THE BRETTON WOODS COMMITTEE

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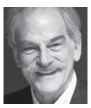
Sovereign Debt: A Critical Challenge

An introductory report of the Bretton Woods Committee's Sovereign Debt Working Group

WORKING GROUP MEMBERS

William R. Rhodes, *Co-Chair*
President and CEO, William R. Rhodes Global Advisors



John Lipsky, *Co-Chair*
Distinguished Scholar and Senior Fellow, Johns Hopkins School of Advanced International Studies (SAIS)

Terrence J. Checki
Former Executive Vice President, Federal Reserve Bank of New York

Richard J. Cooper
Senior Partner, Cleary Gottlieb Steen & Hamilton

William C. Dudley
Senior Research Scholar, Princeton University

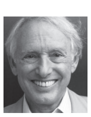
Gail Kelly
Senior Global Advisor, UBS

Joaquim Levy
Director for Economic Strategy and Market Relations, Banco Safra S.A.

Maria Ramos
Chairman, AngloGold Ashanti Limited

Susan Segal
President and CEO, Americas Society/Council of the Americas

José Viñals
Group Chairman, Standard Chartered



Mark Walker
Senior Managing Director, Guggenheim Securities

PREFACE

The sharp, Covid-19-related buildup in sovereign borrowing by emerging and developing economies represents a looming challenge: Many countries will require relief in the next few years in order to restore debt sustainability and to assure access to needed financial flows. At the same time, it seems evident to both observers and participants that significant reforms are needed urgently to improve the efficiency, inclusiveness, and effectiveness of sovereign liability management.

The Bretton Woods Committee is dedicated to effective global economic and financial cooperation. It is clear already that the prospective problems of sovereign debt will engage International Financial Institutions (IFIs), governments, and the private sector alike. In anticipation, the Bretton Woods Committee formed a Sovereign Debt Working Group. The Working Group is developing concrete proposals and will seek to build consensus around new approaches and market practices that are well-suited to the anticipated post-Covid-19 round of sovereign debt restructurings.

This introductory paper, titled ***Sovereign Debt: A Critical Challenge,*** is the first in a series planned by the Working Group for the coming 18 months. Each successive publication will deal with one of the four key aspects of this challenge—previewed in this paper—and will culminate in a summary paper presenting the conclusions of the Working Group's study and deliberations.

We would like to thank our Working Group colleagues for guiding our collective effort. We extend our appreciation to Mark Walker, Rich Cooper, and their colleagues, Stephanie Fontana and Destiny Kanu, for their leadership in preparing this report. We also thank the Bretton Woods Committee Secretariat, Emily Slater and Greg Brownstein, for their coordination and support. We look forward to receiving your comments regarding the Working Group's contributions, as well as to maintaining an open dialogue with all those interested in strengthening this important aspect of global governance.

William R. Rhodes
Co-Chair, Sovereign Debt Working Group

John Lipsky
Co-Chair, Sovereign Debt Working Group

I. OVERVIEW AND OBJECTIVES

Overview

The Covid-19 pandemic created an unprecedented combination of challenges: government-ordered lockdowns, dramatic economic downturns, instability in various markets and industries, and an historic surge in government spending on health and social needs. These events precipitated an urgent need for liquidity among emerging market economies and an increase in their debt burdens. Today, the earlier fear of a dangerous lack of liquidity has been replaced in large part by concerns about the ability of the international financial architecture to support countries with increasing levels of debt and uncertain access to capital. One worrisome aspect seems clear: Many countries will require debt relief in the next few years if they are to maintain or restore access to financial flows. Higher interest rates in advanced economies, and the United States in particular, could compound the difficulties of emerging market countries in servicing existing debt and refinancing maturing debt.[1]

Objectives

For countries experiencing distress or loss of market access, sovereign liability management is an essential tool to alleviate financial pressure and enable the pursuit of economic policies designed to support or promote sustained growth. But reforms are needed to improve the efficiency, inclusiveness, and effectiveness of sovereign liability management. Toward this end, the Bretton Woods Committee has formed a Sovereign Debt Working Group (the "Working Group") to develop a concrete approach to reform.

The landscape of sovereign debt has changed significantly over the last 30 years. Typical sovereign balance sheets have become much more complex. In addition to bank and bonded debt, external liabilities of many countries today include large exposure to highly structured and often nonconventional project and trade debt, derivatives, repurchase obligations, commercial claims, secured debts, and a panoply of contractual obligations. If these obligations are not honored, they can be converted into judgments and arbitration awards in multiple jurisdictions. In addition, many state-owned enterprises have similar liabilities that sometimes benefit from an explicit or implicit government guarantee, collateral or other assurance of repayment. As a consequence, the management of sovereign liabilities in times of crisis will likely prove a more complex and challenging exercise than in the past.

As the type and form of sovereign liabilities have expanded, the creditors of sovereign borrowers have themselves become more diversified, even within the same class of credits. Recent restructurings in Argentina and Ecuador,

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1 Jonathan Wheatley, "Emerging Markets Suffer First Outflows Since October on Rate Jump," *Financial Times*, March 5, 2021, https://www.ft.com/content/41283847-30e4-49ef-82a0-9cd4dfca1c12.

as well as the ongoing restructuring negotiations in Zambia, illustrate this phenomenon. The fact that different creditors respond to different incentives and are subject to different regulatory and legal considerations compounds the difficulty of carrying out successful debt restructurings.

In short, with the expansion of financing sources and techniques, many of the assumptions that informed and influenced sovereign debt management in the past have changed. Consequently, there is a need to ensure that the guard rails and architecture that will guide sovereign debt management today and in the future will serve us well.

The Working Group intends to examine this topic in depth, with a view to formulating concrete recommendations as to how current practices could be improved and new tools and approaches added to better equip sovereigns to avoid or manage the financial challenges of the future.[2] The objective is not to answer every question, but rather to explore innovative new approaches, gain insight into the advantages of certain alternatives over others, and help build a broad consensus around what must be done to avoid or, if necessary, better manage and resolve sovereign debt crises.

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To accomplish its goals, the Working Group will examine four discrete areas that it considers to be essential for achieving a fair and balanced restructuring and for restoring debt sustainability where needed. Success in these efforts will create the opportunity for debtors to pursue sound economic policies that will promote sustained economic growth.

The four areas to be examined are:

1. Promoting **greater transparency and disclosure** with respect to the terms of sovereign liabilities, including restructurings, as well as to the processes by which these liabilities are incurred and modified.
2. **Achieving full and constructive participation** of the private sector.
3. **Promoting equitable burden sharing** among all creditors—official, bilateral, and private.
4. Analyzing possible options for **state-contingent financing** from private and official creditors, evaluating these options both in the context of new money lending arrangements and as instruments issued as part of restructurings.

The Working Group aims to formulate concrete recommendations, including actionable proposals and practical tools, to help policy makers, debtor countries, and market participants alike. Among other things, the Working Group will study tools that are currently being used effectively outside of sovereign

2 The Working Group acknowledges the Group of 30's preliminary report "Sovereign Debt and Financing for Recovery after the Covid-19 Shock" (https://group30.org/images/uploads/publications/G30_Sovereign_Debt_and_Financing_for_Recovery_after_the_COVID-19_Shock.pdf). The G30 report is a significant contribution to the literature on sovereign debt, highlighting the importance of the issues to be addressed by the Working Group, and is complementary to our work.

finance. In addition, attention will be paid to finding better ways to garner private sector support for addressing sovereign debt challenges, recognizing the legitimate interests of private investors and the real constraints they face.

Work Plan

The Working Group will publish a series of papers over the next 12 to 18 months that will address each of the four areas identified above. A final paper will summarize the conclusions and recommendations of the Working Group on these issues.

The following sections summarize the issues that are central to each of the four key areas that the Working Group will address.

II. TRANSPARENCY

Background

Transparency is essential to the sense of fairness and equal treatment that underlies a successful debt restructuring framework. Thus, improved transparency is a predicate for the successful reform of the international financial architecture and for meaningful progress on each of the other issues that the Working Group will address. Moreover, a shared and complete understanding regarding existing indebtedness is necessary for credible credit analysis, price discovery, risk assessment, and debt management.

The refusal of Zambia's bondholders to consider interim relief in the absence of full disclosure of agreements with Zambia's largest creditor—in this case, China—is illustrative of the problems that are created when transparency is lacking. Private sector creditors can hardly be faulted for wanting to understand the exposure and proposed treatment of their debtor's largest creditor before committing to a process intended to restructure Zambia's debt. These concerns go beyond the Zambian case: Most members of the official sector and other stakeholders agree that in general, the disclosure of sovereign liabilities by both debtor countries and creditors has been inadequate.

Too often, critical facts remain inaccessible and existing disclosure practices do not reflect the expanding panoply of sovereign liabilities and obligations. Moreover, many bilateral and private sector lenders—as well as sovereign borrowers themselves—often insist on strict confidentiality requirements that exceed those generally accepted as justified by legitimate business and other interests. In response, the call for enhanced transparency has received widespread support, including from private sector financial institutions and the International Institute of Finance (IIF), as well as from official institutions, including the International Monetary Fund (IMF), the World Bank,

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the Group of 20 (G20), and the Organization for Economic Co-operation and Development (OECD).[3]

Private sector investors have also been frustrated by the current sovereign debt restructuring process in which the official and bilateral sectors take decisions and make judgments—without consulting the private sector—that largely determine the expected contribution of the private sector to a restructuring.

Full Disclosure of Sovereign Liabilities and Their Treatment in Restructurings

There is scant specificity in the literature as to what constitutes acceptable standards of transparency. There is no agreed guide with regard to exactly what information should be required to be disclosed, how to compel or encourage disclosure, and the consequences, if any, of less than full or misleading disclosure.[4] The Working Group will seek to provide practical suggestions for setting such standards.

Approaches to consider include:

- Enlisting rating agencies to take disclosure and transparency into account in rating sovereign credit.
- Conditioning the governmental authorization of the sovereign to incur or modify debt, and thus the legitimacy and enforceability of sovereign debt, on public disclosure.[5]
- Modifying disclosure requirements of securities regulators such as the US Securities and Exchange Commission to provide more guidance for sovereigns that register their debt as to the level of disclosure that is required.
- Including an analysis and assessment of compliance with best disclosure practices within the scope of the IMF's Financial Sector Assessment Program.

A More Transparent Debt Restructuring Process

The **G20's Common Framework for Debt Treatments Beyond the Debt Service Suspension Initiative (DSSI)** seeks to codify a process in which the IMF will consult with other official creditors, but it does not

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3 IIF Draft Principles for Debt Transparency (2019); IMF notes "The Architecture for the Resolution of Sovereign Debt Problems Involving Private Sector Creditors" and "The Role of State-Contingent Debt Instruments in Sovereign Debt Restructurings" (both 2020); ODI working paper "Improving Transparency of Lending to Sovereign Governments," by Shakira Mustapha and Rodrigo Olivares-Caminal, Section 5, "How to Make Transparency Initiatives More Effective?" (2020); G20 Common Framework for Debt Treatments Beyond the Debt Service Suspension Initiative (2020); OECD report "Sovereign Borrowing Outlook for OECD Countries" (2021).

4 The question of *what* to disclose garners less consensus than the idea that there should be public disclosure. The IIF has proposed a number of items for disclosure, including, as one interesting example, the intended use of proceeds at drawdown (IIF Draft Principles, 2019).

5 G30, "Sovereign Debt and Financing for Recovery," 2020.

appear that the private sector is included in this exercise. The IMF is a central actor in virtually all debt restructuring exercises in which a debtor country's solvency is at issue. The IMF's position has been that it, together with the World Bank when operating under the Common Framework, has complete discretion to conduct its analysis and determine what is required to achieve debt sustainability.

The Common Framework indicates that other official creditors, in addition to the IMF and World Bank, may have at least a consultative role in the process of determining the contours of a debt restructuring. As official creditors determine their own contribution to a restructuring unilaterally, at times after consultation among themselves, the private sector's expected contribution is typically presented as a *fait accompli*. Exclusion of the private sector from even a consultative role taints the atmosphere and leaves private participants legitimately feeling ill-informed and ill-treated—thus making reaching an agreement more difficult and more time-consuming.

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Without suggesting that the IMF conduct its analysis and determinations by committee, whether and how participation by the private sector could be included should be explored in any effort to improve the process. The economic subcommittees of creditor committees that were set up in the 1980s to interact with the IMF and debtor countries in the context of debt sustainability analysis could provide a model for how to include the private sector. In this regard, the Working Group will examine whether practices used outside the sovereign context may be instructive, such as the experiences gained from the Financial Oversight and Management Board for Puerto Rico and other governmentally sanctioned oversight boards.

Realistically, consultation and transparency in the restructuring process will not by themselves be sufficient to dispel private sector concerns about the integrity of the restructuring process, as official institutions are not impartial arbiters or independent advisors. Rather, these institutions are or will become creditors with competing claims, in many cases claiming preferred creditor status.[6] Moreover, the official institutions have their own distinct mission and answer to constituencies with different interests from those of the private sector, whose for-profit objectives and fiduciary responsibilities are often discounted and dismissed by the official sector.

6 The G20 Common Framework seeks to ensure equitable burden sharing between private and bilateral creditors (more precisely, its objective is to ensure that private creditors contribute at least as much as their bilateral counterparts), but not with multilateral development banks or the IMF itself.

III. PRIVATE SECTOR PARTICIPATION

Background

Viewed from the perspective of a struggling sovereign seeking relief from its creditors, securing the support and participation of the private sector is all too often a frustrating and unproductive exercise. Many sovereigns and other knowledgeable observers would go further, saying that the private sector has often proven to be an obstacle to an orderly restructuring. In particular, this perception is deeply held in circumstances where private sector creditors refuse to provide relief even where the causes of distress are forces beyond a sovereign's control or, in the most egregious cases, when holdout creditors actively obstruct transactions that have substantial private creditor support. It is not surprising that a common outgrowth of this perception is a renewed call for effective mechanisms to compel greater private sector participation.[7]

When examined more closely, however, this perception does not tell the whole story. When the private sector abstained from joining in the G20/Paris Club initiative to defer debt service payments falling due between May 20, 2020, and the end of last year (the **Debt Service Suspension Initiative,** or **DSSI**),[8] the outcome should not have come as a surprise, despite the torrent of criticism that followed. The very design of the DSSI, a one-size-fits-all program that ignored the differences in circumstances among countries, made it particularly ill-suited for voluntary private sector participation. And somewhat lost in the criticism of the private sector was the reality that countries themselves did not seek out private sector participation, because the rating agencies announced that they would downgrade any country that did so, resulting in a loss of market access.

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It would be a mistake to conclude, based solely on the DSSI, that private sector participation in sovereign restructurings has been limited or unconstructive, or that the private sector is unwilling in all instances to provide assistance to a struggling sovereign. Recent precedents in Argentina, Ecuador, and Barbados, among others, demonstrate that bondholders have been willing to address the liquidity and solvency challenges of countries that seek their aid. In addition, the private sector has played an important and constructive role in the development and adoption of collective action clauses and, through the IIF, has led the effort to formulate and promote the Principles for Stable Capital Flows and Fair Debt Restructuring, which are largely supported by sovereign borrowers and aim to improve the processes through which consensual debt relief is obtained.

7 Private sector assistance to countries in distress need not be limited to creditors. Other private sector firms that do business with a debtor country's public sector may be able to help as well, such as by providing Covid-19 vaccine on favorable terms (see William Rhodes and Cristina Valencia, "Debt for Vax," Reuters, March 9, 2021, https://www.breakingviews.com/features/guest-view-consider-a-debt-for-vaccines-program/).

8 Under the DSSI, bilateral creditors of Paris Club and G20 countries and China agreed to defer debt service payments owed by 73 poor countries and falling due between May 1, 2020, and June 30, 2021 (initially December 31, 2020).

That said, more can and should be done to engage private creditors as constructive participants in sovereign restructurings where appropriate. Key among the mechanisms used to broaden private sector participation are **collective action clauses,** first introduced in 2003 into sovereign bonds issued by Mexico and governed by New York law. Simply put, collective action clauses are provisions in bond documentation that allow a defined supermajority of bondholders to agree with the debtor country to modify payment and other fundamental terms of all bonds outstanding, including bonds held by nonconsenting bondholders. The text of these clauses has undergone several iterations and was "codified" by the International Capital Markets Association (ICMA) in a form that became the market standard. A bespoke version was successfully used by Greece in 2012 to restructure 97 percent of its bonded debt. The latest ICMA version was first deployed last year to facilitate the Argentine and Ecuadorian restructurings. However, these restructurings revealed shortcomings and unintended consequences that are inherent in the ICMA model.

To achieve success, new structures and strategies will need to acknowledge the reality of today's environment: Sovereigns borrow from multiple funding sources and through a multitude of instruments, and investors have a broad array of investment choices and opportunities.

The Working Group will look to instances outside the sovereign context in which financial actors and interested parties have devised structures and strategies to encourage new investment or to manage liquidity or solvency issues. To achieve success, new structures and strategies must accommodate the reality of today's environment: Sovereigns borrow from multiple funding sources and through a multitude of instruments, and investors have a broad array of investment choices and opportunities. The Working Group will also need to take into account the regulatory and fiduciary obligations that many market participants themselves face and that differ across jurisdictions in ways that can make it difficult for private creditors to align their positions.

No proposed solution will be viable if it ignores or wishes away the realities of the marketplace. In general, investors will resist a one-size-fits-all approach, as they will naturally insist that any impairment of their claims be justified by the particular circumstances of their debtor. To the extent that proposed solutions reduce investors' returns or their flexibility independently of a debtor's particular situation, they will reduce participation, as was the case with the DSSI. In the extreme case of a systemic sovereign debt crisis, the financial stability of the private sector and the loss-absorbing capacity of creditors, including local creditors in affected jurisdictions, will need to be taken into account.

To have as broad an impact as possible, proposed solutions should be crafted that will attract new capital when investors believe the future looks bright, as well as garner creditor support for debt relief during times of financial stress, when the outlook is less certain. The Working Group will examine market-based, contractual and legislative approaches with a view to broadening private sector participation in sovereign restructurings.

Market-Based Approaches

Not surprisingly, the private sector favors positive incentives as a means to increase participation in lending and debt restructuring transactions. The incentives that have attracted the most attention are financing structures that include some form of official sector credit enhancements or other similar incentives (from either multilateral or bilateral institutions). Official sector enhancements that have been used in the past include partial credit guarantees and sharing in the umbrella of an official-sector lender's preferred creditor status. An example of the latter would be a cofinancing or A/B loan structure in which payments by the debtor are shared pro rata between official and private creditors. This technique was used in the 2012 Greek restructuring, and is used commonly in Inter-American Development Bank and International Finance Corporation lending.

Similarly, multilateral institutions could offer private participants the opportunity to participate in official on-lending or refinancing facilities for distressed sovereign borrowers. From the distressed sovereign's perspective, such structures could increase resources available to it and lower the overall cost of funds. At the same time, private sector creditors may be willing to accept a new instrument with a lower yield, in exchange either for obtaining more favorable treatment in a subsequent restructuring or for the likely higher trading price of their securities after a restructuring.

To have as broad an impact as possible, proposed solutions should be crafted that will attract new capital when investors believe the future looks bright, as well as garner creditor support for debt relief during times of financial stress when the outlook is less certain.

Similarly, expanding private or public sector credit or political risk insurance products to cover, in part, obligations of stressed sovereigns may be another fertile area to explore. Multilateral development banks (including the World Bank Group), developing country institutions, and the private sector are all active in providing similar coverage for private and public sector borrowings. Additionally, rescue funding, whether inside or outside a formal insolvency regime, often provides participating creditors and distressed borrowers with an additional means of increasing creditor participation, by offering opportunities or benefits to participating creditors that nonconsenting creditors are not entitled to receive, often without additional cost to a debtor. To date, the official sector has shown little enthusiasm to pursue these types of ideas. Nonetheless, they have attracted serious proponents, and the Working Group believes they are worth exploring in greater depth.

Although sparingly used, official multilateral and bilateral guarantees of private sector credit have in the past played an important role in attracting new sources of low-cost financing for sovereigns. Despite the official sector's scant enthusiasm for credit enhancement, it can serve a useful purpose, particularly by attracting private participation in new forms of finance.[9] It may

9 Suppose, for example, a multilateral development bank agrees to provide a partial guarantee of a $1 million sovereign obligation in which it agrees to absorbs the first 35 percent of losses in respect of such sovereign obligation. In this case, the development bank would incur a lower capital charge than if it lent the full $1 million itself, thereby permitting the official sector to leverage its balance sheet and provide support to other sovereigns.

also attract financing from sources not generally available to emerging market borrowers. A partial guarantee is not a direct subsidy to the private sector. Rather, by lowering the risk of default, it allows a debtor country to borrow from a broader universe of private creditors at a lower cost, thus providing a benefit to the debtor.

Another potentially valuable tool to encourage new, low-cost lending to emerging market sovereigns, as well as participation in a subsequent restructuring, is tax incentives. The development of the US municipal bond market illustrates the power of this tool. For example, advanced economies, on their own or through an international tax convention, could grant favorable tax treatment to interest income on restructured debt, thus allowing the debtor to borrow at lower cost. A more controversial measure would be to permit restructuring losses in respect of debt to eligible sovereigns — that have been restructured pursuant to internationally sanctioned processes — to be credited in some manner against income or capital gains in the lenders' home jurisdictions. A sovereign's eligibility for such a program, in turn, could be linked to standards of fiscal prudence, transparency, and governance.

Finally, an idea that has attracted increasing support from the international community and that might broaden private investor participation is to combine efforts to tackle environmental, social, and governance (ESG) issues with debt relief.[10] This approach would benefit from the growing demand by investors for ESG bonds and sustainable investment opportunities. The Emerging Markets Investors Alliance has recently proposed an exchange of debt of distressed sovereigns for new bonds linked to the United Nations Sustainable Development Goals (**SDG**s). If the sovereign meets pre-agreed targets tied to the SDGs, the terms of the new bond would reflect reduced debt service obligations. This, too, is an idea that the Working Group intends to explore.

Contractual Tools

As part of its efforts to consider means to increase private sector involvement, the Working Group will also consider whether there are contractual improvements in debt instruments — beyond collective action clauses — that could encourage enhanced sustainable flows to emerging market borrowers from a broader universe of private creditors, as well as broader private sector participation in restructurings.

10 A similar idea underlies debt-for-nature swaps. In these transactions, a third party facilitates the restructuring of a portion of a sovereign's debt by purchasing outstanding instruments at a discount and exchanging them for a lower principal amount in new instruments. The savings are then used to fund environmental protection initiatives in the debtor country. The Nature Conservancy facilitated the first of these transactions with Seychelles in 2016, and in 2019, the prime minister of Barbados announced that the country was in discussions with The Nature Conservancy to conduct a similar debt-for-nature swap (The Nature Conservancy, "Rising Tides: Debt-for-Nature Swaps Let Impact Investors Finance Climate Resilience," June 17, 2016, https://www.nature.org/en-us/what-we-do/our-insights/perspectives/rising-tides-debt-for-nature-swaps-finance-climate-resilience/; Sharon Austin, "Interest in Maritime Debt for Nature Swap," Barbados Government Information Service, April 19, 2019, https://gisbarbados.gov.bb/blog/interest-in-maritime-debt-for-nature-swap/).

Additionally, the Working Group will explore other potential modifications to lending terms that will lessen the likelihood of default. The result would be reduced risk to both debtors and creditors, that the debtor will be downgraded or compelled to seek debt relief. The underlying approach is to build a mechanism into new or restructured debt instruments that will automatically allow the debtor to defer cash debt service payments under limited circumstances of liquidity constraint. A contractually permitted cash deferral would not be a default.

In the high yield bond market — and in the context of private sector restructuring — it is not uncommon to allow borrowers, in certain circumstances and subject to agreed limitations, the flexibility to capitalize and defer interest through payment-in-kind (PIK) arrangements. In the sovereign context, Grenada and Barbados, both countries subject to periodic extreme adverse weather, have included so-called hurricane clauses in their bond issues. These clauses allow debtors to capitalize interest payments and to defer principal payments in the event of significant losses due to extreme weather conditions. By alleviating a relatively common cause of debt crises, these clauses encourage investment in otherwise risky emerging markets.

A similar approach could be adopted to avoid short-term liquidity crises triggered by events such as the recent pandemic, rapid and unforeseen exchange rate movements or loss of foreign reserves.[11] In a recent white paper, one large market participant has gone even further and proposed a bond that would allow an issuer to defer two consecutive semiannual interest payments, with an alternative option under which the obligation to make these payments would be waived entirely.[12] Although state-contingent debt — of which deferrals of this nature and hurricane clauses are examples — is generally thought of as a means of providing relief to debtors, it also benefits creditors by avoiding needless default under carefully defined circumstances. As a result, such instruments could encourage both new flows and, where inevitable, sound restructuring terms.

Legislative Tools

Every sovereign restructuring takes place in the context of a legislative framework that influences the behavior of its participants, even if it is less visible than a private sector bankruptcy regime. The parameters of the legislation applicable to sovereigns are so well established and ingrained that they are taken for granted. Sovereigns enjoy broad immunity under most national

11 Myrvin Anthony, Gregorio Impavido, and Bert van Selm, "Barbados' 2018–19 Sovereign Debt Restructuring: A Sea of Change?" IMF Working Paper No. 20/34, 2020, https://www.imf.org/en/Publications/WP/Issues/2020/02/21/Barbados-201819-Sovereign-Debt-RestructuringA-Sea-Change-49044.

12 Carl Ross and Mustafa Ulukan, "Sovereign Contingent Bonds," GMO, August 18, 2020, https://www.gmo.com/americas/research-library/sovereign--contingent-bonds-how-emerging-countries-might-prepay-for-debt-relief/.

laws that serves to protect their assets from seizure and that provides a level of protection that would make any corporate borrower envious.[13]

In addition to the broad protections that most sovereigns enjoy, several countries have recently considered or adopted legislation designed to further protect sovereign borrowers from so-called vulture (or holdout) creditors. To date, the United Kingdom, Belgium, and France have passed legislation to this effect.[14] Lawmakers in New York have recently proposed a bill that would retrofit a collective voting mechanism into bonds governed by New York law. This bill would empower the New York State Department of Financial Services to oversee portions of the negotiating process. It would also prevent so-called vulture funds from buying sovereign debt with the intent to earn a profit through litigation following a default.

Whatever one thinks of these legislative initiatives, they underscore the possibility of influencing the process and even the outcomes of sovereign restructurings by modifying the legislative framework within which they occur or that is likely to govern enforcement action.

Legislative approaches to foster greater participation of private parties in the restructuring process—and to address the unique challenges confronting state-owned enterprises, whose assets and cash flows may be particularly vulnerable to creditor attachment or disruption—may also be promising. However, care must be taken that the benefits of new legislation are not outweighed by adverse effects on the availability and cost of capital.

For example, statutory schemes applicable to private sector debtors in several jurisdictions, including the United Kingdom, Canada, and many emerging markets, allow a supermajority of similarly situated creditors holding claims that are substantially similar (whether bank, bond, or other indebtedness) to modify those obligations.[15] These laws might serve as a template for broader-scale legislation applicable to sovereign debtors. By expanding the pool of creditors that could be bound by collective voting mechanisms, legislation

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13 For example, the US Foreign Sovereign Immunities Act of 1976 (28 U.S.C. §§ 1220, 1332, 1391(f), 1441(d), and 1602–1611) provides that foreign states are immune from the jurisdiction of US courts, with exceptions under 28 U.S.C. §1610 including, primarily, waiver of immunity by the sovereign and an exception for commercial activities. Similarly, under the UK State Immunity Act of 1978, the same presumption of immunity exists, subject to exceptions, including an exception for certain commercial activities.

14 The UK's legislation is narrowly tailored, applying only to heavily indebted poor countries (HIPC) and limiting creditor recoveries to the level set by the HIPC Initiative (Debt Relief (Developing Countries) Act 2010, c.22, § 3). The Belgian law is much broader: it applies to all debtor countries regardless of the debtor nation's wealth, and limits recoveries to the purchase price paid by the creditor (Loi Relative à la Lutte contre les Activités des Fonds Vautours, Moniteur Belge, September 9, 2015, 57357). The French law protects the assets of a country from seizure by a creditor that purchased a debt instrument in default or subject to a pending restructuring proposal if the country was recognized by the OECD as a recipient of official development assistance when the debt instrument was acquired, subject to certain other conditions (Loi n° 2016–1691, Relative à la Transparence, à la Lutte contre la Corruption et à la Modernisation de la Vie Économique, December 9, 2016, Article 60, https://www.legifrance.gouv.fr/loda/article_lc/LEGIARTI000033561959).

15 Companies Act 2006, Part 26, https://www.legislation.gov.uk/ukpga/2006/46/contents; Canada Business Corporations Act, R.S.C. 1985, c. C-44, https://laws-lois.justice.gc.ca/eng/acts/C-44/INDEX.HTML; Argentina Reorganisations and Bankruptcy Law, No. 24, 522; Brazilian Bankruptcy Law—Law No. 11,101 of 2005, Articles 41 and 45.

of this nature could extend the reach of current restructurings well beyond bonds that contain collective action clauses. Where these legislative actions purport to apply retroactively to modify the contractual rights of creditors under existing debt instruments, they will be subject to greater legal challenges than legislation that applies solely on a prospective basis, and the advantages and disadvantages of those approaches will need to be considered.

The protection of assets is of particular concern in the case of state-owned enterprises that own assets or generate receivables outside their home jurisdictions and that may not be protected by applicable foreign sovereign immunity laws. As is the case of Venezuela's state-owned oil and gas company, Petróleos de Venezuela S.A., these entities face significant risks of disruption to their activities and seizure of assets by creditors and suppliers that the traditional sovereign tool kit is ill equipped to address. One way to avoid disruption to a sovereign's economy in these circumstances, and to ensure equitable treatment of creditors, would be for debtor countries to adopt public-sector reorganization laws that protect the functioning and assets of state enterprises but allow for a restructuring of their liabilities in a manner that would be recognized and enforced in other jurisdictions.[16] This solution has worked in the private sector context, where countries that have adopted the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency (1997) routinely recognize and enforce insolvency proceedings involving corporate issuers whose reorganizations are being carried out in their host countries.[17]

Statutory approaches that enhance creditor rights may also be worth exploring. For example, restructured debt issued in consensual sovereign restructurings could be granted priority of payment over the original debt held by creditors who declined to participate in the restructuring.[18] Legislative preferences of this nature, whether they are enacted locally or as part of an international convention that states can elect to apply to their obligations by treaty, could be an effective way to encourage creditors to engage in a

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16 Mark Walker and Richard Cooper, "Venezuela's Restructuring: A Realistic Framework," SSRN (2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3039678; Mark Walker and Richard Cooper, "Venezuela's Restructuring: A Path Forward," Emerging Markets Restructuring Journal 9 (2019): 1–14, https://www.clearygottlieb.com/-/media/files/emrj-materials/issue-9-2018/venezuelas-restructuring--a-path-forward-pdf.pdf?h=16&thn=1&w=16.ashx&hash=6FAD5288D01C063BAEA8F4E9DA59D870D867D0EC.

17 The Model Law was designed to "assist States to equip their insolvency laws with a modern, harmonized and fair framework to address more effectively instances of cross-border proceedings concerning debtors experiencing severe financial distress of insolvency" and provide "a framework for cooperation between jurisdictions, offering solutions that … facilitate and promote a uniform approach to cross-border insolvency" (UNCITRAL, *Model Law on Cross Border Insolvency (1997) with Guide to Enactment and Interpretation*, 2013, https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/1997-model-law-insol-2013-guide-enactment-e.pdf).

18 Similarly, at least one commentator has proposed a template for a model law in which creditors lending new money in the context of a restructuring process would receive a priority repayment claim (Steven L. Schwarcz, "Sovereign Debt Restructuring and English Governing Law," *Brooklyn Journal of Corporate, Financial & Commercial Law* 12, no. 1 (2017): 73, 98, https://brooklynworks.brooklaw.edu/bjcfcl/vol12/iss1/24/).

restructuring. There are other examples of "statutory enhancements" of creditor rights that may even encourage increased lending.[19]

Legislative solutions can also be problematic. If crafted or used carelessly, they can be blunt tools with unintended consequences, and their refinement after enactment can be difficult to accomplish. Any proposed change in the legal landscape therefore needs to be examined thoughtfully in advance.

Role of Rating Agencies

The determination by the three major rating agencies that a deferral by a debtor of debt service payments on its bonds in the context of the DSSI would constitute a "distressed debt exchange" (thus leading to a rating downgrade) became a significant barrier to private sector participation. This determination introduced a nontrivial difference in treatment between bonds, which are rated, and bank and other forms of private debt, which are not rated. The position of the rating agencies is that a deferral of debt service on official or, in most cases, bank debt (both unrated) would not be a rating event, whereas similar action with respect to bonds would be.

Apart from the merits of this determination, it constitutes a real obstacle to the inclusion of different classes of debt in a restructuring. Efforts to persuade the rating agencies to change their approach have been rejected out of hand, and there seems little prospect of achieving a different outcome. That said, the consequences of a rating decision are not in the control of the rating agencies. Therefore, the Working Group will explore the possibility of muting the effect of a downgrade in these circumstances on both creditor participation in restructurings and on market access for debtor countries.

IV. EQUITABLE BURDEN SHARING

Background

In principle, and at the most basic level, the concept of **burden sharing** appears simple and straightforward. It is, in fact, an exercise that national bankruptcy and reorganization courts deal with every day. Courts classify and prioritize claims and creditors based on characteristics determined by law and apportion recoveries accordingly. Virtually all claims against the debtor are dealt with, and creditors do not have the option to stand on the sidelines and retain their claims.

19 One potentially instructive example is the success of the Cape Town Convention, which has encouraged aircraft manufacturers and lessors to engage in business in numerous emerging markets based on the protections afforded to them by the convention. The convention overrides the limitations of establishing secured claims, allowing creditors covered by the convention to take possession of, sell or lease, or collect revenues from their collateral in the event of default—substantive rights that wouldn't necessarily be possible under local insolvency laws ("Convention on International Interests in Mobile Equipment," Cape Town, November 16, 2001, United Nations Treaty Series 2307, p. 285, https://www.icao.int/sustainability/Documents/CPTConvention_AnnexA.pdf).

In a sovereign restructuring, by contrast, there are no generally accepted normative principles to achieve this result, apart from outdated market practices that are manifestly inadequate for the task. At a time of increasing fragmentation of interests, inclusiveness ranks high on the list of objectives to be achieved by the reform of debt restructuring practices.

Burden sharing includes two discrete sets of issues: (1) How to bring all creditors—whether private, multilateral, or bilateral—into the restructuring process; and, (2) How to ensure that the burden of a restructuring is shared among them on an equitable basis. In practice, it is hard to separate the two, as creditors will often accept the notion of inclusion only if what they believe to be their entitlement to special treatment is recognized.

The Working Group will seek to identify elements that should be considered when determining fair burden sharing in an effort to develop a framework for distinguishing between legitimate and spurious claims for special treatment, and in assessing the legitimacy of rules of equivalency. Consensus on such a framework would help to substantiate the legitimacy of a proposed restructuring, thereby fostering broader support among stakeholders.

At a time of increasing fragmentation of interests, inclusiveness ranks high on the list of objectives to be achieved by reform of debt restructuring practices.

Inclusion of All Creditors

There have been three notable efforts to formalize the inclusion of creditors: the Sovereign Debt Restructuring Mechanism (**SDRM**), collective action clauses and the G20/Paris Club Common Framework.[20] The SDRM, a quasi-legislative and bureaucratic approach pursued by the IMF and others in 2002 and 2003, was designed to compel the participation of all private sector holders of sovereign bonds in a restructuring approved by 75 percent of the creditors. Notably, the mechanism would not have applied to official bilateral or multilateral debts. After a lengthy gestation period, the SDRM emerged stillborn for lack of political support from debtor or creditor countries and in the face of vociferous opposition from the financial sector. As a result, the effort was abandoned in favor of collective action clauses.[21]

20 On an ad hoc basis, there is precedent (Iraq and Venezuela) for national governments and (in the case of Iraq) the United Nations, through a Security Council resolution, to protect assets of a debtor country from seizure and thereby leave creditors with no chance of recovery other than through participation in a debtor-sponsored restructuring. State intervention of this nature is, however, a heavy-handed, arbitrary (as opposed to rules-based) and controversial way to enlist creditor support, that tilts the playing field by compulsion and, in the end, may only defer creditor action without leading to a resolution of claims.

21 A mechanism similar to the SDRM was proposed for the eurozone in 2010 (see Francois Gianviti, Anne O. Krueger, Jean Pisani-Ferry, André Sapir, and Jürgen von Hagen, "A European Mechanism for Sovereign Debt Crisis Resolution: A Proposal," Bruegel Blueprints No. 446, 2010). In addition, the Committee on International Economic Policy and Reform proposed a European sovereign debt restructuring mechanism in 2013 (for discussions of these efforts, see, generally, Eric Helleiner, "The Mystery of the Missing Sovereign Debt Restructuring Mechanism," *Contributions to Political Economy* 27, no. 1 (2008): 91–113 (pp. 91, 99); Committee on International Economic Policy and Reform, "Revisiting Sovereign Bankruptcy," October 2013, https://www.brookings.edu/research/revisiting-sovereign-bankruptcy; and Lee Buchheit, Guillaume Chabert, Chanda DeLong, and Jeromin Zettelmeyer, "The Sovereign Debt Restructuring Process," IMF draft chapter, 2018).

Collective action clauses—no matter how well designed—will remain of limited utility as long as they are uniquely applicable to bonds. They are notably absent from virtually all other sovereign liability classes. Moreover, by their fundamental design, collective action clauses require a supermajority to be activated, and creditors seeking to maximize their recoveries have been adept at organizing themselves to obtain blocking positions that preclude obtaining the required consents.

The latest effort to broaden the creditor base in sovereign restructurings is the G20 and Paris Club's Common Framework, applicable by its terms to DSSI-eligible countries only. The Common Framework would require official bilateral creditors of G20 and Paris Club governments to participate on comparable terms. It would also require a debtor that elects to restructure under the Common Framework to seek to obtain treatment as least as favorable from its private creditors as from its official ones (much as the Paris Club rules themselves do). Of course, the participation of bilateral creditors in restructuring agreements is inherently political and relies on voluntary adherence to agreed practices. Thus, the practical impact of the implementation of the Common Framework will be watched closely.

Collective action clauses—no matter how well designed—will remain of limited utility as long as they are uniquely applicable to bonds.

One objective of the Common Framework seems to be an effort to enlist China—by far the largest single creditor of emerging market countries—as a participating, official bilateral creditor, even as multilateral development banks and the IMF itself are accorded special treatment. As a member of the G20, China has agreed to the G20 finance ministers' endorsement of the Common Framework. The implication is that China in principle has agreed to equal treatment of its official creditor institutions in the context of debt restructurings. China has not, however, agreed to become a full member of the Paris Club and has maintained that Chinese institutions should be free to negotiate bilateral arrangements with their debtors on a case-by-case basis on terms that are often not publicly disclosed.

Additionally, China maintains that the state-owned China Development Bank, perhaps its largest lender to developing markets, and other state-owned investors apart from the Export-Import Bank of China, are commercial rather than official entities and, therefore, are not subject to the Common Framework's terms as to full disclosure, transparency, and fair burden sharing in granting debt relief to developing-country borrowers. This characterization of several important Chinese state-owned lenders as commercial lenders has been a source of ongoing friction.

Given the magnitude of China's exposure, its inclusion in restructurings on terms comparable to those of other creditors will be critical to assuring the credibility and effectiveness of future restructuring efforts, as evidenced by the current stalemate between Zambia and its bondholders. That said, comparable treatment of investments is in part a function of the nature of the investments—a distinction absent from the formulation of the Common

Framework. The form of investment and the nature of the direct debtor (for example, a government versus a revenue-generating state-owned enterprise) are material elements in determining the appropriate treatment in a restructuring. If principles of transparency are agreed to that include disclosure of the nature of investments, and if the concept of comparable treatment is accepted, it may be possible to elaborate rules that will satisfy all parties.

Principles of Fair Burden Sharing

Past debt restructurings are replete with special exceptions: At various times, local currency debt, trade credits, commercial credits, bank loans, derivative claims, debt issued at a deep discount, and other liabilities have received special treatment, in both the private and official sectors. In the recent Argentine restructuring, different series of unsecured government bonds received different treatment based largely on different collective action clauses. The Common Framework provides that fair burden sharing and the contributions of creditors will be assessed based on debt reduction in net present value terms, nominal debt service due over the life of the relevant IMF program and the duration of treated claims.

These are unobjectionable criteria, but they are inadequate by themselves to serve as an objective standard. The relationship between the different criteria lacks definition, and the criteria themselves are incomplete. Among other things, it is not self-evident how they should be applied to various categories of debt that are arguably dissimilar. For example, will 30-year debt and 18-month debt; secured and unsecured debt; project finance, guaranteed debt of operating state-owned enterprises, and debt of subsovereigns with identifiable sources of income not dependent on transfers from the sovereign—all receive the same treatment?

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V. STATE-CONTINGENT DEBT

Background

An intriguing option that is receiving renewed attention is the prospect of linking sovereign debt payment terms to a country's capacity to pay. These instruments—referred to as state-contingent debt—differ from conventional debt in that all or a portion of debt service may be deferred, accelerated, or forgiven in whole or in part as a function of one or more designated parameters. If the linkage between the parameter chosen and the country's payment capacity can be designed appropriately and the risk of moral hazard mediated, these instruments could help reduce the frequency of defaults and restructurings.

In the context of sovereign finance, the most prominent example is that of **value recovery instruments (VRIs).** These instruments are designed to provide additional payments to creditors that have agreed to compromise their claims as part of a restructuring in the event of an improvement in the debtor's payment capacity as measured by reference to an agreed benchmark. For example, value recovery payments have been scaled as a function of GDP growth or changes in the price of oil. Argentina, Greece, Mexico, Ukraine, and Venezuela are examples of countries that have issued instruments of this nature.

Although modeled on contingent recovery instruments common in private sector restructurings, VRIs have fallen out of favor in large part because previously issued VRIs have often been poorly designed.[22] As a result, they have not been included in sovereign restructurings since 2015.[23] However, it is possible that well-designed and standardized VRIs could encourage creditors to enter into constructive restructuring negotiations of sovereign debt, much as they have in the case of private debt.

With many countries having increased their debt considerably to deal with the Covid-19 pandemic and still in need of significant new financing, the issuance of state-contingent debt could be a helpful option.

A recent IMF staff paper on state-contingent debt[24] considered this instrument in the context of restructurings only, but the concept potentially could be applied to other uses. With many countries having increased their debt considerably to deal with the Covid-19 pandemic and still in need of significant new financing, the issuance of state-contingent debt could be a helpful option.

Issues of Design

Whether included in the documentation of new borrowings or a restructuring the design of state-contingent debt instruments will need to address several discrete and complex questions. These questions include what event or events will give rise to an adjustment of debt service payments; how should the adjustment be calculated; if triggered, how should the timing or amount of payments be adjusted; and in what circumstances should the sovereign have the right to redeem these instruments. There is no "right" answer to any of these questions.

Market participants reward simplicity, and at first blush, the design of state-contingent instruments would seem to defy standardization. To the extent this is true, these instruments might be better suited to extensions of credit by the official multilateral or bilateral sector, and we understand that this is being considered in some quarters. However, it should be acknowledged that markets also dislike uncertainty. The ability of state-contingent debt instruments to reduce uncertainty in the case of a trigger event should not be

22 However, in the recent proposed restructuring plan for Puerto Rico's commonwealth debt, a plan that has been endorsed by the Federal Oversight Board overseeing the negotiation and a majority of Puerto Rico's commonwealth creditors, contingent VRIs tied to sales tax receipts play a prominent role ("Breaking: PROMESA Oversight Board Files Amended Plan of Adjustment," Reorg Research, March 8, 2021; "Oversight Board's Latest Plan of Adjustment Contemplates Recovery for 'Clawback Claims' in Form of Contingent Value Instruments; Holders of Over $13B of GO, PBA Bonds Now Support PSA," Reorg Research, March 9, 2021).

23 VRIs have been sporadically used since their inception. Grenada's 2015 restructuring included a similar upside instrument tied to revenues of a "citizenship-by-investment" program. The two major debt restructurings in 2020, those of Ecuador and Argentina, did not include VRIs (Charles Cohen, S. Ali Abbas, Myrvin Anthony, Tom Best, Peter Breuer, Hui Miao, Alla Myrvoda, and Eriko Togo, "The Role of State-Contingent Debt Instruments in Sovereign Debt Restructurings," IMF Staff Discussion Note 20/06, 2020; see also IMF, "The International Architecture for Resolving Sovereign Debt Involving Private Sector Creditors—Recent Developments, Challenges, and Reform Options," Policy Paper No. 2020/043, 2020, p. 11).

24 Cohen et. al., "The Role of State-Contingent Debt Instruments," IMF.

underestimated. Options for enhancing the viability of state-contingent debt could include inviting the private sector to make long-term investments in a fund managed (and possibly supported in some fashion) by one or more official multilateral or bilateral entities that would make state-contingent loans to one or more sovereign borrowers. Alternatively, it might be possible to develop a set of principles applicable to a variety of instruments that would substitute for complete standardization but would nevertheless be attractive to investors.

The Working Group's forthcoming papers will explore these issues in depth in an effort to develop a practical approach to state-contingent debt that could contribute to best practices for sovereign liability management.

Market participants reward simplicity, and at first blush, the design of state-contingent instruments would seem to defy standardization.

Bretton Woods Committee

Sovereign Debt Working Group Members

William R. Rhodes is President and CEO of William R. Rhodes Global Advisors, LLC and former Chairman and CEO of Citibank and Senior Vice Chairman of Citigroup. Mr. Rhodes gained a reputation for international financial diplomacy in the 1980s and 1990s as a result of his leadership in helping manage the external debt crises that involved developing nations and their creditors worldwide. Mr. Rhodes is the author of *Banker to the World: Leadership Lessons From the Front Lines of Global Finance*. He is a member of the Bretton Woods Committee's Executive Committee.

John Lipsky is the Peter G. Peterson Distinguished Scholar at the Henry A. Kissinger Center for Global Affairs and a Senior Fellow in the Foreign Policy Institute at the Johns Hopkins School of Advanced International Studies (SAIS). Previously, Mr. Lipsky served as First Deputy Managing Director of the IMF, Vice Chairman of the JPMorgan Investment Bank, and Chief Economist at JPMorgan Chase & Co. He is a member of the Bretton Woods Committee's Executive Committee.

Terrence J. Checki serves as an Independent Director of the Hess Corporation, a trustee of the Franklin Funds, and in various advisory roles. Previously, Mr. Checki was an Executive Vice President of the Federal Reserve Bank of New York, and served as the Bank's Head of Emerging Markets & International Affairs. He is a member of the Bretton Woods Committee's Advisory Council.

Richard J. Cooper is a Senior Partner at Cleary Gottlieb Steen & Hamilton, LLP. Mr. Cooper is one of the preeminent cross-border bankruptcy and restructuring lawyers in the United States and is the recognized leader in cross-border and sovereign restructurings involving companies and countries in Latin America and other emerging markets.

William C. Dudley is a Senior Research Scholar at the Griswold Center for Economic Policy Studies at Princeton University. From 2009-2018, Mr. Dudley served as the President and CEO of the Federal Reserve Bank of New York. Prior to joining the Bank in 2007, Mr. Dudley was a partner and managing director at Goldman, Sachs & Company and was the firm's chief U.S. economist for a decade. He is the Chairman of the Bretton Woods Committee.

Gail Kelly is a Senior Global Advisor to UBS, Director of Singapore Telecommunications, and Member of the Group of Thirty. Previously, Mrs. Kelly served as the Group Chief Executive Officer and Managing Director of two banks in Australia: St.George Bank from 2002 to 2007 and Westpac Group from 2008 to 2015. She is a member of the Bretton Woods Committee's Board of Directors.

Joaquim Levy is Director for Economic Strategy and Market Relations at Banco Safra S.A., and a member of the World Resources Institute's Global Board. Previously, Mr. Levy served as President of the Brazilian Development Bank, Managing Director and CFO of the World Bank Group, and Minister of Finance for Brazil. He is a member of the Bretton Woods Committee's Advisory Council.

Maria Ramos is Non-Executive Chair of AngloGold Ashanti Limited and serves as Independent Non-Executive Director on the Boards of Standard Chartered PLC and Compagnie Financière Richemont SA. Until 2019, she served as CEO of Absa Group Limited. Previously, she served as the CEO of Transnet Limited and Director-General of South Africa's National Treasury. She is a member of the Bretton Woods Committee's Advisory Council and the Group of Thirty.

Susan Segal is President and CEO of Americas Society/Council of the Americas. Prior to her current position, she was a founding partner of her own investment and advisory group focused primarily on Latin America and the U.S. Hispanic sector. Previously, Ms. Segal was a Partner and Latin American Group Head at J.P. Morgan Partners/Chase Capital Partners. She is a member of the Bretton Woods Committee's Board of Directors.

José Viñals was appointed Group Chairman, Standard Chartered PLC in December 2016. Mr. Viñals was formerly the Financial Counsellor and Director of the Monetary and Capital Markets Department at the International Monetary Fund. Mr. Viñals began his career as an economist before spending 25 years at the Central Bank of Spain, where he rose to be Deputy Governor. He is a member of the Bretton Woods Committee's Board of Directors.

Mark Walker is Senior Managing Director at Guggenheim Securities, LLC and a former Managing Director and Head of Sovereign Advisory at Millstein & Co. Previously, he was a Managing Director at Rothschild London, and the Global Managing Partner of Cleary Gottlieb Steen and Hamilton LLP. He is a member of the Bretton Woods Committee's Advisory Council.

THE BRETTON WOODS COMMITTEE
1701 K St NW #950, Washington, DC 20006
www.brettonwoods.org