Six Lessons From Prior Sovereign Debt Restructurings

Lee C. Buchheit

Cleary Gottlieb Steen & Hamilton LLP, New York

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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 will offer you six candidates; three involving measures designed to prevent a crisis or ameliorate the severity of one that cannot be avoided, and three in the realm of how to handle a crisis once it erupts.

Prevention

Lesson One: Don’t let a sovereign debt problem become a banking sector problem

Sovereign debt crises come in two forms: (i) those that are accompanied by a threat to the stability of the banking sector in the debtor country and/or important creditor countries and (ii) those that are not. Of these, the former is 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 of any (or few) 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 writedowns 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 eurozone 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 Two: 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.

The attached column “Pathological Procrastination” contains some avuncular advice to a minister of finance facing these temptations.

**Lesson Three: 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 debt public 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 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.

**Cure**

**Lesson Four: 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 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 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. They may not always get it right, but no other plausible candidate now exists to play this role.

**Lesson Five: 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 Six: Be even-handed**
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 (in terms of the treatment handed out 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.

Attachment: Pathological Procrastination

Lee C. Buchheit*

An Open Letter to the Minister of Finance of the Republic of Ruritania

Dear Minister:

There is no easy way to say this—Ruritania is broke. It isn’t merely illiquid, whatever that means. It isn’t just experiencing temporary financial distress or enduring a bad patch. In truth, Ruritania has accumulated a debt stock that under even the most benignant growth assumptions can never be repaid. Unless that unsustainable debt stock is addressed, it will blight the economic prospects of Ruritania for generations.

Dozens of countries have had to face this same situation over the last thirty years. Some have done it well and emerged from their debt crises quickly. Others have mangled the process and found themselves mired in a financial crisis for years, like a bellowing mastodon stuck in a tar pit.

This history teaches one important lesson. Pathological procrastination by the sovereign debtor in acknowledging the severity of its problem and commencing the necessary workout process can make the ultimate resolution of the crisis far more costly for all concerned—the sovereign debtor, its citizens and its creditors. But every atom of the debtor’s political flesh will cry out to delay a process that is never pleasant and can often be incandescently painful. Deferring the debt restructuring until the next government takes office is, of course, the most tempting option.

In today’s world, a politician’s instinctive preference for denial and delay may receive encouragement from unexpected quarters. The creditors will naturally want to put off the day of reckoning as long as possible. To this end, creditors will alternately flatter (“proud Ruritania has always stood as a champion of the sanctity of contract”) and bludgeon (“we shall neither forgive nor forget a default”) the Ruritanian government into paralysis. Denial and delay may also be urged by Ruritania’s neighboring countries who may fear contagion and market turmoil as a result of a

* Cleary Gottlieb Steen & Hamilton LLP
Ruritanian debt restructuring. If those neighbors fear it enough, they may even offer to lend Ruritania all the money it needs to continue servicing a visibly unsustainable debt stock. That path lends inexorably to the visibly unsustainable debt stock being owed to bilateral and multilateral creditors.

The proponents of inaction will never publicly concur with the proposition that a sovereign debt stock has reached the point where a restructuring is the only feasible option. Frugality, discipline, sacrifice and patience, they argue, will eventually remedy any problem. But this is also when fairy dust and a profound belief in the efficacy of prayer may enter the picture. Allow economists to assume in their mathematical models the watchful presence of a Merciful Providence, and any sovereign debt stock can be judged sustainable. Even IMF economists, under pressure from some of that institution’s more influential shareholders, have been heard to clap for Tinkerbell when preparing debt sustainability analyses.

My advice, Minister, is that you:

- Disregard any debt sustainability analysis that assigns a greater than 50% probability to the occurrence of the Second Coming of Christ before the next bond maturity.
- While avoiding unrealistic optimism, do not careen to the other extreme of soul-destroying despair. A request for financial assistance addressed to the Executive Board of the IMF should not begin with the sentence, “The last camel died at noon”. Panic is as infectious as yawning. So, however, is a sense of composure and control.
- Once it becomes clear that the debt stock must be addressed, get on with it. Creditors may not like the prospect of having to write off a portion of their claims or defer repayment dates, but they positively loathe prolonged periods of indecision and dithering. Efficiency, discipline and fairness, even in carrying out a disagreeable task, will be remembered by markets long after the financial pain of a sovereign debt restructuring has been forgotten.

A sovereign debt crisis is just that, a crisis. It does not have to become a catastrophe.

Respectfully submitted,

Lee C. Buchheit