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Lessons from the Recent Debt Crises

by

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SOVEREIGN DEBT RESTRUCTURING

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I. Background

II. Recent Experiences of Debt Restructurings

III. Enhanced Sovereign Clauses

IV. Takeaways
Section I

BACKGROUND
The Fund approach to SDR derives from its mandate to assist members in resolving balance of payment problems within a timeframe that allows them to return to medium term viability and repay the Fund.

In most Fund supported programs, a combination of policy adjustment and financing from the Fund catalyzes spontaneous financing from the private sector.

SDR can have drastic adverse consequences for economic growth, trade, capital flows, banks and other financial institutions.
Sovereign Debt Restructuring

- Based on Debt Sustainability Analysis that concludes that a macro-economic adjustment program cannot realistically restore sustainability

- The scope of debt relief should be proportional to the country’s debt sustainability problem
  - Good faith negotiations to involve private creditors
  - Taking into account spill-over effects on member states
Section II

RECENT EXPERIENCES OF SOVEREIGN DEBT RESTRUCTURING
Experience shows that debt restructurings have often been too little and too late, thus failing to reestablish debt sustainability and market access in a durable way.

Experience also shows that debt restructurings often took place a considerable period after Fund staff had assessed that the debt was unsustainable.

Source: IMF 2013, Sovereign Debt Restructuring—Recent Developments and Implications for the Fund’s Legal and Policy Framework
Public Debt-to-GDP and Timeline of Debt Restructuring and Fund Arrangements

St. Kitts and Nevis (2001-2015)

- Staff assessed debt to be unsustainable
- Request for emergency assistance
- Approval of SBA

PSI
OSI

End-01 End-02 End-03 End-04 End-05 End-06 End-07 End-08 End-09 End-10 End-11 End-12 End-13 End-14 End-15
Public Debt-to-GDP and Timeline of Debt Restructuring and Fund Arrangements


- Staff assessed debt to not be sustainable with high probability
- Loss of market access
- Approval of SBA
- Approval of EFF arrangement

Timeline:
- End-07
- End-08
- End-09
- End-10
- End-11
- End-12
- End-13
- End-14
- End-15

1st OSI
2nd OSI
1st PSI OSI
2nd PSI
Determining Loss of Market Access

- Assessment of indicators over a period, combined with judgment
- Determining if LMA has occurred and if likely to be reversed
- Made in the context of a debt sustainability analysis
- Looks at indicators such as:
  - Sovereign spreads
  - Patterns of primary issuance
  - Maturity & financing terms
  - Cash balances
  - Sovereign ratings
Selected Examples of Re-profilings

- Jamaica (2010, 2013)
- Pakistan (1999)
- Uruguay (2003)
Experience of Recent Restructurings

- Credit participation has been adequate but market based approach is becoming less potent in overcoming collective action problems – particularly in pre-default cases
- Making the contractual framework more effective through
  - Robust aggregation clauses
  - More tight use of Fund financing to the resolution of collective action problems
  - Clarifying the framework for official sector involvement

Source: IMF 2013, Sovereign Debt Restructuring – Recent Developments and Implications for the Fund’s Legal and Policy Framework
Section III

ENHANCED
SOVEREIGN CLAUSES
In October 2014 the IMF Executive Board endorsed inclusion of enhanced collective action clauses (CACs) and pari passu clauses in new international sovereign bond issuances.

- **Enhanced CAC:** menu of voting procedures: “single-limb”, “two-limb” and “series-by-series”
- **Modified pari passu:** explicitly disavows “ratable payment”

Endorsement followed 18-month consultation process with stakeholders. ICMA published model clauses in August 2014.

Board recognized that euro area sovereigns are required by law to include EuroCACs and considered this approach appropriate as most issuances are governed by domestic law.

Inclusion of CACs

Substantial Progress Has Been Made:

- October 1, 2014 - July 31, 2015: 73 international sovereign bond issuances for $86 billion
- 42 issuances, representing 60% of nominal principal, included the enhanced clauses
- No observable market impact

21 issuers included the clauses:

- *English law:* Armenia, Bulgaria, Croatia, Egypt, Ethiopia, Gabon, Kazakhstan, Montenegro, Tunisia and Zambia

- *New York law:* Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Indonesia, Jamaica, Mexico, Panama, Turkey, and Vietnam
Non-inclusion of CACs

Issuances can be divided into two categories:
- “new issuances”: 85% of these issuances included the new CACs
- “re-openings and take-downs”: none included the enhanced clauses

Of the new issuances, uptake is greater under New York law than English law: 92 percent vs 75 percent

Too early to identify definitive reasons for non-incorporation and the uptake differential between NY and English law.

Other Observations:
- Possible lack of awareness/understanding in certain jurisdictions
- Infrequent issuers
- Influence of Mexico in NY market
Formulation of CACs

- Board endorsed “key features”, not specific language, recognizing there would be differences in formulation

- All issuances include the “key features” (e.g., “uniformly applicable,” 75% voting threshold, disenfranchisement, information covenant)

- However, formulation has evolved to reflect use and market preferences

- In **May 2015** ICMA published New York and English law versions of the clauses to achieve two objectives:
  - *Between New York and England, substantive alignment of the key features despite different formulation between the two jurisdictions*
  - *Consistency of formulation within jurisdictions*
Pari Passu

- All issuances with enhanced CACs include modified pari passu – a few have included pari passu but not enhanced CACs

Modified clause included as Package with Enhanced CACs

Markets view favorably

- No pricing impact observed
Key Challenge: the Outstanding Stock

- Value of outstanding stock increased to $915 billion
- Around 6 percent ($51 billion) contains enhanced CACs
- Approximately 50% governed by New York law – 39% maturing after 10 years
- Magnitude of risk: depends on future court interpretation of the *pari passu* clause
Trust Structures: Benefits

- Trusts restrict ability of minority bondholders to disrupt restructuring process, by limiting individual enforcement action:
  - Minimum % of bondholders and trustee required to request acceleration
  - Only trustee can commence legal proceedings against the sovereign on behalf of bondholders
  - Pro rata distribution of litigation proceeds among all bondholders.

Trust Structures: Recent Experience

- Recent increase in use of trusts, especially under New York law

- 45% of issuances since October 2014 under trusts – of these, 83% under NY law

- Not a panacea: trusts do not restrict enforcement action by holdouts remaining after restructuring agreement reached
Section IV

TAKEAWAYS
Takeaways

• Positive changes in the use of enhanced CACs
  • Inclusion of enhanced CACs and modified pari passu clauses

• Consideration should be given to amend existing documentation to include the enhanced CACs

• Monitoring and assessing whether LMOs can accelerate the turnover of the outstanding stock so outstanding stock of debt without CACs is reduced
Annex: Relevant IMF Publications