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Sovereign Debt: No Clause for Celebration

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OVERVIEW

Bottom Line: New clauses in sovereign debt contracts will make it much harder for holdout creditors to disrupt future bond restructurings. This move is a step forward, but policymakers now need to finish the job and accelerate the switch from old debt that lacks these clauses into the new instruments.

Sovereign debt restructuring is again in the news. Following a series of adverse rulings in U.S. courts, Argentina has fallen back into default on $30 billion of restructured debt rather than pay holdout creditors in full. Holdouts were also a focus during the complicated and contentious 2012 Greek debt restructuring, though in the end 96 percent of its creditors eventually participated in an exchange that reduced private debt by two-thirds. The remaining 6.4 billion euros of mostly foreign-law debt will be repaid in full. Although the holdout problem in bond restructuring has been apparent for years, these cases created broad-based interest among sovereign borrowers and lenders to finally address it.

In a recent report, Greg Makoff, a senior fellow at the Center for International Governance Innovation, and I look at the recently proposed standard terms for aggregated collective action clauses (CACs) that would be inserted in new sovereign bond issues. These new terms, when included in all of a country's international debt, provide a number of routes through which a supermajority of creditors can bind the minority to agreed-on restructuring terms, subject to strong protections against the abuse of minority creditors by the majority. Concurrently, new model wording was released for the *pari passu* (equal footing) clause typically included in sovereign international bond contracts that governs how payments are shared among creditors. These announcements are an important milestone in the evolution of sovereign bond restructuring mechanisms. Neutralizing holdout creditors in this fashion is of immense economic importance, as it should facilitate more predictable outcomes for debtors and creditors and fairer outcomes among creditors when countries face severe financial distress. For more detail on how these clauses work, see here and here.

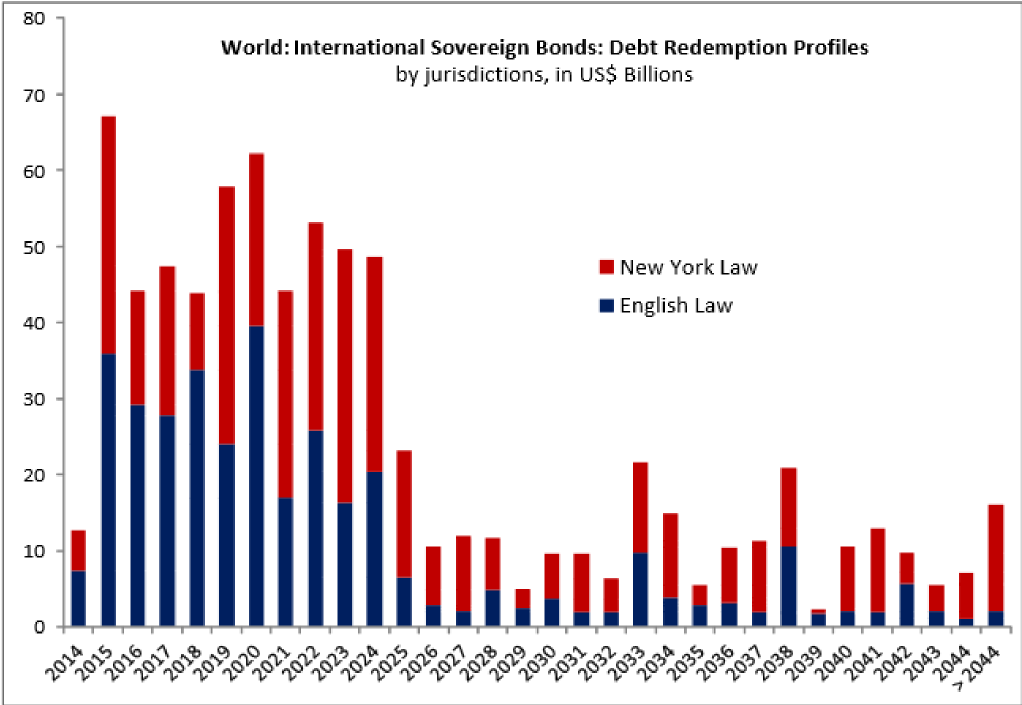
Neutralizing holdout creditors is of immense economic importance.

Since the announcement of the new clauses, a number of governments have issued bonds containing them. These issues have been well received and by all accounts the governments did not pay a premium to introduce the new clauses.

However, the battle is not yet won: the risk of inefficient or unpredictable sovereign debt restructurings will remain elevated until the vast majority of the stock of outstanding international bonds has been converted to the new format. Having the new clauses in one bond may not do much good if all of the country's other debt is at elevated risk to hold-out activity. Until most or all of a country's debt includes the new language, restructuring efforts will be at risk of failure because of significant holdouts. The larger the debt held by holdouts, the bigger the loss that must be imposed on participating creditors in order for a country to achieve a sustainable debt position. For this reason, creditors willing to restructure share an interest with the debtor in seeing the broad-based introduction of these new clauses.

Because much existing debt has long maturities, it will be some time before the bulk of sovereign debt features the new clauses (Figure 1). Why not accelerate this timeframe, transforming all of the existing debt to new debt containing the clauses? The complexity and cost of this process have been raised as issues. But this is not an excuse for inaction.

FIGURE 1: SOVEREIGN BOND REDEMPTION PROFILE



Source: International Monetary Fund.

Governments need to finish the job and switch existing debt from the old legal format to the new standard. There are a number of ways to do this: bonds may be refinanced at maturity with new bonds, bonds in some cases may be amended to the new form via a vote of bondholders, or they may be switched over via an exchange offer in which old debt is swapped for new debt with the new clauses. In light of the many well-received precedents for these types of transactions, countries launching one in the future—with the support of leading investors—are likely be successful.

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A STEP-BY-STEP APPROACH

The accelerated, universal adoption of the new contractual framework will require a continuing concerted, consensual process involving borrowers, lenders, and leading-country policymakers. Well planned and implemented, the accelerated transformation of the debt can be achieved at low cost. But many countries seem concerned that doing so could stigmatize them as at-risk debtors. To address these concerns, leading countries, led by the Group of Seven and the Group of Twenty, should author and endorse a step-by-step strategy that lends credibility and legitimacy to these conversion efforts.

The first step to converting outstanding debt stocks to the new format is to complete the new-issue market adoption of the new clauses. This process is well under way with new-issue transactions already completed by countries including Mexico, Kazakhstan, Vietnam, Chile, Indonesia, Colombia, and Ethiopia. This can be done by publishing new terms that would apply to other legal systems commonly used for sovereign international bonds, and further issuance of new benchmark bonds under the new framework by leading international bond issuers. It also would be helpful for creditors and debtors to be brought together to discuss strategies to accelerate the transition of outstanding debt stocks to the new format over the next few years. Publication of guidelines, followed by a first operation by a major borrowing country, would lessen the stigma from conversion and play a helpful role in encouraging sovereign bond issuers around the world to follow suit.

The accelerated transformation of sovereign debt can be achieved at low cost.

Western nations have made an important first step toward fixing the terms that govern sovereign borrowing. But they cannot stop there. A coordinated, accelerated effort to swap old debt into new debt with the improved clauses is needed so that countries can effectively deal with financial distress. Borrowing countries will need to be in the lead, but to be successful they need the active support of lenders, the major creditor countries and the leading international financial institution more broadly. There are some costs involved, but with the economic health of nations potentially at stake, the adage attributed to Benjamin Franklin comes to mind: an ounce of prevention is worth a pound of cure.

Looking Ahead: Kahn's take on the news on the horizon

The cost of a stronger dollar?
Growing calls for currency-manipulation language in U.S. trade legislation could stall efforts to conclude the Trans-Pacific Partnership.

Greece's bridge to nowhere
Greece's February agreement with its European partners ensures transitional financing (mainly from the European Central Bank), but does little to set the stage for the sustainable, competitive economy needed to sustain euro membership in the long term. Difficult negotiations lie ahead.

Beware, cliffs ahead
In the United States, fiscal cliffs are set to return. The standoff over funding homeland security highlights the risks.