Sovereign Debt Restructuring: The Legal Context

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Sovereign debtors are unique. Unlike corporate borrowers and individual debtors, overextended sovereign debtors have no institutional framework, such as a bankruptcy code, that will permit them to obtain debt relief without worrying about hostile creditor actions. Although proposals for such a transnational sovereign bankruptcy regime have been floating around for years, they are still floating.

How to Restructure Sovereign Debt

The legal context in which any sovereign debt restructuring must proceed assumes that individual creditors of all types (multilateral, bilateral, commercial) will be holding debt instruments that constitute legal, valid, binding, and enforceable obligations of the sovereign debtor. The challenge for the sovereign debt restructurer is to cajole or to bludgeon the holders of these instruments into giving debt relief; the creditors cannot be compelled to grant relief. Broadly speaking, there are two options for achieving this objective—carrots and sticks.

The Carrots

A variety of techniques can be used to entice a creditor into giving debt relief to a sovereign borrower. For example, in return for a stretch-out of maturities,
the interest rate on the debt can be raised. To balance the negative net present value effect of a principal haircut, the sovereign can offer credit enhancements, such as the posting of collateral security or guarantees from creditworthy entities to secure the residual amount of the restructured claim. Credit enhancements feature prominently in the July 21, 2011, restructuring package for Greek debt.

The financial problem with sweeteners of this kind is that they are (to use a pharmacological term) contraindicated for a sovereign in deep financial distress. In other words, they are expensive.

The legal problem with sweeteners is that they may run afoul of the sovereign’s existing contractual covenants. The posting of collateral security to benefit a new creditor may violate a so-called negative pledge restriction (a promise not to create secured indebtedness in the future). An attempt to give legal seniority to new claims may violate the sovereign’s *pari passu* clauses.

The Sticks

If a sovereign cannot, or does not wish to, pour honey over a debt restructuring proposal, it must find some other method of encouraging creditors to grant a measure of debt relief. There are, by the way, only three types of debt relief—an extension of maturities, a reduction of interest rates, and a haircut to principal. They can obviously be combined in limitless ways.

Over the last 30 years, a number of techniques have evolved to induce less-than-voluntary participation in a sovereign debt restructuring. Among these are the following:

- **Default, real or threatened.** In every sovereign debt restructuring of the last 30 years, except for the July 21, 2011, proposal for a Greek debt restructuring, the sovereign has either suspended payments on its existing debt before the restructuring was launched or threatened (explicitly or implicitly) a payment default on any debt instrument that did not join the restructuring. Sovereign debt restructurers have gotten quite expert in delivering this “abandon hope all ye who do not enter here” message.

- **Exit consents.** Starting with Ecuador in 2000, debt restructurings implemented through bond exchange offers have frequently used a technique known as exit consents. As participating bondholders tender their existing bonds into an exchange, they give the sovereign a proxy to vote at a bondholders’ meeting to strip away features of the old bonds in a way that renders those instruments less attractive to prospective holdout creditors. For example, these voting proxies can permit the sovereign to strip out clauses in the old bonds such as the waiver of sovereign immunity, the choice of foreign governing law, the submission to foreign court jurisdiction, the acceleration provision, and the requirement to keep the bonds listed on an exchange. Because many bonds permit modifications of this kind to nonpayment terms with only a bare majority of the holders consenting,
this approach can be an effective coercive technique. It does not make the new instruments being offered to creditors any prettier, but it makes the old instruments a whole lot uglier.

- Collective action clauses. Collective action clauses (CACs) are contractual provisions that permit a majority or supermajority of creditors to modify features of an instrument, including its payment terms (maturity, principal amount, or interest rate), with the consequence that the change is binding on any dissenting minority of the holders. CACs have been used in English law bonds since 1879. They were reintroduced into New York law–governed sovereign bonds (after an 80-year absence) in 2003 and now appear in most sovereign bonds governed by New York law. Three countries (Uruguay, the Dominican Republic, and Argentina) have “aggregated” CACs that permit a single vote of all bondholders across multiple series of bonds. CACs make a sovereign debt stock more malleable. In effect, the sovereign needs to win the hearts and minds of only 76 percent, not 100 percent, of its creditor group in order to implement the restructuring.

- Local law. If a sovereign’s debt stock is governed by the sovereign’s own law, it may be possible to change features of that law to facilitate a debt restructuring. Emerging-market sovereigns have generally not been able to issue bonds in international markets governed by their own law because investors feared some local legislative mischief down the road. The debt stocks of European peripheral sovereigns like Greece and Ireland, however, are predominantly local law governed. It remains to be seen whether one of these sovereigns will use this advantage to restructure those debts.

What Does History Teach?

What lessons can be gleaned from the past 30 years of sovereign debt restructurings, and how might those lessons be applied to the debt crisis in peripheral Europe? I offer six candidates, three involving measures designed to prevent a crisis or mitigate the severity of one that cannot be avoided, and three in the realm of how to handle a crisis once it erupts.

Lesson 1: Don’t Let a Sovereign Debt Problem Become a Banking Sector Problem

Sovereign debt crises come in two forms: (1) those that are accompanied by a threat to the stability of the banking sector in the debtor country and/or important creditor countries, and (2) those that are not. Of these, the former are far more difficult and dangerous.

The debt crisis of the 1980s posed a clear and present danger to many of the world’s international banks because of their precariously high exposures to emerging-market sovereigns, aggravated by the absence (or limited amount) of prudential reserves against that exposure. As a result, the debt restructuring
technique adopted in 1982 (which lasted until the Brady Initiative in 1989) avoided any principal write-downs in order to preserve the accounting fiction that allowed the bank creditors to hold restructured sovereign credits on their books at par. This was an example, as the euro area peripheral sovereign debt crisis is today, of a situation in which the fragile balance sheets of creditor banks drove a debt restructuring technique that was in many respects artificial and visibly inadequate to deal with the problem. Nicholas Brady and his debt reduction plan came along only after seven years had passed, a period during which the creditor banks had built up their loan loss reserves.

When a sovereign debtor allows its own domestic banks to bulk up on government debt obligations, things can get even more complicated. Jamaica in the spring of 2010 was a good example. Well over half of the domestic law government bonds were in the hands of Jamaican financial institutions. Any restructuring of that debt stock involving a principal haircut would only have precipitated a domestic banking crisis, so no principal haircut was inflicted. Greece suffers a similar problem today.

Encouraging commercial banks to buy government bonds can be very tempting. This practice allows sovereigns to issue more debt, more cheaply, than they otherwise could. Encouragement can take the form of a zero risk weighting of such bonds for bank capital purposes, or easy access to a central bank discount window with little or no haircutting of any sovereign bonds offered as collateral. But the clear lesson of the last 30 years is this: when sovereign debt instruments are held predominantly by regulated financial institutions, it may prove impossible to address the sovereign’s debt stock in a sensible way without triggering a banking crisis. The result? The sovereign’s debt stock will probably be addressed, at least initially, in a less-than-sensible way.

**Lesson 2: If It Can’t Be Avoided, Don’t Try**

History tells us that sovereign debtors usually delay too long in facing up to an unsustainable debt stock. Mexico’s international reserves in the summer of 1982 (the year Mexico declared its moratorium) “went negative”—whatever that means. The reasons are perfectly understandable. Politicians do not like to admit that they have ruined the economy (which is why most sovereign debt restructurings have begun only after a change in administration). Politicians hope that things can be held together until they leave office. Politicians routinely evince a profound belief in the efficacy of prayer.

**Lesson 3: Keep Track**

How often over the last 30 years have we seen a sovereign borrower lose the end of the string in terms of its debt stock? How much has been borrowed, by whom, on what terms, and pursuant to what documentation? For some countries, the answer has been—who knows?
Even an inept public debt management department is likely to know the extent of the central government’s liabilities. The problem often resides in the unmonitored borrowings of ministries, parastatals, and subnational political units like provinces or municipalities. When these entities borrow, particularly from foreign lenders, the creditors are apt to see the loans as “quasi-sovereign” exposure. This perception usually means that a visit will be paid to the ministry of finance if the quasi-sovereign loan is not serviced. “The market will not distinguish between the liabilities of Petro Ruritania and the Republic of Ruritania,” the Minister of Finance of Ruritania will be told by the aggrieved lender. I will let you fill in the remainder of this depressingly predictable speech.

An even more widespread problem relates to contingent obligations of sovereigns. Wrapping a government guarantee around a loan incurred by a state-owned enterprise, for example, allows that SOE to borrow on better terms. All will be well until the SOE can’t pay the loan back and the once-contingent liability lands on the balance sheet of the sovereign guarantor.

Contingent liabilities may not be reported by the sovereign as forming part of its debt stock. Investors and analysts can thus be misled about the real state of the sovereign’s financial picture, and this in turn leads to mispricing of credits.

**Lesson 4: Ask for Enough Debt Relief**

Once a sovereign debt restructuring becomes unavoidable, the worst possible outcome is for the country to endure all of the turmoil of a restructuring only to emerge from the process with a debt stock that prospective investors still view as unmanageable. The sovereign will not regain market access after a half-baked restructuring, thus ensuring that another debt restructuring must surely follow. The classic example is the three or four rounds of rescheduling that each of the Latin American countries limped through in the 1980s. It was not until those debt stocks were cut and the balance of the debt stretched out for 30 years under the Brady Initiative that new lending and investment began to flow back into the debtor countries.

The sovereign’s existing lenders, of course, may sit on one shoulder and whisper advice such as, “Walk softly, you don’t want to earn a reputation as an irresponsible debtor.” Sitting on the sovereign’s other shoulder, however, will be future creditors. They will whisper: “The more debt relief you extract from your current crop of lenders today, the more generous we will be in lending to you tomorrow.” The sovereign must balance the need for debt relief today against the predictable consequences of a restructuring, in terms of higher interest rates and limited market access, in the future.

The trick, of course, is getting the balance right. How much debt relief is enough? And when does it begin to look as though the sovereign is just using a debt crisis as an excuse to force its creditors to underwrite a disproportionate share of the burden of adjustment?
Unfortunately, these are judgment calls, not matters of indisputable number crunching. For obvious reasons, neither the sovereign nor its creditors can be trusted to make this call unilaterally. There are two ways the matter has been handled. One approach locks the sovereign in a face-to-face negotiation with its lenders over the terms of the restructuring. If each side is doing its job in that negotiation, a balance will be struck.

For sovereigns whose debt stocks are too disparate to permit face-to-face negotiations with representative creditors, some neutral umpire must be found to pass upon the reasonableness and proportionality of the country’s request for debt relief. By default, this job normally falls to the International Monetary Fund (IMF). An assessment of what a “sustainable” debt stock is for any country requires a balancing of economic, political, and social factors. To be blunt, how far can fiscal austerity be pushed before the social compact breaks down? The IMF has had to strike that balance many times in many places. It may not always get the balance right, but no other plausible candidate now exists to play this role.

**Lesson 5: Be Ruthlessly Efficient**

Sovereign debt crises never occur in isolation. They are usually accompanied by political, banking, economic, and sometimes social crises. Once they begin, however, it is in everyone’s interest to conclude a debt restructuring as quickly as possible. This requires both political will and technical competence.

The Latin American debt crisis that began in 1982 languished for a full decade. The Latins still call it the “lost decade.” Even the Brady bond exchange deals of the early 1990s sometimes took years to negotiate, document, launch, and close.

Fortunately, with bondholders replacing commercial banks as the dominant creditors, sovereign debt restructurings have been compressed into shorter timeframes. Mark to market institutional holders of sovereign bonds have an incentive to cooperate in a speedy resolution of the situation. For so long as their bonds are in default or near-default status, the market value of the instruments will be depressed. A successful debt restructuring, even one that calls for a principal haircut, can often restore market value to a portfolio. It is this alchemy that has allowed most sovereign bond restructurings to proceed more efficiently than the workouts of commercial bank loans in the 1980s.

**Lesson 6: Be Evenhanded**

Every creditor group caught up in a sovereign debt restructuring can make a plausible argument for why it should be treated more gently than all the others. Trade creditors, for example, will point to a history of preferential treatment in sovereign debt workouts. Commercial banks may argue that they will
be the lenders of last resort when fickle bond markets have closed. Bilateral creditors may play the geopolitical card.

It is very dangerous for a sovereign debtor to begin discriminating among its creditor groups (that is, to hand out different treatment in a debt workout), absent a clear and convincing reason for doing so. In a corporate bankruptcy, once the senior and secured creditors are dealt with, everyone else gets lumped together as “general unsecured.” A similar approach is wise in the sovereign context.

Differential treatment is sometimes appropriate—trade and supplier debt is a good example—and other creditors will normally accept the rationale for this. But when a sovereign appears to be picking favorites among its creditors without a compelling explanation, the result will be an aggravated sense of grievance on the part of the disfavored creditors.