Rethinking Sovereign Debt Restructuring

Dr Rodrigo Olivares-Caminal

London, June 2011
“Spain is not Greece”
Elena Salgado, Spanish Finance Minister, Feb. 2010

“Portugal is not Greece”
The Economist, 22 Apr. 2010

“Ireland is not in Greek Territory”
Irish Finance Minister Brian Lenihan.

“Greece is not Ireland”
George Papaconstantinou, Greek Finance Minister, 8 Nov. 2010

“Spain is neither Ireland nor Portugal”
Elena Salgado, Spanish Finance Minister, 16 Nov. 2010

“Neither Spain nor Portugal is Ireland”
Angel Gurria, Secretary-General OECD, 18 Nov. 2010
... and, even on:

By Aram Roston

It is 2002 and the west African country of Liberia has been driven to economic ruin. Liberia's president, Charles Taylor, is an alleged war criminal who bankrupted his country, and the country now faces a devastating civil war. The United States and other Western countries have imposed sanctions on Liberia in an attempt to force the Taylor government to hold free and fair elections. In response, Taylor has refused to step down, and the situation continues to escalate.

Meanwhile, businessman Paul Newman was plotting their next move in the world of vulture capitalism. He had spent nearly $55 million to buy the actual capital of the grand canyon, or Dart Village. In fact, the entire Caymans had spent just $1.4 million to buy a lobbyist to counteract it. "These guys went to change New York law to essentially eliminate Peru's defense," says one lawyer. "We got engaged in a pretty rigorous lobbying effort." The law remained the same, but Elliott momentum paid the judge's verdict and won. Elliott had spent just $1.4 million to buy.

That's just a taste of how profit-
INSOLVENT OR NOT INSOLVENT?
(that is the question)

- Liquidity problems are evidenced when a debtor fails to perform his obligations when they have fallen due (liquidity test).

- Illiquid debtor \(\Rightarrow\) still solvent despite the fact that he is not able to perform his obligations.

- Insolvent \(\Rightarrow\) the amount of obligations has exceeded the value of his assets, quite irrespective of whether he timely performs his obligations (assets test)

- The difference between liquidity and insolvency is difficult to establish—even more in the context of a sovereign state where solvency is presumed.

- Can a sovereign state be declared insolvent (?)
  - tax its citizens
  - dispose of its resources
    - a. natural resources
    - b. part of its territory (e.g. Alaska or Louisiana)
    - c. expropriation of assets of its own citizens
SOVEREIGN DEBT RESTRUCTURING

ECONOMIC LITERATURE ON DEFAULTS (1/1)

- Sovereign debt ≠ private debt: there is no structured approach for managing sovereign defaults or an effective procedure for enforcing sovereign debt contracts.

- Sovereign debt creditors have limited legal recourse: limited enforceability

- Since contracts cannot be easily enforced, why do sovereigns repay?

- The economic literature on sovereign debt has focused on the reputational and trade costs of defaults.

  • Reputational effects:

    +: defaults lead to either higher borrowing costs or more limited access to the international financial markets, and, in the extreme case, to a permanent exclusion from these markets (Eaton and Gersovitz, 1981).

    -: reputational costs appear to be limited and short lived (Borensztein and Panizza, 2009)

  • Trade Costs

    +: defaulters will suffer a reduction of international trade, either as a consequence of direct trade sanctions (Bulow and Rogoff, 1989, Díaz-Alejandro, 1983) or because of lack of trade credit.

    -: there is some evidence that defaults affect trade (Rose, 2005), there is no evidence of formal trade sanctions (at least in recent times) or of a strong causal nexus from default to trade via trade credit (Borensztein and Panizza, 2009).
A possible answer … ONLY strategic defaults (i.e., defaults that could have been easily avoided) carry a high cost.

Defaults due to true inability to pay are unavoidable
- They do not provide any signal on the type of government and do not carry a large cost (Grossman and Van Huyck, 1988).

Knowing the high cost of strategic default, countries will avoid them.

Downside: sovereigns may pay a large cost by trying to postpone a necessary default in order to signal to all parties that the default was indeed unavoidable (Borensztein and Panizza, 2009, and Levy Yeyati and Panizza, 2009).
SOVEREIGN DEBT RESTRUCTURING

Multilateral Lending

Bilateral Lending

Private Lending

Borrowers Perspective

Lenders Perspective

Ex-ante

Ex-post
The relationship between each type of creditor and the debtor is governed by a different set of rules. Upon an event of default, the interest of each type of creditor is different (inverse to the pre-Brady era).
UNDERSTANDING THE DYNAMICS:
CREDITORS’ PERSPECTIVE

- Articles of Agreement (Treaty)

- Paris Club
  (i) An informal group of official creditors willing to treat in a co-ordinated way the debt due to them by the developing countries.

  (ii) It can be described as a "non institution".

  (iii) Makes decisions on a case by case basis in order to permanently adjust itself to the individuality of each debtor country.
SOVEREIGN DEBT RESTRUCTURING

1982: PRE-BRADY PLAN

- **LOAN**
  - Parties: Banks (regulated – Deposit Ins.)
  - Type of relationship: personal
  - Type of Doc.: Loan Agreement
  - Payment: Interest Rate & Quotas
  - Docs: Info. Memo

2002: POST-BRADY PLAN

- **BOND**
  - Parties: Private Investors
  - Type of relationship: impersonal
  - Type of Doc.: Bonds (Indenture)
  - Payment: Coupon & Bullet Payment
  - Docs.: Offering Circular & Prospectus

Exposure: 287.7% of banks' total capital
### Key features of SDRM

<table>
<thead>
<tr>
<th>Mechanism</th>
<th>Legal Stay</th>
<th>Financing Reorganization</th>
<th>Restructuring Debt</th>
<th>Restraining Holdouts</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SDRM – 1</strong>&lt;sup&gt;1&lt;/sup&gt;</td>
<td>Capital Controls + Automatic stay</td>
<td>Preferred Creditors + Limited IMF lending</td>
<td>Negotiations supervised by IMF + IMF program</td>
<td>Super majority voting + Arbitration?</td>
</tr>
<tr>
<td>Krueger (2001)&lt;sup&gt;2&lt;/sup&gt;</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>SDRM – 2</strong>&lt;sup&gt;3&lt;/sup&gt;</td>
<td>Payments standstill + short stay which may be renewed upon the decision of a super majority vote of creditors</td>
<td>Preferred creditor status for new money</td>
<td>Negotiations supervised by neutral agency + IMF program</td>
<td>Super majority voting across all classes</td>
</tr>
<tr>
<td>Krueger (2002)&lt;sup&gt;3&lt;/sup&gt;</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>SDRM – 3</strong>&lt;sup&gt;4&lt;/sup&gt;</td>
<td>Stay upon the decision of a super majority vote of creditors</td>
<td>Preferred creditor status for new money upon the decision of a super majority vote of creditors</td>
<td>Negotiations with creditors + IMF program</td>
<td>Super majority voting across all classes</td>
</tr>
<tr>
<td>IMF (2003)&lt;sup&gt;4&lt;/sup&gt;</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

---


One picture is worth a thousand words ... (this one, probably more!)
There is an informal legal framework built on previous restructuring experiences and mainly NY case law. No formal regime.
SOVEREIGN DEBT RESTRUCTURING

UNDERSTANDING THE DYNAMICS OF SOVEREIGN DEBT RESTRUCTURING

APPROACH TOWARDS A SICK PATIENT

<table>
<thead>
<tr>
<th>Diagnosis</th>
<th>Apply first aid</th>
<th>Determine cure</th>
<th>Operate on patient</th>
</tr>
</thead>
<tbody>
<tr>
<td>What is the real situation?</td>
<td>How can sovereign buy time and minimize impact of crisis?</td>
<td>Which restructuring is the appropriate path for bondholders?</td>
<td>How should sovereign debt be restructured?</td>
</tr>
</tbody>
</table>
SOVEREIGN DEBT RESTRUCTURING

UNDERSTANDING THE DYNAMICS: CREDITORS’ PERSPECTIVE

- Private Investors:
  - Sophisticated vs. Un-sophisticated
  - Trust Indenture v. Fiscal Agency
  - Bonds issued either under NY law or UK law (different amendment terms)

**NY:**
- Payment terms: unanimity (100% of the nominal value of the series)
- Other terms: $66\frac{2}{3}$ % of the nominal value of the series

**UK:**
- Simply majority of the nominal value of each series
- Quorum:
  - Payment terms: persons representing not less than 75 %
  - Other terms: two or more persons representing more than 50%
# Sovereign Debt Restructuring

## Fiscal Agent vs. Trustee Structures

<table>
<thead>
<tr>
<th>Role / Position</th>
<th>Fiscal Agent</th>
<th>Trustee</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Legal Position – Agent of Issuer?</strong></td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Overriding Duty</strong></td>
<td>To the Issuer</td>
<td>To the Bondholders</td>
</tr>
<tr>
<td><strong>Discretionary Powers</strong></td>
<td>Not significant (administrative)</td>
<td>Yes – Can be significant (most enforcement powers vested in Trustee)</td>
</tr>
<tr>
<td><strong>Monitoring duties</strong></td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Position of Bondholders</strong></td>
<td>Can take action individually</td>
<td>Trustee takes action that binds all bondholders (based on Trustee’s own initiative or as instructed by required % of Bondholders)</td>
</tr>
</tbody>
</table>

**Legal Position – Agent of Issuer?**

- **Yes** (admin.): No
- **No** (admin.): Yes

**Overriding Duty**

- **To the Issuer**: No
- **To the Bondholders**: Yes

**Discretionary Powers**

- **Not significant (admin.)**: Yes
- **Can be significant**: No

**Monitoring duties**

- **No**: No
- **Yes**: Yes

**Position of Bondholders**

- **Can take action individually**: Yes
- **Trustee takes action that binds all bondholders (based on Trustee’s own initiative or as instructed by required % of Bondholders)**: No
- **Mostly same as English Law; except that individual bondholders may take action in case of Non-payment**: Yes
Obtain debt sustainability by reducing debt burden in an orderly manner.

Protect the value of the assets and the rights of the creditors to avoid litigation.

Achieve the restructuring over a short time of period to reduce disruptions and re-access capital markets.

Share effort by all the parties involved (exception).
DIFFERENT ALTERNATIVES FOR THE CREDITORS & DEBTOR

**CREDITOR**

- IFIs
  - Roll-over vs. default
  - Moral hazard vs. hair-cut?
- Bilateral Agreements (Paris Club)
  - Roll-over vs. default (A way of hair-cut: NPV)
  - Hair-cut accepted for HIPC (Iraq)
- Private Investors
  - Accept exchange offer (hair-cut)
  - Litigate (organized action vs. individual action)
  - Holdout and ambush debtor (Elliot)

**DEBTOR**

- IFIs
  - Roll-over vs. default
- Bilateral Agreements (Paris Club)
  - Roll-over vs. default (A way of hair-cut: NPV)
  - Hair-cut accepted for HIPC (Iraq)
- Private Investors
  - Exch. offer (haircut?)
    - Exit Consent
    - Contractual Enhancements
  - CACs
  - Collective Actions
  - Trustee v. Fiscal Agent
  - SDRM?
SOVEREIGN DEBT RESTRUCTURING

TGT (The Greek Tragedy)

**ACT I:** Mistmatch ⇒ 31/12/2014 - 150% Debt/GDP ratio (approx.)

**ACT II:** Assuming: NO Haircut
- Primary Deficit to at least "0" (Deficit decreases from 9% to 0% or that there will be a Primary Surplus)
- Interest Rate Cost of 4.6% ⇒ then it should produce a growth rate of at least 5.0% (so as Debt/GDP ratio to remain Stable)

**ACT III:** Way forward?
- Haircut is the only viable solution but buying back bonds at market value (i.e. almost 25% to 30% haircut) will not be accepted because this is going to be a direct Fiscal Transfer from the Countries that finance EFSF + Moral Hazard

**EPILOGUE:** Magic word: Debt Re-profiling (especially now that big part will be on ECB’s hands)

Is debt re-profiling enough?
NO, RESTRUCTURING
SOVEREIGN DEBT RESTRUCTURING

- **EFSF**
  - €440bn

- **EFSM**
  - €60bn

Available to all 27 EU member states

- **ESM**
  - €700bn

  for EAMS

- **EAMS**

  €250bn

  Up to half the amount drawn from EFSF and EFSM
SOVEREIGN DEBT RESTRUCTURING

➢ **Who?:** The European Financial Stability Facility (EFSF) is a Luxembourghish company incorporated in 2010 by the 16 countries that share the euro.

**What?:** Provide temporary financial assistance (3 year loan with an average maturity of 7½ years) to EAMS in difficulty.

➢ **Where?:** EMU

➢ **How?:**
  ➢ issue AAA bonds (backed by 120% guarantees given by the 16 euro area Member States of up to € 440 billion on a pro rata basis) or other debt instruments on the market to raise the funds needed to provide loans.

  ➢ In exceptional circumstances intervene in the debt primary market in the context of a programme with strict conditionality.

  ➢ Not authorised to intervene in the secondary market.

➢ **When?:** EAMS in financial difficulties.

➢ **Why?:** To preserve financial stability of EMU.
SOVEREIGN DEBT RESTRUCTURING

INVESTORS

PURCHASE PRICE

SECURITIES

P+I PAYMENT

CASH RESERVES

EAMS 120% GUARANTEES

BORROWER

LOAN

CASH RESERVE

EAMS BORROWER

LOAN CASH BUFFER

P+i

IMF €250bn

EFSM €60bn

Bilateral Lending

European Financial Stability Facility (EFSF)
EAMS is unable to borrow on markets at “acceptable” (?) rates.

Acceptance of the Programme by the euro area finance ministers

Signing of a MoU

EAMS requests support

A country programme has been negotiated with the European Commission and the IMF

EFSF Loan
CREDIT ENHANCERS

- Guarantees
- Grossing up of guarantees (120% over-collateralisation)
- Loan-specific cash buffer (50bp on the aggregate principal amount)
- Cash reserve (the net present value of the margin of the EFSF loan)
- Such other credit enhancement mechanism as may be approved (Article 5, EFSF Framework Agreement)

- A downgrade of a member country would not necessarily lead to a downgrade of EFSF securities.

- Guarantees are several, irrevocable, firm, unconditional and binding.

- If a guarantor did not respect its obligations, guarantees from others could be called in to cover the shortfall.

- The cash reserve and the loan-specific cash buffer are invested in very safe and liquid assets (asset-liability management conducted by the German Debt Management Office).
EFSF will only provide financial support if an EAMS loses access to markets (NO pre-funded or precautionary credit lines as LOLR under strict conditionality).

It could be agreed with an EAMS that funds are to be used to stabilise the banking sector (see Irish Programme—€35 billion out of the total €85 billion allocated to the banking sector).

The volume of the EFSF, together with the EFSM and the IMF, is large enough to provide temporary liquidity assistance to several Member States of the euro area.

EFSF does not have any currency limitation for its funding activities (majority of funds expected to be raised in €).

EFSF will not crowd other borrowers out of the market ⇒ EFSF will substitute refinancing needs of a country that is unable to borrow at reasonable rates.

Fail to meet conditions? ⇒ the loan disbursements and the country programme would be interrupted ⇒ review of the country programme + renegotiation of the MoU.

Member States that are not members of the euro area cannot access the EFSF (Balance of Payments facility under Council Regulation (EC) No. 332/2002 = €50bn)

Greece financial assistance was arranged prior to the EFSF’s existance
## SHAREHOLDER CONTRIBUTION

<table>
<thead>
<tr>
<th>Member States</th>
<th>Credit rating (S&amp;P/Moody's/Fitch)</th>
<th>ECB Capital Subscription Key</th>
<th>Contribution Key</th>
<th>Maximum Guarantee Commitments (€m)</th>
<th>Adjusted Contribution Key</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>(AAA/Aaa/AAA)</td>
<td>1.9%</td>
<td>2.8%</td>
<td>12,241</td>
<td>3.0%</td>
</tr>
<tr>
<td>Belgium</td>
<td>(AA+/Aa1/AA+)</td>
<td>2.4%</td>
<td>3.5%</td>
<td>15,292</td>
<td>3.7%</td>
</tr>
<tr>
<td>Cyprus</td>
<td>(A-/A2/AA-)</td>
<td>0.1%</td>
<td>0.2%</td>
<td>863</td>
<td>0.2%</td>
</tr>
<tr>
<td>Finland</td>
<td>(AAA/Aaa/AAA)</td>
<td>1.3%</td>
<td>1.8%</td>
<td>7,905</td>
<td>1.9%</td>
</tr>
<tr>
<td>France</td>
<td>(AAA/Aaa/AAA)</td>
<td>14.2%</td>
<td>20.4%</td>
<td>89,657</td>
<td>21.9%</td>
</tr>
<tr>
<td>Germany</td>
<td>(AAA/Aaa/AAA)</td>
<td>18.9%</td>
<td>27.1%</td>
<td>119,390</td>
<td>29.1%</td>
</tr>
<tr>
<td>Greece</td>
<td>(B/B1/BB+)</td>
<td>2.0%</td>
<td>2.8%</td>
<td>12,388</td>
<td>0.0%</td>
</tr>
<tr>
<td>Ireland</td>
<td>(BBB+/Baa3/BBB+)</td>
<td>1.1%</td>
<td>1.6%</td>
<td>7,002</td>
<td>0.0%</td>
</tr>
<tr>
<td>Italy</td>
<td>(A+/Aa2/AA-)</td>
<td>12.5%</td>
<td>17.9%</td>
<td>78,785</td>
<td>19.2%</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>(AAA/Aaa/AAA)</td>
<td>0.2%</td>
<td>0.3%</td>
<td>1,101</td>
<td>0.3%</td>
</tr>
<tr>
<td>Malta</td>
<td>(A/A1/A+)</td>
<td>0.1%</td>
<td>0.1%</td>
<td>398</td>
<td>0.1%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>(AAA/Aaa/AAA)</td>
<td>4.0%</td>
<td>5.7%</td>
<td>25,144</td>
<td>6.1%</td>
</tr>
<tr>
<td>Portugal</td>
<td>(BBB-/Baa1/BBB-)</td>
<td>1.8%</td>
<td>2.5%</td>
<td>11,035</td>
<td>0.0%</td>
</tr>
<tr>
<td>Slovakia</td>
<td>(A+/A1/A+)</td>
<td>0.7%</td>
<td>1.0%</td>
<td>4,372</td>
<td>1.1%</td>
</tr>
<tr>
<td>Slovenia</td>
<td>(AA/Aa2/AA)</td>
<td>0.3%</td>
<td>0.5%</td>
<td>2,073</td>
<td>0.5%</td>
</tr>
<tr>
<td>Spain</td>
<td>(AA/Aa2/AA+)</td>
<td>8.3%</td>
<td>11.9%</td>
<td>52,353</td>
<td>12.8%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>100%</td>
<td>440,000</td>
<td>100%</td>
<td></td>
</tr>
</tbody>
</table>

Source: EFSF
SOVEREIGN DEBT RESTRUCTURING

“The Aaa rating is based on EFSF’s contractual elements, including the irrevocable and unconditional guarantees by the participating states, EFSF’s cash reserve and the loan-specific cash buffer as well as the creditworthiness of the participating Aaa Eurozone Member States and their firm commitment to EFSF.”

“The ‘AAA’ rating is based on the credit enhancement provided by the ‘over-guarantee’ mechanism and cash reserves. The cash reserves will be sized to ensure that any potential shortfall of ‘AAA’ guarantor coverage of EFSF debt payments due in the event of a borrower default will be sufficient to meet all payments.”

“The rating on EFSF reflects our view that guarantees by ‘AAA’ rated sovereigns and freely available liquidity reserves invested in ‘AAA’ securities will, between them, cover all of EFSF’s liabilities.”
### CDO V. EFSF

<table>
<thead>
<tr>
<th>Feature</th>
<th>CDO</th>
<th>EFSF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Enhancer</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Over Guarantee</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Cash Buffer</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Cash Reserve</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Guarantee</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Underlying (Collateral) Asset</td>
<td>✓</td>
<td>X</td>
</tr>
</tbody>
</table>
SOVEREIGN DEBT RESTRUCTURING

IRELAND’S FINANCIAL ASSISTANCE PROGRAMME

- 28/10/10: ECOFIN Ministers, European Commission and the ECB agreed to provide a loan to Ireland to safeguard the financial stability in the euro area and the EU as a whole.

- Total lending programme ⇔ €85 bn.

- The programme for Ireland will be financed as follows:
  - €17.5 bn from Ireland (Treasury and the National Pension Fund Reserve)
  - €22.5 bn from IMF
  - €22.5 bn from EFSM
  - €12.9 bn from EFSF
  - €4.8 bilateral loans:
    UK (€3.8 billion)
    Denmark (€0.4 billion)
    Sweden (€0.6 billion)

- The programme rests on three pillars: (1) strengthening and comprehensive overhaul of the banking system; (2) ambitious fiscal adjustment; and, (3) growth enhancing reforms, in particular on the labour market.
17/5/11: the Eurogroup and ECOFIN Ministers agreed to grant financial assistance.

Total lending programme €78 bn.

The programme for Portugal will be financed as follows:
- €26 bn from IMF
- €26 bn from EFSM
- €26 bn from EFSF

The three year joint EU/IMF programme is based on three pillars: (1) fiscal adjustment (including better control over Public-Private-Partnerships and State-Owned Enterprises; reforms of the health system and of public administration; ambitious privatisation programme); (2) growth and competitiveness enhancing reforms of the labour market, the judicial system, network industries and housing and services sectors; and, (3) measures to ensure a balanced and orderly deleveraging of the financial sector and to strengthen the capital of banks, including adequate support facilities.
24-25/03/11: the European Council confirmed to establish a permanent crisis resolution mechanism – the European Stability Mechanism (ESM).

Operational as of mid-2013 ⇒ following an amendment to the European Treaty by 1 January 2013 (Art. 136)

The ESM will be established as an intergovernmental organisation under public international law.

The function of the ESM will be to mobilise funding and provide financial assistance (under strict conditionality) to EAMS.

ESM may also exceptionally intervene in the debt primary market under the same conditionality.

The ESM will have a capital structure similar to multilateral lending institutions of €700 bn. (effective lending capacity will be €500 bn).
- Paid-in capital (€80 bn)
- Callable capital + Guarantees (€620 bn)
ESM will work closely with the IMF in providing financial assistance + active participation of the IMF (in all circumstances) will be sought on a technical and financial level.

The debt sustainability analysis will be jointly conducted by the Commission and the IMF, in liaison with the ECB.

The policy conditions attached to a joint ESM/IMF assistance will be negotiated jointly by the Commission and the IMF, in liaison with the ECB.

EAMS may participate on an ad hoc basis alongside the ESM in financial assistance operations for euro area Member States.

This therefore means that the ESM would not require the credit enhancements of the EFSF to secure a AAA rating.
"The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality".
SOVEREIGN DEBT RESTRUCTURING

ESM SHAREHOLDER CONTRIBUTION KEY
(BASED ON ECB CONTRIBUTION)

- Austria
- Belgium
- Cyprus
- Estonia
- Finland
- France
- Germany
- Greece
- Ireland
- Italy
- Luxembourg
- Malta
- Netherlands
- Portugal
- Slovakia
- Slovenia
- Spain
... *rara avis* or another layer of bureaucracy?
SOVEREIGN DEBT RESTRUCTURING

ESM Stability Support (ESS) request from a EAMS

The EU Commission and the IMF (+ECB) will be responsible for monitoring compliance with the policy conditionality.

The EU Commission together with the IMF and in liaison with the ECB will assess the actual financing needs of EAMS

ESM’s Board of Directors will then approve the financial assistance agreement containing the technical aspects of the assistance.

The EU Commission and IMF (+ECB) will negotiate a macro-economic adjustment programme with the EAMS in a MoU

EU Council will endorse the macro-economic adjustment programme and the Commission will sign the MoU on behalf of the EAMS.
The EFSF has the same standing as any other sovereign claim on the country (pari passu).

ESM will enjoy preferred creditor status in a similar fashion to the IMF, while accepting preferred creditor status of IMF over ESM.
SOVEREIGN DEBT RESTRUCTURING

THE BIG DILEMMA

... *rara avis*, another layer of bureaucracy?

or

INTERNATIONAL MONETARY FUND
In a small outstanding amount ⇒ a modest investment can position a creditor in the driver’s seat (hold-out = 26% of the issue) ⇒ CACs cannot be used.

At an adjourned bondholders’ meeting where the quorum has been reached with only 25% ⇒ the bond can be cancelled with the affirmative vote of 18.75% of the holders (75% of 25%).

Bondholder’s are not practical (as opposed to US written amendments practice).

Several bondholders meetings for several series of bonds.
The 75% supermajority should be 75% of the aggregate outstanding amount of the issue even if the vote occurs at a bondholders’ meeting.

Reserve Matter modifications could be made either by a vote at a bondholders’ meeting or by written consent.

The list of Reserve Matter should be expanded to include other issues beyond a traditional English-style CAC (e.g. authorization for the trustee or fiscal agent to exchange the entire series).

Aggregation: 85% of the aggregate outstanding amount of all bonds + affirmative vote of at least 66⅔% of the holders of each series affected by the modification.
In order to facilitate this process, standardized and identical collective action clauses (CACs) will be included, in such a way as to preserve market liquidity, in the terms and conditions of all new euro area government bonds starting in June 2013. Those CACs would be consistent with those common under UK and US law after the G10 report on CACs, including aggregation clauses allowing all debt securities issued by a Member State to be considered together in negotiations.
SOVEREIGN DEBT RESTRUCTURING

ISSUES TO BE DETERMINED BEFORE 30 JUNE 2013

- Implementation: Each series or a Master Issuance Documentation?
- Administrator (UK/US Trustee)?: votes, currency conversion, etc.
- Are CACs enforceable on every jurisdiction? Different Interpretations. Governing Law? ⇒ UK (only for the clause or a MID = dépeçage)
- Aggregation + De-aggregation?
- Disenfranchaisement: “owned or controlled (directly or indirectly)”
- Vote packing?
Meetings of Noteholders

Convened by Issuer and Guarantors

Convened by the Trustee upon request of noteholders holding 10%+

All other matters

Extraordinary Resolution

Reserved matters

Q: Representation at least 66 ⅔% of principal amount

Q: 2+ persons representing 50% of principal amount

Adjourned meeting: 2+ noteholders

Written Resolution Signature

Reserved matters: 75+% of principal amount representation

Other matters: 66⅔% of principal amount representation

 Modification and Waiver (not materially prejudicial to the interest of noteholders; of minor matters or to correct manifest error)

Trustee must notify Noteholders

No consent of Noteholders needed
SOVEREIGN DEBT RESTRUCTURING

BUSTING SOME MYTHS ...

- Countries can be insolvent.
- A restructuring implies a default.
- A restructuring will trigger CDS.
- After default, a country cannot re-access the capital markets.
- An EAMS can leave the euro.
- Some of the debts of Greece, Portugal and/or Ireland are odious debts.
- Vulture funds are bad.
- Due to the *pari passu* clause, when a payment is made I will also receive a share.
- EFSF debt has priority.
John B. Moore: 'Changes in the government ... of a state do not as a rule affect its position in international law. A monarchy may be transformed into a republic, or a republic into a monarchy; absolute principles may be substituted for constitutional, or the reverse; but, though the government changes, the nation remains, with rights and obligations unimpaired.'

The rationale behind the state succession doctrine is that the government in office should be separated from the sovereign state.

Jackson v. People’s Republic of China: 'The People's Republic of China is the successor government to the Imperial Chinese Government and, therefore, the successor to its obligations.'

The government is an agent contracting on behalf of the debtor, the sovereign state.
AN ODIOUS MUTATION

Debts of an Odious Regime

Odious Debts

Illegitimate Debts

- All debts are illegitimate: mutation
- What is a despotic Regime? Marcos? Fujimori?
- Who will make the assessment?
- Which will be the competent court?
- Money lent to build a hospital?

SOVEREIGN DEBT RESTRUCTURING

- Exception to the Doctrine of State Succession
- Only apply in cases of newly independent states
- Did not make its way to any norm

‘[t]here is … no justification to characterize these debts as illegitimate in the legal sense’.

a one-off debt relief policy measure and that all future debt forgiveness will be performed through multilaterally coordinated debt relief operations.
Narrow exceptions of the doctrine of state succession made inapplicable the odious debts principle—the ‘supporters of the political approach’ embraced a new terminology.

Multiple definitions of illegitimate debts: (1) debt incurred by non-democratic governments; (2) debts incurred with elements of corruption; (3) debts used against the interests of the people who has to repay them; (4) debts which cannot be serviced without causing harm to the population (threatening the realization of basic human rights); (5) debts incurred with high interest rates (usurary or predatory); and, (6) debt resulting from Brady plan agreements.

The concept of illegitimate debts has not been conceived as a purely legal definition but rather encompassing ethical, social, political and economic implications.

‘Supporters of the political approach’ cannot be subject to a legal analysis because it is not based on legal principles ⇒ lack of the authority to declare illegal the debts.

Illegitimate ⇒ moral, social, legal, etc ⇒ different standards ⇒ neither illegal, nor odious ⇒ **NOT SUBJECT TO LEGAL ANALYSIS**
SOVEREIGN DEBT RESTRUCTURING

Ecuador had gone through two sovereign debt restructurings (95’ and 00’) and managed to obtain substantial debt relief.

2006 Presidential election: a candidate campaigned on a platform that implicitly referred to a redirection of a substantial amount of the money used to service external debt into social programs.

With the pretext to redirect the use of public resources allocated to service Ecuador’s external debt incorporated the CAIC

The audit report produced by the CAIC includes several findings, mainly that there were several cases in which Ecuador’s debt was incurred by illegal and/or illegitimate means.

The continuous increase in oil prices between 2002 and 2008, allowed Ecuador to amass an enviable amount of USD reserves (external debt represented 26.12% of GDP, which was totally manageable).

A 2008 financial report stated that the default might ‘…reflect [an] increased need to have enough fiscal resources to guarantee a successful election result’ and that ‘…it is still difficult to argue that Ecuador’s debt faces a sustainability problem …the current situation is triggered by a lack of willingness to pay (rather than a lack of ability to pay)…’

Ecuador allegedly performed an aggressively secondary repurchase via intermediaries when the price for the defaulted 2012 and 2030 bonds hit rock bottom ((increased trustee responsibility in post-default scenarios + prohibitions against a borrower repurchasing its defaulted debt)).
### ANOTHER CASE STUDY (Ecuador Again!)

<table>
<thead>
<tr>
<th>Most Relevant Findings by the CAIC</th>
<th>Comments on the Findings</th>
</tr>
</thead>
<tbody>
<tr>
<td>The increase of the interest rates by the US Federal Reserve in the late 1970s constitutes an illegal practice</td>
<td>Ecuador does not have the capacity to determine the legality of the monetary policies of the US Federal Reserve.</td>
</tr>
<tr>
<td>The conversion of accrued interests in arrears in Past Due Interest (PDI) Brady Bonds and Interest Equalization (IE) Brady Bonds resulted in anatocism and therefore is illegal</td>
<td>The conversion of accrued interests in arrears into Brady bonds implied a novation of the original obligation giving rise to a new debt instrument with its own terms and conditions. The inclusion of an interest rate in bonds in a common and legal practice.</td>
</tr>
<tr>
<td>Submission to foreign court jurisdiction is contrary to Ecuadorian law</td>
<td>Submitting to a foreign court jurisdiction is a common practice in international sovereign debt transactions. Usually a specific exception is obtained for that purpose. Otherwise, international lenders will not be willing to lend. This is expressly acknowledged in the CAIC report (see page 51).</td>
</tr>
<tr>
<td>Waiver of sovereign immunity is contrary to Ecuadorian law</td>
<td>This is a common practice in the international sovereign debt markets. However, in the UK (SIA §3.1(a)) and the US (FSIA §1605), those activities in which the action is based upon a commercial activity will be considered as an exception to the general state immunity from jurisdiction.</td>
</tr>
<tr>
<td>To maintain a relationship with multilateral organizations (e.g. IMF) is contrary to Ecuadorian law</td>
<td>It seems that what constitutes an illegal practice is to agree in a written contract that Ecuador will maintain a formal relationship with multilateral organizations, i.e. to continue being a member of organizations as the IMF, WB, etc..</td>
</tr>
<tr>
<td>The lack of registration of certain bonds with the US Securities and Exchange Commission is against the law</td>
<td>According to US securities law, bonds can be sold to Qualified Institutional Buyers by means of a private placement of unregistered securities outside the US (Rule 144A and Regulation S). The advantages are that it requires substantially less disclosure requirements and it implies fewer costs. After a seasoning period, the securities can target US private investors.</td>
</tr>
<tr>
<td>The choice of foreign governing law is illegal under Ecuadorian law</td>
<td>The choice of a foreign governing law in international sovereign bond issuances is also a common practice that is usually resolved by a specific norm authorizing it as an exception to the general rule. For example, the ‘Ecuador Noteholder Circular dated 20 April 2009 to submit in a modified Dutch auction to sell Bonds for Cash’ states that the choice of a foreign law (New York law) in the area of public debt affects national sovereignty (see page 16 of the Circular). However, the Circular itself is subject to English law which accounts for a similar situation (see page 13 of the Circular).</td>
</tr>
</tbody>
</table>
EX-ANTE v. EX-POST?

- Assessing sovereign debt, in general terms, can refer to different aspects, e.g. financial, economic, legal, social, etc.

- The assessment can be performed before (ex ante) or after (ex post) a benchmark moment in time which usually is the incurrence of a debt obligation documented in a legal instrument.

- What can be assessed? ⇒ the validity and legitimacy of debt.

- Validity ⇒ an objective test based on the governing law of the debt instrument.

- Legitimacy ⇒ a subjective test that is usually performed under a different political government than the one who incurred the debt obligation (same aim but probably a different criteria for priorities ⇒ the legitimacy of the debt incurrence can be questioned (+ difficult ⇒ shadows of doubts about the “legitimacy” of governments, e.g. corruption or despotic practices.

- Since the analysis is performed ex-post, it entails a degree of uncertainty.
When Raúl Alfonsín took office as the democratic elected president of Argentina after the military regimes (1976-1983), he stated that ONLY those debts that were legitimate were to be honored.

The Argentine Senate unanimously decided the creation of a commission to investigate illicit economic acts performed between 1976 and 1983.

The Argentine Congress passed law 23,062 in May 1984 whereby all acts and norms adopted by the military regime lacked of legal validity.

This law was complemented by law 23,854, repelling the all the financial transactions carried out between 1976 and 1983.

Alfonsín, in an interview stated that the debt audit provided a result different from that expected, ‘...only in a very small, in fact irrelevant, number of cases we were able to effectively prove that we were dealing with [illegitimate] loans...’.
SOVEREIGN DEBT RESTRUCTURING
SOVEREIGN DEBT RESTRUCTURING

**CAMEROON:**
Grace Church Capital
Based in the Cayman Islands
Still in court, seeking $39.7 million

**NICARAGUA:**
Greylock Global Opportunity
Based in the British Virgin Islands
Won $50.9 million judgment

**CONGO REPUBLIC:**
Kensington International
Based in the Cayman Islands
Won $118.6 million judgment

**DEMOCRATIC REPUBLIC OF CONGO:**
FG Hemisphere
Based in the U.S.
(1) Won $151.9 million judgment
(2) Won $81.7 million judgment

**ZAMBIA:**
Donegal International
Based in the British Virgin Islands
Won $15.4 million judgment

- Vulture funds purchase defaulted debt to satisfy the seller’s liquidity requirements.
- Take risk in exchange of face value reduction.
- Vulture funds provide a floor for the value of the debts of many poorly graded borrower countries.
- Illegal actions should be pursued with all the weight of the law.
SOVEREIGN DEBT RESTRUCTURING

THE WAY FORWARD

- It is important to revert this status quo.
- Provide certainty to assess the level of protection of rights, certainty and predictability of outcomes in sovereign debt lending and borrowing.
- The main objective should be to focus more on the fostering of the system as a whole by means of prevention rather than focusing on the ex-post effects, taking into account not only the large number of parties involved but also the multi-faceted nature of the sovereign debt.
- Facilitation? lenders and borrowers should refer to an agreed set of standards to observe during the negotiation phase ⇒ a common reference point in the case of a dispute + enhance responsible practices.
- Guidelines ⇒ of utmost importance: betterment of the debt markets by means of clear and predictable scenarios which are beneficial and convenient for the different parties involved and could even reduce lending costs.

---

RULES

1. you can....
2. you can’t...
3. you can....
4. you can’t
Any Questions?


olivares.caminal@gmail.com
DEFINITIONS

CACs are clauses whereby, if they are included in the prospectuses of the bonds, the interaction of the bondholders is required. There are four different types of CACs. These are: (1) collective representation clauses; (2) majority action clauses; (3) sharing clauses; and (4) acceleration clauses. Within CACs, majority action clauses are the type of clauses that have been strongly pursued by the official sector and many academics, and they were effectively incorporated in bond issuances. Majority action clauses enable the amendment of any of the terms and conditions of the bonds, including the payment terms, if the required majority therein established is obtained. So far, the required threshold to amend the terms of the bonds containing majority action clauses has been 75% in aggregate principal amount of the outstanding bonds (e.g. Egypt, Lebanon, Mexico, Qatar, Uruguay, etc). Brazil and Belize have been the only cases where 85% has been required.

Exit consent is the technique, by which holders of bonds in default, who decide to accept an exchange offer, at the moment of accepting the said offer, grant their consent to amend certain terms of the bonds that are being exchanged. By using the exit consent technique, the exchange offer is conditioned to a minimum threshold of creditors’ acceptance and the amendments to the terms are performed once the required majority has been obtained. By means of these amendments, the defaulted bonds subject to the exchange offer become less attractive (in legal and financial terms), forcing a greater number of bondholders to accept the exchange offer. Otherwise, if holdout bondholders do not accept the exchange offer, they will be holding an impaired bond not featuring some of the original contractual enhancements.