Sovereign Debt Restructuring: Current Challenges, Future Pathways

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Outline

- A backgrounder on sovereign debt restructuring
- Global consultations on sovereign debt restructuring
- Preliminary feedback from global consultations

Sovereign Debt Restructuring: The Basics

- Sovereign debt restructuring is an exchange of outstanding government debt, such as bonds or loans, for new debt products or cash through a legal process. It can take one or both of two forms:
  1. ***Debt Rescheduling***: extending contractual payments into the future and, possibly, lowering interest rates on those payments.
  2. ***Debt Reduction***: reducing the nominal value of outstanding debt.
- Sovereign defaults and debt restructurings have occurred regularly since the early 19^{th} century. Since 1950, there have been over 600.
- Recent developments strongly suggest that sovereign debt crises will remain a serious problem in the coming years.
- At the same time, new challenges and opportunities to governing sovereign debt – including through restructuring – are emerging.

New Challenges

- The ***euro zone crisis*** showed that sovereign debt crises, which now affect "rich" countries, are not going away or getting any easier to resolve.
- It also revealed new, or intensified, economic challenges associated with sovereign debt distress, and the handling of the crisis revealed significant gaps in the way sovereign defaults and debt restructurings are governed.
- More recently, the legal battle between Argentina and its "holdout" creditors (***Argentina v. NML Capital***) has cast uncertainty on the legal aspects of sovereign debt and the viability of smooth restructurings in the future.
- At the same time, sovereign debt burdens remain high in much of Europe, are rising to dangerous levels in many African countries, and are becoming more of a challenge for many other developed and developing countries.

New Opportunities

- Relative power in the global economy is shifting from advanced economies to developing and emerging ones, creating new important players – with their own priorities and interests – in global economic governance.
- Emerging economies will become increasingly important in shaping the international sovereign debt architecture.
- For instance, as the world's largest creditor, China has a direct stake in promoting strong (rule-based) system for preventing and resolving sovereign debt difficulties. Its creditor status gives China growing influence.
- The IMF is looking to reform its lending framework to better deal with cases of sovereign debt restructuring.
- At the urging of the G77, the UN General Assembly recently passes a resolution that mandates the UN to create a "multilateral legal framework for sovereign debt restructuring."

Should We Reform the International Debt Architecture?

Against Reform

- The status quo has a ***proven track-record*** of success.
- Making restructuring easier would make ***defaults more frequent***.
- More frequent defaults ***will increase borrowing*** costs for sovereign debtors and thus ***undermine development.***
- Easier restructurings and more frequent defaults ***will undermine the bonding role of debt and thus the functioning of sovereign debt markets***.

For Reform

- Even if becomes easier or less costly to default or restructure, ***countries still face strong incentives not to***.
- The status quo of IMF bailouts creates ***creditor moral hazard*** which contributes to the build-up of unsustainable debt.
- The current approach leads to ***deadweight losses*** which worsen the economic welfare of debtors, creditors, and entire economies.
- The current approach also fails to deal with the various ***equity issues*** that arise from, and complicate, sovereign debt restructurings.

What Types of Reform Are Needed?

- The ***Contractual Approach*** embodied in collective action clauses (CACs);
- The ***Statutory Approach*** embodied, for instance, in the IMF's 2001-2003 proposal for a sovereign debt restructuring mechanism (SDRM);
- The ***Arbitration Approach*** embodied in proposals for a sovereign debt tribunal or arbitration process.

The Contractual Approach

- The contractual approach (as embodied in CACs) involves specifying the procedures for a sovereign debt restructuring in the legal contract that governs a given sovereign bond or bond series.
- While CACs have been common in the UK since the late 19^{th} century, they have only become widespread in the US since 2003, when Mexico became the first major emerging market to issue them.
- By 2004, close to 90% of new international bonds included CACs.
- Recently, Europe has introduced a new requirement that all euro zone sovereign bonds issued after January 1, 2013, include CACs.

The Contractual Approach (Cont.) New ICMA Clauses

- Recently, the International Capital Market Association (ICMA), alongside a US Treasury-led working group, has made significant efforts to strengthen CACs.

- In August 2014, the ICMA released new standard CACs designed to aggregate and bind disparate bondholders to a common restructuring agreement, and a standard *pari passu* provision designed to prevent the type of bondholder litigation brought against Argentina.

- Already, these new CACs have been adopted by Chile, Ethiopia, Kazakhstan, Mexico, and Vietnam in recent bond issuances.

The Statutory Approach

- The statutory approach calls for the creation of a formal treaty-based sovereign debt restructuring regime – something akin to an international bankruptcy court or procedure for sovereign states.
- The most prominent example of a statutory approach is the Sovereign Debt Restructuring Mechanism (SDRM), which was proposed by the IMF in 2001 but dropped from the agenda in 2003.
- While CACs are issued unilaterally and therefore are decentralized, a SDRM would be decidedly centralized.
- Critics suggest that a SDRM-like arrangement would be more unfriendly to markets than CACs. For these reasons and others, a statutory approach is often seen as politically infeasible.

The Statutory Approach (Cont.)
UNGA Resolution

- Still, significant efforts to move toward a formal statutory approach have been revived.
- At the urging of the G77, the UN General Assembly passed a resolution on 9 September 2014 that calls for the creation of a “multilateral legal framework for sovereign debt restructuring.”
- Although 124 countries voted to pass the resolution, almost all countries with major financial centers voted against it, including the US and the UK.
- Without support from these major financial powers, where sovereigns place most of their emissions under foreign law, efforts to create a formal framework for sovereign debt restructuring would be of limited effectiveness.

The Arbitration Approach

- The arbitration approach, such as a Sovereign Debt Tribunal (SDT), would involve an international arbitration process designed to adjudicate disputes arising from sovereign debt restructurings.
- To ensure neutrality, a SDT would be established under the auspices of a multilateral institution that is not itself a creditor, such as the UN.
- Like a SDRM, a SDT would be able to bind creditors and debtors to common solutions and thus overcome many of the collective action problems associated with sovereign debt restructuring.
- Like CACs, the use of a SDT in the event of a restructuring would have to be agreed by all parties prior to lending/borrowing. Sovereign bond contracts would thus have to include arbitration clauses.

The IMF and Sovereign Debt Reprofiling

- When the IMF is fundamentally unsure of the sustainability of a sovereign's debt level, it advocates an approach whereby the sovereign reprofiles – rather than restructures – its debt before becoming eligible for IMF assistance.
- Under reprofiling, there would be an extension of maturities on existing sovereign debt, but no change to the interest or principal – essentially, it is a way of giving sovereigns more time to repay debt.
- In cases of genuine uncertainty regarding a country's debt sustainability, reprofiling could help buy much needed time to assess the situation, restore growth and debt sustainability, and avoid the steep costs of potentially unnecessary bailouts and restructurings.

Sovereign Cocos and GDP-Linked Bonds

- **Sovereign cocos:** bonds that would automatically extend in maturity when a country receives an IMF loan. Cocos would be similar to reprofiling in effect, but different in design. Cocos would be written into bond contracts, while reprofiling would be a condition of IMF lending.
- **GDP-linked bonds:** the bonds that directly link principal and interest payments to the nominal level of a country's GDP, so when its GDP falls, so too do its debt servicing payments. While sovereign cocos are meant to address liquidity crises, GDP-linked bonds reduce the likelihood of a solvency crisis.
- The appeal of these two complementary bonds is that they do not require collective multilateral action to come about and they fit broadly within a "market-oriented" approach, both of which make them more politically feasible than some of the alternatives.
- Advocates of this approach note that the widespread introduction of collective action clauses (CACs) from 2003 onward provides precedent for this type of sovereign bond contract change.

The Sovereign Debt Forum (SDF)

- The SDF would be a semi-formal institutional venue where sovereign debtors and their creditors could come together (without stigma) and discuss concerns and strategies for dealing with sovereign debt.
- The SDF would be a non-statutory body, modelled loosely on the Paris and London Clubs but with wider membership.
- While sovereign cocos and GDP-linked bonds represent an extension and improvement of the contractual approach, the SDF breaks from the statutory-contractual dichotomy altogether.
- Arguably, the SDF is well positioned to deal with the fact that sovereigns tend to delay restructuring their debts even when necessary, because it provides "a venue for proactive discussions between debtors and creditors to reach early understandings on treating specific sovereign crises" (Gitlin and House 2014: 7).

Bondholder Aggregation and Immunized Payments

- Enhancing **bondholder aggregation** would mean strengthening CACs so that a supermajority (e.g. 85%) of *all* bondholders, rather than just the holders of an individual bond series, could decide to restructure debt against the will of a minority of holdout creditors.
- Holdouts often succeed thwarting a restructuring agreement by buying up "blocking positions" in individual bond series (e.g. 16% of bonds when an 85% supermajority is required to amend payment terms). Aggregation will thus help reduce the effectiveness of holdouts.
- As the recent Argentina case shows, holdout creditors have also managed to inflict collateral damage on sovereign debtors by interfering with payments being made by the sovereign to other creditors (third-parties) under performing debt contracts.
- To counter this, laws and/or regulations could be introduced in major financial centers in order to **immunize payments** and clearing systems from attempts to target third-party payments streams.

Global Consultations on Sovereign Debt

- The Global Consultations on Sovereign Debt were initiated by the Centre for International Governance Innovation (CIGI) and are being coordinated by the New Rules for Global Finance Coalition.
- The Consultations seek to identify the full spectrum of proposals and ideas for addressing sovereign debt crises, and organize these ideas in a way that moves the debate forward.
- To do so, they bring together and galvanize input from, a diverse group of stakeholders around the world, including academics, civil society groups, government officials, lawyers and legal experts, international organizations, practitioners, think tanks, and others.
- Independent from any official/multilateral organization

Global Consultations (Cont.)

- Participation in the Consultations is organized around Webinar discussions, video conferences, workshops, meetings, and written responses to a broad Issues Paper on sovereign debt restructuring.
- As part of its broader global engagement, CIGI has also co-hosted a series of regional workshops on sovereign debt restructuring (first in China, then Africa, and next in Latin America) to take stock of regional experiences and perspectives on a timely and critical issue.
- Once the Consultations are concluded later in 2015, CIGI will be releasing a report that synthesizes the contributions from these various stakeholders in a way that can engage with, and inform, mainstream debates on sovereign debt restructuring.
- http://www.new-rules.org/what-we-do/sovereign-debt-consultation

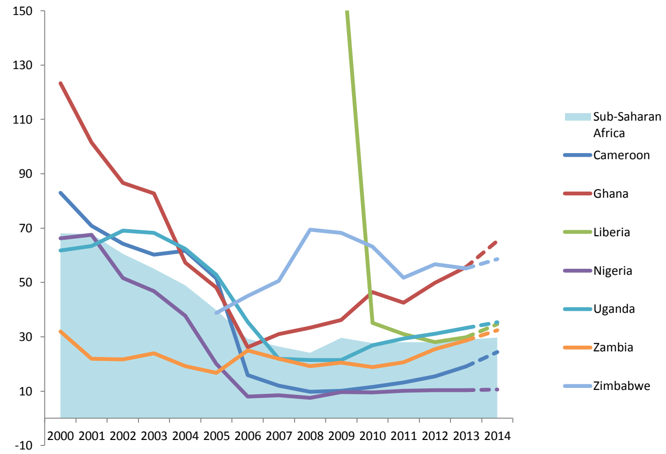
China's Concerns and Interests

- When it comes to sovereign debt, China's main concern has to do with "safeguarding the value of its overseas assets from the detrimental effect of macroeconomic policies of Western countries, especially the United States."
- China also lends large amounts to Africa and other regions, and thus has a large stake in how sovereign debt and debt difficulties are managed there.
- With a huge portfolio of sovereign claims, it's not surprising that China places more emphasis on *preventing*, rather than managing, sovereign debt crises.
- China thus has a strong interest in promoting a rule-based system that does facilitate necessary restructurings and, in doing so, discourage over-lending and the mispricing of risk.

African Concerns and Interests

- African experts and policymakers have expressed great concern over the recent and sharp rise in government debt throughout the continent, and the consequent prospect of a new round of sovereign debt crises in Africa.
- Traditionally, African countries have borrowed mostly from multilateral lenders and the Paris Club. But African countries are increasingly turning to international capital markets and new bilateral lenders – China and other emerging market governments – for their borrowing needs.
- This means that the creditor-specific mechanisms used to facilitate past debt restructurings in Africa (Paris Club workouts, HIPC/MDRI, etc.) are fading in relevance and will be of diminished utility in the event of future debt crises.
- This situation gives African countries an interest in promoting and helping to build a new international framework for sovereign debt restructuring.

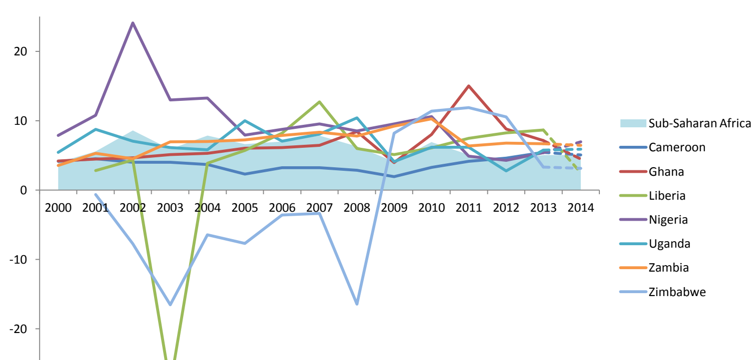
Debt-to-GDP (Africa)



Source: IMF World Economic Outlook Database, 2014.

Ghana's debt-to-GDP has risen the fastest, from 26% in 2006 to ~65% in 2014

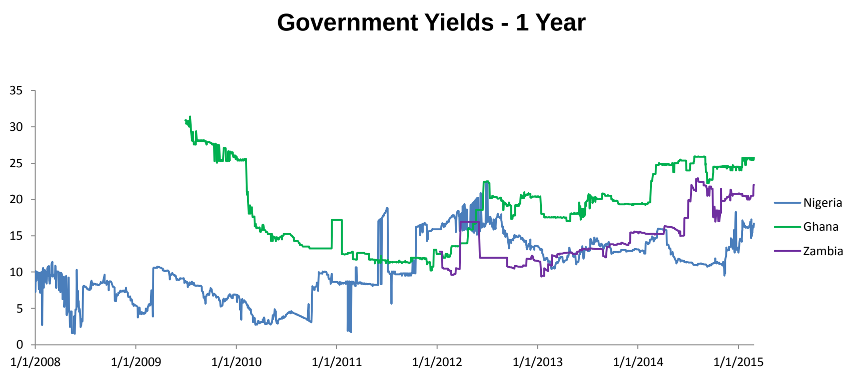
GDP Growth (Africa)



Source: IMF World Economic Outlook Database, 2014.

GDP growth remains relatively strong, but recent history shows a susceptibility to dramatic shocks.

Borrowing Costs (Africa)



Source: Thomson-Reuters Datastream 2014.

Yields on government bonds have been trending upward since mid 2012

Downside Risks in Africa

- In 2013, the IMF noted that Africa's robust growth faced the *downside risks* of persistently weak demand in the Eurozone and negative shocks to private investment in the BRIC (Brazil, Russia, India, China) countries.
- As Europe continues to stumble and the US Federal Reserve continues to unwind its unconventional monetary policies, these risks remain prevalent.
- The IMF also warned in 2013 that some Sub-Saharan African countries were at "high risk of debt distress."
- Trends in debt-to-GDP, growth, and borrowing costs strongly suggest that the number of high risk SSA countries has only increased since then.
- And with the growing appetite for sovereign bond issuances, the IMF also warned of increasing currency risks. These risks remain especially high in the context of US Fed "tapering."

Outstanding Equity Issues

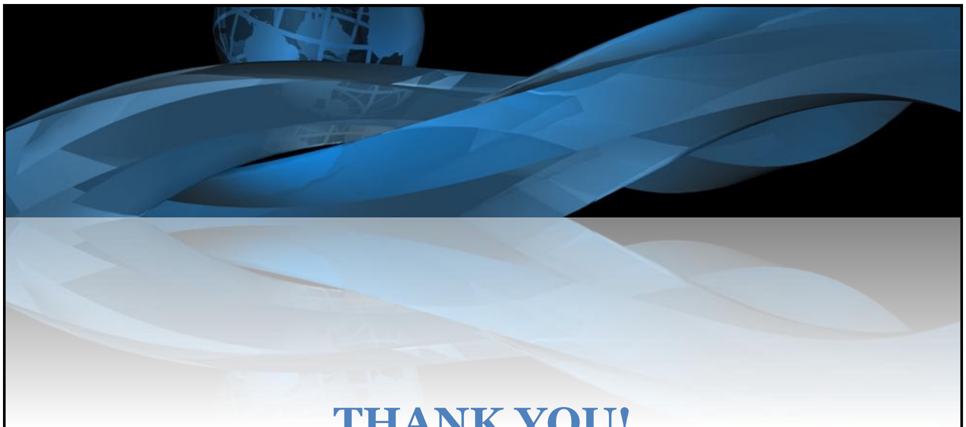
- The burden-sharing exercise of sovereign debt restructuring is played out not just between debtors and creditors, but also between different types of creditors.
- The private sector approach centred on CACs is not sufficient to solve the myriad problems, including those of inter-creditor and debtor-creditor equity, associated with sovereign debt restructuring.
- Policy measures: tighter regulation of sovereign credit default swap contracts; greater role for reprofiling and aggregation; common rules for valuing public/private concessions in restructurings; and the establishment of greater creditor rights for implicit creditors.

Conclusions

- Despite the wealth of proposals, the international community has two broad (non-mutually exclusive) choices, besides maintaining the status quo:

  1. ***Increase the IMF's financial firepower for bailouts***
  2. ***Reform the arrangements that govern sovereign debt (modular vs big-bang approach)***

- While these choices are bound to reflect political interests and priorities, G24 member countries can play a very active and critical role in shaping these interests and priorities and thus the way forward.
- Bookmark this page to follow CIGI research on sov. debt restruct.: https://www.cigionline.org/thematic/management-of-severe-sovereign-debt-crises



THANK YOU!

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