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Sovereign Debt Workouts: Quo Vadis?

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The existing framework for sovereign debt workouts is often described as a 'non-system', a loose mix of Paris Club arrangements for official debts, voluntary renegotiations with commercial creditors, and more ambitious but, ultimately, temporary schemes for debt relief such as the Heavily Indebted Poor Country (HIPC) initiative (which is now nearing its end). With sovereign debt crises looming in a range of countries, from advanced economies to former HIPCs, the question of how such crises should be confronted is again growing louder. Whereas most would agree that the current framework for sovereign debt workouts needs reform, opinions on the design of the reform diverge widely. This policy brief outlines a number of initiatives that are currently under way or on the table and discusses their main advantages and drawbacks.

The rationale for better sovereign debt workouts[1]

Recent events in countries as different as Argentina (see **Box 1**), Greece, Ukraine and Mozambique (see **Box 2**) have made it painfully clear that sovereign debt crises have not been banished to the history books. Moreover, these experiences show that the way sovereign debt problems are dealt with remains very ad hoc. This seems to be especially the case when debts owed to commercial creditors are involved, a category of debt that is growing in importance in developing countries, also in the poorest. Due to increased international bond issuance, relative to syndicated bank loans, the ownership of commercial claims on sovereigns is also more dispersed and fluid than before, complicating collective action (Krueger, 2002).

Since the 1950s debt owed to official bilateral creditors has been dealt with primarily in the Paris Club, an informal forum which evolved from being a mere 'debt collector' into a provider of sequential debt relief to HIPCs and, to a lesser extent, middle-income countries (Cheng *et al.*, 2016).[2] That notwithstanding, official creditor debt too may

1 This policy brief draws in part on but updates our previous work on the topic (see Cassimon *et al.*, 2015).

2 Official multilateral creditors have typically not participated in debt restructurings, given their preferred creditor status, with the important exception of the HIPC initiative and its successor, the Multilateral Debt Relief Initiative (MDRI).

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become harder to restructure in the future, now that non-Paris Club bilateral creditors such as China and India are gaining terrain.

In the past it was often feared that a more elaborate 'regime' for sovereign debt workouts would lead debtor governments to resort to debt restructuring too early and opportunistically ('too much, too soon'). However, the lack of such a regime is now increasingly seen as hampering deep restructurings that provide debtors with a fresh start, and as discouraging governments from initiating debt restructurings in the first place ('too little, too late'). The current 'non-system' is said to be inefficient; both *ex ante*, by standing in the way of prudent borrowing and lending, and *ex post,* since delays in necessary restructurings tend to increase the eventual costs for debtors and (most) creditors (see e.g., Buchheit *et al.*, 2013; Panizza, 2013; IMF, 2013; UNCTAD, 2015; Guzman *et al.*, 2016).[3] There are also concerns about the vulnerability of sovereign debt restructurings to legal challenges, in particular the problem of so-called 'vulture funds' that buy distressed debt at heavily discounted prices and then seek to recover the full nominal amount of claims (plus penalty interests) through litigation of the sovereign debtor in court. Vulture funds and other holdout creditors saw their strategies rewarded in recent debt restructurings, most notably in Argentina (see **Box 1**). As a result, the topic of sovereign debt restructuring was again put firmly on the international policy agenda. For example, it features prominently in recent G20 Communiqués, the Addis Ababa Action Agenda and current work programmes of the IMF, UNCTAD and other organisations.

The remainder of this policy brief outlines two broad, contrasting approaches to the reform of sovereign debt workouts: i.e., a market-based approach focused on enhancements in debt contracts, and a statutory approach which foresees the establishment of a binding multilateral legal framework. We document the progress made so far with both approaches and discuss their respective advantages and drawbacks. We conclude with a brief look into the future of sovereign debt workout reform.

The contractual approach

The contractual approach to sovereign debt workouts exists of enhancing the contractual design of newly issued debt so as to facilitate a more efficient and equitable restructuring of such debt, if needed. This approach is often referred to as 'market-based', since the decision of whether or not to adopt particular contractual terms ultimately falls on the market participants themselves, i.e., the sovereign issuer and its creditors (IMF, 2014). The contractual approach has arguably become the dominant mode of sovereign debt workout reform ever since the IMF's proposal for a treaty-based Sovereign Debt Restructuring Mechanism (SDRM) was voted down (see next section).

Above all, contractual modifications have sought to mitigate the risk of holdout creditors blocking debt restructuring and related collective action problems. Most notably, the inclusion of Collective Action Clauses (CACs) in bond contracts allows the financial terms of a bond to be modified if supported by a qualified majority of bondholders, typically representing 75% of the outstanding principal of a given bond series. In 2003 Mexico issued a seminal New York law bond with such CACs, deviating from the custom of granting each bondholder a veto over contract amendments (Gelpern *et al.*, 2016).[4] Ever since, the inclusion of CACs in international sovereign bonds has become standard market practice, with overall little impact on bond prices (see, e.g., Bardozzetti and Dottori, 2014).

While these 'series-by-series' CACs mitigate collective action problems at the level of a particular bond series, they do not address such problems *across* different series. If a creditor obtains a 'blocking position' (say 26% of face value) in one bond series, it can effectively veto the rescheduling of that series. The possibility of such holdouts could make bondholders in other series too less inclined to accept rescheduling terms (IMF, 2014).

3 Besides changes in sovereign debt workout rules, there are also other instruments that could be employed to promote *ex ante* efficiency in development finance, including UNCTAD and NGOs' guidelines for responsible lending and borrowing and the IMF-World Bank's Debt Sustainability Framework (DSF) (see Cassimon *et al.*, 2016).

4 Sovereign bonds issued under English or Japanese law have a much longer tradition of including CACs that allow for collectively-binding restructuring decisions (IMF, 2014).

In the 2012 Greek debt restructuring, for example, holdout creditors prevented the restructuring of foreign law bond series totalling about US$6 billion by purchasing blocking minorities. Eventually they were paid in full (Zettelmeyer *et al.*, 2013).

Some of the limitations of series-by-series CACs can be overcome by CACs that allow for the aggregation of voting across bond series. A first kind of 'aggregated' CACs uses a 'two-limb' voting structure, which brings down the minimum threshold level of support needed for a restructuring of each bond series (from the typical 75% to 66.7%) and complements it with the requirement of qualified majority support across all series being restructured (75% or 85%). Following the Greek debt crisis, Euro zone countries agreed to make it mandatory to include such 'two-limb aggregated' CACs in all new longer-term sovereign bonds issued from January 2013 onwards, irrespective of governing law. But while the two-limb voting procedure increases the cost of obtaining a blocking position in a particular series (requiring a minimum holding of 33.4%), it does not rule out holdout strategies (IMF, 2014).

Conversely, 'single-limb aggregated' CACs drop the series-by-series voting and require only one aggregated vote with qualified majority across all affected bond series. This makes it nearly impossible for holdouts to acquire blocking positions. In order to avoid discrimination of smaller by larger bondholders, or senior by juniors bondholders, however, single-limb aggregated CACs typically specify that all bondholders affected by a restructuring should be offered the same new instruments or menu of instruments to choose from (IMF, 2014). The power of single-limb aggregated voting was illustrated in the Greek debt restructuring, where parliament passed an act that made it possible to restructure domestic law bonds with the consent of creditors representing two thirds of the aggregated face value of such bonds. These 'retrofit CACs' were crucial in ensuring near-universal participation of Greek law bondholders in spite of large haircuts (Zettelmeyer *et al.*, 2013).

In August 2014, spurred by the Greek debt restructuring and Argentina's court battles, the International Capital Markets Association (ICMA), a trade association representing issuers, investors and capital market intermediaries, formulated an enhanced set of model CACs that includes a menu of series-by-series, two-limb aggregated *and* single-limb aggregated voting procedures (Gelpern, 2014). These enhanced CACs were explicitly endorsed by the IMF's Executive Board in October 2014 and soon thereafter applied in Kazakhstan's English law bonds and Mexico and Vietnam's New York law bonds. The latest available figures reveal that about 85% (in terms of nominal principal amounts) of international sovereign bonds newly issued between October 2014 and October 2016 included such enhanced CACs (IMF, 2016).

ICMA also proposed a new standardised version of the *pari passu* clause. This clause has typically been understood by market participants as a 'ranking' clause (protecting creditors from legal subordination of their claims in favour of other relevant creditors), but in a New York court case against Argentina it was interpreted more narrowly as requiring the sovereign to pay all creditors, including holdouts, on a *pro rata* basis (see **Box 1**). ICMA's modified clause explicitly disavows the latter interpretation (IMF, 2014). The modified *pari passu* clause too has been broadly adopted in newly issued bonds since October 2014, often in conjunction with the enhanced CACs (IMF, 2016).

While contractual modifications such as the ones outlined above limit the tools available to vulture funds and other obstinate holdout bondholders, these changes alone cannot be expected to fix all or even most dysfunctions in sovereign debt workouts (Gelpern, 2014). A first limitation of the present contractual approach is the fact that it only concerns sovereign bonds and hence does not address larger coordination problems across different creditor classes, i.e., foreign bondholders, holders of syndicated bank loans, official bilateral and multilateral creditors, domestic creditors, etc.[5] This reduces the overall relevance of the contractual approach, especially for low-income countries (Krueger, 2002; Panizza, 2013).

Furthermore, by nature of relying on a decentralised, market-based approach, the inclusion and exact formulation of contractual

5 That said, ICMA has proposed a bond 'information' covenant which requires from the sovereign issuer disclosure of its restructuring plans vis-à-vis creditors other than bondholders and of all new (official and private) financing it receives (Gelpern *et al.*, 2016).

clauses will be, at least in part, dependent on the relative bargaining powers and negotiation skills of bond issuers and investors, rather than driven by considerations of efficiency and equity (Guzman and Stiglitz, 2016). Relatedly, there remains a real possibility that 'vultures' (highly specialised in distressed debt matters) will circumvent the enhanced clauses in ways that are difficult to anticipate today. Debt contracts can never incorporate all possible contingencies.

Finally, contractual adjustments to new bonds may take a long time to bite, given that previously issued debt does not include them. As of end October 2016 only an estimated 18% of the total outstanding stock of international sovereign bonds carried enhanced CACs. 33% of that stock did not even include the older two-limb aggregated or series-by-series CACs (IMF, 2016). As these percentages are changing very gradually, the risk of holdouts in debt restructurings will linger on for the foreseeable future. Of course, the transition to better bond contracts could be sped up through liability management operations, including bond buybacks and swaps; a strategy which comes with transaction costs and may be ill-perceived by investors. IMF staff is currently engaging with market participants to evaluate the feasibility of such operations (IMF, 2016).

The statutory approach

In view of the limitations of improved debt contracts, over the years many have argued that a more centralised, statutory approach to debt workouts is needed. At least since the 1970s, proposals for the creation of an international sovereign debt court or similar institution have been floated, in analogy with existing national mechanisms for the restructuring of corporate and municipal debt (e.g., Chapters 9 and 11 of the US Bankruptcy Code) (see Rogoff and Zettelmeyer, 2002).

The proposal that came closest to actual implementation was IMF First-Deputy Managing Director Anne Krueger's Sovereign Debt Restructuring Mechanism (SDRM), first launched in 2001. In essence, the SDRM would provide a legal mechanism allowing a qualified majority of a sovereign's creditors (bondholders, banks and potentially others) to approve a debt restructuring, if needed overriding the underlying debt contracts. Other core features included a stay on creditor litigation after the suspension of debt service; the protection of creditor interests during the stay; and the awarding of seniority to fresh financing by private creditors. A single body would oversee the process of claims verification and dispute resolution (Krueger, 2002).

After two years of intense debate, the SDRM proposal was eventually abandoned at the 2003 IMF Spring Meetings, primarily due to opposition from the US Treasury (reluctant to concede power to the supranational level) and large emerging market countries (worried about higher *ex ante* borrowing costs) (Brooks and Lombardi, 2016).[6]

Triggered by the unfolding Argentinian debt crisis, the idea of the statutory approach was again revived by the G77+China, an intergovernmental organisation of developing countries, at its 2014 summit in Bolivia. In September 2014 the G77+China successfully passed a resolution at the United Nations General Assembly (UNGA) committing it to elaborate and eventually adopt a 'multilateral legal framework for sovereign debt restructuring processes'. Although support for resolution 68/304 was relatively strong, with 124 countries voting in favour, 41 abstentions and 11 votes against, those opposing included the US and the UK, i.e., the main jurisdictions in which foreign law debt is issued.[7] The concerns voiced about the resolution focused on the economic uncertainty such a statutory mechanism would create; on the preference for market-based solutions under the aegis of the IMF; and on the presupposition of the final outcome (i.e., a legally binding multilateral framework), inhibiting genuine discussion.[8]

In December 2014 a follow-up UNGA resolution (69/247) established an ad hoc committee tasked with the preparation of the multilateral legal framework. However, with major creditor(-housing) countries unwilling to participate in the negotiations, the Bolivia-chaired committee was

6 Allegedly, both the US and emerging market borrowers were actively lobbied and influenced by private sector creditors (Brooks and Lombardi, 2016).

7 Other countries voting against the resolution were Australia, Canada, Czech Republic, Finland, Germany, Hungary, Ireland, Israel and Japan. Most of the abstentions were accounted for by other European countries, but also Mexico, New Zealand and South Korea abstained.

8 See, e.g., https://www.un.org/press/en/2014/ga11542.doc.htm.

from the outset limited in what it could realistically achieve. Based on the committee's meetings and similar work by UNCTAD, a third UNGA resolution (69/319) was adopted in September 2015, declaring that sovereign debt restructuring processes should be guided by nine 'basic principles': a sovereign's right to restructure its debt, good faith, transparency, impartiality, equitable treatment of creditors, sovereign immunity, legitimacy, sustainability, and majority restructuring. This time around, 136 countries voted in favour, 41 abstained and only six voted against, including again the US and the UK.[9] Both the US and EU stressed that the way in which some of the principles were formulated seemed to go against international law and practice, and repeated that the IMF rather than the UN was the appropriate place to discuss sovereign debt restructuring-related issues.[10] On the contrary, most developing countries see the UN as the most inclusive forum, much more so than the IMF, which is considered biased, given its role as a creditor and the still dominant position of advanced countries in it.

The nine UNGA principles are non-binding and currently too broadly formulated to be practically useful. Ideally, they could serve as the basis for further negotiations for a SDRM-type statutory mechanism. However, after the principles' adoption, it seems the UN ad hoc committee was disbanded and nothing has since moved on this front.

Moving forward

From the foregoing it thus appears that whereas slow but steady progress is made under the contractual approach to sovereign debt workout reform, the statutory approach has reached an impasse for now, due to lack of support (and even cooperation) by the US, UK and the EU. One way of viewing this is that the creation of a full-fledged, legally binding multilateral debt workout regime dealing with many problems at the same time may be first-best but remains 'practically and politically unfeasible' (Buchheit *et al.*, 2013, p. 29). That does not mean the statutory approach should be discarded altogether.

Recent years have seen a number of interesting proposals for more limited but hence more realistic statutory reforms. We limit ourselves here to three such proposals. The first is to outlaw the business strategies of vulture funds at the national level. In July 2015 Belgian Parliament passed a so-called 'Anti-Vulture Fund Law', which makes it impossible for buyers of distressed debt to use the Brussels-based Euroclear system to enforce claims that give them an 'illegitimate advantage', i.e., if such claims are in disproportion with the price originally paid (Richelle, 2016). The UK passed similar, albeit less comprehensive legislation in 2010. It would be especially useful to extend these legislative initiatives to the US (New York) where litigation has been most prevalent. A previous US Congressional bill attempting to do so, died in committee.[11]

A second possible area for further action is increasing the relevance of the Paris Club, as highlighted by IMF Managing Director Christine Lagarde.[12] Broadening creditor participation in the Paris Club is currently done by inviting other bilateral creditors as ad hoc participants in monthly *Tour d'Horizon* meetings and, where relevant, in negotiations. But ultimately the goal should be to widen permanent membership too. Korea (July 2016) and Brazil (November 2016) were the last two creditors to join the Paris Club as permanent members. China, India and the Arab Gulf states are notable absentees. To counter critiques on its workings, perhaps the Paris Club may also want to invite additional observers to its debt restructuring negotiations.

Third, a watered-down version of the failed SDRM, acceptable to both debtors and creditors, may still be worth pursuing. Ocampo (2016), for example, proposes the creation of a mechanism inspired by the WTO's dispute settlement mechanism, that proceeds in steps. The first step

9 Also Canada, Germany, Israel and Japan opposed the resolution. With the exception of the UK and Germany, all EU member states abstained. Mexico, Colombia and Gabon abstained too.

10 See e.g., http://www.twn.my/title2/finance/2015/fi150901.htm and http://data.consilium.europa.eu/doc/document/ST-11705-2015-INIT/en/pdf.

11 For the 'Stop Very Unscrupulous Loan Transfers from Underprivileged countries to Rich, Exploitive Funds Act' see https://www.govtrack.us/congress/bills/110/hr6796/text.

12 See https://www.imf.org/en/News/Articles/2016/07/06/17/56/SP070116-Paris-Club-60th-Anniversary-Keynote-Address-by-Christine-Lagarde-Managing-Director.

would be for the debtor country to find a voluntary agreement with its creditors. If that fails before a pre-set deadline, an independent institution would intervene to try to mediate a solution. If also a second deadline passes or if requested by the parties involved, the institution would take up the role of arbitrator in the dispute. To placate creditor countries, the new institution would not fall under the UN system (requiring a new international treaty), but would be established by amending the IMF's Articles of Agreement. Provisions would be made so as to ensure that the institution operates independently from the IMF's Executive Board, Board of Governors and Management.

In parallel, the contractual approach to sovereign debt workouts could be deepened too. Besides liability management operations (to deal with legacy debt that has outdated terms), contract-related topics that have received some attention as of lately include the role of creditor committees, and exit consents, as well as state-contingent instruments, such as GDP/commodity price-linked bonds or sovereign contingent convertible debt (CoCos) (See e.g., Das *et al.*, 2012; Brooke *et al.*, 2013; DeSieno, 2016; Guzman and Stiglitz, 2016). An in-depth discussion of these topics falls outside the scope of the current policy brief.

Even if the reform path is likely to be long and winding, it should be remembered that sovereign debt restructuring is typically not a zero-sum game. Costs to both debtors and creditors (with the exception of vulture funds perhaps) can be avoided by making the sovereign debt workout process quicker, more comprehensive and less adversarial.

Box 1: Argentina

Argentina defaulted on its public debt in December 2001. After long but inconclusive negotiations, the country withdrew from the negotiating table and made a unilateral offer to its private creditors in 2005. 76% of its creditors accepted the offer and exchanged their claims at about a third of the original face value. A re-opening of the exchange in 2010, at slightly less generous terms, increased participation to 93%. The remaining 7% holdout creditors, led by NML Capital (a 'vulture fund' with a long tradition of litigation), continued to demand full repayment from the Argentinian government. They argued that Argentina had violated the *pari passu* clause in its original bond contracts by paying debt service on the restructured but not on the original bonds.

The case gained momentum when in December 2011 New York Federal Judge Thomas Griesa ruled in favour of the holdouts by interpreting the *pari passu* clause as requiring 'ratable' payment (in contrast to its usual interpretation as a 'ranking' clause, prescribing equal treatment of creditors): if Argentina continued to pay periodic coupons to its restructured bondholders, it should also pay all interests and principal amounts owed to the holdouts. Argentina refused to comply with this ruling, after which Griesa ordered financial intermediaries to stop forwarding payments to the restructured bondholders and instructed Argentina to negotiate with the holdouts. Following two unsuccessful appeals by Argentina to the US Supreme Court, Griesa's blocking orders were executed in the summer of 2014 and led Argentina to default once more, now on its restructured bonds.

Only in early 2016 the Argentinian debt saga finally settled when, in the wake of the election of President Mauricio Macri, Argentina reached an agreement with its four main holdout creditors (including NML Capital) to pay them US$4.7 billion or about 75% of the demanded sums. This convinced US courts to lift their injunctions barring Argentina from paying its restructured bondholders. In April 2016 Argentina finally returned to international capital markets, after a 15-year hiatus, selling a record amount of US$16.5 billion.

Sources: IMF (2014), Hébert and Schreger (2016), Wall Street Journal, Financial Times and Bloomberg.

Box 2: Mozambique

In 2013, Credit Suisse and Russian bank VTB helped newly created Mozambican state-owned company *Empresa Moçambicana de Atum* or EMATUM to borrow US$850 million from investors through a private placement of seven-year amortising loan participation notes, ostensibly to fund the purchase of a tuna fishing fleet. When the IMF was informed of this credit and the sovereign guarantee it carried, Mozambique was asked to explicitly include it in the state budget. By 2015 it was widely reported in the international press that proceeds of the EMATUM issue had been used in part to purchase maritime defence equipment, in the form of military vessels imported from French shipyard CMN, rather than just tuna fishing boats. Meanwhile, EMATUM reported heavy losses. More importantly, rapidly falling international oil and gas prices led to the drying up of FDI flows into Mozambique, large exchange rate depreciation and shrinking foreign exchange reserves.

After months of uncertainty and speculation among investors, Mozambique in March 2016 suddenly proposed to exchange the outstanding notes, worth US$697 million, for a US$727 million Eurobond with bullet repayment of the principal in 2023. This would ease the immediate financial pressures on Mozambique coming from the amortisation of the notes and would give the country three extra years to monetise its recently discovered but still-to-be exploited oil and gas reserves. Thanks to the substantially higher coupon rate of the Eurobond, the exchange was considered investor-friendly and ensured the participation of more than 85% of the noteholders.

Soon after the restructuring, however, journalists brought to light that Mozambique had secretly, and without parliamentary approval, guaranteed loans to two other state-owned companies involved in maritime security, i.e., Proindicus (US$622 million) and Mozambique Asset Management (MAM) (US$535 million), and had taken out secret suppliers' credits of US$221 million between 2009 and 2014. It appeared that the loans had been negotiated and signed off by then president Armando Guebuza and his inner circle, and that Privinvest, the owner of CMN (where EMATUM's military vessels were constructed), was the main contractor in the deals financed by Proindicus and MAM. In response to the revelation of almost US$1.4 billion in hidden debt, the IMF terminated its Standby Credit Facility arrangement with Mozambique and a group of 14 donors suspended their budget support. An independent audit into Mozambique's public debt and the various associated deals was ordered from risk management firm Kroll, which is due to report mid-2017. The US Securities and Exchange Commission (SEC) as well as British and Swiss financial watchdogs have started to investigate the role of Credit Suisse and VTB in arranging the different loans, which some of the EMATUM/Eurobond investors claim to have been unaware of.

The drying up of donor support and continued low-commodity price environment pushed the Mozambican government in December 2016 to declare it would be unable to service its current debts (which the Ministry of Finance estimated to total around 130% of GDP), including the just-restructured Eurobond. In January 2017 Mozambique failed to pay out the Eurobond's very first US$60million coupon payment and, after a 15-day grace period had passed, the country was officially in default. Eurobond investors, including AllianceBernstein and Franklin Templeton, have formed a credit committee but have refused to negotiate with the Mozambican government before the results of the debt audit are in and the IMF clarifies its future engagement with the country.

Sources: Hanlon (2016), Wall Street Journal, Financial Times, Bloomberg and Reuters.

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