems to have infinite layers of complexity, which keep revealing themselves just as we think we have it figured out. It is frustrating because the more we study CACs, the less able we are to produce a clean narrative of how they came about and what they do for everyone involved. For all its messiness, we think the story is worth telling, if only to dislodge some sticky ideas about public intervention in global financial markets, sovereign debt, standard form contracts, lawyers and politicians. To the extent these ideas stand in the way of managing debt and debt crises fairly and efficiently, the CAC saga might help make the world a better place after all.
Financial crises boost demand for comfort food and government debt. When the U.K. authorities blocked Barclay’s from saving Lehman Brothers for fear of catching “the American disease,” Britons loaded up on sticky toffee pudding and investors everywhere piled into the U.S. Treasuries (Paulson 2011, Wallop 2008, Noeth and Sengupta 2010). It is commonplace to attribute the Treasuries’ status as the safest of all safe havens to the dollar’s role the global financial system and other factors specific to the United States. The observation is fair, but it obscures a broader point.

Government debt is just another IOU, but it is not used like any other IOU. It is the dominant asset in banking systems, the leading benchmark for pricing other assets, the favorite savings vehicle of pension funds, insurance firms and currency reserve managers, the indispensable policy instrument of central banks, essential collateral for trillion-dollar wholesale funding markets, and in October 2008, a place to hide. Much like its cousin money, it is the lifeblood of national and global financial systems. Not all government debt does all this work all the time—the Treasuries are extreme in that sense—but virtually all does some of it some of the time.

To function as a safe asset, government debt must be very liquid (easy to sell for cash) and come free of credit risk.² Liquidity is rarely a problem, since governments are usually bigger than all the other actors in the national economy, and issue lots of debt. Freedom from risk is more complicated, since no asset is literally risk-free. But if the debt is safe enough to be “information-insensitive,” where investors have no reason to consider default and recovery, it will do the trick (Dang, Gorton and Holmström 2009). Once the debt is information-insensitive,

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² Some of the functions also put a premium on minimal interest rate and exchange rate risks, among other characteristics. (IMF 2012)
many traditional contract protections become irrelevant: if default is impossible, covenants are unnecessary.

As government debt managers see it, making the debt they issue information-insensitive and keeping it that way is the central part of their job description. To be sure, all debtors hate to think about default (Willis 2009). The stakes are considerably higher for national treasury officials, who presumptively equate debt default with wholesale meltdown of the financial system, bank runs, currency collapse, economic contraction, and losing office. Moreover, consumers may succeed at avoiding bad thoughts, but they rarely succeed at avoiding contracts. Most outstanding sovereign debt might be fairly described as a mostly contract-free space.

**Figure 1: Domestic and International Sovereign Debt by Issuer Category**

![Figure 1: Domestic and International Sovereign Debt by Issuer Category](image)

At the start of 2012, the world’s governments had over $40 trillion in outstanding medium and long-term debt securities. A little over $600 billion, or less than two per cent of the total, represented foreign debt issued by poor and middle-income countries. Domestic debt issued by wealthy countries stood at over eighty per cent of the total, split more or less evenly among the United States, Japan, and Europe, with a smattering of others. Despite changes in capital flows and reporting methodology since the mid-1990s, the pie chart is a fair general picture of the sovereign debt market throughout the period we study. Then as now, the bulk of

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3 Estimates based on BIS Securities Statistics and Syndicated Loans, Tables 12D and 16A, as of December 2011, using reports preceding the change in BIS debt statistics methodology effective December 2012 (available at http://www.bis.org/statistics/secstats.htm). Data exclude securities with remaining maturity under one year.
the world’s sovereign debt is issued by the rich in their domestic markets under their own laws. Debt issued by poor and middle-income countries abroad, in foreign currencies, and under foreign laws is a vanishingly small share of the total.

The pattern is not an aberration. Governments have traditionally borrowed for the most part from their own citizens, at home, in their own currency, and under their own laws (Reinhart and Rogoff 2009). Here governments have a distinct advantage over private debtors: they can declare their own debt to be “safe” and to a remarkable extent, make it so. For example, central banks can commit to lend against government debt collateral. Regulators might require banks to hold government debt against short-term liabilities, relieve banks from holding capital against government debt, encourage pension funds to keep a portion of their investments in safe, liquid assets defined as government debt, and exempt government debt from borrower concentration limits and activities restrictions. These and similar strategies go way back, blessed by the likes of Alexander Hamilton (Sylla 1998). They create broad and stable demand for government debt, which can become self-reinforcing.

This is not to claim that no one would buy government debt but for some regulatory sleight of hand.⁴ Capacity to tax and print money gives governments a genuine credit advantage, which can make their debt feel safe when private debt feels risky. By sheer virtue of its volume, government debt tends to be more liquid than other debt. Nevertheless, the ability to jump start and nurture their debt markets by law has been invaluable for sovereigns the world over.

A government’s influence over the market in its debt weakens beyond the national borders. Favorable regulatory treatment abroad takes international cooperation, which is hard to achieve. Although the Basel Committee on Bank Supervision and the European Union each would allow banks to treat some foreign sovereign debt as risk-free, it is not the general rule (Basel Committee on Banking Supervision 1999, European Parliament 2006; Hannoun 2011). And yet, some countries have had the privilege of selling local currency, local law debt to foreign creditors. For example, slightly less than half of all U.S. government debt in the hands of the public is owed to foreign creditors (U.S. Treasury 2013). Japan, Switzerland, and the United Kingdom, among others, enjoy a similar advantage. For a time, the entire Euro area appeared to

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be part of the club (Gulati and Smets 2013). To varying degrees depending on outstanding volume and liquidity, such debt can act as a safe asset globally. Some combination of the issuers’ abundant resources, political stability, and deep markets, as well as the widespread use of their currencies, is understood to put their safety beyond question.

Developing countries have only recently begun to issue significant amounts of domestic debt to foreign creditors (Inter-American Development Bank 2006). Much like the foreign-law, foreign-currency debt they had sold to foreigners before, this debt is understood to come with high credit risk and no regulatory benefit for the investors. It is not used as a safe asset abroad. The result is a paradox: at the extreme, the same instrument can be risk-free and in demand at home, but high risk or unwanted abroad.

Foreign-currency, foreign-law debt of developing countries—the site of the contract revolution we describe in Part I—is concentrated in the smallest sliver of the pie in Figure One. Governments had issued foreign bonds in the nineteenth century and into the 1930s, until depression-era defaults shut down the market for over sixty years. Sovereigns returned to private borrowing in the 1970s, mostly in the form of bank loans. A wave of loan defaults beginning in 1982 triggered a new debt crisis, which ravaged the debtors’ economies, stunted growth for a decade, and threatened the health of major international banks. In the early 1990s, banks agreed to exchange bad loans for Brady Bonds, named after the U.S. Treasury secretary who helped broker the solution. Nicholas Brady’s staff designed the complex instruments, backed by U.S. Treasury collateral, and ensured their favorable regulatory accounting treatment. Trading in the Brady Bonds paved the way for new issues and today’s emerging market bond market.

“ Emerging market” or “EM” debt is normally used in contrast to “mature market” or “MM” debt, to describe the debt of developing countries. At the time we began our study, only a few low- and middle-income countries could access international markets on any meaningful scale. Their debt was part of J.P. Morgan’s Emerging Markets Bond Index Global (EMBIG), which comprised the dollar debt instruments of governments and state-owned entities in thirty-three countries for which dealers quoted prices daily. Market participants used this index as a proxy to describe EM external debt as an asset class. In the summer of 2003, EMBIG market capitalization was $224 billion. Mexico, Brazil, Russia, and Turkey comprised over half this total then, and have continued to dominate the index since. Argentina had been a big presence
until its default in 2001. In all, a dozen countries accounted for nearly 90 percent of the index. Over one-third of the debt in the index was investment grade (Kim et al. 2004). Total foreign debt outstanding issued by EMBIG countries, including instruments denominated in euro and others not included in the index was closer to $300 billion in 2003. EM debt is actively traded: the leading industry association reported annual volume growing from about $4 trillion in 2003, to over $5 trillion in 2005, and nearly $7 trillion in 2011 (EMTA 2012).

By 2013, J.P. Morgan’s family of indices had expanded along with foreign investor penetration, to include emerging market domestic debt as well as foreign bonds issued by “next generation” or “frontier markets,” such as Gabon, Mongolia, Papua New Guinea, and Sri Lanka. Despite rapid growth and expansion in the EMs, foreign-currency debt issued by MM governments (such as New Zealand’s yen-denominated securities) has remained a multiple of the emerging market total.

The number of actors involved in EM sovereign debt is small, reflecting the relative size and concentration of the market. On the issuer side, raising money abroad is usually the responsibility of the finance ministry, occasionally of the central bank. Stand-alone debt management offices have gained popularity since the turn of the century. The core government team for a new foreign issue is normally about half a dozen people.

Domestic debt is sold in government-run auctions and is typically exempt from securities disclosure requirements applicable to private issuers. A dedicated cohort of large financial institutions (primary dealers) stands ready to buy and sell this debt by prior arrangement with the government. In contrast, EM foreign sovereign debt offerings are typically “managed” by one or more international investment banks. The banks design and market the instruments, and, for underwritten deals, commit to buy the debt. These “sell-side” firms compete for mandates from governments. Sell-side bankers refer to the issuing governments as their clients; their fees are a portion of the issue proceeds. Fewer than half a dozen investment banks dominate the scene, with another handful managing an occasional issue for a marginal sovereign. Sell-side banks also have research departments that report regularly on the emerging markets. In theory, research and investment banking are separated by “Chinese walls” (Blustein 2005). When sell-side research analysts speak of clients, they refer to the investors, also known as the “buy-side.”
Investors in “mature market” government debt are a large and heterogeneous group: regulated pension and mutual funds, commercial banks, central banks, corporations, hedge funds, non-financial firms and individuals at home and abroad, who use it for the most part as a savings vehicle and as a hedge against risk (IMF 2012, Poszar 2011). Until near the end of the period we study, MM sovereign debt presumptively enjoyed the highest credit ratings, and was eligible for inclusion in the widest range of regulated firm portfolios. Traders use MM debt to bet on interest rate and currency fluctuations, not credit risk. Investors in EM sovereign debt are a distinct category, and have more in common with risky corporate bond traders than the staid world of MM.

There is no comprehensive, authoritative source of information on emerging market investors. Sell-side research departments occasionally survey their clients, and governments occasionally try to get a fix on their creditor base, but neither effort produces a full picture. Less concentrated than the sell-side, the buy-side universe is still small: at the time of our study, a few dozen funds held most of the external debt issued by most EM governments, except where domestic, expatriate, or retail investors were a significant presence. The funds are a mix of “dedicated” and “cross-over” institutions, active trading accounts, and “buy-and-hold” investors. Dedicated investors, such as a Latin America or Southeast Asia Fund, commit to put all or some of their money in risky emerging market assets. Cross-over investors are more risk-averse, and are often regulated entities such as pension funds and insurance companies that may invest a portion of their portfolio in the EMs to boost returns when yields are low on MM assets. Riskier debt attracts more active traders that look for a quick profit in arbitraging price and interest rate differences worldwide. Some buy-side outfits have their own research departments. Domestic residents and institutions in the issuing countries are an increasingly important investor category in some cases, as are retail investors (real people investing directly), especially for governments raising money in Europe and Japan.

Domestic and foreign sovereign debt contracts look different. Most people would not even recognize the domestic lot as contracts. The United States is a prime example: most terms in the contract between the government and its creditors are found in U.S. Treasury regulations.\(^5\) These mostly consist of auction procedures, and are generally devoid of conditions, covenants,

\[^5\text{See e.g., Wolak v. United States, 366 F. Supp. 1106 (D. Conn. 1973); [Uniform Offering Circular cite]}\]
and events of default one might expect in a debt agreement. Elsewhere, domestic debt documentation is short, sometimes no more than a few lines in a law or regulation drafted in-house. The terms are never negotiated, and are not always readily accessible to the public or translated for the benefit of foreign investors (ICMA 2011).\(^6\) Contracts simply do not figure prominently in the life of domestic government debt.

Contracts are all-important in foreign debt—heavily lawyered, highly standardized, and mind-numbingly long. Foreign sovereign bond documentation is elaborate, including a disclosure statement distributed to investors (and, in the case of a registered public offering, filed with securities regulators), a distribution agreement between the issuer and the managers, and a series of agreements, including the debt instrument itself, that govern the relationship between the sovereign debtor and its bondholders. Most large issuers take advantage of shelf registration and medium-term note programs, which enable them to establish a document umbrella that applies to multiple issues and thereby to streamline documentation for any single borrowing. The key contracts are a product of issuer-manager negotiations with their respective lawyers. Buy-side investors generally do not see the disclosure statement until the marketing phase, with little room for negotiation. As a result, it is up to the managers and their lawyers to negotiate a document package they can sell. Structuring, negotiating, and selling a sovereign issue can take anywhere from a few days to several months.

Lawyers in this practice mirror the market’s concentration (Cf. Dezalay and Garth 1996). Half a dozen U.S. law firms, all but one headquartered in New York, document nearly all New York–law sovereign issues. A handful of London-based firms dominate the English-law sovereign market. Few of these firms have more than one or two partners specializing in

\(^6\) Information on domestic debt issuance in Mexico and Brazil is instructive. These countries’ governments have become the leaders in emerging market public debt management and investor relations; however, their websites—much as the U.S. Treasury’s—reference domestic laws, regulations, and auction rules, with no links to anything that looks like a traditional debt contract. Compare Secretaria de Hacienda y Credito Publico, Domestic Debt, at http://www.hacienda.gob.mx/English/public_credit_new/domestic_debt/Paginas/DOMESTICDEBT.aspx (Mexico), Ministerio da Fazenda, Tesouro Nacional, Domestic Debt, at https://www.tesouro.fazenda.gov.br/en/domestic-market/domestic-public-bonds (Brazil), and U.S. Department of the Treasury, Bureau of Public Debt, TreasuryDirect, Treasury Marketable Securities, at http://www.treasurydirect.gov/RT/RTGateway?page=institMktbles (United States). Contrast this to the disclosure and documentation of public external debt, for example, in Mexico, where contracts are extensively described in the readily-available prospectus. Secretaria de Hacienda y Credito Publico, External Debt, Government Securities Issued in the International Market, at http://www.hacienda.gob.mx/English/public_credit_new/external_debt/Paginas/GOVERNMENTSECURITIESISSUEDINTHEINTERNATIONALMARKETS.aspx.
sovereign debt. The most senior lawyers in this cohort tend to be veterans of the 1980s loan crisis; the younger ones spent their early days documenting new bond issues in the 1990s and 2000s.

Sovereign debt contracts have had trouble establishing their free market credentials. The debt’s value comes from a mix of the sovereign’s capacity and willingness to pay, third-party backing, and contractual safeguards. Capacity to pay is comparatively straightforward: it refers to the government’s ability to generate the revenues\textsuperscript{7} and foreign exchange to service the debt (Krugman 1988, Sachs 1989, IMF 2013). Willingness to pay is harder to assess, since borrowing governments enjoy expansive immunities, and at least in theory might be able to walk away from foreign debts when it suits domestic political purposes (Eaton and Gersovits 1981, Cole et al. 1985, Weidemaier 2013). As a matter of fact, they do so rarely, if ever—but individual governments have few credible ways to commit. On the other hand, there is no sovereign bankruptcy. As a result, sovereign debt contracts cannot be modified and debts cannot be discharged without creditor consent. The reforms initiatives we describe focus on changing standard form sovereign debt contracts to reduce the scope for individual creditor consent. The baseline is a set of contracts that are incomplete, commitment-challenged, and forever.

Third-party backing is rarely explicit. However, creditors have long relied on rich governments for repayment of their loans to the less fortunate. In the early 20\textsuperscript{th} century, this might have meant “gunboat diplomacy,” or taking over debtors’ customs houses to collect revenues for the creditors’ account (Alfaro and Maurer 2010). In the late 20\textsuperscript{th} century, this meant “bailouts,” or rescue financing from rich countries and multilateral institutions. The money was conditioned on economic policy reform, and helped repay foreign creditors when their debtors ran out of money (Roubini and Setser 2004). Latter-day bailouts were never openly justified in terms of paying the creditors. Rather, they were described as a response to externalities from sovereign debt crises, especially the fear of financial contagion.

The relationship between implicit third-party backing and express terms in sovereign debt contracts is at the heart of our story—and has broader relevance for other parts of the financial

\textsuperscript{7} There is an obvious and well-recognized fuzzy zone between ability and willingness to pay when it comes to raising tax revenues. A government’s ability to tax depends both on the amount of money in the private tills, and the government’s willingness to bear the political cost of harvesting it (e.g., Sturzenegger and Zettelmeyer 2007).
system. When the debt is so safe that it is information-insensitive, contracts are irrelevant. When the debt is risky, creditors might use conditions, covenants, events of default, and remedies provisions to commit the debtor. When the debt’s safety derives from a third party’s willingness to step up, both debtors and creditors might try to use their contracts to “bail in” the implicit guarantor (Bulow and Rogoff 1988). In EM sovereign debt, making contracts hard to amend and default disorderly might make the able-but-unwilling debtor more likely to pay (Dooley 2000, Shleifer 2003)—or, related, might be adopted by a debtor as a strategy to distinguish itself as the paying sort (Wenschelbaum and Wynne 2005). On the other hand, restructuring under brittle contracts might threaten such massive spillover damage so far beyond the debtor’s borders that the world’s richest countries would simply have to come to the rescue.

The United States and other members of the Group of Seven (G-7) were implicated in managing the 1980s debt crisis both because of the region’s strategic significance and because sovereign defaults threatened the health of major banks in their jurisdictions. The next generation of crises started with Mexico’s near-default in 1994-1995, averted with the help of a $40 billion U.S.-led rescue package. As financial crises proliferated, pressure for bailouts intensified, and rescue packages grew bigger, rich country guarantors decided to step back. But they needed a tangible way to advance this policy: it is one thing to say that debtors and creditors were on their own, quite another to make them believe you would stand idly by as contagion wreaked havoc on the world economy. Ideally, the promise to back off should come with a package of concrete policy initiatives that would make it more credible. This search for concrete initiatives prompted a turn to contracts.

Soon after Mexico’s “Tequila Crisis” in 1994, G-7 officials commissioned and inspired countless academic and policy projects to identify contract terms that could impact crisis management. The official goal was to make an otherwise inevitable sovereign debt restructuring more orderly. Both creditors and EM sovereigns interpreted “orderly” as code for making restructurings more likely and/or less subsidized. For EM government debt managers, especially those in large countries with reasonably steady market access, this was a deeply uncomfortable conversation. From their perspective, one big difference between “emerging” and “emerged” was that in the latter state, contracts did not matter. Contract irrelevance, a proxy for safe asset status, was the Holy Grail—even if patently unachievable for the foreseeable future.
Governments that had spent years driving painful domestic economic reform and convincing foreign investors that they were creditworthy received the contract reform agenda as a statement that they were still—perhaps forever—risky wards of the official sector. Being thus put in their place had to come with economic and political costs.
CHAPTER THREE

HOLDOUTS, BAILOUTS, AND BANKRUPTCY KILLERS

Mexico holds a special place in the enterprise now known as International Financial Architecture reform (Group of Seven 1998). In August of 1982, its debt moratorium marked the start of the Third World Debt Crisis, which redefined the role of the International Monetary Fund and shaped the prevailing debt restructuring institutions (Rieffel 2003). In 1989, Mexico issued the first Brady Bonds. These not only launched the EM debt market, but also seeded the contract boilerplate that took hold in it. The 1994-1995 Tequila Crisis prompted the quest for reform in sovereign debt and crisis management.

By 2003, this history of crashes and near-defaults seemed like a distant memory. Mexico was accelerating political transition to “full-fledged democracy,” modernizing its domestic capital markets, reducing inflation, and professionalizing its debt management. The Mexican government and private firms increasingly financed themselves at home and in local currency (IMF 2004). Mexico had become the toast of Wall Street and Washington. Foreign traders and economic officials could not say enough good things about Mexican leaders’ intelligence, maturity, policy savvy and market sophistication. Mexican debt managers told us that they could issue a billion dollars in debt on a day’s notice. By February, they had pre-financed their needs for the full year. No one read their debt contracts because they did not need to. Mexico had arrived.

But Mexico had a problem; its name was Argentina. In the 1990s, Argentina had undertaken dramatic structural and macroeconomic reforms, privatizing its economy, fixing the peso at 1:1 to the U.S. dollar, and borrowing up a storm in the capital markets. It survived shockwaves from the Tequila Crisis, but then succumbed to the mix of Brazil’s devaluation against a rising U.S. dollar, falling soybean prices, and contagion from Russia’s debt default in 1998. With no growth prospects, dysfunctional fiscal arrangements, fragile banks, and no market access, Argentina stopped making payments on over $80 billion in foreign debt in December 2001—the largest sovereign bond default in history. Argentina’s default and the ensuing battles
with creditors demoted it from “star performer” to “rogue debtor” in market analysts’ books. (Porzecanski 2005)

During the year running up to default, Argentina had financed capital flight with captive lending from domestic regulated firms and increasingly incredible IMF programs (Setser and Gelpern 2006). The latter caused great discomfort for the new Bush Administration in the United States. Eager to distance itself from Clinton-era bailouts, the Bush Treasury was searching for a way to inject market discipline in the last Argentine package before default. Inspired by the financial engineering of the Brady Plan and by faith in market ingenuity, the Treasury team pressed the IMF to set aside $3 billion out of $23 billion for a “market-based, voluntary restructuring operation” (IMF 2001). It soon became clear that restructuring $100 billion with $3 billion would take more magic than engineering. But some of the early design meetings introduced Paul O’Neill, the eccentric first Treasury Secretary of the second Bush Administration, to negative pledge constraints in sovereign debt contracts. For O’Neill, the celebrated former head of Alcoa, having a contract clause interfere with a necessary workout seemed simply wrong. On September 20, 2001, in his first Congressional testimony after the September 11 attacks, the Secretary publicly called for sovereign bankruptcy.

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Earlier that week, O’Neill had hosted a private breakfast for Horst Koehler, the Managing Director of the IMF, and Anne Krueger, his newly-appointed First Deputy. Several senior staff were in attendance. One participant told us that at breakfast, O’Neill “waxed poetically” about international bankruptcy. Another reported O’Neill saying something like, “We need an international bankruptcy court … and do it by December.” The IMF had explored sovereign

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8 A standard negative pledge clause restricts the borrower’s capacity to pledge collateral to secure future debts. Most private lenders to sovereigns, as well as the World Bank, require negative pledge commitments. If the $3 billion were to be used, as in the Bradies, to buy super-safe collateral to back restructured Argentine debt, the government would have to obtain negative pledge waivers from existing creditors.

9 “We need an agreement on an international bankruptcy law, so that we can work with governments that in effect need to go through a Chapter 11 reorganization instead of socializing the cost of bad decisions.” The Condition of the Financial Markets and Regulatory Responses Following the September 11 Terrorist Attacks: Hearing Before the Committee on Banking, Housing, and Urban Affairs, 107th Cong. 33 (2001) (statement of Paul O’Neill, Secretary, United States Department of the Treasury).

10 O’Neill mentions the meeting in his September 20, 2001, testimony. He dates it the preceding Monday, which was September 17. Id. The IMF’s first deputy is traditionally nominated by the United States. Krueger, a prominent economist, was a Bush White House choice.
bankruptcy several times in the preceding decade, each time without an action mandate from its major shareholders. For the IMF officials at the Treasury breakfast, O’Neill’s call signaled an institutional boost. Elated, “Horst and Anne sort of floated out of the place.”

In contrast, O’Neill’s deputies took his words as rhetorical gloss. The Secretary had identified a problem – inflexible debt contracts – and commissioned a solution. Statutory sovereign bankruptcy was a solution, but one that was costly (at a minimum, requiring Congressional involvement) and more importantly, too “dirigiste” for most of the Bush team’s free market sensibilities. One team member, a lawyer by training, suggested that bankruptcy functions could be replicated in a contract. Officials became convinced that “not only was it possible, it was smarter to do it contractually.” But by then, the IMF machine was in full gear designing the statutory framework.

Some Treasury participants in the September breakfast say they saw right away that Krueger’s understanding of O’Neill’s marching orders differed from their own. But Treasury officials, still completing transition to the new Administration, thought they had time to bring Fund management “back on the reservation.” They miscalculated. Krueger gave her first speech launching the Sovereign Debt Restructuring Mechanism (SDRM) in November 2001 (IMF 2001). IMF had sent an advance copy to the Treasury but heard nothing back. Krueger may have assumed she had what “clearance” she needed; Treasury officials assumed more substantive consultations would ensue: after all, she was proposing to amend the IMF Articles of Agreement (Charter) and the United States held the blocking vote.

Market reaction to Krueger’s speech was scathing. One lawyer recalled that the speech “scared the Bejesus out of” some business contacts. A money manager summarized market concerns as two-fold: discomfort with “institutionalizing a process by which your contracts would be trumped” and having that process run by an institution like the IMF, controlled by the G-7 and exposed to their shifting policy priorities. Many others suspected Fund motives, and accused it of conflicts of interest: the IMF is often the largest creditor of a sovereign in distress.

Once the idea was out, it proved hard to squash. O’Neill had no problem with the contract alternative, but refused to allow his deputies to end the statutory experiment. His
industry past had taught him that competition was the best route to innovation. Competition began to resemble confrontation the following spring, when Krueger and John Taylor, Treasury Under Secretary for International Affairs, both spoke at a conference on sovereign debt restructuring at a Washington think tank.

Krueger delivered a modified version of the first SDRM proposal, scaling down the IMF’s role (Krueger 2002). She identified creditor coordination problems as the principal obstacle to debt relief for countries that required it. Echoing theoretical accounts going back to the 1990s (Eichengreen and Portes 1996), Krueger described the shift from bank loans to diverse, dispersed, tradable bonds as leading inevitably to free-rider problems. She specifically pointed to lawsuits against Peru, where a specialist fund had secured a very favorable settlement, and to ongoing litigation against Congo, as evidence of holdout behavior that could only get worse. Creditor diversity and dispersion also raised concerns with inequitable treatment and uncertainty, which caused delays and deadweight losses.

In the face of such formidable problems, contracts were a feeble solution: they were piecemeal, likely to fragment along bond issues, debt types and jurisdictional lines, and slow to take hold in a world full of 25-year Brady Bonds. A relatively minimal treaty regime could secure an aggregated majority vote across the debtor’s foreign debt stock and overcome any heterogeneity within it. It could achieve predictability and equitable treatment for all creditors, catalyze interim private financing, discipline the debtor, and reduce the need for bailouts.

Taylor, who spoke the next day, saw uncertainty as the principal problem with sovereign debt restructuring. Uncertainty had been made worse by the rampant bailouts he blamed on the Clinton Treasury. He too mentioned holdouts, but did not emphasize them. A “centralized” approach that involved IMF treaty amendments was simply unnecessary to solve the uncertainty problem. Instead, Taylor endorsed three categories of sovereign debt contract clauses to promote creditor coordination in a restructuring: majority amendment, where 75 per cent of all creditors can vote to bind the rest, engagement, where debtors and creditors would spell out a process by which they would come together, and initiation, providing for a “cooling-off” period at the start of negotiations, potentially including a payment suspension. These were all generally recognized as species of CACs, though majority action was by far the best known of the three. Taylor did
not insist that the new clauses be standardized marketwide, nor did he favor a bankruptcy-style aggregated vote across the debt stock. He described his approach as pragmatic, decentralized, and market-based. He acknowledged that adoption would take sustained “financial diplomacy,” and even floated the possibility of a subsidy for countries adopting CACs, or conditioning IMF assistance on CAC adoption. For Taylor, contracts held the promise of organic reform that would inject certainty in the restructuring process, reduce potential for contagion, and eventually eliminate the need for bailouts. In the end, contracts would prove superior to IMF-centered institutional change—even when that change was of the sort he favored, such as firm limits on access to IMF financing (Taylor 2002).

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Taylor and his staff did not invent CACs, nor were they the first to invoke them as a policy solution. Although they had not realized it when they first proposed the contract alternative to O’Neill’s bankruptcy, these Bush Administration officials were following in the footsteps of their bailout-prone predecessors. One official implicated in the clauses’ comeback described a tinge of awkwardness when he first learned about it: “It’s round, it rolls, look what I’ve discovered!” Mexico’s near-default in 1994 solidified public consensus that the era of bond crises had arrived, and was worse than the 1980s loan crisis, which involved fewer creditors and fewer instruments. By the mid-1990s, emerging market sovereign bonds had acquired a measure of “safety” partly because they seemed technically difficult to restructure, but also partly for their association with the moral commitment the official sector had made in sponsoring the Brady Plan.11 In many ways, the Bradies were ordinary bond contracts like any other governed by New York law; however, they were written to be inflexible. One provision in the bonds turned out in retrospect to be near-comical bluster – a promise that they would never be restructured.

The promise drew credibility from another clause, which required each bondholder’s

consent to restructure the debt. We consider the origins of unanimous consent later in the book; for now, we focus on how lawyers and policy makers saw the term in the late 1990s and 2000s: as a holdout veto on restructuring. The unanimity requirement in New York law bonds also seemed wholly unnecessary, since the London market had long allowed amendment of financial terms with creditor supermajorities. Starting in 1995, academic and trade journals began publishing lawyers’ bond restructuring proposals; yet more ideas circulated informally.

On the official side, worries about stalled bond restructuring went hand in hand with concern about mega-bailouts: many in the finance circles fumed at the $40 billion Mexico package (Blustein 2005). Central banks took the lead in making sure it did not happen again. A series of central bank deputies’ meetings beginning in February 1995 produced a Group of Ten (G-10) working party under the leadership of Jean-Jacques Rey, the Belgian central bank deputy chosen, in the words of one participant, “because he was neutral – not American but not crazy Bundesbank – no bailouts.” The Rey group’s mandate was “a reaction to what you [the Americans] did – there has got to be a better way of handling sovereign liquidity crises.” The fruits of the group’s work, known informally as the Rey Report, came out in May 1996. It considered and rejected statutory sovereign bankruptcy as neither feasible nor appropriate and proposed a “market-led process to develop for inclusion in sovereign debt instruments contractual provisions that facilitate consultation and cooperation” between debtors and creditors, as well as among creditors. This specifically included majority modification to improve restructuring predictability.

It is not clear how the contract proposal made its way into the report. Some later commentators credit a volume edited by economists Barry Eichengreen and Richard Portes, commissioned by the British Treasury and the Bank of England in connection with their work in the Rey group (Eichengreen and Portes 1996). But some of the authors and working party members describe the bond clause proposals as “already out there” and part of the crisis management discussion. Veterans of the 1980s crisis who participated in the Rey effort said that the lengthy, costly and traumatic restructuring delays they attributed to high-majority and unanimity requirements in loan contracts played a role in framing their concerns. Some private practitioners had expressed similar worries several years before the 1994 Tequila Crisis.
For all the focus on CACs in the wake of the Mexican crisis, there was also a disconnect. The instruments at the heart of that crisis were neither New York nor English-law bonds, but rather domestic-law Tesobonos that probably could have been amended unilaterally. But to our knowledge, no one tried amending them or even seriously research the terms. And neither the 1990s CAC reforms, nor Taylor’s CACs, not even Krueger’s SDRM would have applied to the Tesobonos, had they been in place in 1994. At best, the link between the Tequila Crisis and the later initiatives is that it had brought home the fact that bonds might become a problem.

In market surveys commissioned for the Rey Report, investors dismissed the officials’ contract proposal:

Market participants opposed any change to the present structure of bond contracts. The general view among the respondents was that bonds represent a simple promise by the borrower to pay, and their attractiveness as an investment vehicle reflects their character as easily transferable, unencumbered and difficult-to-restructure securities (Rey Report 1996).

To put things in perspective, investors had also dismissed sovereign bankruptcy and bondholder committees – they pretty much wanted to be left alone. Nevertheless the clause proposal, initially mocked as a “tinny deliverable,” survived to see the next crisis almost five years. After the Rey Report, clauses reappeared in a report on crisis resolution by the G-22 in the aftermath of the Asian financial crisis, and as part of the G-7 International Financial Architecture Initiative in 1999. One staffer suggested this resilience was due to a combination of intellectual appeal and bureaucratic convenience:

[CACs offered a] very elegant, simple theoretical framing. It worked in the economics world. Collective action problems are a well-accepted category that a legal problem falls into – a well-accepted model of market failures … Government is only involved if there is a market failure. It is easy to show market failure here. …Very powerful framing overlapped with the concern in the legal world whether document standards in New York law Brady Bonds made sense – set up in a way – exit – no more restructuring – that made it harder down the line. This simple accepted model of potential problem that worked both in legal and economic world – there was an element of truth to the arguments – got elevated and expanded into a notion that because CACs are not there, there is no market
solution, the only option is a bailout. Somehow it went from “absence of CACs makes restructuring harder than it should be” to “there will always be bailouts”.

Jeff Sachs was pushing international bankruptcy\(^\text{12}\) – seemed too far. Traded securities difficult to restructure – means a bailout next time – the Mexico problem – not tenable. As always the case, you put the unattractive options as the first bullet and the third, everyone picks the option in the middle. The option in the middle was to do something that makes tradable bonds easier to restructure.

The intellectual appeal story is plausible because of the large number of academic economists involved in CAC policies over time. Lawrence Summers and John Taylor are the best-known of the lot, but the economics PhDs involved over time and at the highest levels numbered in the dozens. It helps explain the search for market failures, and the willingness to commission academic studies in support of the effort.

The bureaucratic story requires elaboration. The officials who discussed the topic with us made clear that their advocacy of CACs related to a bigger policy objective. If $50-billion bailouts were no more, bond restructuring was inevitable. In the late 1990s, CACs became part of the effort to signal that the erstwhile guarantors of EM sovereign debt would not stand in the way of sovereign bond restructuring, and in some cases may even demand it. The implications of that judgment translated into two big policy shifts in the late 1990s under the rubric of “private sector involvement in crisis management,” or “PSI”. First, the Paris Club of government-to-government creditors would condition its relief on the debtor’s commitment to seek private bond restructuring terms comparable to the official concessions (bond comparability). Second, the IMF would announce its willingness to finance countries in default on bonded debt (Lending into Arrears).\(^\text{13}\) Several participants said that at the time, CACs ended up on the laundry list of “things to be for” in operationalizing PSI. Despite three years of market


\(^\text{13}\) Before 1989, the IMF refused to finance countries in arrears to private creditors. This empowered the creditors to hold up both their own as well as the IMF’s financing. As bank restructurings progressed, the Fund changed its policy to allow lending where the country was in still in default on its loans, provided the country was complying with its policy program. With qualifications, the policy expanded to cover default on bonded debt in the late 1990s. INT’L MONETARY FUND, FUND POLICY ON LENDING INTO ARREARS TO PRIVATE CREDITORS—FURTHER CONSIDERATIONS OF THE GOOD FAITH CRITERION 3-9 (July 30, 2002), available at http://www.imf.org/external/pubs/ft/privcred/073002.pdf.
resistance beginning with the Rey Report investor surveys, the clauses still had an inoffensive, vaguely market-friendly ring to the official ear.

But in the late 1990s CACs never quite overcame their status as an adjunct initiative. A former Clinton White House official suggested that Treasury Secretaries Robert Rubin and Lawrence Summers never seemed eager to push hard on the CAC front. Staffers observed that Rubin and Summers had expressed their respective reservations differently:

Rubin was happy to have us talk about it, but would not have supported drafting model clauses. …“These guys have a problem coming down the pike – [they will have to] restructure bonds – if they can’t do it, this is when it will happen. This will not be solved until they believe it is a problem, and when they do, then they will solve it better than we ever had.” Larry was worried that it would make us look feckless. We publicized it a certain amount, but how they structure contracts is not our business. If this is our primary recommendation and they do not do anything about it, we look feckless.

In the minds of Clinton Treasury officials, the delicate state of the global economy in the late 1990s weighed heavily against regulation or even pressure on market participants: Moving precipitously might “screw up fragile equilibrium.” Mulling the CACs’ eventual success, another participant in the Clinton-era debates admitted being torn between feeling “sheepish – they made it happen when we could have done it in 1999-2000 – and what I used to think then … which is that … in the hierarchy of priorities … it is not number one, number two, or number three.”

Early-iteration CACs were part – even if the mildest part – of a policy package that signaled “we want banks to take a hit.” The official sector was not about to get out of the crisis management business; rather, private creditors that got a subsidy after the Tequila Crisis would now be asked to pay their way. In the late 1990s, the official sector was united around bond comparability and lending into arrears on bonded debt. These were measures that governments could and did implement on their own, with minimal cooperation from the private sector. Once they did, officials could wait and see how bond restructurings might pan out. Within two years, Pakistan, Ukraine and Ecuador had secured high participation rates in distressed bond exchanges without significant litigation. Ecuador was especially influential because it restructured New York law Brady Bonds without CACs, thanks in part to another market-generated contractual

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The context had changed by the time CACs re-emerged in 2002, several years after the Paris Club and IMF policies had been implemented. IMF packages were getting even larger under the new U.S. Administration, which had made opposition to bailouts a plank of its foreign economic policy. The new U.S. leadership framed this opposition as leaving the market to its own devices – getting the public sector out of crisis management, rather than making the private sector pay.\(^{14}\) In contrast, for many European officials SDRM seemed like a natural next step in escalating the PSI debate.

The free-market contingent at the U.S. Treasury needed an alternative that promised to reduce bailouts, empower market forces, and look credible enough to preempt SDRM. CACs – long rejected by Wall Street – were arguably the worst candidate. On the other hand, once SDRM was out of the box, the time constraint was real, especially if one believed as some did that the debate itself was harmful to the markets. No other palatable alternative had materialized. Republican officials may have found philosophical appeal to a fix that literally “came from the markets” in the form of standard English-law contracts, and bonus bureaucratic appeal to a fix that looked familiar and essentially harmless to the finance officials in the major industrial countries and even some emerging markets countries that had to buy into CACs to make the shift happen. Within two years, CACs went from being a symbol of “bail-ins” to being a symbol of market-friendly reasonableness.

The way in which the new team pursued CACs is instructive. As Under Secretary for International Affairs, John Taylor was head of Treasury’s international division; Quarles was his deputy. They oversaw an organization of 150 or so staff, organized into “functional” and geographic offices. Functional offices are responsible for policies that span geographic regions,

\(^{14}\) Taylor contrasted the Bush Administration’s approach to their predecessors’: “They tended to be government-focused rather than market-focused, emphasizing large loans by the official sector and later government-induced bail-ins of the private sector.” Taylor, *The Bush Administration’s Reform Agenda* (______). Whether this market focus went beyond rhetoric and the extent to which it made for sound policy is much debated. See e.g., ROUBINI & SETSER, supra note 33, at 8-9, 368-69.
such as international debt, development, trade, terrorist finance, and U.S. participation in institutions such as the IMF and the World Bank. “Country” offices are responsible for policy with respect to specific countries and regions, and generally maintain staff-level communications with other finance ministries and central banks. The functional office responsible for U.S. policy in the IMF and the G-7 process had the “lead” in staffing the CAC initiative, with input from in-house lawyers and the office of the U.S. representative at the IMF. Treasury’s country offices would help carry the gospel to their counterparts in EM finance ministries.

Between Krueger’s first speech in November 2001 and the summer of 2002, the lead office collected research on the clauses, and consulted with academics, some emerging markets issuers, and selected market participants (mostly trade groups and researchers at large investment banks). Early efforts focused on including CAC advocacy in important policy signaling documents, such as G-7 communiqués, speeches and other public statements by senior U.S. officials, meetings with foreign counterparts, and market outreach. This was similar to the late 1990s tactics.

The approach began shifting soon after Krueger’s and Taylor’s dueling speeches in early April 2002. The fine details of the two proposals got lost in the press firestorm that followed. The U.S. Treasury was read as dismissing the IMF’s initiative as a matter for academic speculation Those involved in preparing the text say that Taylor, a renowned macroeconomist, had never intended to slight Krueger, a former Stanford colleague—he certainly did not mean “academic” as a pejorative. Looking back, it is hard to see how a U.S. proposal with no role for the Fund could escape being perceived as threatening. In any event, the press reported the speeches as open conflict between the IMF and its largest shareholder (Beattie and Colitt 2002). The signal that sent may have trumped the substance of either initiative. To control the damage, Taylor’s new deputy Randal Quarles told the press the United States was for a two-track approach – where the Fund and the G-7 would explore both contract reform and treaty-based sovereign bankruptcy (Blustein 2002).

Later that month, the G-7 Finance Ministers and Central Bank Governors adopted an “Action Plan” to strengthen crisis prevention and resolution (Group of Seven 2002). In those days, G-7 ministers’ meetings produced statements and communiqués, broader-brush documents
meant to signal economic trends and policy intentions. An Action Plan signaled urgency and specificity — an emphasis on results reflecting the public style of the new U.S. team. “Contingency clauses” were the first item in the plan, followed by limits on IMF lending, greater transparency in official decision-making, and further work on SDRM (which “would take time”). The one-page plan described the clauses in detail, tracking Taylor’s speech a few weeks earlier. CACs also appeared in G-7 statements in the 1990s, but their prominence in this “action” document meant a promotion.

One official described the plan as a U.S.-British compromise to diffuse European support for SDRM and present a united G-7 front for CACs. Shortly after giving the speech that launched the CAC campaign, Taylor traveled to Russia. On the way back, he stopped for a G-7 meeting in London. There, Taylor and his U.K. counterpart Gus O’Donnell agreed to frame CACs as a predicate for limiting IMF lending in crisis—a policy long advocated by the Europeans. For the Clinton Treasury, CACs were marginal and strict limits were unacceptable (and in any event not credible); for their successors, both CACs and limits sent a message against bailouts. Concerned that the other G-7 members would see any U.S-British deal as suspect, Taylor and O’Donnell asked the Canadian deputy to present what became the Action Plan (Taylor 2006).

In June 2002, shortly after the release of the G-7 Action Plan, the G-10 established a working group of officials to infuse more content in their CAC exhortations (Group of Ten 2002). Quarles was in the chair. We have no evidence that the group was intended as a “counter-design” project to balance the IMF’s work on SDRM; however, in retrospect it appears to have played some such function. The group’s product, released in three months, contained two parts: an official report recommending clauses for inclusion principally in New York law bonds, and a set of model clauses drafted by an advisory group of “eminent lawyers” who represented sovereign debtors and creditors in jurisdictions where most external sovereign debt is issued.

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15 Action plans returned after the 2008 crisis.
16 Canada chaired the G-7 process that year. The Canadian finance ministry welcomed the new approach as reflecting ideas Canada had been pressing for years to reform international financial architecture. A chronology accompanying the Canadian press release dates the architecture reform effort to the start of Mexico’s Tequila Crisis in December 1994, and features Canada’s advocacy of CACs and its own CAC issue in 2000. Press Release, G-7 Fin. Ministers, Can. Dep’t of Fin., Adopt Financial Crises Action Plan (Apr. 20, 2002), available at http://www.fin.gc.ca/news02/02-034e.html.
(England, Germany, Japan and New York). The effect was to produce a tangible alternative to SDRM, but also to the clauses drafted by private industry association and released four months later, an alternative that had “intellectual heft” and appeared to come pre-endorsed by major countries and law firms in the sovereign market.

Quarles’s role in the enterprise was critical. Before joining the Bush II administration, he was a partner at Davis, Polk & Wardwell in New York; he had also held a domestic finance appointment in the Bush I Treasury. In his new government stint he soon gained a reputation as an engaged listener, a quick thinker, and a dynamic interlocutor even among those who disagreed with him. One sell-side banker who met Quarles several times described him as “one that looked like a dyed-in-the-wool Republican,” and in the same breath recalled being “pleasantly surprised” with his willingness to listen and delve into substance.

Some said the drafting effort was Quarles’s idea; others saw his leadership as a U.S. effort to control G-10 mission creep. Belgian officials were especially keen to use the CAC campaign to bolster the role of the G-10, a forum where Belgium and other “small Europeans” not part of the G-7 play an important role. Even some European participants in the working group described it in part as a Belgian play for relevance.

Taylor was not at the meeting that sanctioned the working group, and though he went along with it, he was never comfortable with officials prescribing contract text to the market. He had a point: even as the group’s report put distance between its own recommendations and the eminent lawyers’ model clauses, and even as insiders all attested to Quarles’s scrupulous enforcement of that distance in the process, virtually all our market contacts perceived the model as the official position on the merits. This was especially significant with respect to the 75 percent amendment threshold for “reserve matters” (key financial and legal terms): “Randy was not shy about 75 percent. The report said certain countries, certain profiles, certain problems . . . [but] 75 percent is the mandated number.” Other G-10 recommendations for New York law bonds included trustees or permanent bondholder representatives, elected bondholder representatives to negotiate in restructuring (engagement), brakes on acceleration and litigation, and additional disclosure by the issuer.
The extent to which the G-10 effort helped convince some of the early movers is a matter of debate. One “eminent lawyer” who was also involved in an early CAC issue suggested that “[t]he G-10 report gave enough legitimacy to the use of the clause” for issuers to experiment. But large EM debt managers apparently did not want room to experiment. One Mexican official expressed concern at the proliferation of drafting and discussion fora: “Discussions at [industry groups], G-10, U.S. government—process not leading anywhere. It was seen as opening every single item in the contract.” Soon U.S. officials found themselves reassuring issuers that the G-10 would not make a fuss if they went ahead with clauses different from the template.

Participants report a sudden escalation in urgency for the CAC project in the fall of 2002. Staff in “country” offices were charged with learning the issuance pipeline for their region in the last quarter of 2002 and early 2003, working with in-house lawyers and using informal market contacts. The lead functional office put together a composite log and coordinated an intensified outreach plan with calls from Taylor, Quarles, and other officials to finance ministers, deputies, and debt managers in the issuing countries. With issuers’ permission, U.S. officials and staff also contacted the lawyers and investment bankers involved.

Our official sector contacts stressed that there was no “arm-twisting”, no threats were made and no rewards were promised. Taylor and others have described an exercise in persuasion; the briefings and reports we have seen do nothing to refute this characterization. It is difficult to ascertain how the conversations were perceived on the other end. While none of our investor and emerging markets contacts would admit to having their own arms twisted, many seemed certain that twisting was going on elsewhere. U.S. officials and staff involved in the calls describe the response as mixed – some ministers knew nothing of the clauses; others said they had heard issuing with CACs would be costly. Everyone was polite, but no one volunteered. Smaller, shakier issuers said they could not afford to jeopardize their market access; others said they had no plans to default, did not need new clauses, and would not risk paying a penalty for no good reason. The outreach log from January 2003 records lots of “broadly supportive” and “maybe next time” sentiment. Issuers pointed to the bankers, bankers pointed to the issuers, everyone pointed to the investors.

Against this background, broadening investor outreach was a key aspect of the new
strategy. As noted, in the first half of 2002, officials were in frequent contact with trade associations and research analysts at investment banks (the “sell-side”). End investors (the “buy-side”) were usually represented in these discussions by members of the Emerging Markets Creditors Association, a group that emerged out of Ecuador’s Brady default in 1999. EMCA had been vocal in opposing any contract change that would diminish investor protections. By the end of 2002, U.S. officials engaged with a broader cross-section of the buy-side, including large investors who reached out to the Treasury and tried to distance themselves from EMCA positions. On the sell-side, the team shifted focus from research to bankers “actually doing deals”:

After we really got down into the dirt [in late 2002], making calls to the debt managers in the countries and to the real live investment bankers actually doing the deals, these people knew very little about the whole CAC debate. It was quite astonishing. The people doing the deals hadn't been going to the conferences, could have cared less, hadn't heard much from the conference goers, and didn't know much at all. They just knew how to generate fees. So, the private sector talking heads weren't worth much.

Just as SDRM was identified with Anne Krueger, in 2002-2003 many saw CACs as John Taylor’s initiative. Observers familiar with early CAC efforts said Taylor’s voluntary contractual initiative was doomed on arrival. Comments from the audience at his April 2002 speech predicted nothing would happen without a government mandate; hallway chatter bordered on disparaging – but Taylor seemed undaunted. In less than a year, he proved them all wrong. For a non-lawyer, Taylor had an impressive grasp of how key clauses worked; he missed no opportunity to raise CACs in speeches and testimony, and asked for frequent progress reports on the initiative. He was invested in the targeted, intensive outreach. Contacts at all levels described encounters where Taylor – a mild-mannered man – showed visible frustration with the slow progress to CACs, most notably in late 2002. One person remembered getting a call while Christmas-shopping at Target – “Nothing is happening, we need to do something!”; another only tangentially involved with CACs recalled Taylor’s reaction to a CAC-less bond issued without Treasury’s knowledge – “There is no excuse, we should be calling everyone!”

Some suggest CACs made sense as a defensive move on Taylor’s part – “the principal aim was to stop SDRM and his mad boss.” Yet among all U.S. participants in the CAC episode, only academic economists (of which he is one) expressed Taylor’s level of enthusiasm for the
clauses’ substantive value and their potential importance in crisis. As late as 2007, Taylor’s website put CACs among his most important accomplishments at the Treasury, under the headline “Essential Reform of the International Financial System: Collective Action Clauses”, and alongside Iraq’s reconstruction, terrorist financing, and China’s exchange rate. In speeches, he has credited the success of the CAC effort partly to the post-9/11 spirit of international cooperation. We have no way of knowing whether this conviction was genuine; if it were, we can only speculate on the reasons. But we cannot help wondering whether a cooler, more pragmatic approach to CAC advocacy in 2002 might have failed as its predecessors had in the late 1990s: “History needs a midwife in this situation. John was the midwife.”

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Active controversy around SDRM and CACs lasted for about a year and a half from Krueger’s first speech. Several senior U.S. and IMF officials suggested quietly it was a no-win battle, and tried to distance themselves from both sides to the extent possible. Their reasons were some combination of believing that neither initiative was likely to succeed, that CACs were inadequate, while SDRM was ill-conceived. Some said that at the Fund, Krueger “owned” the initiative so completely that it left little room for others of her stature. “It was going to be her legacy” and was her battle to fight. For example, neither Ken Rogoff, then Chief Economist at the IMF, nor Tim Geithner, in charge of the policy department technically responsible for developing the initiative, seem to have been particularly invested in SDRM—a curious sign considering Rogoff’s pre-eminent place in theorizing sovereign debt, and Geithner’s history of leading the Clinton Treasury’s private sector involvement efforts in prior crises. On the other hand, our contacts often pointed to a small cohort of “true believers” in SDRM, comprising Krueger and several senior IMF staff, sustained in their design work by encouragement from O’Neill, the desire to boost the role of the IMF, at least acquiescence from the White House, and importantly, by support from European capitals.

By the end of the 1990s, European officials had come to lead the opposition to outsize IMF packages. Germany’s insistence on hard lending limits typified this view, as did a joint paper by the Bank of England and the Bank of Canada, advocating debt standstills and lending limits (Haldane and Kruger 2001). Unlike the newly minted Bush appointees, many European
representatives in the CAC-SDRM debate were veterans of the “private sector involvement” debates of the late 1990s (Roubini and Setser 2004). Back then, European officials had favored automatic burden-sharing for private creditors. The Rubin Treasury favored discretion and proposed contract reform as a middle ground, but invested scant political capital in implementation. Wary of discretion, which had let the United States steamroll over their objections, and weary of the old CAC initiatives that looked in retrospect like a fig-leaf for U.S.-led bailouts, the Europeans wanted firm crisis management rules (Tarullo 2001). SDRM was their chance, thanks to the space created by O’Neill. Europe’s over-representation in the IMF Board made its support impossible to ignore, even if the U.S. alone could have blocked the supermajority vote to amend the Charter (Bini Smaghi 2006).

With the U.S. tied to the parallel tracks for as long as O’Neill was in office, the most vocal resistance to SDRM in the IMF Board came from large emerging market issuers, notably Mexico and Brazil (Setser 2010). One official called the SDRM “a wrong idea at the wrong time”, noting flatly that if it had prevailed, his country would have lost all market access. In private, borrowers also worried about losing access to IMF funds; some raised the IMF’s conflict of interest. In public, they framed their resistance in the language of government debt managers and large-volume market issuers, as in this example: “From the point of view of [this issuer], all discussions of default, possibility of making default easier, were not genial. … Our scenario is not default.”

By early 2003, Paul O’Neill had been replaced at the Treasury with John Snow, who had no ownership of the bankruptcy idea. However, outreach to issuers suggested that no single country was willing to go first. As an alternative, the U.S. Treasury and its allies in the investor community tried to get a group of highly rated issuers, potentially including Mexico, Korea, Poland and South Africa, to announce together their intention to issue with CACs. The announcement would not be linked to any particular issue that might fail. To set the stage, they planned a meeting with the target issuers in late February, a week or so before John Snow’s first G-7 Finance Ministerial. The objective was to have large investors reassure the countries that they were willing to buy their debt with CACs and did not expect to charge a penalty.

17 Because Mexico was part of the Spanish constituency, it could only voice its objections intermittently, when it held the constituency chair.
At the last minute, Mexico canceled. It later turned out that Mexican officials were meeting with their bankers and lawyers to plan for the country’s first CAC issue—and what everyone had thought was the pioneering issue in the New York market. By many accounts, U.S. officials found out about the issue shortly before the launch. According to Mexican officials, the Finance Minister broke the news casually at the end of a lunch with the new Treasury Secretary. One senior U.S. official describes intense coordination leading up to the launch, where Treasury pledged and delivered a public statement of support and procured similar backing from the G-7; others describe a compressed process following Mexico’s surprise revelation.\(^\text{18}\) Within days of Mexico’s announcement, at Snow’s first G-7 meeting, the United States signaled the end of the two tracks. SDRM was officially shelved in April.

Mexico’s move was a puzzle. SDRM was malingering at the IMF, the U.S. Treasury had lobbied Mexico for months, and clause drafting efforts were proliferating, sponsored by the G-10 and creditor associations. These factors weighed against what seemed like unwavering resistance to SDRM and CACs alike at the highest levels in the Mexican government. The core team responsible for making Mexico’s decision consisted of three officials led by the Finance Minister. The Minister went so far as to write a scathing 13-page letter to O’Neill in November 2002, expressing his intractable opposition to both CACs and SDRM. What changed minds so drastically that (apparently, on a weekend) Mexican officials called their lawyers down to Mexico City to implement CACs?

We heard two explanations. Market participants, both lawyers and bankers, told of a rumor that a small country was going to launch an offering using creditor-friendly clauses with a high amendment threshold. Such unfavorable CACs risked becoming market standard if Mexico did not preempt this unnamed country. Others focused on Mexico’s leading role in opposing SDRM. A trade press account of the CAC shift suggested that taking SDRM off the table was the quid pro quo that Mexico extracted out of the United States (Salmon 2003).\(^\text{19}\)

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\(^\text{18}\) While the precise form and timing of the issue appear to have been a surprise, file memos indicate that Mexican officials told their U.S. counterparts that they were ready to move in principle as early as January. See also U.S. Treasury Statement Regarding Decision by Mexico to Issue Bonds with Collective Action Clauses (February 24, 2003), available at http://www.treasury.gov/press/releases/200322418171120575.htm.

\(^\text{19}\) Like Salmon, we found no evidence of other tradeoffs, for example, on immigration or trade policy. The fact that
Both stories are problematic, even though we heard them from multiple sources. Not one of our contacts had a clue as to the identity of the country in the “small country-bad clauses” rumor, raising the possibility that it was just that – a rumor. In public and in private, Mexican officials expressed only a general desire to preempt bad precedent, and concern about proliferating public and private initiatives that threatened to destabilize the boilerplate. Bankers and lawyers involved in the deal echoed the sentiment.

As for fear of SDRM and the quid-pro-quo theory, it rings only partly true. It is unlikely that a U.S. Treasury under John Snow would have continued the two-track charade much beyond the spring of 2003. Hubbard’s keynote at the IMF conference on January 22 signaled to a spectrum of interested parties that White House support was not there. If U.S. support were all that mattered, SDRM would have died a natural death without help from Mexico. On the other hand, even after Mexico’s debut, a market-wide shift looked far from certain. Its CAC issue was a hopeful sign and a new argument for contract proponents, but not mission accomplished. And in any event, even wholesale adoption of CACs was never an adequate substitute for statute in the SDRM camp. Almost two years and two dozen CAC issues since Mexico, one U.S. contact speculated that if a vote were held on the day of our interview, a majority of the IMF Board would have supported SDRM.

Mexican officials tell the ultimate market story – an issuer with significant market power that perceived a threat to this power from a mix of official meddling and bondholder activism:

For us, the issue was our role as issuer. We were concerned about the state of discussion on the markets … What generated the change? We didn’t like the fact of being pushed around by international initiative where our fate was not very clear.

This is not so much a story of Mexico eager to get the best possible clauses into its debt, or Mexico worried that SDRM would come to pass, but of Mexico worried that talk of SDRM – and clauses – would go on and on. The talk got everyone thinking about default threatened to create uncertainty in the markets about G-7 and IMF behavior in crisis, and to increase the cost of capital for the very countries supposed to benefit from the initiatives. Argentina’s crisis had the White House was uninterested in CACs makes these kinds of tradeoffs unlikely.
set in motion a set of events that threatened to deprive Mexico of control over its contracts and its debt issuance process, just at the time when it had finally acquired a measure of control.

We have no way of knowing whether the story of market and political leadership that we read in the press and heard from Mexican officials in fact reflects their true motives for using CACs. Virtually all the lawyers, bankers and investors involved in the first CAC deal, as well as the G-7 officials who lobbied Mexico, stress reputational factors and U.S. pressure and de-emphasize the CACs’ substantive value. The narrow scope of Mexico’s CACs as a technical matter, to which we return later in the book, supports the point.

If Mexico wanted to use the CAC incident to create a perception of autonomy and leadership, it was wildly successful. A European official put it this way:

Mexico may have been ahead of the curve … They not only earned the respect of the official sector (that didn’t mean anything to the Mexicans) – they showed the markets that they were ahead of the markets. … They are too intelligent, too sophisticated to have believed SDRM was a realistic possibility.

Even if sovereign bankruptcy had no prospect of adoption, the general perception among its opponents was that SDRM had to be vanquished before it did any more damage to the status of EM sovereign debt. Internal divisions prevented the United States from doing the dirty work. Mexico did it with flourish. One apocryphal story has Mexico’s Deputy Secretary of Finance (now central bank governor) Agustín Carstens declaring, “We killed the motherfucker!” after launching the pilot CAC issue.

Market participants and officials alike were effusive about the Mexican debt managers’ competence and integrity. Mexico, they said, was not like any other emerging markets issuer. Observers spoke of a “revolutionary experience”, a “transformation of mentality between 1994 and 2000”, of getting “out of the victim mentality” that plagues the emerging markets. Reacting to an early draft of this study, one U.S. official mused that his Mexican counterparts “may well have been the only adults in the whole crowd”:

Carstens had been Mexican ED at IMF. He was always very open minded and into modernizing the IMF – he was ok on transparency etc, which put him in contrast with
many of his EM colleagues on the Board. In FinMin, he worked a lot with markets. I actually think Agustin was being internationalist minded at the time and believed that he thought Mexico should be internationalist to show that it was playing a greater role as a responsible player on the global scene. He and Alonso Garcia should be mega-stars of the article.

While Mexico’s circumstance and leadership indeed stood out at the time, many of our contacts also noted that the shift conceived in the turmoil of the 1990s finally happened under unusually benevolent market conditions, when interest rates in mature market economies were at all-time lows and investors flocked to emerging market debt. Mexican debt was investment grade, and attracted growing numbers of crossover investors. The government had pre-financed for the year, and did not need the money from the CAC issue (it used the proceeds to retire more costly Brady Bonds). It was difficult to envisage a better time. But in the mind of a key Mexican participant, the experiment was not riskless:

At the time, Mexico could issue $1 billion on a day’s notice; everyone knew our contracts. [Issuing with CACs] disturbed it a little bit without an immediate benefit for Mexico. … Push [to] strengthen international financial system. … Instead of opening the book in the morning and closing six hours later oversubscribed, three days working the phones. Some committed clients surprised, some sensed betrayal – [because Mexico had] not consulted them.

The same official described CACs as beneficial, but suggested that their principal benefit in 2003 was to let business people return to business:

Both debtors and creditors like having a set of contracts, and proceed to issue. Impractical to make the issue of contracts … [Settling procedural terms] allows to focus on the substantive issues of the transaction – issues, rights, options – this is what the market participants want.

In this framing, which we also heard from other EM government debt managers, they are first and foremost market participants, whose goal is to minimize borrowing costs and keep

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20 A biweekly sell-side research note a few weeks before Mexico’s launch described the market conditions: "EM debt has soared in recent days in moderate volume, allowing the asset class to deliver a year-to-date return in excess of 2%. The rally in the US Treasury market, where 10-year yields have dropped from 4.20% two weeks ago to below 4.00% at present, is creating a hothouse effect for investors in EM bonds. Portfolio managers in the US and Europe continue to receive inflows of funds looking to be invested in EM bonds." ABNAmro Emerging Markets Fortnightly, February 9, 2005, at 1.
21 “Clients” here means “investors.”
contracts at bay. When they spoke of a disequilibrium that prompted the CAC shift, they referred to the flurry of public sector crisis response initiatives. Correcting it required adopting clauses that were just good enough to make the official sector go away—what work they did inside the contract was beside the point. For these debt managers, public good and international prestige came by way of being superior market players.\(^{22}\)

\[\text{\textasteriskcentered}\]

In retrospect, one small contract change took a staggering amount of policy, political, and technical effort to achieve. It might not have happened but for an improbable confluence of events, from Argentina’s default and the apparent miscommunication between the IMF and the U.S. Treasury, to the auspicious market conditions in February 2003. Some might say that the costs of “unsticking” sovereign bond contract boilerplate\(^{23}\) were much too high, and the experience not replicable. But from the perspective of contract champions and bailout banishers, the policy outcome was worth it: from now on, any sovereign that borrowed too much would have a ready path to restructuring without bailing in rich country taxpayers.

After Mexico’s pioneering issue, all that remained was the task of diffusing CACs throughout the EM asset class. It was then that two Australian researchers discovered CACs in a small batch of New York law bonds issued in the late 1990s, long before Mexico, unnoticed by the G-7 officials who were busy marketing CACs. The discovery seemed to suggest that debtors, creditors, and their lawyers were perfectly capable of drafting CACs when they wanted them—which would in turn hint at the possibility that CACs’ absence in other debt was not really a market failure—which would make sticky boilerplate in New York a faulty predicate for government intervention. We investigate the boilerplate puzzle next.

\(^{22}\) Here it is useful to contrast Mexican and U.S. accounts of the months leading up to the first CAC issue. Mexican officials and their advisers stress the fact that the decision was made independently and all but sprung on the U.S. Treasury, even as they express gratitude for U.S. and G-7 support. U.S. officials emphasize long-term, painstaking coordination.

CHAPTER FIVE

THE FAILURE OF SUCCESS

The lawyer sounded much too young to have been around during the 1980s and much too zen for the bitterness of his words:

I did not pay much attention to the early rounds; it did not make sense to. We thought it would go away. And for a period it seemed they vanished . . . and then they reemerged. I try to stay away from Washington; I am not a lobbyist. Here, Washington lobbied us, invaded . . . . I thought they were on a tear to fix . . . but fix the wrong thing. Boy, they sure got CACs. Now you can bind 25 percent.

In late 2005, this sounded like the usual Wall Street griping about Washington. If only the bureaucrats had understood that the real problem was rogue debtors, not rogue creditors; if only they had let the market do its work; if only they had kept to their job of supplying emergency liquidity when confidence failed crises, there would be no problem to begin with. The man’s criticism seemed particularly off point when it came to CACs, which after all originated in the market (albeit in the U.K.), had a sterling theoretical pedigree in economics and political science, and had, with barely any additional bureaucratic effort whatsoever, taken the market by storm.

Figure 2: CACs in New York-law Sovereign Bonds

Source: Bradley and Gulati (2013)
In the turmoil of 2003—from Mexico’s debut in February, to the death of SDRM in April, and the adoption of CACs soon thereafter by Uruguay in its restructured debt and by Brazil in its return to the capital markets—drafting conventions turned upside down. Until then, over 95 percent of all foreign sovereign bonds issued under New York law required unanimous consent to amend payment terms. Over 95 percent of the bonds first sold after 2003 could be amended with the consent of the creditors holding 75 percent of the issue (Bradley and Gulati 2013, Weidemaier and Gulati 2013). The perception that CACs had taken over the EM world and thereby solved creditor coordination problems was so strong and pervasive that the U.S. Court of Appeals for the Second Circuit relied on CACs to support a high-profile ruling against Argentina: “With the inclusion of collective action clauses, the type of ‘holdout’ litigation at issue here is not likely to reoccur.”

In this chapter, we wrap up the account of the emerging market CAC shift with an assessment. Did the sovereign bond documentation revolution result in better contracts, and deliver the market and policy outcomes it had promised? In particular, did it solve the uncertainty problem highlighted by John Taylor and the holdout problems that had motivated Anne Krueger? Would it result in more efficient restructurings, guard against moral hazard, and produce fewer, smaller bailouts?

At first blush, it seems obvious that official outreach produced better contracts across the sovereign debt market. Beginning sometime in 2004, the official sector lost interest in CACs. Taylor returned to Stanford in 2005; his successors stopped mentioning debt contract terms in bilateral meetings with EM finance officials, and the IMF confined itself to more-or-less perfunctory endorsement of majority modification and majority enforcement in its debt management guidelines (Gelpern and Gulati 2008). Yet debtors and creditors did not revert to unanimity, as some had predicted. If anything, they accelerated adoption of majority modification terms on their own—prima facie evidence that the market wanted CACs. Numerous pricing studies seemed to find either no significant price penalty for using CACs or no price penalty at all; one study even found that CACs came with a pricing bonus for the issuing government (BIS 1999, Becker et al. 2003, Eichengreen and Mody 2004, Gugiatti and Richards)

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24 NML Capital Ltd. v. Republic of Argentina, 699 F.3d 246 (2d Cir. 2012)
Indeed, the pattern of broad-based organic adoption is consistent with the changing rhetoric on CACs among our EM contacts. The same people who described CACs in 2003 as at best unnecessary and potentially destructive (making default easy for solvent governments), spoke of them in 2012 as “generally a good thing.”

Although the official sector had abandoned the contract reform project by mid-2000s, academics were just beginning to ramp up the empirical studies of sovereign debt contracts. Along with developments in the sovereign debt markets, these studies pointed to five potential problems with the unqualified success story. First, CACs were not used to restructure sovereign debt, even when they could have been. Second, majority modification clauses in New York law bonds were not the only sovereign bond contract term to change after Mexico. Some of the changes that accompanied the introduction of Mexico-style majority modification made restructuring harder than it had been for sovereign debtors. Third and related, where CACs improved process certainty, potential holdouts welcomed it. Fourth, CACs failed to stop bailouts. Fifth, CACs could not possibly cover all the relevant debt. We discuss these concerns in turn.

Linking official crisis response to sovereign bond restructuring was a 1990s innovation, implemented through Paris Club comparability requirements and the IMF’s policy on Lending into Arrears. As a result, even before Mexico adopted CACs, a number of governments had restructured their foreign sovereign bonds. These included Pakistan, Ukraine, Moldova, and Ecuador. Uruguay, Dominica, Argentina, and the Dominican Republic followed on the heels of Mexico’s CAC issue (Sturzenegger and Zettelmeyer 2007). Grenada, Belize and the Seychelles came late in the decade. Western Hemisphere sovereigns had mostly New York-law debt stocks and old-style unanimity provisions, though both Argentina and Uruguay also had a smattering of bonds governed by English, Japanese, and other laws, some of which had CACs. Belize had New York-law bonds and Mexico-style majority modification terms. Ukraine had Luxembourg law

\[25\] Our market contacts were uniformly skeptical of academic pricing studies. The following reaction from a buy-side investor in 2006 is typical:

*Academic studies on pricing were useless as they always are. [They] grossly misunderstand how investors behave, investor sophistication. The data sets they use would make [a quantitative analyst] cringe.*
bonds with English-style CACs, and German law bonds with unanimity. The rest had mostly English-law bonds and English-style majority modification. Only Belize and Seychelles relied on CACs to restructure their bond stocks. Pakistan refused to invoke CACs at all, apparently for fear of calling a creditor meeting. Ecuador did not have CACs, but restructured nonetheless, with high creditor participation. Other issuers used either CACs or the threat of CACs on the margins, but did not rely on them for most of the restructuring. In the euphemistic words of a recent IMF survey, “the triggering of CACs in past debt restructuring episodes was not common and in the cases they were triggered the results were mixed.” (IMF 2012) Less than a decade after their triumphant introduction, both the IMF and market observers had concluded that while CACs were positive on balance, they were “no panacea” (PIMCO 2012).

CACs turned out to be inessential because just as Rubin had predicted when he refused to elevate them in his financial architecture agenda, creative lawyers and bankers faced with the need to restructure came up with the tools to get it done. These included bond exchanges with minimum participation thresholds, and exit amendments borrowed from corporate bond restructurings (Bi et al. 2011). Minimum participation thresholds discourage free-riding. When a sovereign debtor announces that it would not go forward with a restructuring unless it secures the support of, say, 90 per cent of the outstanding bonds, potential holdouts must weigh the possibility that the entire operation would fail, and they would have nothing to free-ride on. When a sovereign debtor uses exit consents, it asks participating creditors to vote in favor of amending important non-financial terms of the bond, which could be changed by simple majority. Although no one could change their payment terms without their consent, potential holdouts might be left with an illiquid claim stripped of protections from subordination, submission to jurisdiction and sovereign immunity waivers. Beyond these restructuring techniques, contract provisions limiting individual creditors’ capacity to enforce, an expanded role for trustees and bondholder representatives, and aggregation across debt instruments were all known and raised in the reform discussions leading up to 2003, but not pushed with anything like the energy devoted to majority modification. Very few of these provisions were adopted. By pouring immense amounts of effort into majority modification, at a minimum, the officials neglected other potential avenues for improving the restructuring process.
This points to the second problem with CACs as they emerged after 2003. Unanimity was not the only provision to go, and New York law bonds were not the only ones to change. Before official initiatives made CACs salient, English-law bonds allowed amendment of financial terms with as little as 18.75 per cent of the debt stock—75 per cent of a bondholder meeting quorum, which could be as low as 25 per cent at a postponed meeting. Once New York boilerplate was dislodged, the new modification threshold there settled at 75 per cent of the bonds outstanding. Two issuers (Uruguay and Argentina) introduced aggregation terms, which made it possible to amend more than one bond series together. After a very brief period of turmoil, there was relatively little variation. In contrast, the London market embarked on a frenzy of experiments with voting provisions and other terms. Minimum modification requirements in newly issued English-law bonds jumped around half a dozen thresholds between 18.5 and 75 per cent (Weidemaier and Gulati 2013). While both New York and English-law bonds raised the threshold for amending nonfinancial terms that would be prime candidates for to exit consents,26 some issuers in London returned to unanimity for choice of law, submission to jurisdiction, and waiver of sovereign immunity, following a new trade association template. Others agreed to pay the expenses of bondholder committees for the first time (Gelpern and Gulati 2008).

None of these changes are necessarily unreasonable or suboptimal from the perspective of aligning debtor and creditor incentives. However, most of them make it harder for a sovereign to obtain the necessary votes to restructure its bonds, and some of them make it easier for creditors to sue. Whether the loss of unanimity in New York is a worthwhile tradeoff from the perspective of the borrower and its would-be guarantors in the official sector is an open and difficult question.

The third problem with CACs was eminently foreseeable but, oddly enough in retrospect, not discussed at the time of the 1990s and 2000s campaigns. To the extent majority modification introduced certainty in the sovereign debt restructuring process, it benefited the debtors, participating creditors, and holdouts alike. In the past, would-be holdouts had to choose their target instruments carefully for fear of getting derailed by exit consents and minimum participation thresholds announced on the eve of restructuring. At an industry-sponsored panel in

26 This meant that bond status, negative pledge, and enforcement-related provisions that could be amended with a simple majority before 2003 now required a supermajority.
2012, a lawyer counseling investors who refused to accept Greece’s debt exchange offer explained that CACs made their investment decision much more straightforward. Faced with a sovereign committed to using CACs, an investor wishing to free-ride on a successful restructuring would look for a small issue trading at a deep discount (say, $300 million trading at twenty cents on the dollar), determine the necessary blocking position under applicable CACs (say, 26 per cent) and buy enough bonds to ensure that the issue drops out of the restructuring. In this example, it would cost less than $16 million to buy a $60 million stake, and force $300 million issue out of the deal. Such small issues are known as “orphan bonds” in the trade; some investors specializing in distressed sovereign debt have joked about “running an orphanage” on the eve of an expected restructuring. Once everyone else restructures, the holdout would demand full payment, and would usually get paid at a premium over the restructuring formula.

The “orphan bond” dilemma highlights the more fundamental fact that CAC votes can fail. Had the Greek government relied entirely on its market-based English-style CACs to restructure its debt stock in 2012, the debt exchange that saved Europe would have failed miserably. Of the seventeen CAC votes in individual bond series governed by English and Swiss law, nine failed to secure the majorities needed to proceed with a restructuring, and are being paid on schedule. Greece’s success, such as it was, was due entirely to its capacity to amend its domestic debt retroactively, a subject to which we return in the chapters that follow (Zettelmeyer, Trebesch, and Gulati 2013).

Failed votes are not necessarily a bad thing: if the debtor’s offer is not good enough for most creditors, and if they are willing to risk protracted default, perhaps it should be that way—the debtor gets a measure of protection from immunity, while creditors get the benefit of a debt that cannot be discharged. Eventually, one side will blink. Moreover, where the rest of the restructuring does go forward, the mere presence of free-riders need not be very costly for the sovereign or very upsetting for the participating investors. It does not mean that the restructuring system is broken. To the contrary, most investors we have interviewed do not subscribe to the prevailing academic and official sector view that the presence of free-riders would dissuade everyone else from participating in a restructuring. They explain that holding out and suing an immune government is a time- and resource-intensive task reserved for the most dedicated of
experts. Most players in distressed EM debt simply want to make a quick buck: buy defaulted bonds at twenty cents on the dollar, wait a few weeks or months for the government to offer 30 cents (implying 70 per cent debt relief), and pocket ten cents, or a 50 per cent profit. They point to the challenge of chasing the government and its assets around the world to explain the rarity of sovereign bond litigation, confirmed in recent empirical studies (Schumacher, Trebesch and Enderlein 2013). We have heard versions of this explanation from 2005 repeated over and over again by buy-side and sell-side investors alike:

Suing a sovereign is so damn hard—being a holdout is hard, not smart. . . . [The] official sector was offended by what happened to Peru—someone bought low and shook down Peru. . . . It offended [their] sense of fairness in the financial system. I was pretty offended while the Brady deal was going on, but not when [the holdout] collected. Peru was flush. It paid when it did not hurt to pay.

Nevertheless, the CAC exercise has always been justified in terms of “defanging holdouts”: preempting free-riding in general and litigation in particular. It appears that CACs in individual bonds, without aggregation across the debt stock, might actually facilitate free-riding.

For G-7 policy-makers promoting CACs and bankruptcy alike, an end to free-riding has always been an intermediate goal. The ultimate goal is ending bailouts, or, in the memorable words of Paul O’Neill, “a sustainable Argentina, not just one that continues to consume the money of plumbers and carpenters who make $50,000 a year and wonder what in the world we're doing with their money.” (The Economist 2001) The fourth problem with CACs as achieved beginning in 2003 is their utter inefficacy at stopping bailouts. Greece is the latest and possibly the most embarrassing example. Despite having a debt stock that was easy to restructure, including CACs in its English and Swiss-law debt, Greece got an IMF package at over 50 times the IMF access limits, or over 3,000 per cent of its Fund “quota” (IMF 2011, IMF 2013, Schadler 2013).

A U.S. Congressional Research Service report in 2013 observed a dramatic increase in the size of IMF packages relative to country quota over the past decade (Weiss 2013). Although programs in large European economies account for much of the trend, a casual scroll through the IMF website reveals a host of “exceptional access” programs for smaller and poorer economies.
More to the point and following from CACs’ ambiguous record in debt crises, not one of the debt restructurings over the decade since CACs took hold had displaced an official rescue package—nor could it have (Roubini and Setser 2004). As one analyst with a leading bond investment house observed, sovereign debt crises are “unique and unpredictable,” laden with political implications and potential for systemic spillovers (PIMCO 2012). It certainly helps to have an extra restructuring tool on hand, inasmuch as the 2003 CAC package delivers such a thing. But for all the factors affecting the availability and extent of official involvement, it is difficult to imagine how CACs could determine the outcome.

The fifth and simplest problem with CACs as pioneered by Mexico and adopted across the world is that they are incomplete. In the best of all possible worlds, CACs are introduced in all of a sovereign’s tradable bonds. Assuming that no debtor would be willing to pay for a giant debt swap just to get CACs in all its bonds, the transition period could take years depending on the residual maturity of the sovereign’s exiting debt stock. Once all the bonds have CACs, the sovereign still has bank loans, trade finance instruments, and various and sundry obligations that are simply not susceptible to the inclusion of CACs in their current form. Guaranteed debt is one example that is becoming increasingly important (Buchheit and Gulati 2013).

Distressed debt investors that specialize in free-riding have historically targeted one-off, exotic instruments that cannot be “bailed in” as part of a broad-based restructuring operation. The celebrated case of Elliott vs. Peru featured bilateral loan instruments rather than the prevailing syndicated loans, which may have contained features to promote creditor collective action.27 To be sure, if exotic CAC-less instruments are harder to find, holdout strategies become harder to execute. But since the free-rider strategy hinges on being in a small minority, the initial effect could be to clear the field of inexpert competition.

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As a matter of contract change, the CAC shift was a great success. As a matter of policy

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27 For example, sharing clauses that appeared in syndicated EM loans in the late 1980s and required creditors who sued on their own to share litigation proceeds with other creditors under the same instrument. These served as a powerful disincentive to litigate.
influence, it was similarly impressive: the mighty New York market did as the official sector asked (Helleiner 2009). As a matter of policy outcomes, the verdict is at best ambiguous.

During the Annual Meetings of the IMF and the World Bank in 2013, more than one participant in the prior efforts at sovereign debt contract reform could be overheard saying that officials had “grossly overestimated” the usefulness of CACs in foreign-law bonds. It is hard to see how. Of all the people we have interviewed and observed, the only one who seemed to believe that CACs had the capacity to end bailouts was John Taylor. Everyone else who was for CACs described them as basically good, but not terribly important. The clauses helped deflect sovereign bankruptcy initiatives and unpleasant talk of defaults; they made some policy makers in wealthy and developing countries look market-friendly, and they added a useful tool to the restructurer’s toolkit, albeit at a cost that remains uncertain considering all the other contract and restructuring practice changes that came with it, as well as the resources spent on implementation.

Like Cinderella after the ball, once CACs were done with their glamorous symbolic work in politicians’ speeches and communiques, they came home to lawyers’ conference rooms in the mid-2000s to do the small-bore things that contract terms do. They were just another pretty girl in a ratty dress. Few expected 2010 to be the Year of the Glass Slipper.
“The Minister will not deliver the speech tomorrow. I will deliver it for him.”

We struck gold for the second time in one night. Our subject—an obscure set of clauses in government debt contracts—was emerging at the center of political controversy and a web of global intrigue, charged with saving Europe. Moments earlier, we heard the heavily accented but unmistakable words “kollektif akshn klohses” echo across the lobby of the German finance ministry, an imposing mass of straight lines that had been the largest office building in Europe when it was built to house the Luftwaffe in 1935. Two tall men, no doubt ministry officials, were chatting in rapid-fire German on their way past the guard desk. “Collective Action Clauses” were the only English words the pair had said, but they spoke volumes to us.

Before we could bask in our imminent glory, we were fetched upstairs. The wispy fellow who received us was new to his ministry appointment and unsure what to make of us. But he was also a well-regarded economist, which meant that within moments, we were in receipt of a crisp rendition of the theory behind introducing Collective Action Clauses in Eurozone government debt. Investors had been mispricing the debt of peripheral member states in anticipation of a bailout. This was unacceptable. Market discipline required a credible commitment to restructure unsustainable debt. CACs were the \textit{ex ante} commitment device. But we should not expect to hear much about them at our sovereign bankruptcy conference the next day; the speech will be about fiscal policy.

The ministry building had old-style paternoster elevators with open-front compartments that run in a continuous loop, quite unsuitable for jumping up and down in excitement. We compensated by hopping puddles all the way back to our hotel, where we would feel warm, dry, and smug in our inside knowledge of the next day’s keynote switcheroo. The first colleague we saw pulled us aside. “The Minister’s not coming.”
Apparently, the no-show was the talk of the conference dinner, which we had skipped to visit the ministry. One version of the inside scoop was that it was simply too toxic for the Minister to speak about sovereign debt restructuring, as Greece was teetering on yet another brink, and half a dozen others stood next in line. Our new friend would take the fall for his boss. (We wondered briefly whether there was a secret room where officials sat drawing straws to see who would play the Stern German at the next international gathering.)

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Greece’s debt troubles came to light in the fall of 2009. For much of the next year, European politicians stuck to four positions in growing tension with one another and the facts: first, Greece was solvent and did not need a debt restructuring; second, Greece would not get a bailout because EU treaties barred fiscal transfers and monetizing debt; third, Greece was unique; and fourth, the Euro was safe. After two reform programs, EU and IMF rescue packages, and a European Central Bank bond buying initiative failed to stem the bleeding, consensus began to shift in favor of a comprehensive European crisis response mechanism. What shape that mechanism would take was an open question in mid-2010. One thing was clear: it would involve large-scale emergency transfers among member states, which in turn created the twin political imperatives of conditionality and “PSI.” Conditionality meant big policy concessions on the part of crisis-stricken members. PSI was the 1990s euphemism for concessions from private creditors, or debt restructuring. Because the 2010 revival of PSI was taking place in Europe as part of a fundamental institutional reassessment, it promised to be more ambitious than its predecessor: treaty change was not just plausible, it may have been the baseline.

Institutional design options included a version of the 2003 SDRM, proposed by Krueger and colleagues at a Brussels-based think tank, and a regional monetary fund with debt resolution powers (Sapir et al. 2010; Gros and Mayer 2010). Both were public ordering moves, and implied ceding sovereignty on the part of member states. With these proposals in the background, French and German leaders held an emergency summit in Deauville in October 2010 to chart the way forward. By all accounts, it was the turning point that brought CACs to Europe.

When they returned from their iconic beach walk in Deauville, President Nicolas Sarkozy
and Chancellor Angela Merkel instructed their staff to prepare a statement that included, among other crisis measures, a promise to adopt “necessary arrangements for an [sic] adequate participation of private creditors” in financing the recovery programs of crisis-stricken countries (Franco-German Declaration 2010). A month later, CACs’ made their official European debut in a three-page Euro group policy statement, but they had been in the air for some time.

An Italian member of the ECB Board publicly supported their adoption in remarks before the European parliament in September. Lorenzo Bini Smaghi was an old G-7 hand who had participated in the earlier EM initiatives. His remarks deftly collapsed the policy and theoretical debates of the 1980s, 1990s and 2000s into one neat passage that inevitably led to CACs: because debt restructuring had been debated at the IMF, there was “no need for Europe to reinvent the wheel.” Governments that commit to credible reform cannot be insolvent; more “orderly” restructuring was a recipe for moral hazard; mandatory PSI was counterproductive; consensual “reprofiling” was acceptable; therefore Europe should just pick up where the IMF debate left off, and adopt CACs (Bini Smaghi 2010).

Officials present at Deauville recalled that specific instructions to adopt CACs came then, and from on high. According to one, “If the President of France and the Chancellor of Germany say something, you have got to do it. To me—I am not a lawyer—it was a political instruction to us …” Soon after Deauville, a Finnish paper advocating CACs was leaked to the press (Strupczewski 2010). A European journalist reporting on the events of that fall told us that "[t]hrough subsequent meetings this was then adopted and adapted by the European Council, leading to the agreed standard form euro area CACs for adoption from 1.1.2013."

The Deauville mandate might strike an outside observer as odd for four reasons. First, it primarily (if implicitly) addressed the domestic debt of rich countries—the biggest slice of the pie we identified in Chapter One, or over 80 per cent of all government securities outstanding worldwide, as compared to less than two per cent representing all EM foreign bonds. What little foreign debt Europe had issued was mostly under English law, and already had CACs. European governments had long committed to use CACs in their foreign law debt, in an earnest if slightly
nonsensical attempt to “lead by example” (EFC 2003, 2004, HM Treasury 2004)). To our knowledge, before Deauville, no policy maker had tried to use the CACs in Greek or any other European debt, or to take advantage of accumulated research on the subject to see whether they could be used in the Greek crisis. Second, in contrast to the 1990s and 2000s, no policy maker had initially identified a collective action problem for Collective Action Clauses to solve in Europe. Eurozone government debt was held overwhelmingly by large regulated institutions, and increasingly by other governments and central banks. These are not hard to locate, and relatively easy to coordinate through informal suasion, regulation and diplomacy. In some countries such as Spain and Ireland, most of the problem debt was private, and technically could be restructured using domestic corporate bankruptcy and bank resolution laws. Third, CACs had been sold in 2003 as a market solution, and was followed by competition among clause designs. In Europe in 2010, the rhetoric of CACs was used instead to dress up a centrally-mandated set of uniform clauses. Why?

A remarkable number of outside observers attribute CACs to a mix of ignorance, desperation, and failure of planning. When we asked how CACs made it onto the policy agenda in 2010, we heard similar answers from those involved in the previous iterations of contract reform. This reaction from a Bank of England official is typical:

One person in the room … says, ‘Wait, I remember fifteen years ago there were four letters … and three letters … I don’t remember the four, but the three is CAC …’ It was totemic – says there will be some burden-sharing.

In contrast, those involved in developing the German position describe a delicate political compromise that took months of bureaucratic maneuvering. It is true that German officials were

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28 The EM debt managers we interviewed at the time appreciated the solidarity, but said that CAC adoption by wealthy states whose debt was already safe enough to be contract-irrelevant would do nothing for their own debt, perceived to come with a risk of default.

29 In an interview in 2013, one policy maker from a large southern European member state observed that Euro area domestic debt was much more widely held than EM foreign debt, and would therefore be more prone to coordination problems. This is an interesting hypothesis that deserves more systematic study. However, to the best of our knowledge, it does not appear to have been articulated in 2010. It also ignores the government’s ability to amend domestic debt unilaterally and retroactively, following the Greek template—as well as the fact that some sovereign debt in the Eurozone is highly concentrated in domestic banking sectors highly susceptible to government “suasion.”

30 To the extent these laws were inadequate to the task, the response would be to reform them, not to tinker with sovereign debt contracts.
under domestic political pressure to stick it to private creditors, as more and more people realized the Greek crisis would not be solved quickly. One described the realization that led to CACs this way: “The Greek black hole is getting bigger. And we are going to keep paying to bail them out.” By then, forswearing bailouts was hardly an option: No-Bailouts was the starting position, enshrined in EU treaties, and one that looked increasingly untenable. It would have to be modified to introduce flexibility to finance distressed countries in crisis, provided the financing burden was shared, and flexibility were contained within clear institutional boundaries under the new standing European Stability Mechanism (ESM).

It so happened that German officials were already committed to an institutional design of sorts. The German Government Coalition Agreement in the summer of 2009 contained a pledge, included at the behest of debt relief NGOs, to promote international sovereign bankruptcy to address the problem of illegitimate debts in poor countries. Some of the implementation papers written in connection with this domestic political undertaking were making rounds in the finance ministry just as the Greek statistics scandal broke. They were put to immediate use, though not quite the one that the original authors – or NGO proponents – had intended.

At least some of the ministry staff knew of the CAC-SDRM controversy and the challenge that NGO bankruptcy proposals had faced. CACs were a familiar and logical back-up. Economists and lawyers from inside and outside Germany, who attended European negotiating sessions, all suggest that the German team had a better understanding of CACs than any of the others. Moreover, most were convinced that Finance Minister Wolfgang Schaubale (a lawyer by training) was personally informed and involved in the decisions involving CAC advocacy. German finance ministry staff were tasked in the summer of 2010 with researching CACs down to the technical details. One U.S. lawyer reports being summoned to the German finance ministry that summer, and seeing a desk covered with a decade’s worth of academic research on CACs. This put Germany in a position to offer an alternative when the others rejected bankruptcy.31

31 Many of our French and German interlocutors attributed the outcome of Eurogroup negotiations to the difference between French and German bureaucracies. French finance ministry staff serve a rotation on the secretariat of the Paris Club of official bilateral creditors, which may have given them insight into poor and emerging markets
Two U.K. market participants who had been involved in EM restructurings and the 2003 CAC shift gave all the credit to ECB President Jean Claude Trichet. It was well-known by late 2010 that German officials had favored statutory bankruptcy, but faced vigorous opposition from most of their European counterparts, who shared Trichet’s worry about market contagion from a Eurozone debt restructuring. Trichet drew on his experience overseeing official bilateral debt negotiations decades earlier, and used CACs to diffuse German radicalism:

He had been [head of] the Paris Club. He is a gifted technocrat. That was a high level meeting and the others there might not have known what they were signing off on when they agreed to CACs. But Trichet knew.

French participants tell a simpler story that straddles U.K. and German accounts. Since Greece’s troubles first came to light, Trichet had led the opposition to PSI. He was invested in the inviolable status of Euro area sovereign debt on monetary policy, financial stability, and political grounds. His extraordinary sovereign bond-buying program, justified as a monetary policy intervention, made the ECB a substantial holder of the riskiest sovereign debt in the region (ECB 2010, 2013). He lost the battle in October 2010. One French official explained this as a function of Sarkozy’s commitment to the bilateral relationship with Germany. Under pressure from the Bundestag, Merkel had to deliver PSI. Sarkozy had decided to yield, but needed cover to go against Trichet and the French Treasury. Past experience had established that PSI came in two flavors: automatic and market-hostile (German) or flexible and market-friendly (un-German). CACs were market-friendly; France chose them as the lesser evil. Nevertheless, a number of our French contacts agreed with this official’s sentiment that “CACs were a big concession by Sarkozy.” Other Euro Area policy makers said that it was completely improbable that a technical subject like CACs would be discussed at the Merkel-Sarkozy level, but they too described a similar dynamic. PSI came first at the highest level, “CACs come out later, to eliminate automaticity.” For PSI opponents at the ECB and in southern Europe, the implications were rather profound: “If there is no automaticity, it [restructuring] will never happen.”

Ultimately it is unimportant whether the Germans outwitted the French, or vice versa.
All accounts converge around the idea that CACs were a fallback, a compromise meant to signal that Europe would ask private creditors to contribute, but “at least signal that we were not doing something extraordinary.” But of course they were doing something extraordinary and different: European CACs were proposed as an integral part of the standing European crisis resolution mechanism and the new political bargain underpinning the European sovereign debt market. They would be mandated by those who had the power to enforce their adoption and uniformity, in a category of debt that did not seem prone to coordination problems, even in theory.

The introduction of CACs was deliberate; however, those who attribute their appearance to uninformed desperation were right in one sense. CACs’ function in late 2010 seemed to be mostly about market and political messaging: creditors were put on notice that they would be “involved” in debt relief, and voters in surplus states were told that private creditors would be footing some of the crisis bill. In the cryptic words of one Italian official, CACs were a commitment device “not to take restructuring off the table.” The success of the message at the outset depended on a peculiar mix of audience knowledge and ignorance. Markets would accept CACs if they remembered them as the benign reform that had diffused the last PSI flare-up and ended SDRM. Citizens would believe the new distribution bargain underpinning government debt markets if they saw CACs as a tool to extract concessions from private creditors. Both groups would do well not to ask hard questions about how emerging market foreign bond contract techniques might work in rich countries’ domestic debt.

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The 2003 CAC initiative went out of its way to show that CACs were an organic market development; its successor in 2010 was a uniform, universal mandate. In 2003, officials worked vigorously to “nudge” the market to its senses, but Taylor and his colleagues were scrupulous to avoid mandating any clauses, much less uniform clauses in any particular form. Anything different would have been inconsistent with their faith in market forces and their belief that all that the markets needed was a nudge. In their view, CACs issued with the G-10 report were a concrete alternative to unanimity, which could be adopted wholesale or could serve as the basis for customization. In fact, the degree of variation between and even within debt stocks after 2003 was remarkable. In contrast, in 2010, the “political instruction” to European officials was “that
CACs should be standard and identical.” One lawyer representing an early CAC adopter in the emerging markets observed:

When we did CACs in 2003, we were careful about testing the markets with different types of clauses -- Mexico did 75%, Brazil 85%, ... other variations as well. We wanted to see what the market would accept. The Euro CACs impose a mandatory scheme ... will the market accept it?

To be sure, in 2003, the proponents of CACs were foisting them on other sovereigns they could not control. In 2010, European issuers were mandating CACs for themselves. But the mandate applied to all European issuers, was uniform in content, and was embedded in a treaty obligation, not case-by-case issuer choice. One explanation for the difference might be that CACs’ job as bankruptcy deflector loomed large throughout 2002-2003, but was accomplished up front in 2010. SDRM lingered for over a year; European sovereign bankruptcy appeared to lose viability in a matter of months. But in the minds of their proponents, CACs had other work to do. Over and over, we heard that Germany in particular wanted a rulebook to manage future crises, and that CACs had an important place in the rulebook. In 2010, we found many more policy makers sharing John Taylor’s faith in CACs’ proto-bankruptcy potential, even though no new evidence for or against had emerged between 2003 and 2010. A German official described CACs as the opposite of “ex-post blackmail” that seemed to prevail in the ongoing crisis. A central bank lawyer echoed the sentiment:

There is no such thing as a sovereign insolvency process. CACs are a way for sovereigns to create a process – an enlightened, pro-market [process]. … The very creation of it is arguably against the sovereign.

An academic who consulted with German government officials at the time observed:

I remember in 2010 that the guys from the Ministry of Finance were running around underlining their will to action and portraying the introduction of CACs as panacea to all the problems. The sense, at the time, was that the CACs would make everything more orderly. No holdouts, no ad-hoc rules by avoiding holdouts … [T]here is a VERY strong sense here that we need better rules (we Germans love rules) and this whole restructuring thing looked chaotic. The gut reaction to about 95% of higher-ranking officials … is that we need a new "orderly debt restructuring regime", setting rules and calming the chaos. Schäuble initially tried to push for a new type of SDRM, an initiative called the "Berlin Club" at the time, but the first (un)official whitepapers were a disaster, so this was
shelved. The alternative then was to rely on something that sounded easier and still like a rules-based crisis resolution mechanism.

This was much bigger than the caricature of rule-loving Germans. Creating a uniform rule-bound sovereign debt market in Europe, and giving contract clauses a leading role in advancing and harmonizing the rule system, is especially significant in light of the fact that the vast majority of all the debt at issue was governed by domestic law of the member states. The 2003 initiative expressly excluded domestic debt, and Europe’s earlier promise to use CACs was scrupulously limited to foreign issues designed to create a demonstration effect for the emerging markets. Sovereign debtors wield enormous influence over the accounting and regulatory treatment of their domestic debt; they can do much by law, regulation, and political pressure to create captive domestic demand for their debt and to force its restructuring. Domestic debt contracts (where they exist and look like contracts) rarely provide for default, and with good reason: default in this category of debt is least likely to be determined by contract. Standardizing EU domestic sovereign debt documentation would be a big step in any case; it is radical to start the standardization process with modification provisions only relevant in the shadow of default while asserting the safe asset status of the debt.

EU lawyers involved in the exercise observed that the idea of CACs as uniform rules constraining the sovereign stood in some tension with their role of signaling investor losses:

Civilized countries such as the Euro area should have a process. But that was not the intent at all. It was about signaling of investor losses.

The tension spilled out into the open when Greece finally moved to restructure its debt. At the onset of the crisis, Greece like the rest of Europe had a debt stock that was over 90% local-law bonds. As is typical for domestic debt, it had precious few contract terms. That in turn might have meant that it could not be restructured at all (a signal of its risk-free status)—or that the contract was silent on the matter and other sources of law would fill in the gap. Greece’s lawyers realized that they could use the fact that its bonds were governed by local law to legislate amendment provisions, including ones resembling CACs, across the entire Euro 350 billion stock of domestic government bonds. The idea was initially decried as crazy, contrary to European Human Rights laws, international law, the Greek constitution, and the German
constitution among others. But as the crisis worsened between 2010 and 2012, the din subsided and, by February 2012, changing Greek law was one of the only options left for Greece. (Zettelmeyer et al. 2013)

The Greek parliament enacted the Greek Bondholder Law, which allowed two-thirds of its bondholders to amend its domestic bonds by a simple majority vote across series, and bind the rest. In one fell swoop, this move lifted the prospects of a successful restructuring, and transformed the CAC debate. It certainly reaffirmed the rhetorical power of CACs. Attaching the contract label to retroactive legislation somehow made it more publicly palatable. One lawyer credited with the idea points out that without the CAC label, retroactive amendment might have been publicly unacceptable—perhaps leading to a failed restructuring, a Greek default, exit from the Euro area, and even collapse of the Euro—inevitably raising the specter of “Cossacks grazing their horses on the slopes of Montmartre.” The Greek “retro-CACs” also demonstrated sovereign debtors’ capacity to alter the terms of their domestic debt by fiat, and raised doubts about the relevance of any contract terms in domestic debt.

This was not the “good” irrelevance of contracts in safe assets, but a “bad” irrelevance of contracts in a lawless environment. At a large law firm gathering in London several months after the Greek debt exchange, the air was thick with outrage: over and over again, participants were asked whether retroactively amending Greek bond contracts undermined the Rule of Law. Some called the move “heinous,” others foretold quick retribution from the markets. EM debt traders rolled their eyes at the hopeless naïveté of the “rate investors.” Yet for others, the abusiveness of the retro-CACs conclusively demonstrated the need for common rules, now represented by a package of Euro-CACs being fashioned pursuant to the 2010 Eurogroup statement and the ESM treaty following the G-10 template and “IMF best practices.”

There were three problems with this new rulebook. First, member states promised to adopt the new CACs, not to use them in crisis. A treaty commitment that “[c]ollective action clauses shall be included, as of 1 January 2013, in all new euro area government securities, with

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32 At least one member of the creditor committee in the Greek restructuring has pointed out that the Greek Bondholder Law was enacted following consultation with the creditors (or at least a substantial majority of them), and was therefore less coercive than it might seem.
maturity above one year, in a way which ensures that their legal impact is identical”33 said nothing about the way in which a government would go about restructuring its debt if and when it needed to. Officials might have genuinely intended to bind themselves to use the new CACs—and several speculated that failure to invoke CACs would now be against the norm—but they certainly did not by the terms of their treaty (Cf. Tirado 2012).34

The second problem was that the new CACs did not in fact follow the G-10 template—quite the opposite. According to one lawyer involved in the drafting, while the G-10 CACs were for emerging markets countries where default was a regular occurrence, European CACs were “designed for debtors that do not default” (Greek restructuring notwithstanding). They used lower voting thresholds, gave more procedural options, and imposed fewer voting qualifications on EU sovereign debtors compared to prevailing documentation standard for developing counties. Sovereign issuers at the top of the asset hierarchy would retain flexibility in debt restructuring—presumably on the theory that they could be trusted—even as they sought to appear rule-bound in their contracts (Pistor 2013).

Third, to the extent IMF best practices for CACs existed (they didn’t), Eurozone governments did precious little to figure out what they might be. They certainly made no attempt to follow them. Those involved in the drafting tried and failed to get the IMF to endorse the new CACs as conforming to their guidance.

Looking back, the crisis gave rise to genuine demand for a rulebook to govern European sovereign debt markets. When it came time to draft the rules, the result was noncommittal. European member states appear to retain control in the next round of restructuring, notwithstanding all the treaty and contract work undertaken to create binding rules on their behalf. But maybe the point was altogether different: making rules binding was less important than making them uniform. From the perspective of one Portuguese academic advising the government, CACs were a vehicle for advancing Europe’s version of federalism:

33 Treaty Establishing the European Stability Mechanism, Art. 12(3).
34 This is entirely consistent with CACs’ limited history in the emerging markets: sovereigns that have CACs in their contracts have the discretion to invoke them; some do, others do not, for strategic and tactical reasons of their own (Sturzenegger and Zettelmeyer 2006, Gelpern and Gulati 2009).
This is part of the European project. They don't want market competition in standards. It is the opposite of the Delaware story ... competing states with different standards. They want a different approach from the Americans. Uniform rules for all of Europe. That is the new CAC thing. It is also a consistent theme in other aspects of European law. Uniformity. Not experimentation and competition.

A British academic concurred:

People in the U.S. have to understand that there is a federalist project going on. Once you understand it, everything falls into place.

For two years after the Euro group announcement, this all-important federal project would be entrusted to a group of twenty-seven debt managers and their lawyers.