In the late spring of 1995, Economics
Professor Richard Portes had just arrived
at London Business School when he was
asked by the UK Treasury, Bank of England
and Foreign Office to look at how to deal
with sovereign debt problems, in the wake
of Mexico’s devaluation and debt crisis. He
had plenty of ideas having researched the
same issues when they’d taken hold in the
country ten years earlier. As in the 1980s,
there were fears that the Mexican crisis
could lead to a wave of shocks that would
also affect the international financial system.
The UK authorities wanted to contribute
authoritatively to the fierce international
debate.

Portes drew up a paper with his co-author
Barry Eichengreen, Professor of Economics
and Political Science at the University of
California, Berkeley, which they presented
at the IMF meetings in Washington that
September.

A new standard for debt contracts
They said the problem with bond contracts
was that if a country couldn’t make its debt
payments and wanted to propose other
ways of dealing with it’s bonds, such as
reducing or postponing payments, then any
one of thousands of bond holders could
say no and block the deal. Portes and
Eichengreen recommended collective action
clauses, so that bondholders could vote on
a proposal of how to deal with the debt. If
75 per cent (say) of them agreed to it, then
their views would take legal precedence,
and the proposal could go ahead.

It was widely acknowledged that the
clauses made sense, but big banks gave
their ideas a hostile reception. They didn’t
want any interference with the way they did
business. Portes had to wait until 2003 for
the satisfaction of seeing his ideas become
policy. That year Mexico’s Finance Minister
Agustín Carstens decided to override the
views of the bankers and put collective
action clauses into his country’s bond
contracts. “Mexico was followed by South
Africa, Turkey, Korea and other countries,”
says Portes, “and it quickly became the
standard.”

Bringing change
“It was very exciting when this change in
the sovereign debt system came through
after all the effort we’d put in, making
presentations and talking to officials,” he
adds. “And you do feel like you might have
had some effect for good.”

The impact of this change was seen in
the spring of 2012 when collective action
clauses made it possible for Greece to
restructure its debt and avoid total chaos.
When the country wrote off most of its
private debt, bondholders didn’t get all
their money back but they did at least
receive some, because Greece was able to
impose the clauses and get 75 per cent of
its bondholders to agree to a deal. These
clauses are now required in debt issued by
all European Union countries.

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