OBSERVATIONS REGARDING THE "PRINCIPLES FOR STABLE CAPITAL FLOWS AND FAIR DEBT RESTRUTURING IN EMERGING MARKETS"

Introduction:

In the meeting of the G-20 deputies of October 2004, held in Frankfurt a Discussion Note (the "Note") , which briefly commented on the process leading up to the preparation of the draft *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets* (the "Draft"), was distributed to the G-20 members alongside the Draft itself; which Draft was eventually released by representatives of certain G-20 members and private sector participants, after the G-20 Finance Ministers and Central Bank Governors had made reference to the Principles in a communiqué following the November, 2004 meeting which took place in Berlin.

Argentina has not been given participation in any of the drafting sessions leading to the preparation of the Draft.

Our debt restructuring experience has provided us with critical elements with which to assess and analyze the Draft and the assertions contained in the Note. Also, the difficulties we had to face in our debt restructuring process, enables us to elaborate certain proposals that could prove beneficial in scenarios of debt restructuring of Sovereigns.

It is also worth noting that the International Monetary and Financial Committee of the Board of Governors of the International Monetary Fund stated on April 16, 2005[1] that "…it notes the Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets developed by a number of sovereign issuers and the investors community, and encourages further efforts to improve the Principles aimed at achieving a broad consensus".

Thus, reflecting on our experience, and in line with the IMFC´s statement, we develop below our views on the matter, which consists both; on comments on the Draft, and on proposals for the improvement of the Principles.

A. Comments on the Draft

1. The purpose of the Draft

In spite of the fact that the Draft has been distributed as principles aimed not only at "fair debt restructuring in emerging markets" but also at "stable capital flows", it is quite difficult to find any relation between the contents of the Draft and ideas for capital flows stability, unless the Draft has been drafted assuming that there is a conclusive, exclusive and definitive linkage between capital flows stability and the way in which Sovereign debtors are expected to behave in cases of debt (pre or post-default) restructuring.

[1] See Press Release No. 05/87 of the IMF

Moreover, and merely as an example; even though Argentina through the 90´s breached the supposedly ideal policy conditions detailed in the Draft (such as sound monetary, exchange rate and debt management policies), it was nevertheless also shown as an example to the international financial community -i.e. Menem' s invited to address the IMF Annual Meeting in October 1998. Such granting of a seal of approval was not a bullet proof solution to prevent or avoid the massive capital flight that occurred in Argentina during 2001, as well as the purchasing by the market of Argentine debt issued at increasing rates.

2. The lack of due attention to the "case by case basis" approach

We agree with the *caveat* in the Preface according to which, the so-called "Principles" set in the Draft should be applied flexibly and on a case by case basis. We believe this is extremely important, since each specific situation varies greatly from each other. Also, this is a pivotal pillar of the IMF *lending into arrears policy*. In fact, we believe that most of the mistakes and miscalculations of public and private institutions in elaborating sovereign debt restructuring behavioral frameworks, stems from disregarding the case by case approach.

Notwithstanding such recognition to the Draft, we understand that the "case by case basis" approach seems to have been included as merely formal concession, in order to gain acceptance for the Draft.

The sole reading of the full Draft, clearly demonstrates that behind its "case by case basis" facade, the Draft is an only one-way set of prescriptions to address issues that, as the Argentine experience has demonstrated, are of such a level of complexity that do not leave room for ideological clichés and that requires, above all, a pragmatic approach unavoidable if the "case by case basis" is, from an intellectual point of view, honestly and coherently accepted.

Otherwise, if different individual scenarios (i.e. amount, profile and diversification of the debt, different types of creditors, IFIs policies, payment capability, etc.) and different alternatives for all players (and not just debtors) behavior are not contemplated, it is crystalline exposed that the so declared "case by case basis", is just a meaningless formula.

3. Regarding the "bail out" policies

The Draft assumes (in its Preface) that most creditors do not expect official sector bailouts. A curious assumption, if you consider that some G-20 Members have received important bail out assistance in recent years.

Our experience does not support such "no bail out expectation" assertion. In effect, the above mentioned capital flight that occurred in Argentina during 2001, was preceded by a bail out occurred, at least partially, with the IMF packages of January 2001 (the USD equivalent of 3 Billion) and September 2001 (the USD equivalent of 6,3 Billion).

Furthermore, the Draft paper is intended to settle procedural basis even though the IMF policy on bailouts is under analysis (if not strong criticism, because of its lack of results and perspectives) under the light of the moral hazard issue. Consequently, we

understand it takes to know the future of the bail out policy of IFIs, before drafting procedures for debt restructuring. Not just only for Sovereign debtors but also for actual or potential creditors, in this last group, in order to make them able to make projections about debt sustainability and future payment capabilities of their debtors.

4. Regarding the "Transparency and Timely Flow of Information" Principle

We share the view on the desirability of relevant disclosure practices. In fact, in our experience we went to great lengths in order to make public all relevant information regarding our debt load and economic information. In our opinion, however, the effect of current regulatory requirements are underestimated, since the most relevant jurisdictions enforce important disclosure requirements and securities regulatory agencies throughout the world are constantly thinking on ways to ensure a level informational playing field. In fact, engaging in pre-default consultations with certain private creditors would necessarily entail the transferring of information (even if such information is scarce, or even if it consist on there existing a solvency -or at a minimum- a liquidity problem), and it would generate asymmetric information benefiting certain market participants. Consequently, the proposed of early dialogue with certain creditors risks ticking the balance of information for the benefit of some creditors, affecting the fair treatment criterion.

We understand that the implied assertion that it is feasible to preserve confidentiality and to avoid commercial use of the shared non-public information would be troublesome to secure.

Another aspect that should be advanced for purposes of enhancing transparency in debt restructuring scenarios; which aspect is not yet being thoroughly discussed –specially in the framework of limited information dissemination alternatives due to regulatory restrictions-, is that of the needed transparency of IFIs (in particular IMF´s) reports on the debt structure of relevant countries. Transparency of the works of IFIs regarding debt sustainability of issuers would have the effect of putting forward more candid information, effectively curtailing "asymmetric information problems".

5. Regarding the "Close Debtor-Creditors Dialogue and Cooperation to avoid Restructuring" Principle

The Draft paper mentions the need to engage in consultations with relevant creditors before defaults occur. We believe this issue should be looked into extremely carefully. First and foremost, because in the current international finance architecture, creditors are, act and view themselves more as market participants than as "mere creditors".

Regarding dialogue to avoid restructuring, we understand that its importance is overestimated, because dialogue can not avoid debt restructuring, if it is forced by degraded payment capacity and overcoming of the debt sustainability model; in other words, dialogue can not supersede reality and in the best case, it could help to reduce damages by helping to organize a restructuring process, before or after default.

There are points to be made, also, regarding the Draft ´s suggestion of creditors granting roll over or interbank advances in order to advance and finance *reforms*, as in the old fashioned times of the steering committees of the 80s.

Having the private sector grant rate-increasing packages without assessing the debt sustainability of the relevant Sovereign, might risk increasing the debt load without generating sufficient benefits. Such approach would be harmful for the Sovereign debtor, for the creditor and at the end, for the market, since contagion is unavoidable; we can merely discuss degrees of contagion.

Also, requesting “adjustments” might hinder the possibility of growth. In brief, granting credit packages in and of itself, without focusing on sustainable debt load and growth recovery, as well as insisting on “adjustment”, risks increasing the debt load while hindering growth. The Argentine crisis is a good example of such frame of events.

In general terms, when default occurs we believe it would be helpful for debtors to make relevant factual information available for creditors, make such information public generally and share with creditors candid analysis of the debt sustainability and repayment capacity prospects.

For that purpose, certain capital markets regulations could be revisited, in order to admit information releases during the required dialogue between creditors and debtor. Otherwise, the Sovereign’s explanations would be taken as unilaterally made.

The posting of such information also fosters inter-creditor equity. This is also important as to the credibility of the debtor. We view, however, that there are certain capital markets regulatory restrictions to the dissemination of information; specially in the midst of restructuring process. For instance, one of the paradoxes that Argentina had to face, was to explain to IMF´s officers that in dialoguing with creditors, it was important that Argentina did not breach U.S. SEC´s regulations.

We believe efforts should be made in order to enhance factual disclosure possibilities as much as possible in post-default scenarios. The existing dissemination restrictions, in the context of ample sovereign debt restructurings, risk having the effect of, more than protecting investors, preventing creditors from having access to valuable information.

One additional shortcoming of the Draft is that it does not address the different ways in which dialogue contributes in pre and post default scenarios. The Draft requests dialogue as if it was a magic formula but without addressing its limitations nor the way in which it can be more profitable for all interested parties.

When default has not happened, dialogue can contribute to avoid it only if default avoidance is feasible (and in that field, again, IFIs role in preventing and granting proper advise is critical); otherwise, if default is unavoidable, there is no dialogue that can change such a reality an then, dialogue must be focused on finding a new sustainability model, to make reasonable any post-default debt restructuring plan.

6. Regarding the “Good Faith Actions” Principle

We also laud the Good Faith Principle criterion for when debt restructuring becomes unavoidable, and its application to both creditors and debtors. In particular, however, we wanted to reflect on the need of protecting asset values during the restructuring.

We share the view on the need of assuring the effectiveness of and the need of political support for policies that will ensure the key objectives of macroeconomic stability, and sustainable economic growth. This is of the utmost importance. In fact, we believe that throughout the paper, the importance of such objectives is underscored, and -on occasions- assertions are made that would ultimately conflict with these guiding objectives. Regretfully more than too often we have found from multilateral bodies excessive attachment to ideas and policies that simply do not work, or worse, that deteriorate stability and generate recession.

The most important objectives in any debt restructuring are the two mentioned objectives; sustained growth and macroeconomic stability. Without such items, the repayment capacity of the relevant Sovereign will decrease steadily and the best restructuring procedure would be useless and even worse, harmful, if we think on the consequences of a post restructuring default.

The good faith criterion seems to be a meaningless and misleading good will purpose, if it is expected from debtors without admitting the importance of debt sustainability (jointly with its factual prerequisite, the payment capacity) as the cornerstone of any offer to be made to creditors.

The proposed "sustainability" criterion is the best source of reliability in the best interest of creditors, since convinced (and not just proclaimed) good faith, limits and exclude dishonest conduct, such as would be acting under pretenses other than the actual interest a party might have, or promising or committing to something that the party positively knows it will not comply.

From our perspective, good faith obliges the debtor to restructure debt within the framework of repayment capacity. Because the debtor wants to negotiate and relate with creditors and execute agreements in good faith, and because of the gargantuan costs associated with defaults, is that its interest should be not to default again. Therefore, it is fundamental to ensure to creditors that they will get paid. Closing a deal that the debtor knows that will not be honored, would be not only negligent, but a willful and unjustifiable breach of trust.

There can be no good faith negotiations if the final result is not a sustainable debt structure. If there are genuine doubts on the sustainability of whatever final agreement is reached, then there is deception. If negotiations lead to such a result, then they are not good faith negotiations reached for the common interest of debtors and genuine creditors; but rather a result that would force the debtor into further restructuring or rescheduling down the line, and that would benefit not the general creditors, but only some actors of the debt restructuring who might not be creditors but rather agents, or certain creditors that have better information than others of the not so sustainable restructuring and that could benefit from such advantage in knowledge.

Finally, the Draft brings a conceptual mistake which consists in associating in and of itself good faith with the purpose of achieving a "critical mass of market acceptability". Good faith is not evidenced only by market acceptability. Good faith is evidenced by facing and showing reality.

We find, however, that the Draft stays short of emphasizing the need for the creditors that are engaged in dialogue of –likewise- acting in good faith. This element is of paramount importance, not only due to the necessary collaborative atmosphere of a restructuring process, or because of it being the counterpart of the Sovereigns´ good faith efforts; but also –as we point out in the following item- because not granting due attention to the good faith of pretended creditors risks disregarding the essential requirements that participants engaged in dialogue are truly representative and are not affected by conflict of interest. If such were to be the case; if the relevant Sovereign was forced to engage in dialogue with pretended creditors ultimately unrepresentative and acting under conflict of interest, then the whole restructuring process and efforts would be influenced by agendas other than the accomplishment of a sustainable restructuring.

There is another element that should be considered in the gathering of elements that compose a Sovereign´s default scenario. That is, the role of the relevant agencies and, more specifically, of certain placing institutions in the dissemination of securities to unsuitable constituencies. This is a fact that should be considered not because certain placement institutions of the original bonds should be considered a part of the restructuring process (they are not) or because the regulatory agencies could engage in ex – post surveillance; but because such behavior is -along with the default by the Sovereign- also part of the cause of the post- default scenario.

7. The "Creditors Committees"

After accepting the correctly sized importance of dialogue with creditors, its consequence is the necessity of finding a counterpart. In scenarios like the Argentine one, where the debt structure was so spread, and so blatantly unsustainable, and where there are actors in the restructuring process that are not necessarily creditors and that have a lot to gain out from asymmetric information, the "creditors representativeness issue" -in order to determine which genuine creditors could also be genuinely representative of other creditors- becomes of paramount importance, precisely because engaging in negotiations with actors that are not focused on a sustainable debt restructuring could lead to further restructuring and deception to the creditors generally.

That is why we understand that it is a central issue that the Draft be completed with the incorporation of the representativeness issue,- the requirement of good faith of the other participants, and their lack of conflict of interest[2].

In fact, in assessing creditor´s representativeness, we find that even the framework of the shelved Sovereign Debt Restructuring Mechanism initiative specifically addresses this issue regarding creditor participation and organization. In effect, the initiative stresses the usefulness of a verification of claims process, with the goal of forming a representative creditor body or committee that should include creditors with the greatest exposure to the Sovereign. It is apparent that such committee should not be formed,

[2] As an illustrative side note; the CEO of one of the italian leading financial institutions, who is an active member of the Board of the Italian Banking Association (sponsor and founder of a very vocal entity which claimed to represent italian retail bondholders) and of the Board of the Directors of the Institute of International Finance, has recently been sanctioned by the Italian Ministry of Economy and Finance –at the instance of the Consob (the Italian regulatory authority regarding capital markets)- for the involvement in the selling of Argentine bonds in the italian market in breach of applicable norms.

much less lead, by self-appointed representatives of creditors who are not creditors and who in fact have potential conflict of interest with genuine creditors.

In view of the difficulties, the lending into arrears policy ultimately concedes that, eventually, constructive dialogue with different constituencies could replace the role of a committee when the formation of a single genuine and representative committee is not feasible given the dispersion and disparity of debt holders.

The policy points out certain principles that would clarify the good faith criterion in the framework of debt restructuring of emerging markets; all of which principles –as we mentioned above- we fully endorse and practiced in our restructuring.

- engagement in early dialogue with its creditors.

- sharing of relevant information.

- opportunity provided to creditors for input on the design of restructuring and the new instruments.

<u>8. The “critical mass of market support”</u>

Related to the properly understood importance of dialogue and the good faith requisite, comes the issue of the market support.

First of all, there is not just one market or at least, there is not an homogeneous market. What is the market? The retail investors? The pension funds? The hedge funds? The IFIs? The vulture funds? “The” market is not the reduced group of banks of the 80s; “the” market is a complex group of different kinds of creditors that unavoidably, will have different approaches to a debt restructure proposal.

A proper paper should address this important feature of “the” market, because the managing of investments criteria and the objectives considered when investing in sovereign bonds, vary from one kind of bondholder to another.

At some point of dialogue, there will be a break point at which “the” market will have to decide upon an offer.

In tailoring an offer to such a widespread mass of bondholders, the broad acceptance of it would indicate that –within the economic constraints of the debtor- the concerns of the different types of constituencies were addressed. This would be a key good faith indication; the ability of incorporating features addressed to the interest of the different types of creditors, while maintaining the debt sustainability premise.

In tailoring an offer to such a widespread mass of bondholders, one in which debt sustainability is at the core of the effort, the broad acceptance of it would indicate that - the Sovereign has been effective in engaging in an effort of properly communicating the economic constraints of the debtor. In restructuring processes like the Argentine one, the effort of dialoguing with creditors is all the more intense, because the constraints and difficulties need to be properly conveyed. Also, the concerns of the different types of constituencies were addressed. This would be a key good faith indication; the ability

of incorporating features addressed to the interest of the different types of creditors, while maintaining the debt sustainability premise.

9. The predictability of " Debtor and creditor actions during restructuring" and the "Fair Treatment" Principle

We think that the assertion referred to resumption of partial payments as a sign of good faith, is inconsistent with the lending into arrears of IMF: if on one hand, IMF requires good faith from the Sovereign and if on the other hand, the Draft dictates that good faith is supposed to be demonstrated by paying but paying requires help from IFIs, then good faith (at least, in the narrow sense dogmatically defined in the Draft) would be impossible to be established.

The Draft misses the opportunity to clarify and disclose the rationale legitimizing IFIs, as *de facto* preferred creditors, because rationality does not mean no need of disclosure. In other words, such an assertion does not imply to reject the *de facto* privilege in favor of IFIs; but if such a privilege is not written in stone, its justification should be, at least, clearly disclosed.

That is why regarding creditor and debtor actions, once again, the role of the IFIs must be clarified and be made timely known and understandable for all creditors. Whatever the future essence of the IFI´s role can be good or can be bad, but what it can not be is hidden, as it is in the Draft.

Otherwise, markets would be unable to predict the actions to be taken by important creditors like the IFIs and then, Sovereign debtors would have to face the anger of surprised creditors.

B. Comments for the improvements of the Principles

1. The "free acceptance" of the Principles

While we laud the emphasizing that the adoption of the Principles is strictly voluntary for debtors, we warn against the official sector, and much less the private sector, assuming an arbitrator´s role by establishing with a "seal" the difference between countries that do and countries that do not fully embrace a set of voluntary or self-imposed rules –as interpreted by such self appointed arbiter-, which do not respond to indisputable criteria but to an ideological approach. Differences of approach amongst countries (i.e. the following or not of the Principles as "interpreted" for the specific case) could be unnecessarily harmful to emerging countries, by creating different categories that do not relate with fundamentals of the characteristics of the relevant countries, but rather to the obtaining of a "seal".

For instance, would the lack of adoption of the Principles (as "interpreted") in and of itself translate in the degradation of the debt of the relevant country?. More perplexing even, considering that the adoption of the Principles is said to be voluntary; what effect would the shift of category have for a country that decides to disavow itself from the Principles?; would part of its debt be considered to fall under the Principles?. Conversely, if a country that did not adhere to the Principles shifts and manifest its

adoption, would it generate concerns in the market that such a shift is aimed at compensating eventual sustainability shortcomings?.

Consequently; while we believe that the endorsement and following of certain principles and priorities are important in order to construct an orderly debt restructuring (such as fair treatment, transparency, engagement in dialogue); the granting of "seals" could have the effect of affecting rather than helping debt restructuring processes. Moreover, the whole concept of granting "seals" of approval if countries conform with certain pre established set of rules, could contradict the "case by case approach".

2. Regarding the necessity of assessing a realistic and fully encompassing scope of all involved players

The Argentine experience clearly demonstrates that a good set of principles should not take in consideration only debtors and certain private creditors with lobbying capabilities (as the Draft does) but also IFIs, investment banks and regulatory authorities.

Argentina's debt restructuring signifies an unprecedented loss for sovereign bondholders. This will have widespread repercussions not only for creditors, but for Argentina's long-term financial sustainability, developing country debt markets, guidelines for future sovereign debt restructurings, and the International Monetary Fund (IMF).

The argentine default is not only unprecedented for its haircut, but also for the process that has stretched the guidelines of sovereign debt negotiations.
Therefore, if the expected behavior of each player is not clearly disclosed, the other ones would be taking decisions on conjectural basis.

In that sense, one of the most (and many) shortcomings of the Draft, is to make assumptions without making methodologically due disclosure of them (for instance, whether the *de facto* privilege of IFIs and the abandonment of the bailout policy are assumed as a given or not).

3. Regarding the "case by case basis" approach

We believe that in order to better define the aspects that the "case by case" approach should entail, efforts should be made to determine the elements that would be comprised in such approach

We, thus, believe that the following elements should, among others, be considered in determining how the principles should apply to the relevant specific case;

- The types and quantity of instruments involved in the restructuring efforts
- The different constituencies holding the relevant debt
- The extent, relevance and profile of IFI´s financing
- The role that the IFI´s would play; in particular if the "bail out policy" would be discarded or assumed.
- The debt load, and its relation to GDP
- The currency mismatch of such debt

- The "debt tolerance" of the relevant country to debt, and a candid analysis of repayment capacity.
- The required actions for assuring for sustained growth

4. Regarding transparency

There is a dimension of transparency of information and analysis, not currently present in the Principles, that we believe is worth advancing. The one related to the works and documents prepared by the IFI´s. The timely dissemination of such documents and of the relevant analytical models, could improve the parity of the access to valuable information by all relevant investors.

In effect, timely dissemination of relevant elements within the realm of IFIs analysis on emerging markets would have the beneficial effect of opening up a more candid interaction between IFI´s and the markets; and it would also enable less sophisticated investors to have a more equitable access to information than would be the case if only sophisticated investors had access to relevant data. As a consequence, markets would improve their efficiency, since "asymmetric information problems" would diminish.

Also, as we mentioned before, we believe efforts should be made to curtail regulatory restrictions for the dissemination of information and prospects and analysis in the context of ample sovereign debt restructurings. Such limitation on the dissemination of, for instance, analysis of payment capacity risks preventing creditors from accessing important information. The dissemination of such information would also diminish asymmetric information problems, by having all creditors accessing information of the same quality.

5. Regarding debt repayment capacity

We believe more emphasis is needed on "growth" and "sustainability" as major factors in determining debt repayment capacity.

We are of the view that in the midst or beginnings of a debt crisis, the most important factors are to asses the debt sustainability and to bring the debt load to match the sustainable debt level, as well as to create conditions that will meet the consecrated objectives of sustained growth and macro stability.

6. Regarding "representativeness"

We understand that specific applications of the Principles should take note and advance on the analysis of due representation and credit verification. This issue, is key in evaluating the requirement of good faith of the other participants, and their lack of conflict of interest

7. Proposals regarding the enhancement of fairness amongst creditors in post-default emerging sovereign restructurings

Our restructuring experience has led us to envision certain aspects that would enhance the "fairness" of future post-default restructurings of emerging Sovereigns. In effect, we realized that the differences in constituencies, attitudes and realities of the affected

creditors evidenced that –ideally-, the treatment of each different group of creditors deserved to be different, if fairness was to be prioritized, and if problems of asymmetric information are to be minimized.

As such, we devised certain elements that could enhance fairness in the restructurings processes.

- preferential conditions for creditors holding up to certain minimum investment amounts. It is not equitable to give treat equally unsophisticated retail investors and large institutional investors.

- preferential treatment in respect of the “original” holders of the bonds; the ones that purchased the debt instruments at face value.

- the above two items should be coupled with the standard of giving differential and less preferred treatment to those bondholders who purchased their securities after open default situations.