

Emerging Issues in Sovereign Debt

What can developing countries do?

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Policy goal: Debt crisis prevention and stabilization in stress periods

Prevention

1. Information
2. Standardization
3. Liability management

Stabilization in stress periods

1. Provision of safety valves in contracts to allow creative solutions
2. Reducing the threat of holdouts and litigation through contractual arrangements for bonds and commercial bank loans
3. Improving process – role of trustees vs. Fiscal agents

Information: The missing pieces

- Essential information about sovereign debt is fragmented, costly to procure, and unintelligible
- Stakeholders know less than they think they do
- “Standard-form” contracts are a case in point

Missing pieces (contd.)

- Incomplete and inconsistent reporting of “domestic” and “external” debt
- Residence of holders
Location/“jurisdiction”/governing law
- Incomplete and inconsistent reporting of contract terms/Private offerings, loans
- No central, comprehensive, standardized reporting of restructuring outcomes, and “haircuts” studies
- Incomplete and inconsistent reporting of contingent liabilities

Adverse consequences

- Incomplete, inconsistent information leads to poor risk management and poor accountability
- Unintended variation in supposedly standardized contracts is a source of legal risk (*see e.g.*, NML v. Argentina)
- Do market participants have the information to assess and manage risk?

Improving crisis prevention and management

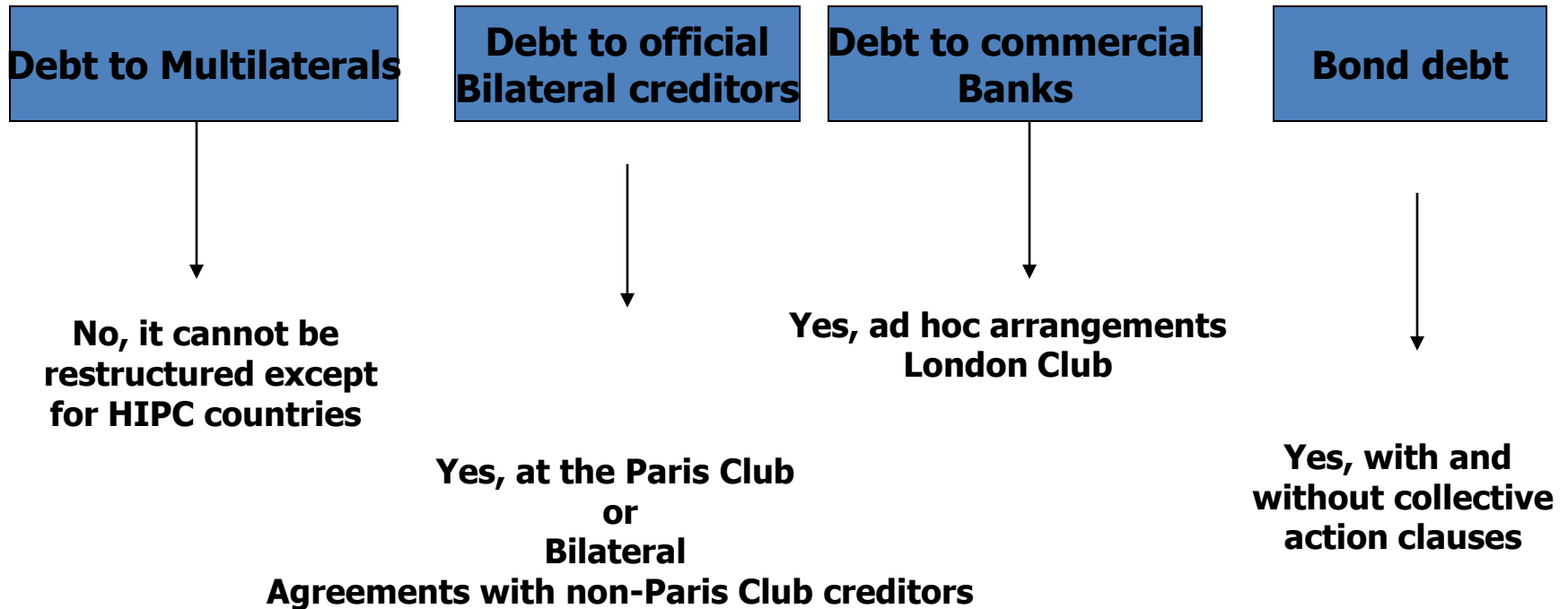
- Institutional memory of past debt restructurings
- Improvement in debt data collection and reporting
- Standardise essential features of contracts
- Liability and debt management

Litigation in sovereign debt defaults is more common than the general perception

- 50% of debt crises involved legal disputes affecting 25 countries (data base covers borrowings under US and UK jurisdictions)
- Increasing strength of holdout creditors – Argentine case is part of a general trend
- Creditor returns high in litigation cases. For example 400 % for Elliot in Peru

Shumacher, Trebesch and Enderline “Sovereign Defaults in Court”
(May 2014)

Fragmented Architecture



Reforms in contractual technology for bonds

- The introduction of CACs in bond issues following the failure of the SDRM in 2003

(CAC allows a supermajority of bondholders within a series of bonds to agree to a debt restructuring that is legally binding on all holders of the bond, including those who vote against the restructuring)

- New aggregated CACs (endorsed by IMF and G20 in 2014)

(allowing majority bond voting mechanisms to operate across multiple series of bonds, thereby ensuring minorities across series of bonds can be crammed down in order to minimise any holdout creditor problems)

- Standardized *pari passu* provision (endorsed by IMF and G20 in 2014)

(disavowing any ratable payment interpretation (as was followed in the case of Argentina))

Progress in implementation

- Approximately 87.1 percent of new international sovereign bond issuances since October 2014 (in nominal principal amount) included enhanced CACs
- Modified *pari passu* provision 80.6 percent
- No observable market impact on inclusion of the enhanced clauses

The problem

- Only 27 percent of total outstanding stock of bonds as of end-September 2017 have enhanced clauses
- 30 percent of such bonds are maturing in more than 10 years, and 48 percent of them are below investment grade. Of the bonds maturing in more than 10 years, 68 percent of these are governed by New York law, and may pose the highest risk of holdout behavior

(Source: IMF, Third Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts, December 15, 2017)

Commercial bank loans (CBL)

- Latin American debt crisis – Commercial bank loans – Lost decade
- Broader trading entities not covered by legislation – makes cohesive solutions difficult
- Innovations in CBL contracts can reduce the likelihood of a holdout and “mitigate the problem of too little too late.” Replicate progress in bond contracts in loan contracts

Restructuring techniques for bond and loans differ

- Bonds – exchange offer – old securities exchanged for new reflecting amended terms
- Syndicated bank loans are just amended or refinanced
- Syndicated bank loans – a majority can accelerate the loan
- On amendment, synd. bank loans still normally require a unanimous consent on payment terms

Assignment clause in commercial bank loan contracts

- Introduce assignment clauses to limit assignments to “financial institutions” so the issuer’s debt doesn’t fall into the hands of unscrupulous people.
- It is to be noted the fact that approval rights for assignments (usually that it can’t be unreasonably withheld and must be granted by a certain time) disappear in the default context

Amendment clause in commercial bank loan contract

- Modify amendment clauses to supermajority rather than unanimity concept
- As a supplement to the above add:
 - Qualified exchange transactions
 - Amend and extend clause
 - Refinancing clause etc.

Pari passu clause in Commercial bank loan contract

- No apparent reason why the new *pari passu* language should not be equally relevant in the loan agreement context
- Clarify the scope of the *pari passu* clause
- If market-standard Amend and extend and/or refinancing clauses are used, ensure that the term *pari passu* in those clauses does not conflict with the meaning of the term in the separate *pari passu* representation and warrant/covenant

Submission to jurisdiction clause

- Seek to limit jurisdiction to the exclusive jurisdiction of specified courts for initial judgments
- Likely requirement that jurisdiction follows countries of credit

Sharing clause in commercial bank loan contract

Draft sharing clause such that any proceeds from litigation have to be shared equally with other creditors will reduce the incentive for litigation

Setoffs

in commercial bank loan contract

- The consent should relate to amounts owed at the time of setoff
- Waiver of immunity should be carefully evaluated
- Limit trigger for setoff clause to acceleration event rather than default

Use of Trust Structures for Bonds

- Historically bonds issued under Fiscal Agency Agreements (issuer's agent) thru whom payments are made (individual bond holders have the right to initiate legal proceedings)
- Under a trust structure, trustee holds the contractual rights for the bondholder and can only initiate when an agreed %age of bondholders ask it do so
- Approximately 42 percent (in nominal principal terms) of international sovereign bond issued between October 1, 2014 and September 30, 2017 have used trust structures

- Under the trust structure, payments received by the trustee are the bondholders' property, not subject to attachment by third party creditors of the issuer (although some fiscal agency agreements can provide that payment to the agent is for the benefit of bondholders).
- A trustee is responsible to enforce the provisions on behalf of all the bondholders (assuming the requisite number of bondholders so direct the trustee, which also reduces the risk of holdout creditors, but is not a guarantee against it
- Some of the downsides of the trustee structure relate to questions of money and alignment of incentives.

Other issues

- New debt instruments
- Standstills through contractual technology
- Debtor creditor engagement – should not be contractual
- Role of IMF, LIA, good faith
- Regulation

Institutional work agenda

- Encourage the IMF to play a greater role in the provision of information, standardisation, and a record of restructuring agreements
- The IMF, World Bank and G20 set up a global debtor and creditor reporting of debt for better coverage, reliability and comprehensiveness
- The regulatory issues can be considered for further discussion by standard setting bodies, the FSB, the G20, and the IMF
- The World Bank/G24 can set up its own study group to provide a template for standardised bond and commercial bank loan contracts

What can developing countries do?

- Debt data – comprehensive and standardized data records
- Liability management
- Give attention to the legal documentation in contracts
- Include aggregation and pari passu clauses both in bond and **commercial bank loans**
- Issuers of sovereign bonds can consider the recommendations on contracts, trust structures and disclosures
- Review existing commercial bank loan and bond contracts