AfSDJN

RESTRUCTURING SOVEREIGN DEBT

PAPER II OF THE AFRICAN SOVEREIGN DEBT JUSTICE PAPER SERIES

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AfronomicsLAW

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FOREWORD

Welcome to the second paper in the African Sovereign Debt Justice Network Paper Series. The African Sovereign Debt Justice is a coalition of citizens, scholars, civil society actors and church groups committed to exposing the adverse impact of unsustainable levels of African sovereign debt on the lives of ordinary citizens.

The African Sovereign Debt Justice Paper Series has four primary goals:

I. To provide insightful and highly accessible analysis of key sovereign debt issues;

II. To create awareness about and elevate public attention to the sovereign debt crisis;

III. To contribute significantly to the menu of reform options for the sovereign debt crisis;

IV. To promote and build capacity among African academics on sovereign debt issues.

The African Sovereign Debt Justice Network is delighted to have been able to work with the experts to produce this paper series. This paper series, written against the background of the ongoing sovereign debt crisis, has been exacerbated by the COVID19 pandemic. The AfSDJN believes there continues to be pathways towards reforming many aspects of the global financial architecture and we hope that this series will speak authoritatively to the types of challenges involved in definitively addressing the sovereign debt crisis.

Introduction

This paper presents an introductory roadmap to sovereign debt restructurings. A sovereign restructuring is the complicated, often painful, and sometimes protracted process by which a sovereign, its citizens, and its creditors accept present losses to increase the sovereign's ability to pay its debts. While not common, sovereign restructurings have occurred often enough that the process can be summarized and given in outline. Ecuador, Argentina, and the Province of Buenos Aires have all restructured their debts in the past year and a half, while Greece conducted the largest sovereign debt restructuring in history within the past decade. All these restructurings, and others, typify the restructuring process.

This paper comes at an interesting time for sovereign debt. The widely recognized growth in sovereign debt balances has been matched by a less recognized proliferation of creditor types. Forty years ago, the picture was clearer. Loans came from traditional and governmental Paris Club lenders or from traditional and institutional London Club banks – with the occasional regional bank as a hanger-on. Today, loans from 'non-traditional' sources have overtaken these funding sources. China has become the largest lender for many countries. Non-bank financial institutions have begun to muscle into sovereign lending. Diffused crowds of bondholders have replaced banks as a principal source of finance. None of this is to say that traditional sources of finance have disappeared. They are just smaller. All this leaves a restructuring sovereign at the mercy of complexity. So many interests must be balanced, so many incentives obeyed, and so many egos assuaged that a sovereign must perform its part perfectly or risk stumbling at every stage of the process.[1]

In the following sections, this paper will introduce the basics of sovereign debt restructuring. It begins with a discussion of the character and incentives of the main actors in the process. It then covers some preliminary steps and considerations for a sovereign before delving into the main methods used to restructure sovereign debt. The paper proceeds to look at the bargaining process and some bargaining techniques used in a sovereign restructuring. It concludes

[1] E.g., Zambia: Stubbington, Tommy and Laurence Fletcher. 2020. "Zambia on brink of default after lenders reject debt relief request." *Financial Times*.

with a review of restructuring outcomes such as duration, haircuts, and holdouts.

I. The Actors

The Sovereign

The sovereign plays the lead role. Its incentives and constraints are partially universal and partially unique. For all sovereigns, the hard facts are financial distress and displeased creditors. Every sovereign seeks relief from its distress. Every sovereign would prefer that creditor displeasure not descend into hostility and protracted litigation. And every sovereign, if not absolutely overwhelmed by financial stress, wants to achieve these aims in a manner compatible with unique economic priorities[2] and political objectives[3] while keeping the social concerns of their citizens in mind. Often, not all these goals are achievable.

Russia's 1998 default and subsequent restructuring illustrate some of these points. For Russia, liquidity pressure in the domestic public securities markets led to an inability to roll-over domestic instruments.[4] Although the debt was in domestic currency, recent hyperinflation precluded any attempt to print money to pay off the debt.[5] This, combined with the Duma's refusal to adopt an IMF anti-crisis program, produced an unprecedented default on Russian domestic debt. This default all but forced a restructuring of domestic debt, much of which was held by residents.[6] In the external sector, the young Russian Federation sought to keep the confidence of the market by remaining current on all Federation obligations. But Russia drew a line between 'its' obligations and the obligations of its political predecessor. It ceased to pay and then restructured Soviet-Era

[2] Santos, A. 2003. "Debt Crisis in Russia: The Road from Default to Sustainability". In *Russia Rebounds*. Washington: International Monetary Fund: 171.

[3] Dickerson, A. Mechele. 2004. A Politically Viable Approach to Sovereign Debt Restructuring. *Emory Law Rev*iew. "[Sovereign] leaders realize that a debt restructuring that triggers a recession, forces severe cuts in public expenditures on social programs, or increases taxes likely will cause citizens to oust them at the next available opportunity.").

[4] Erce, Aitor. 2012. "Selective sovereign defaults." Globalization Institute Working Papers. Federal Reserve Bank of Dallas: 19.

[5] Id. at 24.

[6] Santos, A. 2003. "Debt Crisis in Russia: The Road from Default to Sustainability". In *Russia Rebounds*, 168.

obligations.

Official Creditors

Bilateral Official Creditors. Bilateral official creditors are other sovereigns. Bilateral official debt is typically extended in the form of direct loans or trade credits. This debt was at one time the largest segment of the debt of developing nations, although this is changing fast.[7]

Ghana illustrates the end result of this change.[8] In 2020 its largest bilateral creditors were, in order, France, Germany, China, and South Korea. Ghana's bilateral debt and trade credits from these countries, and others, amounted to only 9% of total external debt. This was down from 11% the year before. Ghana's external commercial debt, by contrast, grew from 48.5% to 51% of total external debt over the same period.

Bilateral official creditors such as France, Germany, and South Korea are often members of the Paris Club, the informal forum for restructuring bilateral official debt. The Club comprises twenty-two nations with several occasional participants.[9] China, while not a member of the Club, collaborates with it from time to time.

As a response to the pandemic, the Club and the G20 have promulgated the Common Framework for further debt relief. The Club has indicated that debt relief will be grounded in the IMF's assessment of a sovereign's debt sustainability as well as the assessments of the official creditors themselves. The Club also will endeavor to coordinate all official claims.[10]

A sovereign that agrees to restructures its debt through the Common Framework must seek comparable treatment from other creditors. In other words, the sovereign must seek the same

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[7] UNCTAD. 2020. *External Debt Sustainability and Development*. Note by the Secretary-General: 7.

[8] Republic of Ghana. (2021) "The Annual Public Debt Report for the 2020 Financial Year." *Available at*: https://www.mofep.gov.gh/sites/default/files/reports/economic/2020-Annual-Public-Debt-Report_v2.pdf

[9] The 22 members of the Paris Club are: Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Italy, Japan, Korea, the Netherlands, Norway, Russian Federation, Spain, Sweden, Switzerland, the United Kingdom and the United States of America.

[10] Common Framework for Debt Treatments beyond the DSSI. *Available at* https://clubdeparis.org/sites/default/files/annex_common_framework_for_debt_treatments_beyond_the_dssi.pdf

amount of debt relief from its private creditors as it receives through the Common Framework.[11] This condition is standard in Club restructurings, but it can reduce a sovereign's flexibility.[12] Comparability of treatment diminishes or eliminates a sovereign's ability to pursue a selective restructuring of some types of debt only.

Multilateral Creditors. Multilateral creditors are multilateral institutions such as the International Monetary Fund (IMF), the World Bank, and the African Development Bank. Many sovereigns will have existing loans from these institutions.[13] Zambia, for example, has multilateral debt amounting to $2.1 billion[14] from *inter alia* the World Bank, the African Development Fund, and the Asian Development Bank.[15] These same institutions may provide advice and further financing to a sovereign while it restructures its debt. But, except for the IMF, multilateral institutions play small roles in a restructuring.

The IMF

The IMF plays an important role in a restructuring.[16] This is a role it has assumed gradually and which stems more from custom and habit than any fixed framework.[17] Established as the protector of the Bretton Woods system of fixed exchange rates, the collapse of Bretton Woods and a series of financial crises in the 1980s and 1990s allowed the IMF to craft for itself a new position international economic supervisor. In this position, it participates greatly in sovereign

[11] *Comparable Treatment*. Glossary of Statistical Terms. OECD. *Available at*: https://stats.oecd.org/glossary/detail.asp?ID=5899

[12] Erce, Aitor. 2013. "Sovereign debt restructurings and the IMF: implications for future official interventions," Globalization Institute Working Papers 143, Federal Reserve Bank of Dallas, 11.

[13] *See* "Republic of Zambia Government Special Report." 2020. Debtwire.

[14] Reuters Staff, (2021) UPDATE 1-Zambia's new finance minister says IMF deal key to fixing debt problems. Reuters. https://www.reuters.com/article/zambia-finmin/update-1-zambias-new-finance-minister-says-imf-deal-key-to-fixing-debt-problems-idUSL1N2Q00K3

[15] Republic of Zambia Government Special Report 10 August 2020. Debtwire.

[16] *Understanding Sovereign Debt: Options and Opportunities for Africa*. 2020. African Legal Support Facility: 27.

[17] Bordo, Michael D. and Harold James, The International Monetary Fund: Its Present Role in Historical Perspective, National Bureau of Economic Research Working Paper No 7724 (2000), 4.

restructurings.

Normally, a distressed sovereign will request IMF assistance to address its financial difficulties. The IMF will hold discussions with the sovereign to identify the causes of the problems, and the parties will agree on a program of adjustment. The IMF may then provide financing to the sovereign. The IMF will also provide a Debt Sustainability Analysis (DSA). The DSA reviews and forecasts the sovereign's financial position and stress tests these forecasts for sustainability.[18] The IMF once defined sustainability as a "situation in which a borrower is expected to be able to continue servicing its debts without an unrealistically large future correction to the balance of income and expenditure."[19] Paper 2 of the African Sovereign Debt Justice Network series discusses the IMF's Debt Sustainability Analysis and how the analysis may compound a borrowing country's debt burden and undermine its ability to meet the social and economic needs of its population.

Private Creditors

Commercial Lenders. Commercial lenders are private financial institutions, typically banks, that provide loans on commercial terms to sovereign borrowers.[20] These loans are "direct" if one bank lends to the sovereign. They are "syndicated" if a group of banks make the loan. Commercial lenders can be both foreign and domestic. Zambia, for instance, has outstanding loans from Citibank and Nordea, among others.

Bondholders. Bondholders are the investors who hold the sovereign's tradable debt securities. These securities can be short term (bills) or long-term (bonds or notes). They are denominated in local currency or in foreign currency. If issued internationally, the latter are called Eurobonds. Eurobonds are typically governed by the law of New York or England rather than the

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[18] IMF. 2021. *Review of The Debt Sustainability Framework for Market Access Countries*. Policy Paper. *Available at*: https://www.imf.org/en/Publications/Policy-Papers/Issues/2021/02/03/Review-of-The-Debt-Sustainability-Framework-For-Market-Access-Countries-50060.

[19] IMF. 2002. *Assessing Sustainability*. Policy Paper. The Fund now, unfortunately for intelligibility, defines sustainability as "when the primary balance needed to at least stabilize debt under both the baseline and realistic shock scenarios is economically and politically feasible, such that the level of debt is consistent with an acceptably low rollover risk and with preserving potential growth at a satisfactory level."

[20] Note 16 at 35.

domestic law of the issuer. Bondholders can be a dispersed mass of investors or a relatively small group of institutions.

The typical private creditor, whether lender or bondholder, has two primary incentives during a restructuring.[21] The first is to lose as little money as possible. The second is not to lose more money, *mutatis mutandis*, than anybody else.

These incentives drive the cautious balancing act every creditor undertakes. A restructuring is triggered by a sovereign's inability to pay. Thus, creditors know they must provide some debt relief to enable current payment. Creditors typically want to provide the smallest amount of debt relief that ensures the sovereign can begin paying and can continue to pay, in full, in the future. Creditors also want to ensure that any losses are shared equitably. If they are not, a creditor with an outsize share of losses may look foolish or even stupid. This can be much more traumatizing than a poor return. This 'inter-creditor equity,' therefore, is taken quite seriously in restructurings.

Inter-creditor equity should not be conflated with the Paris Club's comparability of treatment. Inter-creditor equity is a principle which creditors may or may not enforce on an individual or collective basis. Comparability of treatment is an obligation that a sovereign assumes as part of a Club restructuring. In theory, comparability of treatment is derived from inter-creditor equity, but in practice, comparability of treatment is a way to ensure that Paris Club taxpayers do not subsidize private lenders.[22]

Holdout Creditors. A holdout creditor is a species of private creditors. The holdout refuses to consent to a restructuring in the belief that the sovereign will continue to service the old debt or that litigation or settlement will provide a higher payout.[23] A determined holdout may pursue a sovereign in court for years. For example, Elliot Management, a hedge fund, held out of an

[21] Buchheit, Lee, et al. 2019. *How to Restructure Sovereign Debt: Lessons from Four Decades*. Working Paper. Peterson Institute for International Economics: 10.

[22] Cheng, Gong, et. al. 2016. From Debt Collection to Relief Provision: 60 Years of Official Debt Restructurings through the Paris Club. Working Paper. Inter-American Development Bank: 6, footnote 10.

[23] IMF. 2003. *Reviewing the Process for Sovereign Debt Restructuring within the Existing Legal Framework*. Policy Paper: 22.

Argentinean restructuring and then hounded Argentina in court for fifteen years.[24] The saga ended when Argentina was forced to settle on very unfavorable terms with Elliot.

Holdout creditors must be distinguished from dissident creditors. A holdout creditor wants or contemplates a higher payout *outside* of the restructuring through continued payment of the old debt or through litigation or settlement. A dissident creditor, on the other hand, hopes for a higher payout *within* the restructuring process, typically by inducing the sovereign to make a better offer. The two types are fluid, and one may become the other during the course of a restructuring. But it is important to try and classify creditors in a restructuring so that negotiations can be handled appropriately.

II. The Preliminaries

Initial Steps

The first step is the sovereign's decision to restructure. The decision can come before default as a 'preemptive' restructuring. It can also come after default as a 'post-default' restructuring. Once restructuring is on the table, the sovereign will hire financial and legal advisors. The advisors guide the sovereign through every part of the restructuring. An initial task for the advisors is debt categorization. Important factors are:

- **i.** The face and market value of the debt;
- **ii.** The amortization schedule of the debt;
- **iii.** The interest rates of the debt, and whether fixed or floating;
- **iv.** The currency of the debt;
- **v.** The legal characteristics of the debt; and
- **vi.** Whether the debt is secured or unsecured.[25]

With its debt tallied and categorized, the sovereign must determine what debt to restructure

[24] Wernau, Julie. 2016. "Elliott Management, Other Funds Get Big Rewards on Argentina Bonds." *The Wall Street Journal*.

[25] Trebesch et al. 2012. *Sovereign Debt Restructurings 1950–2010: Literature Survey, Data, and Stylized Facts*. Working Paper. International Monetary Fund: 12.

and how.

Debt Selection

Custom and necessity exclude some types of debt from a restructuring.[26] Short term financing such as treasury bills are rarely included in a restructuring. Collateralized or senior obligations, too, are rarely included. Multilateral loans, such as those from the IMF and World Bank, are generally exempt from a restructuring as a matter of course.[27]

This leaves bilateral official debt, commercial loans, and bonded debt. These debts then divide themselves into two classes. First, debt governed by domestic law and denominated in domestic currency; second, debt governed by foreign law and denominated in foreign currency.[28]

Domestic debt provides the sovereign with several advantages.[29] Domestic legislation can affect domestic debt in unique ways. In contrast to foreign debt, legislation may impair domestic debt and leave the debt holder with little recourse. Legislation may also amend the terms and conditions of domestic debt to make it easier to restructure. Domestic debt may also be paid in local currency. The sovereign need not worry about exchange rate issues and may, if it can, freely print money to pay back the loan.[30] Moreover, residents generally hold domestic debt. Residents are more amenable to the sovereign's persuasion and more susceptible to its threats.[31] For all the above reasons and more, domestic restructurings tend to be quicker than external restructurings.[32]

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[26] Note 21 at 5.

[27] Schlegl, Matthias, C. Trebesch, and M. Wright. 2019. *The Seniority Structure of Sovereign Debt*. Working Paper. National Bureau of Economic Research: 2

[28] IMF. 2018. *Chapter 7: Sovereign Default* in *Sovereign Debt: A Guide for Economists and Practitioners*. Eds. Abbas, S. Ali, Alex Pienkowski, and Kenneth Rogoff.: 9

[29] Gulati, Mitu., and Buchheit, Lee. 2018. "Use of the Local Law Advantage in the Restructuring of European Sovereign Bonds." *University of Bologna Law Review*: 172–179.

[30] Note 25 at 52-53.

[31] Díaz-Cassou, J., A. Erce-Domínguez and J. Vazquez-Zamora. 2008. *Recent Episodes of Sovereign Debt Restructurings. A Case-Study Approach*. Occasional Paper No. 0804. Banco de España: 13.

[32] Note 25 at 53.

Yet there are disadvantages. Restructuring domestic debt may not be a viable option politically. Financially, imposing losses on residents can weaken bank balance sheets and impair the health of the domestic economy.[33] For these reasons, a sovereign may seek to place much of the burden on its foreign creditors even though foreign debt is typically harder and more costly to restructure.

To illustrate the domestic law advantage, consider Greece's 2012 restructuring, the largest in history.[34] Much of Greece's bonded debt was subject to Greek law. To restructure this debt, Greece passed a 'Bondholders Act', which added voting provisions to all domestic bonds. Greece then used these voting provisions to restructure its domestic debt successfully. A similar strategy could not have been employed to restructure Greek bonds governed by English law.

III. The Proposals

The sovereign prepares restructuring proposals as an opening offer in its negotiation with creditors. The proposals contain the basic terms of the restructuring, such as what debt is to be restructured and how. All restructurings consist of three parts:

1. The Old Debt;
2. The Law;
3. The New Debt.

A restructuring is a process by which a debtor and its creditors use the law to get from the old debt to the new debt. Creditors care mostly about the new debt in relation to the old debt. They care much less about how exactly the law is used to turn the old debt into new debt. Only when the legal mechanism is highly coercive or expropriative will creditors begin to care about how the law is used.

The sovereign debtor has four primary methods to change old debt into new debt. The sovereign can and often will use several of these options in tandem.

[33] Id. at 52.

[34] Martinelli, Thibault. 2016. *Euro CAC and the existing rules on sovereign debt restructuring in the Euro area : an appraisal four years after the Greek debt swap*. Working Paper. ADEMU: 3-5.

i. *Principal reductions*. A principal reduction marks down the principal amount of the sovereign's debt. From the creditor perspective, it is the least favored restructuring method.[35] It represents an absolute loss that cannot be regained through subsequent appreciation of the debt instrument.

ii. *Interest rate reductions*. These rarely appear by themselves.

iii. *Rescheduling*. Rescheduling is the deferment of debt-service payments with the application of new and extended maturities to the amounts deferred.[36] The G20's Debt Service Suspension Initiative (DSSI) is an example of rescheduling.

iv. *Reprofiling*. Reprofiling is the extension of the maturities of debt for a specified period without a contemporaneous haircut or interest rate reduction.[37]

The options used to change Old Debt into New Debt will determine investor losses or 'haircuts.'[38] But haircuts must not be conflated with debt relief, which is the actual reduction in the debt burden of the sovereign.[39] The two are measured differently, and a sovereign that bases its restructuring proposal primarily on investor losses risks achieving inadequate debt relief.[40]

Ultimately, the sovereign's restructuring proposals will be rooted in the IMF's DSA.[41] The IMF will verify in advance that the proposals comport with the adjustment program previously agreed upon to obtain IMF financing.[42] The IMF's quiet participation provides an arms-length assessment from which the sovereign and its creditors may negotiate. The IMF's involvement gives the creditors some assurance that the sovereign is not asking for more than what is necessary.

[35] Note 25 at 12.

[36] *Debt Rescheduling*. OECD. *Available at*: https://stats.oecd.org/glossary/detail.asp?ID=5926.

[37] Buchheit, L., et al. 2015. "Reprofiling Sovereign Debt." *Journal of International Banking Law*.

[38] 'Haircut' is also often used to refer to principal reductions.

[39] Sturzenegger, Federico, and Zettelmeyer, J. 2007. Creditors' Losses versus Debt Relief: Results from a Decade of Sovereign Debt Crises. *Journal of the European Economic Association*: 343–51.

[40] Buchheit, L., et al., 2013. *Revisiting Sovereign Bankruptcy*. Washington: Brookings Institution: 12.

[41] Note 16 at 135-136.

[42] Note 25 at 7.

To put it simply, the IMF relieves some of the information asymmetries.

IV. Bargaining Chips

The negotiation with creditors will typically be a back-and-forth process. The restructuring proposals will be the opening offer in the process, but they are rarely sufficient by themselves to secure adequate creditor participation. Often, the creditors will want to bargain. Tweaks to the restructuring proposals are resorted to in the first instance. But tweaks and even changes may not be enough. The sovereign may and often does need to make additions to its proposals.[43] These additions generally come in two forms: 'carrots' and 'sticks.'[44]

The recent Province of Buenos Aires (PBA) restructuring illustrates this process.[45] PBA began its restructuring in 2020. Its opening invitation to one group of eligible bondholders consisted of an offer to exchange the existing bonds for either $90 principal amount step-up[46] bonds due 2032 or $95 principal amount step-up bonds due 2040. Thus, PBA opened with principal and interest reductions combined with a maturity extension.

Over a year later, after some opaque negotiations, PBA revised its proposal.[47] In August of 2021, it offered the same bondholders $100 principal amount step-up bonds due 2037. Not only did these bonds provide a higher principal amount, but the interest payments were higher too. In combination with the new invitation, PBA offered consenting bondholders an extra 'consent' payment, a carrot, and threatened non-consenting bondholders with an exit consent, a stick.

[43] Id. at 14.

[44] The additions provided below are representative but by no means exhaustive. The number of possible additions is infinite. They are limited only by a lawyer's ingenuity.

[45] *See* The Province of Buenos Aires, Invitation Memorandum dated April 24, 2020: 10.

[46] Bonds whose interest payments increase over time.

[47] *See* The Province of Buenos Aires, Amendment No. 1 dated August 6, 2021, To Invitation Memorandum dated April 24, 2020

Carrots

Minimum Participation Thresholds. A minimum participation threshold stipulates that the sovereign will proceed with the restructuring only if a specified majority of creditors agree to the deal. A minimum participation threshold was a defining feature of Ecuador's successful 2020 restructuring.[48] In 2020, Ecuador and Argentina proposed virtually identical and highly unorthodox and coercive restructurings. But Ecuador included a minimum participation threshold of 80%, which made its proposal far less threatening and demonstrated strong creditor support. Argentina did not include a threshold. Ecuador's restructuring was a quick and quiet success. Argentina's restructuring was just shy of a disaster.[49] Whether interpreted as a cause or symptom of success, Ecuador's threshold was the distinguishing feature of its restructuring.

Credit Enhancements. Credit Enhancements are sweeteners designed to make the deal more attractive. They usually appear as cash payments or cash-equivalent notes.[50] The consent payment use by PBA is an example of a credit enhancement.

Value Recovery Instruments (VRIs) are a unique and facially attractive type of credit enhancement. VRIs are derivative securities with payouts linked to an objective variable such as GDP or exports or linked to commodity prices.[51] They are designed to provide creditors with some future upside in return for a present loss. As such, they typically accompany restructurings with deep principal reductions. VRIs were structured historically as warrants linked to the price of oil. More recent restructurings for non-commodity exporting nations have included GPD-linked warrants.

[48] Andrés de la Cruz and I. Lagos. 2021. "CACs at work: what next? Lessons from the Argentine and Ecuadorian 2020 Debt Restructurings." *Capital Markets Law Journal*.

[49] *See, e.g.,* Gelpern, Anna. 2020. "Keeping Cosy by the Dumpster Fire: Argentina Reads Its Contracts ... Twice ... Quel Scandale!" Credit Slips. *and* Smith, Colby. 2020. "Autonomy hedge fund bemoans Argentina's 'bad faith' debt tactics." *Financial Times*.

[50] Note 16 at 160.

[51] Cohen, Charles, et al. 2020. *The Role of State-Contingent Debt Instruments in Sovereign Debt Restructurings*. IMF Staff Discussion Notes. International Monetary Fund: 8.

VRIs have several drawbacks. Investors generally do not like them.[52] Institutions and funds prefer plain vanilla instruments over exotic VRIs. VRIs have no established secondary market, and they are very difficult to trade. VRIs are also hard to price. All these drawbacks typically mean that VRIs are issued at such a steep discount to value that the sovereign should simply have reduced the size of its proposed haircut.[53] VRIs have their place in restructurings, but it is a limited place.

Contractual Enhancements. Contractual enhancements upgrade the legal provisions in a debt instrument.[54] The enhancements typically make the debt instrument more difficult or more costly to restructure moving forward. An example of such an enhancement is a change in governing law from domestic to foreign. Enhancements cost the sovereign nothing in the present, but they can be expensive in the future.

Principle reinstatement features are a unique type of contractual enhancement.[55] These features typically provide that if the sovereign ceases to make payments on the New Debt or otherwise tries to restructure again within a number of years, the losses creditors suffered in the first restructuring will be restored. Principle reinstatement features are rare in sovereign restructurings. They are designed to keep a sovereign from backsliding. They do not have obvious drawbacks like VRIs, but the sovereign must make absolutely sure the amount of debt relief it receives is sufficient to prevent a future default.

Sticks

Collective Action Clauses. Collective Action Clauses (CACs) are voting provisions, typically found in bonds, that allow a supermajority of bondholders to bind *all* bondholders to the deal. CACs are the primary method of restructuring bonded debt. CACs have appeared in almost

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[52] *Id* at 9.

[53] *Id*. at 10.

[54] Note 16 at 160.

[55] Buchheit, Lee C., and E. Daly. 2014. Minimizing Holdout Creditors: Carrots and Minimizing Holdout Creditors: Sticks. In *Sovereign Debt Management*, ed. Rosa M. Lastra and Lee C. Buchheit. Oxford: Oxford University Press.

all recent bond restructurings, including the Ecuadorian[56] and Argentinian[57] 2020 restructurings, as well as the Province of Buenos Aires's 2021 restructuring.[58]

Almost all bond series outstanding contain CACs which allow a supermajority of bondholders to bind their own series. Typically, 75% approval is necessary to restructure a single series. 66 2/3% is required for other, more minor modifications.

Newer bonds contain cross-series or aggregated CACs. Aggregated CACs come in two varieties:

1. A Single Limb Uniformly Applicable voting mechanism which requires the consent of 75% of all bondholders voting on the proposal, but all bondholders must be offered the same instruments or same consideration; and

2. A Double Limb voting mechanism that requires an affirmative vote of more than 50% of the bondholders of each series that is voting and at least 66 2/3% of all bondholders across all series.

These CACs are a package deal. They appear together in almost all, if not all, recently issued sovereign bonds. For the sovereign, the choice between them depends on the presence of holdouts. If holdouts own more than 50% of a bond series, for example, a sovereign would be forced to use the first option.[59]

Exit Consents. An exit consent is a specific use of CACs in a bond restructuring. In an exit consent, "the specified majority or supermajority of bondholders exercises its power to amend the old bond -- just before those creditors leave the old bond -- as an incentive for all other holders

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[56] *See* The Republic of Ecuador, Invitation Memorandum dated 20 July 2020.

[57] *See* The Republic of Argentina, Prospectus Supplement to Prospectus dated April 21, 2020.

[58] *See* The Province of Buenos Aires, Amendment No. 1 dated August 6, 2021, To Invitation Memorandum dated April 24, 2020

[59] This is, of course, subject to the power to 're-designate,' which this paper does not go into but makes the second CAC option extremely powerful. Those interested should see Gulati, Mitu and Mark Weidemaier. 2020. "The Argentine Re-Designation Drama: Notes From Two Frustrated Readers." Credit Slips. *Available at*: https://www.creditslips.org/creditslips/2020/06/the-argentine-re-designation-drama-notes-from-two-frustrated-readers.html

to come along with them."[60] A typical exit consent would offer new bonds to consenting bondholders in exchange for a vote to remove Events of Default from the old bonds, making the old bonds unenforceable. Exit consents were common in restructurings before new and stiffer bond terms relegated them to the periphery. Nevertheless, many sovereigns have old bonds outstanding which are susceptible to exit consents. PBA, for example, had bonds outstanding that were vulnerable to an exit consent.[61]

The Threat of Nonpayment. All sovereign restructurings carry with them a threat of nonpayment.[62] The sovereign can substantiate its threat in two ways. It can demonstrate a willingness to defend and withstand a court judgment, or it can base its nonpayment on a legal argument rooted in a clause or clauses of the debt agreement. Either choice threatens to deprive a creditor of payment for an extended period. Most creditors will accept a reasonably attractive deal rather than pursue a protracted and doubtful legal judgment. Threats can be highly persuasive,[63] but the sovereign that makes a threat must simultaneously ensure that its relationship with its creditors remains mostly amicable.

V. Outcomes

Duration

The length of the restructuring process varies significantly.[64] Nevertheless, most restructurings in the past thirty years have taken place much faster than those before 1990. This is primarily due to the increasing use of bonded debt since the 1990s. Measured from the 1990s,

[60] Buchheit, L. and Gulati, M. 2000. Exit Consents in Sovereign Bond Exchanges. *UCLA Law Review*: 8.

[61] Squires, Scott. (2021) "Buenos Aires Scares Creditors Into Accepting Bond Swap." Bloomberg. https://www.bloomberg.com/news/articles/2021-08-31/buenos-aires-province-scares-creditors-into-accepting-bond-restructuring ("'This was essentially a gun-to-the-head tender, where the province used extreme levels of coercion to achieve creditor acceptance,' said Richard Deitz… a member of the creditor group's steering committee during the negotiations. 'That may get your deal done, but it's not going to endear you to creditors in the long term.'"

[62] Bratton, William W. 2004. "Pari Passu and A Distressed Sovereign's Rational Choices." *Emory Law Journal*: 844.

[63] Galvis, Sergio J. and Saad, A. L. 2005. "Sovereign Exchange Offers in 2010." *Chicago Journal of International Law*: 222.

[64] Note 25 at 27.

the average duration of a bond restructuring is around 13 to 14 months, while the duration of bank debt restructurings during the same period is around 55 months.[65] Bank debt restructurings have taken less time in recent years, but since 1998 they still average around 30 months.

Haircuts

The magnitude of haircuts also varies.[66] Generally, bilateral official creditors suffer the largest haircuts. Paris Club restructurings have averaged losses of about 60%.[67] Private creditors, whether bondholders or commercial lenders suffer an average haircut of around 40%.[68] But there is significant variation in the size of these haircuts. Some restructurings achieve a haircut of 20% or less, while others reach well above 50%.

Whether to seek a large or small haircut is somewhat of a catch-22. The larger the haircut, the more likely it is that the sovereign will face higher borrowing costs in the future as well as a longer period of exclusion from capital markets.[69] But, not surprisingly, a significant haircut puts the sovereign in a much better financial position than a small haircut. A large haircut reduces the likelihood that a sovereign will default again moving forward.[70] The research on these topics is admittedly quite mixed, but the cost to the sovereign in the credit markets appears to be concentrated close in time to the restructuring. It then fades over time. It thus seems that, for the long term, a large haircut is the better option.

The sovereign can achieve its desired haircut through principal reductions, interest rate

[65] Bai, Yan and J. Zhang. 2009. *Duration of Sovereign Debt Renegotiation*. Working Papers 593. Research Seminar in International Economics. University of Michigan: 258.

[66] As stated, haircuts are not synonymous with debt relief. But haircut measurements are the most readily available proxy for debt relief.

[67] Note 27 at 34. The size of the losses in Paris Club deals changes significantly if a different discounting approach is used, pushing the average loss to close to 80%.

[68] Cruces, Juan J., and C. Trebesch. 2011. *Sovereign Defaults: The Price of Haircuts*. CESifo Working Paper Series 3604. CESifo: 3

[69] *Id*. at 25.

[70] Schröder, Christoph. 2014. *Haircut Size, Haircut Type and The Probability Of Serial Sovereign Debt Restructurings*. ZEW Discussion Papers. Leibniz Centre for European Economic Research: 26.

reductions, rescheduling, and reprofiling. Here, too, the sovereign faces something of a catch-22. Creditors are far more likely to accept softer haircut methods such as debt rescheduling, reprofiling, and interest rate adjustments. But a principal reduction, the creditor's least favorite option, is the option that results in the greatest improvement in the sovereign's financial position.[71]

Holdout Creditors

A sovereign should not be unduly concerned about holdout creditors. True holdout creditors are rare.[72] Successful holdout creditors are even rarer. But holdouts, when they do appear, tend to appear in certain places and because of certain actions.

Holdout creditors typically concentrate on debt instruments that provide an easily controlled position in a remunerative instrument. Thus, holdouts prefer instruments with:

- **i.** Small outstanding amounts;
- **ii.** High coupons; and
- **iii.** Foreign law provisions.[73]

A holdout can more easily build a sizeable minority position in an instrument with a small outstanding amount. If the minority position is large enough, a holdout can prevent the use of majority amendment provisions such as CACs.[74] High coupons provide higher returns if litigation or settlement is successful. Finally, foreign law instruments are much more difficult to restructure than domestic legislation. This gives holdouts greater leverage in negotiations.

Holdouts rarely appear without cause. The restructuring proposals in part or in whole typically produce holdouts. Importantly, holdout behavior is not strongly correlated with the

[71] Reinhart, Carmen M. and C. Trebesch. 2015. *Sovereign Debt Relief and its Aftermath*. HKS Faculty Research Working Paper Series. Harvard Kennedy School: 219.

[72] IMF. 2012. *A Survey of Experiences with Emerging Market Sovereign Debt Restructurings*. Policy Paper: 11.

[73] Schumacher, Julian, et al. 2020. *Restructuring sovereign bonds: holdouts, haircuts and the effectiveness of CACs*. Working Paper. European Central Bank: 2.

[74] Id at 21.

absolute size of a haircut.[75] If a sovereign must seek a large amount of debt relief, it can have some confidence that holdouts will not scupper the restructuring. But holdout behavior is correlated with violations of inter-creditor equity. If the sovereign pursues a restructuring that distributes losses inequitably, those creditors with outsize losses may decide to holdout.

If it even *appears* that losses may be distributed inequitably, creditors will be inclined to holdout. Zambia provides a clear example of this. In November of 2020, Zambia requested a payment standstill on its Eurobonds.[76] A standstill would have prevented a default. But creditors rejected the request. They cited as their reasons a lack of transparency about the treatment of other creditors, particularly China, and a lack of sufficient guarantees that all creditors would be treated equally. An apparent violation of inter-creditor equity produced intractable bondholders.

Holdouts can arise in both bonds and commercial loans. If faced with a holdout in its bonds, a sovereign can almost always resort to CACs. CACs are highly effective at dissuading and defeating holdouts. If faced with a holdout in its commercial loans, the sovereign typically cannot use CACs. CACs are not standard clauses in any type of loan agreement.[77] Syndicated loans may have majority amendment provisions, but most sovereign commercial loans are bilateral and have no majority or supermajority provisions. Without such provisions, it is much more difficult to deal with holdouts. The official sector and academic commentators appear cognizant of this issue, but it remains unaddressed, and it remains a barrier to swift and orderly restructurings.

VI. Conclusion

Sovereign restructurings have many moving parts. Each part must be given careful attention. A misstep at any stage can have painful consequences for all involved. But, hopefully, with the broad strokes grasped, the details will fall more easily into their appropriate place. Quick, orderly, and amicable restructurings should be the common goal of all participants.

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[75] Id at 2–3.

[76] Stubbington, Tommy and Laurence Fletcher. “Zambia on brink of default after lenders reject debt relief request.” *Financial Times*. (2020).

[77] IMF. 2020. *The International Architecture for Resolving Sovereign Debt Involving Private-Sector Creditors—Recent Developments, Challenges, And Reform Options*. Policy Paper: 38.

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