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19-8 How to Restructure Sovereign Debt: Lessons from Four Decades

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Abstract

This paper attempts to provide a playbook for the sovereign debt restructuring process, drawing on the experience with sovereign debt restructuring since the 1980s. It begins with a discussion of the participating actors and their interests. It then describes the considerations that must be weighed in designing, negotiating, and concluding a debt restructuring, in light of two problems: asymmetric information between the debtor and the creditors, and creditor coordination problems, which can lead to free riding (the "holdout" problem). The paper focuses on how these problems, which can lead to inefficiently negotiated outcomes, can be managed and minimized in practice.

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I. INTRODUCTION

This paper discusses the process of restructuring a sovereign's debt once this step becomes unavoidable. All sovereign debt workouts are painful—for the debtor country, its citizens, its creditors, and its official sector sponsors. If mishandled, however, a sovereign debt workout can be incandescently painful. A mangled debt restructuring can perpetuate a sense of crisis for years, sometimes even for decades. A return to normal economic activity may be delayed, credit market access frozen, trade finance unavailable, capital flight endemic, financial sector instability acute, and foreign direct investment withered (Trebesch and Zabel 2017). Adding to these inherent difficulties, sovereign debt crises rarely come in isolation. They are often the cause of, caused by, or at the very least accompanied by political crises, banking crises, social crises, and occasionally humanitarian crises.

Sovereign debt restructuring negotiations can be complicated by three fundamental problems:

First, debtors and some creditors may have reasons *not* to desire a quick resolution. Extraneous motives may interfere, particularly on the debtor side. Sovereign debtors are governments responding to political incentives. A confrontational approach, although unhelpful from the standpoint of reaching a deal, may be popular with domestic constituencies.

Second, there is almost always an asymmetry of information between a debtor and its creditors. Sovereign debtors know their capacity to repay better than the creditors because they are in a better position to judge how much adjustment and reform is realistic, as a political and economic matter, to service future debt obligations. This creates a problem: Creditors may reasonably assume that governments are trying to lowball them and overcompensate by offering too little debt relief. But the reverse problem also exists: Debtors cannot be quite sure how much debt relief creditors are willing to accept.

Third, there are conflicts of interest not just between the debtor and creditors collectively but also among creditors. The ability of the debtor to repay an individual creditor, or a group of creditors, will improve the more other creditors agree to debt relief. Hence, each creditor has an incentive to hold out for full repayment—that is, free ride on the debt relief agreed by others. This is referred to as the "creditor coordination problem," or alternatively, the "holdout" problem.

As a result, a sovereign debt restructuring can fail in several ways. It can take too long to execute, it may not provide sufficient debt relief, it may extract debt relief that most creditors see as excessive and confiscatory, or the creditors may view the operation as unnecessarily coercive (Cruces and Trebesch 2013). The extent of the longer-term damage to the sovereign's credit reputation may well depend on the market's perception of whether the country behaved fairly and professionally during the period of its debt crisis.

This paper provides a comprehensive attempt at a playbook that outlines the steps of the sovereign debt restructuring process. The underlying assumption is that the debtor and most creditors have an interest in negotiating in good faith; that is, the paper abstracts from problems that arise because of domestic politics. Based on this assumption, the paper describes how to resolve the remaining two problems—asymmetric information and creditor coordination. It begins with a discussion of the parties involved and then tackles the considerations that must be weighed in designing, negotiating, and concluding a debt restructuring. Case studies throughout illustrate innovations that have been employed over the years to facilitate the process.

II. THE PLAYERS

The Sovereign Debtor

Sovereign debtors are unlike all other debtors on this planet (Buchheit 2013). First, a sovereign is uniquely exposed to hostile creditor legal actions. Unlike a corporate or individual debtor, a sovereign cannot use a bankruptcy code to restructure its debts under the supervision (and protection) of a court. A sovereign's debt can never be legally discharged in bankruptcy; debt relief can only be obtained with the creditors' consent.

Second, sovereigns are subject to suit in most national courts with respect to their commercial activities under the restrictive theory of sovereign immunity. Under this theory (which gained widespread acceptance in the last half of the 20th century), when a sovereign elects to go into the international marketplace and conduct itself as a commercial actor (such as by issuing bonds), it will be accountable to judicial process as though it *were* a commercial actor.[1] However, unlike their corporate and individual debtor counterparts, sovereign assets (e.g., embassies, consulates, and military property abroad) are typically shielded from attachment by national and international law. In short, it is relatively easy for creditors to get court judgments against a defaulting sovereign but relatively difficult for them to enforce those judgments.

A sovereign is also unlike other debtors in that the question of *when* it has become insolvent may be subject to considerable debate. A sovereign's assets, in light of its taxing power, are theoretically congruent with all of the assets in the debtor country. The question then becomes at what point the theoretical power to tax is limited by the economic and political impracticalities of doing so. Separately, there is genuine uncertainty around a sovereign's future earning capacity, as it partly depends on exogenous and difficult-to-predict factors. Conducting a sovereign debt sustainability analysis (DSA), one of the key roles of the International Monetary Fund (IMF) in the debt restructuring process, is far from a precise science (see box 1 for a discussion of other IMF roles).

Finally, sovereign debt is remarkably adhesive. The public international law doctrine known as state succession requires governments to recognize and honor debts incurred by predecessor regimes in that country no matter how different those prior administrations may be in their political philosophy and no matter what the incumbent administration thinks about how their predecessors spent the proceeds of those prior borrowings. The exceptions to this rule of public international law are very limited, an arguable one being the concept of odious debt (Buchheit, Gulati, and Thompson 2007).

State-Owned Entities

In the context of a sovereign debt restructuring, the debt of state-owned or state-affiliated entities may also need to be restructured, either because those credits have been explicitly guaranteed by the sovereign or because attempting to draw a distinction between the finances of the sovereign and the related entity is essentially meaningless. Treating such sub-sovereign debt may also become unavoidable. Creditors of the sovereign may insist that lenders to state-owned enterprises bear a proportional burden of the restructuring for reasons of inter-creditor equity. Restructuring a sovereign debtor's contingent liabilities (e.g., private sector debt with a sovereign

1. Foreign Sovereign Immunities Act (FSIA) of 1976, United States Code (USC) Title 28, §§ 1602, et seq.

Box 1 The role of the IMF in sovereign debt restructuring

Because of its oversight and financing roles enshrined in its Articles of Agreement, the IMF is often central to the debt restructuring process (Ams et al. 2018):

Financing: The IMF provides balance of payments financing "under adequate safeguards" (e.g., conditionality) to a member country implementing an economic adjustment program. The success of that program is meant to assist the member in overcoming its balance of payments problem, enable it to repay the IMF, and foster stability more generally, including by preventing or mitigating spillovers to other countries.

The Trigger: Whether a country requires a debt restructuring will depend on a debt sustainability analysis (DSA), which assesses the feasibility of policy adjustment and the availability of financing from all available sources. The IMF's DSA hence plays a role in the decision on whether a debt restructuring will take place (whether in the context of an IMF- or outside-supported adjustment program).

The Financing Envelope: The IMF's DSA also effectively identifies the envelope of resources available for debt service payments to official and private creditors, which is crucial to anchor deliberations between the debtor and its creditors.

Process: In general, the IMF encourages its members to collaborate with their creditors when seeking a restructuring. Beyond that, the IMF leaves the specific details of the debt restructuring strategy to the debtor and its legal and financial advisors. In pre-default cases, the IMF does not insist on any particular form of dialogue between the debtor and its creditors. In post-default cases, the IMF is guided by its arrears policies, which set more specific standards for dialogue between creditors and debtors, including assessing whether the member is making a good faith effort to reach a collaborative agreement with its creditors.

Inter-Creditor Equity: The IMF does not intervene on issues of inter-creditor equity. Its arrears policies, however, do imply stronger protections for official creditors than for private creditors. Creditors have also accepted, in restructurings undertaken in the context of IMF-supported programs, some *intra*-group differentiation in the treatment of their claims to help limit the extent of economic dislocation, maintain market access, and preserve financial stability.

guarantee that has not been called) presents its own challenges. A large contingent liability may undermine debt sustainability down the road, if and when the guarantee is called (Buchheit and Gulati 2012).

The Creditors

On the other side of the table from the sovereign are its creditors. These can broadly be divided into three categories: multilateral official, bilateral official, and commercial (private).

Multilateral Official Creditors and Other Monitors

Apart from the IMF, a country undergoing a debt restructuring may receive new financing from other multilateral official creditors such as the World Bank or regional development banks (e.g., the African Development Bank, the Asian Development Bank, the Inter-American Development Bank). Other national and international bodies may also monitor and support the restructuring process. In the case of the euro area debt crisis that began in 2010, for example, the European Central Bank and the European Union provided new financing and were actively involved in monitoring economic reform programs in the recipient countries. In past crises, such as the 1980s global debt crisis and the Mexican debt crisis of 1994–95, the US Treasury both provided new financing and played a key role in facilitating the debt restructuring process. Naturally, when the creditor universe comprises regulated financial institutions like commercial banks (which it did during the 1980s), the intervention of national regulators can be important (Buchheit 1990).

Bilateral Official Creditors

Bilateral official creditor claims traditionally take the form of loans from one sovereign state to another, often to finance exports from the creditor country or to provide development assistance. Bilateral lenders regard their credits—because they are not extended for profit but for public policy reasons, such as crises response, official development assistance, and trade development—as senior to the commercial debts of the sovereign borrower. For their part, commercial lenders have sometimes contested this position, arguing that bilateral credits are extended to enhance exports from, or to further the geopolitical objectives of, the lending countries.

Commercial (Private) Creditors

Commercial creditors may include bondholders, banks, suppliers, trade creditors, contractors, and even individuals. Bondholders may range from institutional investors (investment funds, insurance companies, retirement funds) who buy sovereign bonds at or near par in the primary market and hold them to maturity, to "distressed debt funds" who buy defaulted (or near-defaulted) debt on the secondary market at large discounts.

Within the broad genus of distressed debt funds is a species often referred to as a "vulture" fund. Vulture investors may approach a sovereign debt restructuring with malice aforethought; they often intend from the outset to reject a negotiated settlement and to seek a preferential recovery at the sharp end of a lawsuit. Aggressive recovery strategies of this kind have sometimes significantly disrupted the orderly resolution of sovereign debts, prompting debtor countries to develop techniques to counter such behavior (discussed below).

Finally, the universe of private creditors caught up in a sovereign debt crisis may also include retail and individual creditors. Retail investors are often highly dispersed, less sophisticated than institutional investors, and less able to bear significant financial losses.

III. THE RESTRUCTURING ENVELOPE

Once the sovereign determines that a restructuring is necessary (or perhaps even before making this determination), the sovereign should hire financial and legal advisors to guide it through the process. Because those advisors are likely to be the principal interlocutors with the country's commercial creditors, their familiarity with the market—and the market's familiarity with them—is critically important.

The advisors, in conjunction with the IMF, will determine the overall quantum of needed debt relief. The presence of both sets of actors helps solve the information asymmetry problem in both directions. The IMF's debt sustainability analysis helps inform the creditors about the debtor's capacity to pay. The advisors help inform the debtor about the creditor's willingness to accept a debt relief offer.

Excluded Claims

An important question is what categories of debt should be included in the restructuring pool. There are some general rules of thumb. First, trade credits are generally excluded or given more lenient treatment, given the economic necessity of continued trade financing. Any senior or collateralized debt obligation is also generally excluded. Treasury bills, given the need for continued short-term financing of the government, are also generally left out of the restructured claims, with a few prominent examples to the contrary such as Russia (1998), Ukraine (1998), and Uruguay (2003) (Sturzenegger and Zettelmeyer 2007, 2008).

The claims of international financing institutions (IFIs) are also left out of the restructuring bucket. The IMF, for example, enjoys preferred creditor status, which means that its claims will be excluded from the restructuring process. This is a de facto, not a legal, priority generally recognized by all stakeholders, including official bilateral as well as private creditors. IMF financing is conditioned on the member country taking steps to address its underlying economic imbalances, a process that helps to ensure that the other creditors will have their restructured claims repaid as well (IMF 2009). Other IFIs, such as the World Bank and the regional development banks, are also generally considered preferred creditors (Rieffel 2003).

Domestic versus External Debt

One of the biggest dilemmas facing a sovereign debtor embarking on a restructuring will be the extent to which the restructuring burden should be borne by holders of debt governed by domestic law versus holders of foreign-law governed debt. There are several considerations at play. One issue concerns the *means* of restructuring: The sovereign can unilaterally change the terms of domestic-law governed debt by making appropriate changes in its domestic law. This gives the sovereign enormous flexibility in designing the restructuring and limiting holdout behavior (see box 7). Moreover, if domestic law debt is denominated in local currency, the sovereign may also choose to inflate away the debt problem.

Another set of considerations relates to the collateral effects of a debt restructuring. Restructuring local-law governed debt may be easier from a legal perspective, but because this debt may be disproportionately held by domestic residents, including local financial institutions such as domestic banks, restructuring it may undermine the health of the banking system and worsen the prospects for restoring economic growth. Governments may also have political incentives to avoid or minimize the restructuring of domestically-held debt.[2] Those claims are often held by voters or political insiders. On the other hand, focusing a restructuring exclusively on domestic debt may help to reduce the reputational costs in the eyes of the international capital markets. Countries with a strong desire to maintain access to external borrowing may therefore have an incentive to restructure domestic debt before contemplating a restructuring of debt held mainly by external creditors. One example is Russia's 1997 default and subsequent restructuring that excluded foreign law bonds issued by the Russian Federation (Sturzenegger and Zettelmeyer 2008, Reinhart and Rogoff 2009).

Restructuring foreign law bonds requires other tools to limit holdout behavior (see the "Carrots" and "Sticks" sections below), because the sovereign debtor cannot unilaterally change the terms of the bonds by legislative fiat, as it can with domestic law bonds. An attempt to place the major weight of the restructuring on creditors with foreign law debt, however, may give rise to inter-creditor equity concerns. Foreigners may refuse to agree to restructuring terms that effectively subsidize full payments to creditors holding domestic law debt.

2. This applies with less force today than has been the case traditionally, when domestic debt was governed by domestic law, denominated in local currency, and locally held, while external debt was foreign-law governed, held abroad, and denominated in foreign currency. Today, nonresident creditors may hold domestic-law governed debt (denominated in either local or foreign currency), and resident creditors may hold foreign-currency denominated, foreign law debt (Gelpern and Setser 2004).

IV. PREPARING THE RESTRUCTURING PROPOSALS

The sovereign debtor, as the party seeking to modify the terms of its existing debt contracts, is responsible for preparing proposals—often captioned as indicative restructuring scenarios—that lay out both the overall quantum of debt relief the sovereign will be seeking from private creditors as well as the methods (haircuts, maturity extensions, coupon adjustments, etc.) used to convey that relief. Behind the curtain, the IMF team working on the country's fiscal adjustment program will have already vetted these proposals to ensure that they are consistent with the terms of that program. The release of indicative restructuring scenarios is intended to serve several purposes:

- The scenarios psychologically prepare the creditors for the level of debt relief the sovereign is seeking—helping to reduce sticker shock once a specific debt exchange offer is made.
- Having run the scenarios up the proverbial flagpole, the sovereign can proceed to count the number of equally proverbial bullet holes that the documents display when they are taken down and analyzed.
- The release of the scenarios marks the beginning of a formal negotiation process with the creditors. In the patois of the investment bankers, the scenarios represent the debtor's "ask" in the coming negotiations.

A sovereign will have a choice in how to release its indicative restructuring scenarios. If the scenarios describe the proposed treatment of bonds or other securities, they will constitute material nonpublic information within the meaning of the securities laws (because they signal the maximum amount of debt relief the sovereign will be requesting). Sharing the scenarios with selected creditors or with a creditors' committee will therefore require the sovereign to obtain nondisclosure/stop-trading agreements from the institutions receiving the material nonpublic information. The alternative, putting the scenarios on a public website, avoids the need for nondisclosure agreements but comes with its own risk. Once in the public domain, the scenarios will later permit the government's critics to compare the government's opening position (as revealed in the scenarios) with the terms of the final deal; the difference will represent the nature and extent of the government's negotiating concessions.

V. THE NEGOTIATION PROCESS

Once a sovereign debtor concludes that a restructuring is inevitable, the challenge becomes reaching a deal with creditors. Negotiations can sometimes be relatively easy if the sovereign has a simple debt profile and a relatively homogenous creditor base (e.g., Moldova in 2003 and Seychelles in 2010). However, in the context of a complex debt structure with widely diverse creditors—with banks, bondholders, hedge funds, suppliers, trade creditors, contractors, etc. (see, e.g., box 8, the case study of Iraq in 2005)—arriving at an agreement on restructuring terms palatable to all creditors may be extraordinarily challenging.

Engagement with Official Sector Creditors

The principal international forum for restructuring official bilateral claims is the Paris Club (G-20 2016, 2018), an informal group of 22 creditor countries that have worked together since the 1950s to find coordinated and sustainable solutions to countries' debt problems (see box 2).

Box 2 The Paris Club: Evolution in debt treatment

The Paris Club has concluded 433 successful negotiations with 90 countries over the last 60 years. Thirty-five percent of them, spread over around 50 debtor countries, involved non–Paris Club creditors at the time of this paper.

From its first debt treatment in 1956 to 1987, all agreements were reached under the **Classic terms:** non-concessional reschedulings with a repayment profile negotiated on a case-by-case basis but with no nominal debt relief. These reschedulings supported countries with IMF adjustment programs.

With the 1980s debt crisis, lower- and middle-income countries started to face deeper debt sustainability challenges. The Paris Club thus softened its terms by creating the **Venice terms**[1] in 1987, which lengthened repayment and grace periods. The **Toronto terms** were created in 1988 for the most heavily indebted and poorest countries and enabled concessional treatments by providing debt cancellation for the first time. In 1990, Paris Club creditors created the **Houston terms,** designed for lower-middle-income countries, which lengthened repayment periods, allowed official development assistance (ODA) credits to be rescheduled at a concessional rate, and enabled debt swaps on a bilateral and voluntary basis for ODA claims. Considering that debt vulnerabilities were still high in 1991 for low-income countries, the Paris Club replaced its Toronto terms with the **London terms,** which raised the debt cancellation rate from 33 percent to 50 percent.

As it increasingly adopted concessional terms, the Paris Club recognized that the external debt situation of low-income countries had become extremely difficult and deterred future economic growth. For these countries, even full use of traditional mechanisms of rescheduling and debt reduction—together with continued provision of concessional financing and pursuit of sound economic policies—were deemed insufficient to reach sustainable external debt.

Thus, in 1994, the Paris Club decided to treat the debt stocks of some countries by creating the **Naples terms.** For the poorest and most indebted countries, the level of debt cancellation was at least 50 percent and could be raised to 67 percent of eligible non-ODA credits. The rescheduling of ODA claims was further lengthened up to 40 years. The level of cancellation was again raised (up to 80 percent) for non-ODA claims with the **Lyon terms** in 1996. Under these terms, stock treatments were implemented for the very first time for countries with established and satisfactory track records with both the Paris Club and the IMF and for which there was sufficient confidence in their ability to respect the debt agreement.

In 1996, the international financial community, realizing that the external debt of a number of mostly African low-income counties had become unsustainable, launched the **Initiative for Heavily Indebted Poor Countries** (HIPC), which aimed to place the debt on a sustainable path, notably by including in debt treatments multilateral claims that had never been restructured before. In 1999, Paris Club creditors decided to reinforce the HIPC initiative to provide faster and broader debt cancellation to a large number of countries. Consequently, the Paris Club replaced its Lyon terms with the **Cologne terms,** which, for countries declared eligible for the enhanced HIPC initiative, raised the debt cancellation rate of non-ODA claims from 80 percent to 90 percent or more on a case-by-case basis. On top of that, all Paris Club creditors agreed to provide additional efforts to the HIPC initiative assistance on a bilateral basis.

Meanwhile, in 2003, Paris Club creditors agreed on a new approach, the **Evian Approach,** to deal with non-HIPC countries, providing them with more tailor-made and concessional treatments. Under this approach, a debt treatment may take various forms: flow treatment, stock reprofiling, and stock reduction (in exceptional cases). Treatments are phased to ensure that countries only fully benefit from concessional treatment if they maintain a sound track record on their IMF-supported programs over time.

Since the 2010s, and as the creditor base has become more fragmented, the Paris Club has developed an active outreach strategy to progressively expand its membership to major emerging creditors. In 2016, Brazil and Korea became full members of the Paris Club, after Israel in 2014. China, India, and South Africa have also developed a working relationship with the Club under the status of ad hoc participant.

1. The names of the terms refer to the G-7 summit at which they were designed.

The Paris Club has six main principles that underlie and guide its work. These include *solidarity* (members shall act as a group), *consensus* (decisions are taken by consensus), *information sharing* (members share views and information), *case-by-case approach* (decisions will be tailored to each individual debtor), *conditionality* (in particular, the country must have an appropriate IMF-supported program), and comparability *of treatment* (The Six Principles, see Paris Club 2019a).The latter principle states that a debtor country that signs an agreement with its Paris Club creditors should not accept from either its private or non–Paris Club official bilateral creditors terms of debt treatment less favorable to the debtor than those agreed (Paris Club 2019b).

Engagement with Commercial Creditors

The sovereign must decide whether, and how, to engage with committees of representative creditors that may have been formed to negotiate with the sovereign on the creditors' behalf (Buchheit 2009, DeSieno 2016). This requirement can be a surprisingly contentious issue. The presence of committees can influence restructuring outcomes in several ways.

- A committee should help address the creditor coordination problem. In principle, the decisions of the committee, once made, should be accepted by all committee members and the creditors that they represent. This alignment should be in the interests of both the debtor and creditors collectively. Creditors avoid the damage that can be created by free riders seeking a better deal at the expense of the sovereign's capacity to repay the remaining creditors; the debtor avoids the headache and legal risks of dealing with holdouts.
- At the same time, committees may reduce the debtor's flexibility to deal with heterogenous creditors. By recognizing a creditor's committee, the sovereign is implicitly agreeing that it will negotiate the terms of the debt restructuring with that body. The connotation of the word "negotiate" in this context is that the sovereign will not make a formal offer to its creditors without the prior approval of the committee. If discussions bog down, or if members of the committee insist on features that the authorities simply cannot accept (e.g., a requirement that the sovereign also restructure its multilateral debts), then the sovereign's ability to complete its debt restructuring will be blocked, possibly for a long time.
- Finally, committees may of course influence the bargaining power of creditors collectively. However, the channels through which this happens—and the net effect—are less obvious than might appear at first. Creditor committees are usually assumed to raise creditor bargaining power. In the absence of a committee, the debtor could make a take-it or leave-it offer that extracts the maximum debt relief that a broad majority of creditors are willing to accept. Negotiation by committee allows the creditors to make counteroffers, an option not available to creditors as an uncoordinated group. However, in the presence of uncertainty, take-it or leave-it offers could also work to the benefit of the creditors. Without a formal endorsement of terms by a creditor committee, the sovereign runs the risk that its market soundings in these consultations may prove inaccurate and the restructuring offer will fail. One school of thought therefore holds that a sovereign will be under pressure to be *more* generous (to the creditors) following an informal consultation process than it would have been after a formal negotiation process with a committee.

Despite these arguments, creditor groups generally favor committees. The Institute of International Finance (IIF) has endorsed the use of committees and published best practices for their formation and operation (IIF 2016). Creditors have also advocated the incorporation of so-called engagement clauses in sovereign bond contracts. These are contractual commitments to recognize the formation of a creditors' committee upon sovereign default or other signs of difficulty. Such clauses may also require the issuer to negotiate in good faith with the committee and to pay the costs incurred by the committee (ICMA 2014). For various reasons, few sovereign issuers have included such clauses in their bond contracts (Zandstra 2016). If the IMF is providing financing to the sovereign, then the negotiation process between a sovereign and its creditors will implicate the IMF's arrears policies. The policies are designed to encourage a sovereign to engage constructively with its creditors to reach agreement on a debt restructuring and discourage creditors from holding out of a fairly negotiated deal (see box 3).

VI. CREDITOR OBJECTIVES AND CONSTRAINTS

Commercial creditors typically approach a sovereign debt workout with the following objectives and constraints:

(i) If a class of creditors (like trade creditors or Treasury bill holders) can talk their way out of participating in a debt restructuring, that is the best option for them, but it will be proportionally bad for all the other creditors. A debt restructuring is a zero-sum game. The sovereign will need a certain level of debt relief. If one creditor or class of creditors is exempted from the process, the other creditors will have to make additional contributions to cover the shortfall. Accordingly, the basic rule for a creditor is this—if you can jolly your way out of a debt restructuring, great; but if you can't, then do all in your power to ensure that as many other creditors as possible are also roped into the process.

(ii) The basic logic of a debt restructuring for the creditors is simple—accept some degree of debt relief in order to enhance the collectability of the balance of the exposure. That logic, however, requires a judgment about how much debt relief will be required, in combination with fiscal adjustment and official sector support, to return the sovereign to a sustainable position. This is usually where the IMF comes in. The creditors will look to the Fund to vouchsafe (implicitly) that the amount of debt relief being requested from them is sufficient to achieve sustainability but not more than is necessary to reach that point.

(iii) Creditors watch each other warily. No creditor wants to be embarrassed by giving more debt relief than other similarly situated creditors. This instinct inexorably leads to calls for measures designed to assure parity of treatment among different types of creditors (Buchheit 2002; see below, "Parity of Treatment Undertakings").

(iv) Finally, once debt relief has been given, the creditors will want to do everything they can to prevent the sovereign debtor from backsliding. An IMF program may help to enforce fiscal discipline, but only for a while. Over the longer term the creditors will need to look to contractual protections (such as financial covenants and events of default) to impose behavioral discipline on their sovereign borrowers. In truth, however, these are crude and frequently ineffective tools.

Box 3 The IMF's arrears policies

Background: The IMF's arrears policies are rooted in legal principles that seek to avoid disruptions to the international trade and payment system. First, the Fund recognized that incurring arrears undermines a debtor's relationships with external creditors, which exacerbates the member's balance of payments problems in the longer term and does damage to the international trade and payments system more broadly. Second, the arrears policies are designed to establish adequate safeguards for the temporary use of IMF resources by limiting members' ability to achieve financing through the accumulation of arrears. Such behavior may undermine the ability of members to repay the IMF beyond the program period, as it may hinder the member's progress in reestablishing its creditworthiness.

The IMF has recognized that these legal principles are not absolute, and its arrears policies have evolved over time to allow the IMF to lend despite a member's arrears in certain circumstances. The arrears policies make a distinction between arrears to external private sector creditors and arrears to official bilateral and multilateral creditors.

Lending into Arrears (LIA) Policy for Private Creditors: The LIA policy was established in 1989 in the wake of the 1980s debt crisis, after the IMF realized that its non-toleration of arrears to private sector creditors gave creditors an effective veto over IMF lending. The policy, as amended over time, allows the IMF to lend to a sovereign with arrears to external private creditors, only if the member is making a "good faith effort" to reach a collaborative agreement with its private creditors. While the policy does not outline exactly what type of behavior constitutes good faith, it does set expectations about the extent of the dialogue between the debtor and its creditors (IMF 2013).

Official Arrears Policies: The negotiations between a debtor and its official bilateral creditors take place in the shadow of the IMF's official arrears policies. The IMF traditionally had a strict policy of non-toleration of unresolved arrears to official bilateral creditors. In light of changes in the official creditor landscape—the majority of official sector financing is now provided by non–Paris Club creditors—the IMF amended its policy in 2015 to allow it to lend into unresolved official arrears that will be restructured in the context of an IMF-supported program when any of the following criteria are met: (i) the creditors consent; (ii) there is a representative Paris Club agreed minute; or (iii) if there is no representative Paris Club agreed minute, the debtor is negotiating in good faith with the creditor to resolve the arrears, and the IMF's decision to provide financing despite the arrears would not have an undue negative effect on its ability to provide financing in the future (IMF 2015c).

Official bilateral creditors covered by the anticipated terms of the Paris Club's agreed minute are deemed resolved for Fund program purposes. Relying on the Paris Club's comparability of treatment principle, the Fund deems that non–Paris Club official bilateral creditors will restructure the member's debt on similar terms as the Paris Club creditors. Moreover, arrears that will not be restructured in the context of an IMF-supported program are not tolerated, and the IMF will only lend into such arrears if the member does not object to the IMF lending, despite the arrears. Generally, arrears to multilateral creditors must be cleared during the program period, while arrears to the World Bank must be cleared up front (IMF 2013).

VII. METHODS AND TECHNIQUES

Open the toolbox of a sovereign debt restructurer, and you will find three main instruments:

- change the maturity dates for amounts of principal or interest falling due under the affected debts and introduce grace periods,
- reduce the principal amount of the debt (in the jargon, a principal *haircut*), and
- reduce the interest rate on the debt (in the case of bond indebtedness, a *coupon adjustment*).[3]

3. Other techniques for achieving debt relief are sometimes possible. For example, when the sovereign's debt obligations are trading at a significant discount to face value in the market, the sovereign borrower—if it has a

It is possible, of course, to mix and match these techniques (for example, a maturity extension with a coupon adjustment), and this is indeed the norm in most sovereign debt restructuring packages.

For their part, creditors can be expected to express strong views about the method chosen to address a sovereign's debt problem. Principal haircuts are particularly disfavored by commercial creditors. When the restructuring involves only a maturity extension and/or a coupon adjustment, a post-closing improvement in the sovereign's financial prospects and credit rating will directly benefit creditors because the secondary market value of the *entire* principal amount of their claims against the country will increase. Principal haircuts, however, involve the creditor forfeiting a portion of that claim. A subsequent improvement in the credit rating of the country can therefore lift the value of only the residual principal amount of the claim. This explains why transactions calling for principal haircuts are more likely to involve the issuance of some form of a "value recovery instrument" (see section IX below) that will permit creditors to recoup a portion of their loss if the economic fortunes of the sovereign debtor improve in the future.

One restructuring technique that has received recent attention involves a *reprofiling* of maturities (that is, a relatively short extension of the maturity dates of affected debt instruments), often with interest rates left untouched during the extension period (Buchheit, Gulati, and Tirado 2015). The classic example is Uruguay's debt restructuring of 2003. For each of its 18 bonds issued in the international markets, Uruguay extended the maturity date by a uniform five years, while leaving the coupon rates during this extension period the same as originally issued (Buchheit and Pam 2004). In 2016, the IMF endorsed the use of a reprofiling technique in situations where the Fund is providing exceptional access to its financing and cannot assess the sovereign's debt to be sustainable with a high probability (IMF 2014a, 2015a). The reprofiling shifts the maturities of existing debts out of the IMF's program period, thus obviating the need to fund those maturities with official sector resources.

VIII. THE HOLDOUT CREDITOR

For the vast majority of private sector creditors affected by a sovereign's financial distress, accepting a restructuring of their claims is the only practicable solution. The sovereign debtor will lack the resources to pay all of its debts on their original terms; that is essentially the definition of financial distress. Turning all or any significant part of those claims into court judgments does not alter this hard fact. The sovereign will not have the money to pay all claims in full regardless of whether the claimants transform themselves from simple creditors into judgment creditors.

But what is inescapable for most creditors—a negotiated, consensual workout—can be an attractive business opportunity for the few or the one lender who is prepared to break ranks with fellow creditors. The theory is simple: If the sovereign debtor receives debt relief from most of its lenders, the likelihood that the sovereign will

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funding source—may attempt to repurchase the instruments and thus benefit from that discount. This was the method employed by a number of HIPC countries to reduce their commercial debts. Funding for those HIPC buybacks came from official sector grants. As pointed out by Bulow and Rogoff (1988) debt buybacks may not be effective—in the sense of benefitting mainly the creditors rather than the debtor—if they occur at secondary market prices, as debt prices will generally rise in response to the buyback. However, some sovereign debtors have attempted buybacks at prices fixed by the debtor, using some of the methods described in section IX below to induce creditors to buy at that price.

have the money to pay off an importunate maverick creditor that declines to join the restructuring and threatens to pursue legal remedies will increase. In the jargon of sovereign debt restructuring, these maverick creditors are "holdouts" from the main restructuring exercise.

There is a popular belief that holdout creditors attempt to delay or derail sovereign debt restructurings. They don't. Indeed, the holdout creditor prospers only if all or most of its fellow creditors agree to provide debt relief to the sovereign; the more debt relief, the better, from the standpoint of the holdout. If the holdout population in a sovereign debt restructuring is of any significant size, the financial predicates behind the entire exercise are undermined and the holdout's prospects of extracting a preferential recovery diminish. By their very nature holdouts are individualistic and do not regulate themselves as a group. But even if holdouts do not derail a debt restructuring, they can cause considerable mischief after it closes. The sovereign debtor's job is therefore to employ some combination of carrots and sticks (discussed below) in order to reduce the size of any holdout population in a debt restructuring and to neutralize, as much as possible, the extent of any post-closing mischief.

The relationship of holdouts to those creditors who elect to join a sovereign debt restructuring has altered over the years. Once upon a time the investor community welcomed, or at least tolerated, the threat of holdout creditors in a sovereign debt workout. The prospect of litigious holdouts, the argument went, would induce the sovereign debtor to offer more generous financial terms to all of its creditors in an attempt to narrow or eliminate the holdout class. Holdouts, although perhaps insufficiently infused with fraternal creditor spirit, were nonetheless the pebble in the shoe, the burr in the saddle, the bee in the bonnet—choose your idiom—that kept sovereign debtors from demanding excessive amounts of debt relief from the creditor class as a whole.

Those days are over. The perception of holdouts as benign spurs to sovereign debtor restraint ended in 2012 in the context of the Argentine saga. In that year, some of the holdouts from the Argentine debt restructuring of 2005 sought and obtained an injunction from a US federal court effectively preventing Argentina from making payments on the new bonds it had issued in that restructuring to participating creditors unless it was prepared to pay the litigious holdouts in full.[4] The holdouts had thus turned on their fellow lenders. Not only were the holdouts demanding a preferential recovery indirectly funded by the generosity of their quondam fellow creditors, they were now forcing the debtor to default on those indulgent creditors unless the holdouts were paid off in full. Post-Argentina, the suppression of holdout creditor behavior has therefore become an imperative not only for sovereign debtors but also for the vast majority of their other lenders (Buchheit and Gulati 2017b, Buchheit 2018b).

Some restructurings will include minimum participation thresholds (e.g., 90 percent) and will go forward only if such thresholds are reached. In any event, if a debt restructuring ends without all affected creditors participating but is still determined viable, the sovereign will need to decide how it will treat the nonparticipants. A very small number of holdouts may allow the sovereign to pay them according to the original terms of their debt instruments (Ecuador 2000, Greece 2012). A more-than-trivial holdout population, however, probably

4. NML Capital, Ltd. v. Republic of Argentina, 699 F.3d 246 (2d Cir. 2012); and NML Capital, Ltd. v. Republic of Argentina, 727 F.3d 230 (2d Cir. 2013).

portends a disagreeable bout of litigation with holdouts, as the case of Argentina in the aftermath of its 2001 default illustrates.

IX. ENCOURAGING CREDITOR PARTICIPATION

Sovereign debtors sometimes attempt to cajole their lenders into granting debt relief, sometimes they bludgeon them into doing so, and occasionally they try to do both at the same time (Buchheit and Daly 2014).

Carrots

Cajoling usually involves adding sweeteners to the restructuring package to entice widespread creditor participation. Naturally, these sweeteners can operate only at the margin. By its very nature, a sovereign debt restructuring will be distasteful for the lenders caught up in the exercise.

Cash (or Cash Equivalents)

The transaction sweetener with the highest saccharine content will be cash or a cash equivalent, like high-quality short-term debt obligations of a third party. Cash can be used to pay down outstanding principal, to reimburse accrued but unpaid interest, or to pay participation fees to the creditors joining the restructuring. The problem, of course, will be funding. The one commodity that will be in short supply for a country embarking on a restructuring of its external debt is foreign currency. There have been cases (Greece in 2012 is the most recent example) where official sector sources have been prepared to lend a sovereign debtor the cash (or cash equivalent) needed to sweeten its offer to commercial creditors (Zettelmeyer, Trebesch, and Gulati 2013).

Value Recovery Instruments

Lenders may argue that they are being asked to defer or reduce their claims when the country is at the nadir of its economic fortunes. What happens, however, if the economy of the debtor country improves in the future? Isn't it fair, the creditors will ask, that they recoup some portion of the financial sacrifice they will have endured in the debt restructuring to make that future prosperity possible?

This sentiment has led to the inclusion in the financial packages offered to private creditors in a number of sovereign debt restructurings of what are generically called value recovery instruments or VRIs. VRIs most prominently made their appearance during the Brady era,[5] when commercial banks were asked to accept haircuts on their long-outstanding sovereign loans. In the Brady packages for oil-exporting countries like Mexico, Venezuela, and Nigeria, participating creditors were offered warrants linked to the price of oil. The theory was that a future increase in the price of oil exceeding an inflation-adjusted benchmark price would be a fair proxy for concluding that a degree of prosperity had returned to the debtor country. In that situation, the argument went, it would be only fair that the sovereign begin making payments on warrants issued at the time of the restructuring.

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5. During the Brady era, named after then US Treasury Secretary Nicholas Brady, countries exchanged their commercial bank loans for bonds backed by US Treasuries banks, after commercial banks granted debt relief.

In countries that did not rely on the export of a single commodity like oil for a significant portion of foreign currency earnings, creditors occasionally insisted on receiving an instrument (or a feature) linked to the debtor country's future GDP. Costa Rica included such a feature in its commercial bank debt restructuring in 1989. If Costa Rica's GDP in any future year (subject to caps and a sunset provision) exceeded 120 percent of the 1989 level of GDP in real terms, additional payments would be due on the restructured debt. Uruguay in its Brady deal of 1991 issued instruments that paid off if the benchmark price of a basket of Uruguayan commodity exports (deflated by the price of oil—an import) exceeded a target level. Other countries that incorporated a GDP-linked instrument or feature in their debt restructuring packages were Bulgaria (1994), Bosnia and Herzegovina (1997), Argentina (2005 and 2010), Greece (2012), and Ukraine (2015) (IMF 2017).

The economics literature on sovereign debt is not entirely clear on whether insisting on value recovery is a good idea. Apart from restoring the country to solvency, one idea that should influence the extent and design of a debt restructuring is the removal of debt overhang, which causes an economy to grow slower than it otherwise would (Obstfeld and Rogoff 1996). Debt overhang arises when debt is so high that the debtor must deliver a large share of its resources to its creditors even in a relatively good overall economic climate. This undermines incentives to invest. Writing down debt restores this incentive. Value recovery instruments could undermine this effect if they disproportionately raise repayments in good states. That said, observed value recovery instruments are either indexed to commodity prices—which are insensitive to government and private investment—or simply not important enough to reduce the government's inherent incentive to grow the economy. Furthermore, GDP-linked instruments do of course have the advantage that they reduce fiscal pressure in a downturn, which may support growth.

Loss Reinstatement Features

One of the perennial worries in sovereign debt workouts, for both official and commercial lenders, is the problem of the backsliding sovereign. Once the debt restructuring is completed, what happens if the sovereign borrower reverts to the behavior and policies that landed the country in a debt crisis in the first place? Moreover, all sovereign debt restructurings are premised on an unspoken covenant. The creditors grant debt relief on the assumption that the sovereign will perform its obligations on the new terms embodied in the debt restructuring. If the sovereign breaches its side of that covenant by defaulting again on its restructured debt, should not the lenders be restored to their positions status quo ante the restructuring?

One technique for commercial lenders to address this concern is called a principal reinstatement feature. It provides that if a debtor country seeks another round of restructuring of the same debts in the future, some or all of the principal amount forgiven in the first round will balloon back, thus allowing the lenders to come to the negotiating table in the second round with their original claims unimpaired. Ecuador first used this technique in its debt restructuring in 2000. Belize included a principal reinstatement feature in its 2013 restructuring. A similar concept was used by the Seychelles (2010) and by St. Kitts and Nevis (2012), although in those cases the restoration of principal would have been triggered by a failure of the debtor country to implement its IMF program.

Parity of Treatment Undertakings

Lenders don't like to look foolish. And nothing makes them look more foolish than getting caught granting a sovereign borrower significant debt relief while other similarly situated lenders avoid doing likewise. This paints the participating institutions as gullible, incompetent patsies. In extreme cases, some lenders may refuse to participate in a debt restructuring unless this risk can be addressed.

The architects of a sovereign debt workout may attempt to reduce the lenders' anxiety by including in a restructuring package a covenant promising that other lenders will not be given preferential treatment (Buchheit 2002). The most famous example of such a provision, discussed above in the section on engagement with official sector creditors, is the comparable treatment clause in a Paris Club Agreed Minute. A more notorious version of a parity of treatment clause in a restructuring of commercial debt is Argentina's 2005 Rights Upon Future Offers (RUFO) clause, which stated that if Argentina voluntarily made a better offer to creditors within a certain time period, other creditors had a right to the same treatment.

Unlike the Paris Club comparable treatment approach, which prohibits offering sweeter deals to other creditors, commercial lenders word these clauses as a covenant to give participating lenders the benefit of any sweeter deal that may be offered down the road to holdouts. This difference in approach reflects two different underlying visions:

- Commercial lenders are driven by a fear of legal liability. They worry that forcing a borrower to promise that it will not pay other lenders on preferential terms might be portrayed as a tortious interference with the borrower's contracts with those other lenders.
- The Paris Club approach is driven by long-term balance of payment considerations: It aims at ensuring that the debt restructuring it provides is in line with the framework identified by the IMF to fill in the debtor country's financing gap, and that it will not lead to more payments to other creditors instead of restoring the debtor country's financial situation.

One example of a clause designed to ensure that no private creditor receives better treatment for its share of the loan than that enjoyed by other private creditors was the "sharing clause" of the 1980s, which required any bank that received a disproportionate payment of its loan to share those funds with all other banks. A disadvantage of this type of clause is that it curtails not only the ability of creditors to cut a better deal with the sovereign than that agreed with the majority (its intended effect) but can also inhibit the sovereign in negotiating further debt relief arrangements with willing lenders in the future. Box 4 describes how this problem was addressed in Mexico's 1987 restructuring.

Credit Enhancement

The present value of bonds issued in a sovereign debt restructuring (the new bonds) will be enhanced if the sovereign debtor can persuade a creditworthy third party to issue a partial guarantee of amounts due under the bonds, or if the sovereign can post collateral security for the new bonds. An example of the former technique is the Seychelles 2010 debt restructuring in which the country's new bonds benefited from a partial guarantee

Box 4 Case Study: Mexico 1987

Innovation—Debt-for-debt exchange clauses

The sovereign debt restructuring agreements of the 1980s were hugely centripetal. They forced the commercial banks that had originally lent to a sovereign borrower individually or as part of a syndicated loan into massive restructuring agreements to which hundreds of banks might be parties. The smaller banks and the regional banks, however, were wary of this forced togetherness. They feared that in a pinch their larger bank colleagues—those enjoying close relationships with the sovereign debtors—might find a way to get themselves paid while leaving the little guys behind. To assuage these concerns, the restructuring agreements contained a battery of clauses designed for one purpose—to ensure that no bank could receive better treatment for its share of the loan than that enjoyed by all the other banks. A good example was the sharing clause. This provision required any bank that received a disproportionate payment of its loan to share those funds ratably with all the other lenders.

By the end of the 1980s, however, these contractual provisions requiring equal treatment of all banks began to inhibit the ability of sovereign borrowers to negotiate debt relief arrangements with willing lenders. A lender could not, for example, offer to write off a portion of its loan in return for a pledge of collateral security for the balance.

In 1987, Mexico secured the consent of its Bank Advisory Committee to include in the country's debt restructuring agreements a seemingly innocuous clause permitting qualified debt-for-debt exchanges. As drafted, this clause permitted the debtor to exchange any bank's interest in the restructured loan for a new debt instrument, as long as the average weighted life of the new instrument was greater than the average weighted life of the debt it was replacing. Importantly, the clause was explicit in severing the sharing clause and negative pledge clause links between the new instrument and the old restructuring agreement.

Debt-for-debt exchange provisions quickly found their way into the restructuring agreements of other countries like the Philippines and Venezuela. They proved to be the most significant legal innovation of the late 1980s. Debt-for-debt exchange clauses paved the road for the introduction of the Brady Plan in 1989 (which ended the Latin American debt crisis starting in 1990).

issued by the African Development Bank. The most prominent examples of sovereign bonds that benefited from collateral security are the Brady bonds issued in the 1990s. The principal of most Brady bonds was secured by the pledge of US Treasury zero-coupon obligations (or an equivalent high-grade issuer), and some also benefited from the pledge of cash collateral to achieve a rolling partial interest guarantee.

Contractual Improvements

A sovereign looking to encourage private creditor participation in a debt restructuring may be able to offer its lenders a sweetener in the form of an upgrade in contractual terms. If the original debt instruments that the sovereign is attempting to restructure have less-than-fully-robust legal protections for the holder (such as a choice of the sovereign's own law as the governing law of the instrument, submission to the jurisdiction of local courts, the absence of cross-default protections, etc.), these infirmities may be corrected in the new instruments issued in the restructuring.

The most visible recent example of such an upgrade occurred as part of the Greek debt restructuring of 2012. Most of the bonds affected by that restructuring were governed by Greek law, a feature that facilitated their restructuring with the help of a legislatively-imposed class voting mechanism that allowed a majority of creditors to bind the minority to the restructuring (discussed below). As part of the restructuring, however, the Greek government offered participating holders new bonds governed by English law (and thus not subject to the fiat of the Greek parliament).

Box 5 Case Study: Russia 2000

Innovation—Contractual improvements

Following the collapse of the Soviet Union in 1992, Vnesheconombank (VEB)—the agency responsible for the Soviet Union's international trade and financial relations—defaulted on foreign currency loans from Western banks. After several years of negotiation and partial payments, the Russian Federation, as the Soviet Union's legal successor, reached a restructuring agreement by which the banks' Soviet-era claims were exchanged for a bundle of "Principal Bonds" (Prins), "Interest Arrears Notes" (IANs), and some cash. Prins and IANs remained foreign currency obligations of VEB (*without* the explicit guarantee of the Russian Federation).

That 1997 settlement was short lived, however. Following the August 1998 Russian currency crisis, VEB missed payments on Prins in December 1998 and subsequently on both Prins and IANs. This triggered a new round of negotiations between Russia and its Bank Advisory Committee, which led to the exchange, in August of 2000, of Prins and IANs for a set of new Eurobonds issued by the Russian Federation. One wag on the Russian negotiating team dubbed those new bonds "The Instruments Formerly Known as Prins." The new bonds involved significant reductions in both face value and present value, which made this the harshest post-Brady debt restructuring at the time (Santos 2003, Sturzenegger and Zettelmeyer 2007, Gorbunov 2010).

At the same time, however, creditors received a set of Russian Federation Eurobonds that Russia had continued to service throughout the 1998–99 crisis and whose contractual features arguably made them much safer than Prins and IANs. This included an upgrade in the obligor (now the sovereign directly, rather than VEB), as well as cross-acceleration clauses that implied that default on the new bonds would trigger default on any future issues of Russian Federation Eurobonds (and vice versa). As a result, the exchange attracted a very high participation rate (about 99 percent), in spite of the high haircut.

A much earlier example was the Russian Prins/IANs bond exchange of 2000. Unlike Greece, this transaction involved no upgrade in governing law (both old and new bonds were governed by English law). The old instruments, however, were bonds issued by a state-owned bank, Vnesheconombank, while the new instruments were Eurobonds of the Russian Federation enjoying all of the contractual features of bonds targeted to international markets (including expanded cross-acceleration clauses; see box 5). Eurobonds of this type had been issued by Russia since 1996 and constituted the only class of Russian Federation debt instruments that had survived Russia's 1998–2000 default unscathed. The Russian authorities were therefore offering creditors a type of debt instrument that had never been tainted by default, suggesting that the authorities would have reason to keep it default-free in the future (as has indeed been the case).

The technique of upgrading the legal characteristics of a debt contract to induce creditors to accept a restructuring offer was an essential feature of the Brady bond exchanges in the early 1990s. In all but two cases, the limited amount of bonds that had been issued by emerging-market countries undergoing debt restructurings in the 1980s had continued to be serviced normally despite concurrent restructurings of bank loans, bilateral credits, trade lines, and interbank deposits. For a time at least (lasting until the late 1990s), sovereign bonds enjoyed a halo that suggested (but did not promise) an exemption from future debt restructurings. As a condition to giving the debt relief required by the Brady Plan, the commercial bank lenders of that era therefore demanded a switch from their syndicated loans—which had been serially restructured over the prior decade—into new bonds, immediately dubbed Brady bonds.

Sticks

Carrots, even juicy ones, can only go so far in enticing a deeply-dyed holdout to join a debt restructuring. Sovereigns also have more coercive tools in their arsenal to persuade otherwise unwilling creditors to join a deal. Most of these sticks are designed to resolve the collective action problems inherent in a debt restructuring process that must be undertaken in the absence of a formal bankruptcy code. Collective action problems can arise when the majority of creditors conclude that it is in their best interest to agree to a restructuring proposal, but a few maverick lenders want to hold out in the hope of realizing a preferential recovery. If the perceived holdout risk is significant, creditors who would otherwise have agreed to participate in a restructuring may be unwilling to do so for inter-creditor equity and fiduciary liability reasons. Full payment of holdout creditors—if the aggregate size of their claims is significant—can also reduce the sovereign's available resources to pay its restructured creditors. That would be salty insult added to the previous injury of the debt restructuring.

Implicit or Explicit Threats of Nonpayment

Behind every sovereign debt restructuring will be a threat, implicit or explicit, that holdout creditors will not be paid, or at least not paid anytime soon. Normally, this is done obliquely. A sentence along these lines is likely to appear in the disclosure document for the restructuring:

> *Regrettably, the Republic of Ruritania does not now foresee the circumstances in which it will have the financial resources to pay in full any eligible claims that are not tendered in this restructuring.*

Some sovereigns, however, dispense with subtlety and deliver the message bluntly. The most famous example of this occurred in the Argentine bond restructuring of 2005. The Argentine government went so far as to pass a law (the Lock Law) forbidding any payment or settlement with holdout creditors, and the related disclosure document warned bondholders to abandon hope if they did *not* enter the debt restructuring.

Threats of nonpayment can be a powerful tool to achieve full (or near-full participation) in a debt exchange, provided it is combined with an exchange offer that is considered sufficiently attractive relative to the prospects of holding out (Bi et al. 2016). Furthermore, debtors should be careful to avoid Lock Law–style legislative enactments that might allow a holdout to successfully argue, in a New York or English court, that the debtor is in breach of a *pari passu* provision prohibiting the subordination of bonds held by the holdout (Buchheit 2018b).

Collective Action Clauses

Perhaps the most common tool for dealing with holdout creditors in sovereign bonds is the use of collective action clauses (CACs) (Gelpern and Gulati 2013). CACs, long a feature of bonds governed by English law, first made their appearance in sovereign bonds governed by New York law in the early 2000s after endorsement by the official sector (IMF 2002). These "series-by-series" CACs enabled a qualified majority of bondholders of a specific bond issuance (typically 75 percent) to bind the minority *of the same issuance* to the terms of a restructuring.

While these first-generation series-by-series CACs were useful, they risked the possibility that a creditor, or a group of creditors, could obtain a blocking voting position in a particular series and thus nullify the operation of the CAC in that series. The vulnerability of first-generation CACs to holdout creditors was shown in the Greek

Box 6 Case Study: Uruguay 2003

Innovation—Aggregated Collective Action Clause

At the strong urging of the G-10 countries, collective action clauses were introduced into sovereign bonds governed by New York law starting with a United Mexican States bond issued in February 2003. Mexico used a conventional form of CAC that operated only within the four corners of the bond containing the clause. In a debt restructuring involving multiple series of bonds containing such clauses, a separate CAC vote would be needed for each series. This was a weakness of traditional CACs—it can be relatively easy for holdout creditors to amass a 25 percent blocking position in a single series.

Four months after the Mexican issue, Uruguay restructured its international bonds in May 2003 and incorporated an aggregated CAC in the new instruments. The aggregated CAC permitted *all* holders of *all* series to vote together on a proposed restructuring, while also preserving a vote in each series, albeit with a lower voting threshold ($66^2/_3$ percent rather than 75 percent, provided that 85 percent of all affected series approved the exchange). This made it more difficult for a holdout creditor to accumulate a blocking position. The Uruguay clause became the model for so-called two-limb aggregated CACs such as those adopted 10 years later by members of the European Economic and Monetary Union for use in all euro area sovereign bonds issued after January 1, 2013.

restructuring of 2012. Holdouts obtained a blocking position in about half of Greece's foreign-law governed bond series, thereby frustrating the operation of CACs.

Recognizing the limitations of series-by-series CACs, a few international sovereign bond issues provide for a limited form of aggregation in the form of two-limb CACs (see box 6).

These second-generation two-limb aggregated CACs still allow holdouts to control an issue, albeit with greater effort and cost. While the required 66⅔ percent threshold for each individual series under the aggregation clauses is easier to achieve than the typical 75 percent threshold under series-by-series CACs, creditors may still obtain a blocking position with respect to a particular series. In such cases, the particular holdout series would be excluded from the restructuring, while the restructuring would still be carried out for other series, so long as the two-limb voting thresholds are met.

In 2014, the international community endorsed the use of a menu of alternative voting procedures, including a third-generation CAC: single-limb aggregated CACs (ICMA 2014, Sobel 2016). These CACs are now the standard market practice for bonds issued under New York and English law. Single-limb CACs have the benefit of requiring only a single vote calculated on an aggregated basis across all affected bonds. By eliminating the requirement of a series-by-series vote (i.e., the second limb), a single-limb voting procedure removes the possibility of obtaining a controlling position within a particular issuance to block the restructuring of that issuance. While almost 90 percent of international sovereign bonds issued after 2014 have included single-limb aggregated CACs, a large stock of international sovereign bonds does not have them. At this time, euro area sovereigns, for their part, are required by the European Stability Mechanism (ESM) treaty to include two-limb aggregated euro CACs (IMF 2014b). However, the Eurogroup recently announced broad support amongst euro area finance ministers to amend the ESM treaty to require single-limb CACs in all euro area issuances by 2022.

Despite the advancements in CACs, there continue to be calls for statutory solutions to resolve sovereign debt defaults, building on the IMF's Sovereign Debt Restructuring Mechanism proposal of the early 2000s (Hagan 2005, Buchheit et al. 2013).

Exploiting the Local Law Advantage

Suppose a country wishes to restructure debt issued under its own law. This opens up the possibility of the ultimate stick—threatening to change the local law to facilitate the debt restructuring. As long as such legislative changes pass muster under the country's constitution (particularly constitutional protections for property rights), and possible international agreements signed by the issuer, they should be valid. A change in local law is a risk that investors take when they buy local-law governed debt instruments.

For this reason, emerging-market bonds targeted to foreign investors have generally been issued under foreign law, making the use of the local law advantage moot in external debt restructurings. Furthermore, even when foreign investors purchased local law debt in domestic financial markets, as was the case for the famous Russian short-term zero-coupon government bonds known as GKOs in 1996 and 1997, subsequent restructurings did not use the local law advantage, largely because local law instruments tended to be issued in domestic currency, making it easy to expropriate foreign holders through other means such as devaluation, inflation, or capital controls.

Recently, however, there has been an important exception—sovereign debt instruments issued by euro area governments. Developed countries tend to issue most sovereign debt under local law, perhaps because investors trust the government not to exploit this feature to their advantage. At the same time, however, euro area sovereign debt is foreign-currency denominated, in the sense that the issuing country has no unilateral control over euro area monetary policy.

As a result, the use of the local law advantage could have practical implications in euro area debt restructurings and was in fact prominently used in the only major debt restructuring in the euro area so far: Greece in 2012. It was arguably the main reason why the Greek restructuring succeeded in achieving both a large haircut and a high participation rate (Zettelmeyer, Trebesch, and Gulati 2013). Importantly, this success relied on the fact that the local law advantage was *not* used to change directly the payment terms of the bond being restructured—which may have been illegal under the Greek constitution and/or the European Charter of Human Rights—but rather to retrofit a class voting mechanism equivalent to a single-limb aggregated CAC, making it much easier to deter potential holdouts (see box 7).

In principle, the same procedure could be used in future euro area debt restructurings. However, euro area governments have, since 2013, issued bonds that include a form of aggregate collective action clause, making it harder to argue that dealing with holdouts justifies a class voting mechanism that is legislated ex post (Grund 2017, Buchheit and Gulati 2018).

Exit Consents

Another way to discourage potential holdout creditors is through the use of a technique called exit consent. It works as follows: All holders of the old bond are invited to exchange it for a new bond reflecting the terms of the restructuring. When agreeing to tender the old bond in exchange for the new bond, the holders are asked to consent to modification to the old bond that would make it less attractive to prospective holdout creditors. Exit consent modifications may not amend any provisions of the bond that require unanimous consent (such as payment terms), but theoretically any other provision of the bond is fair game for a simple majority amendment.

Box 7 Case Study: Greece 2012

Innovation—Retrofit Class Voting Mechanism

In 2012, the Hellenic Republic faced the daunting task of restructuring more than €200 billion of Greek government bonds in the hands of private investors. To comply with its undertakings with its official sector sponsors (the European Union and the IMF), Greece needed to inflict at least a 50 percent principal haircut on those bonds, achieve a creditor participation rate exceeding 90 percent in the restructuring, and complete the entire exercise within five months—a tall order, by anyone's reckoning.

But Greece had an advantage that no emerging-market country has enjoyed in a previous sovereign debt restructuring (Buchheit and Gulati 2010). More than 90 percent of the Greek government bonds subject to the restructuring were governed by Greek law (rather than a foreign legal system such as the law of England or the law of the State of New York). This gave the Greek parliament the ability to enact domestic legislation to facilitate the coming debt restructuring. The question was how to use that local law advantage in a manner that would be acceptable, as a matter of policy and precedent, to Greece's official sector sponsors and that would survive the inevitable legal challenges.

The solution took the form of domestic legislation that effectively corralled all of the holders of Greek law–governed bonds into a single class for purposes of voting on the eventual debt restructuring proposal. If holders of two-thirds (by value) of those instruments voted to accept the restructuring, that decision bound all members of the class. The Greek parliament's action thus replicated—for the sovereign's own bonds—the class voting mechanism typically found in corporate insolvency regimes. Using this mechanism, all of Greece's eligible local law debt stock was successfully restructured in March 2012.

So, for example, an exit consent might be used to eliminate the requirement that the old bonds remain listed on a stock exchange, delete the *pari passu* clause, remove the acceleration remedy, or repeal one or more events of default.

Exit consents in sovereign bond restructurings were first used in Ecuador's bond exchange in 2000 and in a streamlined form in Uruguay's 2003 restructuring (Buchheit 2000, Buchheit and Pam 2004, and Buchheit and Gulati 2017a). Since the introduction of CACs in bonds governed by New York law, however, the utility of the exit consent technique has diminished. Virtually any change to a material term of the bond will now be governed by the CAC.

Trust Structures

Issuers may reduce the threat of holdouts in the event of a restructuring by issuing bonds under a trust structure. Trust structures reduce the holdout threat by centralizing enforcement powers in the hands of the trustee. Trust structures may also have the benefit of shielding funds paid as debt service from attachment by creditors (Buchheit 2018a). International sovereign bonds are typically issued under either fiscal agency agreements (FAAs) or trust structures. Under an FAA, the fiscal agent serves as an agent of the issuer, and its main responsibility is to make principal and interest payments to the bondholders. Under trust structures ("trust indenture" under New York law or "trust deed" under English law), a bond trustee acts on behalf of, and has responsibilities to, bondholders as a group. Historically, international sovereign bonds governed by New York and English laws tended to be issued under FAAs, as FAAs are marginally cheaper and easier to implement than trust structures. However, in recent years, the use of trust structures has increased in New York–law governed bonds (IMF 2015b).

Box 8 Case Study: Iraq 2005

Innovation—Immunization of Assets from Seizure

In the spring of 2003, Iraq inherited from the previous regime an outstanding sovereign debt stock of over $140 billion owed to an astonishing diversity of creditors—other governments, banks, construction companies, and trade creditors of many kinds. Iraq derived virtually all of its foreign currency earnings from the sale of oil. Creditors could therefore have strangled Iraq's economic recovery by attaching Iraqi oil shipments in the international markets and seizing the cash proceeds from the sale of that oil.

The solution took the form of a UN Security Council resolution—Resolution 1483 of May 22, 2003—that encouraged a prompt restructuring of Iraq's debt and immunized all Iraqi oil sales, as well as the cash proceeds from the sale of that oil, from "any form of attachment, garnishment, or execution." All member states of the United Nations had to incorporate these immunities for Iraqi assets into their domestic law. Resolution 1483 was taken under Chapter VII of the UN Charter and thus was binding on all member states. The legal immunities for Iraqi assets provided by Resolution 1483 lasted until 2011. By the end of 2005, Iraq had successfully restructured most of the debt stock under the cover of these legal immunities, on terms that gave it debt relief (in net present value terms) of at least 80 percent.

Protection of Assets

As noted at the beginning of the paper, in most countries—the United States and the United Kingdom included—sovereigns enjoy significant protection from seizure of their assets by judgment creditors. This protection normally does not, however, extend to any assets that are used in commercial activity. For example, the proceeds of commodity sales by a sovereign—or a state-owned enterprise—are likely to be considered proceeds of the sovereign arising from commercial activity, and subject to attachment. Apart from legal immunities, countries faced with the prospect of litigious creditors sometimes take practical steps—such as redirecting payment flows or changing ownership structures—that are intended to shield vulnerable assets from attachment. One of the most extreme asset protection mechanisms was put in place during the Iraq restructuring, when the UN Security Council passed a resolution to immunize cash proceeds from Iraqi oil sales from attachment in all UN member states (see box 8).

X. CONCLUSION

Failure to repay sovereign debt on contractually envisaged terms is costly. It can disrupt access to finance, trigger or deepen banking crises, depress investor and consumer confidence, damage debtor reputation, and—depending on how it is executed—expose sovereigns to legal risks that can shut off channels of private external finance over a protracted period.

A swift debt restructuring that is both supported by a large majority of creditors and achieves sufficient debt relief to restore a country to solvency can significantly reduce these costs. But getting there is not easy, even when the debtor and a majority of creditors negotiate in good faith. Apart from the inevitable conflict of interest between creditors and the sovereign debtor, debt restructuring requires overcoming asymmetric information problems—particularly with respect to the debtor's ability to pay—as well as the inherent temptation of creditors to free ride on the concessions made by other creditors.

This paper has attempted to distill some lessons from past debt restructurings that help navigate these problems: (i) bring in the IMF as early as possible, second only perhaps to hiring competent and experienced legal and financial advisors; (ii) have extensive consultations with creditors (but not necessarily through creditor committees); (iii) promote—through carrots and sticks—coordination amongst groups of creditors, especially in dealing with the holdout creditor problem; and (iv) beware the temptation to ask for either insufficient debt relief (leading to serial restructurings) or excessive debt relief (leading creditors to view the process as confiscatory or expropriatory).

Despite the commonalities of restructurings, the many innovations noted in this paper are evidence that no restructuring is quite like another. Going forward, approaches will inevitably continue to adapt to deal with new challenges.

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