the Lisbon council

e-brief

Issue 11/2011

Thinking the Unthinkable

Lessons from Past Sovereign Debt Restructurings

By Alessandro Leipold

Alessandro Leipold is chief economist of the Lisbon Council. He joined the Lisbon Council in 2010 after a distinguished career in economics, finance, banking, the European Union institutions and the International Monetary Fund (IMF), where he served as acting director of the IMF's European Department until 2008.

'We cannot solve our problems with the same thinking we used when we created them.'
Albert Einstein

Sovereign debt restructurings – in the form of either negotiated agreements or outright unilateral defaults – have been historical facts of life in the global financial system for centuries.[1] They have occurred with a frequency and regularity that make European Union policymakers' protracted denial of even the remote possibility of such an event in the eurozone clearly untenable – and indeed not believed by the markets, perversely making the event more probable. But the duration and intensity of the euro area's debt crisis has sharpened minds, and the stance has shifted from one of sheer denial to recognition of the need for "an appropriate form of private-sector involvement" – a euphemism for debt restructuring – as part of the approach to crisis resolution.[2]

This breakthrough was most fully articulated at the March 2011 European Council, although it had already been foreshadowed at meetings of the Economic and Financial Affairs Council of the European Union (Ecofin) and Eurogroup in the fall of 2010.[3] Official thinking at this stage is summarized in the so-called "Term Sheet on the European Stability Mechanism (ESM)." This key document has received comparatively little attention and, for ease of reference, the relevant section regarding "private-sector involvement" is reproduced in its entirety as an appendix to this e-brief on Page 11. In addition, the Term Sheet stipulates that collective action clauses "will be included in all new euro area government securities with maturity above one year, from July 2013."[4]

The European focus on private sector involvement and collective action clauses privileges the so-called "contractual" approach, whereby procedures to deal with insolvency are embodied in private debt contracts, including

1. The author would like to thank Paul Hofheinz and Ann Mettler for their comments on an early draft of this e-brief. Also thanks to Stéphanie Lepczynski and Sylwia Stępień for research and editorial assistance. As always, any errors of fact or judgment are the author's sole responsibility.

2. See *Conclusions of the European Council, 24-25 March 2011.*

3. See Eurogroup, *Statement by the Eurogroup*, 28 November 2010. The statement referred to a country's possible insolvency in the following terms: "in the *unexpected* [emphasis added] event that a country would appear to be insolvent." The European Stability Mechanism (ESM) Questions and Answers sheet, which was distributed with the statement, spoke of "the *extreme and unlikely* case of insolvency." The language has since freed itself of all such qualifiers.

4. A collective action clause allows a supermajority of bondholders (typically 75 per cent) to agree a debt restructuring that is legally binding on all holders of the bond, including those who vote against the restructuring.

'The quest for a formal restructuring mechanism has revealed itself to be among the most intractable issues in international finance.'

via re-negotiated agreements. In the alternative, more ambitious "statutory" approach, debt restructurings would be handled by an international bankruptcy mechanism with procedures spelled out in international law which would be binding on all parties. Both approaches aim to deter costly and disruptive litigation. While the purely "contractual" approach is the easier on which to garner consensus, a broader "statutory" solution would constitute a more lasting institutional response. That said, the quest for a formal restructuring mechanism has revealed itself to be among the most intractable issues in international finance: the last attempt in this direction – the International Monetary Fund's proposal of a Sovereign Debt Reduction Mechanism – foundered in the early 2000s, despite considerable effort, research, and academic backing.[5]

The current emphasis on a contractual approach is the sensible, and indeed the only available, step for Europe at this stage. At the same time, however, the eye should not be taken off the bigger ball: Europe's sovereign debt crisis provides it with the opportunity to relaunch efforts toward a permanent international statutory mechanism to handle unsustainable debts, along the lines of an international bankruptcy mechanism. At a time of high public debts and of sharply elevated sovereign risk across a large swathe of countries, reflected also in major sovereign credit downgrades, preparing for orderly sovereign debt restructuring via such a mechanism would be appropriately far-sighted. Europe would do well to become its active advocate.

In this e-brief, we will focus on the lessons from past sovereign debt restructurings so that, if and when the need for a debt workout arises, it is handled promptly and in an orderly manner (A summary of the main recommendations appears in the Five Lessons of Past Restructurings box on Page 3). We will focus essentially on the how, and not the whether, of such a workout – even though the writing on the wall for Greece seems to be increasingly clear. In fact, Greek debt has already been partly "restructured," as regards its official component, via the decision in mid-March 2011 to lower the interest rate on EU loans by 100 basis points and to reschedule the average maturity to 7.5 years for both EU and IMF loans. In addition, the IMF favours providing financing to Greece with longer repayment periods (via its Extended Fund Facility). In the meantime, markets are in the process of delivering their own verdict, and much has been written on both sides of the divide.[6] An assessment of the need for a debt restructuring is ultimately the task of rigorous country-specific sustainability analyses, beyond the scope of the current paper.

5. See in particular Anne O. Krueger, *A New Approach to Sovereign Debt Restructuring* (Washington DC: IMF, 2002). For the dénouement of this effort in 2003, see IMF, *Report of the Managing Director to the International Monetary and Financial Committee on a Statutory Sovereign Debt Restructuring Mechanism* (Washington DC: IMF, 2003).

6. A preponderance of commentators argue in favour of debt restructuring, particularly for Greece. See especially Zsolt Darvas, Jean Pisani-Ferry, André Sapir, *A Comprehensive Approach to the Euro-Area Debt Crisis* (Brussels: Bruegel, 2011). Others argue that all of the crisis countries in the eurozone's periphery should restructure their debts now (see, for example, The Economist, "They're Bust. Admit It." *The Economist*, 31 March 2011). For the most complete counter-argument, see Carlo Cottarelli, Lorenzo Forni, Jan Gottschalk, and Paolo Mauro, "Default in Today's Advanced Economies: Unnecessary, Undesirable, and Unlikely," *IMF Staff Position Note SPN/10/12* (Washington DC: IMF, 2010).

‘The EU’s “read-my-lips: no-restructuring-until-2013” sets an arbitrary and non-credible deadline.’

Summary of Main Conclusions

Five Lessons of Past Restructurings

1) Avoid Detrimental Delays. Delays in needed restructuring are costly: they stand to increase output losses, entail “throwing good money after bad” via increasingly large official bailouts, and ultimately require a larger haircut on private claims. Realistic debt sustainability analyses are needed on a timely basis to readily detect, and communicate to the authorities, the possible need for debt restructuring. Once ascertained, action should follow promptly. The EU’s “read-my-lips: no-restructuring-until-2013” sets an arbitrary and non-credible deadline: the sooner it is abandoned, the better.

2) Repair the Banking Sector. The equation “euro debt crisis equals core European bank crisis” needs to be broken. This requires getting tough on bank stress tests, enhancing their rigour and credibility, possibly by associating the Bank of International Settlements and International Monetary Fund with European Union supervisors. Stress tests need to live up to their name and “think the unthinkable,” including a sovereign debt default assumption in the sensitivity scenarios. They must be accompanied by much greater pressure from EU supervisors to speed up bank recapitalisation and by action, where needed, to close down non-viable entities. Banking resolution legislation should proceed rapidly, as should creation of an EU-wide bank resolution mechanism.

3) Remove Politics from the Driver’s Seat. Realistically, political considerations will always be present. But the current set-up (and that envisaged for the European Stability Mechanism) virtually ensures that EU creditor countries’ domestic interests will play a front-and-centre role. The decision-making and governance mechanism should be devised so as to lessen this presence, and facilitate constructive communication with markets, helping shape expectations as needed to promote crisis resolution.

4) Stay Ahead of the Curve with Pre-emptive Exchange Offers. Traditional bond exchange offers, made pre-emptively, prior to an actual default, worked well in several emerging country debt restructurings over the last decade or so. Experience indicates that such voluntary restructurings need not, contrary to some claims, be too “soft” for the debtors’ needs. Reasonably priced, and with proper incentives, deals can be concluded rapidly with negligible free riding.

5) Do Not Expect Too Much from Collective Action Clauses. Contractual provisions such as collective action and aggregation clauses no doubt help at the margin, but have not shown themselves to be decisive in debt restructurings. Furthermore, they cannot help in dealing with the current stock of debt.

'The strategy is failing in its core objectives. Two ingredients are missing in the current approach, both making for uncertainty and unpredictability.'

A Lot Done, But Crisis Persists: Why?

In a previous e-brief, I urged EU leaders not to let "a good crisis go to waste."[7] Despite the political hesitations, procrastinations, missteps, and risky brinkmanship – and the still significant unfinished agenda – it is fair to say that EU leaders have indeed not done so. The crisis has not been "wasted," and much has been accomplished since May 2010: crisis mechanisms, such as the European Financial Stability Fund (EFSF) and European Financial Stabilisation Mechanism (EFSM), have been set up; financial assistance has been provided; the European Central Bank has adapted and expanded its instruments flexibly; working arrangements with the IMF have been established; tough adjustment programmes are being largely implemented; EU surveillance procedures have been broadened and strengthened; and an agreed road map for the future has been drawn up. Indeed, as was noted in a recent article in *Foreign Affairs*: "If one looks beyond the *son et lumière,* the European Union remains a remarkably solid and vital political structure nowhere near the brink of collapse. The dramatic headlines mask the on-going evolution of an extraordinary constitutional order that is more robust than any other interstate relationship."[8]

But, despite all this, the crisis continues to fester, investors remain clearly sceptical that the rescues will work, and bond yields are spiking further. The strategy is thus failing in its core objectives. Why? What is missing in the current approach? Essentially, two ingredients, whose absence makes for uncertainty and unpredictability, both abhorred by financial markets:

- A clearer recognition of the possibility of insolvency, even before mid-2013.
- A much more proactive approach to addressing eurozone banking weakness, recognising the close interdependence between banking and sovereign crises.

The importance of these two points will be discussed below as we look more closely at the lessons from previous debt restructuring cases.

Past as Prologue

History has witnessed multiple episodes of sovereign defaults and restructurings, but the last case involving an advanced country was that of post-war Germany in 1948. Since then, the world has grown inestimably more interconnected through the rapid expansion of globalisation, and the most pertinent restructuring cases are thus those closer in time, having taken place in a more similar, integrated financial environment – in Larry Summers' terminology, "the crises of the 21st century." That said, these cases all concerned emerging markets, and there remain significant differences between these and euro area countries' realities, which need to be kept in mind when drawing parallels.

7. Alessandro Leipold, *Good Governance for the Euro Area: Proposals for Economic Stability*, e-brief 08/2010 (Brussels: Lisbon Council, 2010).

8. Kathleen R. McNamara, "Can the Eurozone Be Saved?" *Foreign Affairs*, 07 April 2011. In this sense, Europe seems once again to live up to Jean Monnet's dictum, whereby Europe advances only in times of crisis. See Jean Monnet, *Mémoires* (Paris: LGF, 2007).

'When a debt restructuring becomes necessary, the costs of delay are high and the limits of buying time with liquidity provision become increasingly tighter.'

1) Avoid Delays

International experience amply shows that, when a debt restructuring becomes necessary, the costs of delay are high and the limits of buying time with liquidity provision from official sources become increasingly tighter.[9] Indeed, perseverance in these attempts, with prolonged treatment of a crisis as merely a liquidity crisis, has been likened to "throwing good money after bad." The corollary is that a growing proportion of the debt is owed to official creditors, shrinking the pool of private creditors that could be "bailed-in" to contribute to a restructuring and, commensurately, raising the contribution (or "haircut") required from private claimants – or even ultimately requiring a restructuring of official loans as well. In the current euro area cases, the proportion of debt held by the IMF, EFSF, EFSM, and the ECB (via its securities market programme of sovereign bond purchases) is indeed on a rising trend. The EU-IMF share of Greece's debt stock alone is officially projected to rise from zero in 2009, before the crisis, to 9.5 per cent at the end of 2010 and to 28 per cent in 2012-13.[10] Some market participants anticipate that it will go even higher (possibly rising to more than one-half of all Greek debt, if ECB holdings are included). To halt these perverse dynamics it is best, when and where needed, to act sooner rather than later. Rigorous debt sustainability analyses thus need to be conducted on a frequent basis, updating rapidly changing market conditions and outlook, so as to readily determine, and discuss with the authorities, the possible need for debt restructuring.[11]

In this context, Europe's current timeline, whereby defaults would be contemplated only as from mid-2013, is a political and procedural artefact, divorced from economics and heedless of market developments. It is primarily dictated by the fact that, until 2013, the loans to Greece and Ireland (and shortly Portugal) are EFSF credits, which enjoy only *pari passu* status – i.e., on a par with all other creditors and, as such, would be hit by any restructuring, with French and German guarantees to the EFSF consequently at stake. As noted, the more time passes, the greater will be the EU's *pari passu* exposure. As from 2013, however, EFSF loans will be replaced by those of the new institution, the ESM, which will be granted preferred creditor status – thereby shielding the loans (and their guarantors) from restructuring and/or default. By then, it is also thought that European banks may have improved their balance sheets sufficiently to withstand the fallout of any sovereign default.

But there is an internal tension in this strategy: loans are provided to countries to prevent a default in the short term, while the creditors say at the same time that – should the countries later be found to be insolvent – they will have to restructure the debts in the medium term. As noted by Zsolt Darvas et. al., "the current stance of 'no default now, but possible default on bonds issued from 2013' is inconsistent and not credible... History suggests that a 'wait-and-see approach'

9. For a detailed investigation into delays in sovereign debt restructurings, see Christoph Trebesch, *Delays in Sovereign Debt Restructurings – Should We Really Blame the Creditors?* Unpublished Paper (Berlin: Free University, 2008). A contrasting view is provided by Ran Bi, "Beneficial Delays in Debt Restructuring Negotiations," *IMF Working Paper WP/08/38* (Washington DC: IMF, 2008), who argues that delays can allow the economy to recover from a crisis, make more resources available for debt settlement, and enable the negotiating parties to enjoy a larger "cake." In such a context – most unlikely to apply to the fixed exchange rate reality of euro area countries today – delays may be "beneficial."

10. IMF, "Greece: Third Review Under the Stand-By Arrangement," *IMF Country Report No. 11/68* March 2011.

11. In the specific case of Greece, for example, it is reported – but not officially confirmed – that the IMF-EU programme assumption of renewed market access in 2012 has now been withdrawn. Lack of clarity and unpredictability of this sort underlies on-going market jitters.

'A key credibility failing of EU bank stress tests has been the absence of a sovereign debt default assumption in the scenarios.'

is a dubious strategy. The lingering threat of restructuring is likely to be economically and financially damaging."[12] Current events demonstrate as much, and the sooner the artificial 2013 deadline is abandoned, the better.

2) Address Weakness in the Banking Sector

The interconnectedness of banking and debt crises and the important role played by financial interlinkages in transmitting vulnerabilities across sectors are well-known and amply researched subjects in international finance, and need not be further laboured here.[13] The relevant point in the present context is that steps to strengthen the banking system, both in debtor and main creditor countries, have been a feature of all responses to major debt crises. And the degree of success of these responses has often depended on the timeliness and vigour of the treatment of banking sector stresses.

Also, in Europe's current crisis, the oft-repeated concerns about contagion to the banking sector bear witness to the twin nature of the sovereign and banking crises and the need to address them jointly.[14] Unfortunately, the issue has tended to be ducked, at least in public. A key credibility failing of the EU bank stress tests has been the absence of a sovereign debt default assumption in the scenarios. When the most evident and, in the markets' view most likely, "stressor" is not included even as a hypothesis in the sensitivity scenarios, the value of the tests is clearly questionable. As their very name suggests, meaningful stress tests have to "think the unthinkable," so that contingency plans can be devised. Preparing systematically for potential risks – i.e., having a fall back Plan B ready at hand – is integral to responsible crisis prevention. Stress tests consequently need to be significantly more rigorous and credible, and to this end should probably involve the IMF and the Bank for International Settlements (BIS) alongside EU banking supervisors.

At the same time, banks in core countries need to be subject to much greater pressure to build up their capital buffers quickly so that a restructuring does not continue to be viewed as a potentially catastrophic event. Non-viable entities will need to be wound up. In this context, the inclusion, in the Euro Plus Pact agreed by the European Council in March 2011, of a commitment to introduce national legislation for banking resolution, is a helpful (albeit belated) step forward, which should be acted upon promptly – and extended to include a Europe-wide bank resolution mechanism. The many banks (and other institutional investors) that still record their peripheral debt holdings at purchase or par value in their "hold-to-maturity" books, should be induced to mark them to market. If it is true, as we and many others believe, that a final solution to the euro area debt crisis can only occur once the broader re-capitalisation of the EU banking system has advanced further, then it is incumbent on European regulators to proactively speed up the process – beginning with Germany's *Landesbanken*. Without this, events could

12. Zsolt Darvas, et. al., op. cit.

13. See Alessandro Leipold, op.cit. for a more detailed discussion of the importance of fully integrating macroeconomic and financial perspectives in EU economic governance mechanisms – an absence that remains a shortcoming of current initiatives to strengthen crisis prevention.

14. See in particular Lorenzo Bini Smaghi, *Eurozone, European Crisis and Policy Responses, Speech at the Goldman Sachs Global Macro Conference, Hong Kong, 22 February 2011.*

‘The decision-making process will exacerbate the problem, virtually ensuring that EU creditor countries’ domestic political interests will feature dominantly at every step.’

overtake the current slow pace and an “unplanned” restructuring could precipitate a full-fledged banking crisis.[15]

3) Remove Politics from the Driver’s Seat

Experience shows that the trickiest part of a restructuring process is the decision to begin it. And for good reason: restructuring is not a step to be taken lightly. As has been repeatedly highlighted by the ECB during the present crisis, restructurings are damaging and costly, not only for the banking system and creditors, but for the defaulting country and its citizens as well. It is understandable, then, that debt-ridden countries, and often their creditors, too, will strive to postpone the inevitable.

For the indebted country, the decision to restructure is ultimately a political one (unless events simply take over). It is the sovereign country itself that can best assess what constitutes – to use the language of the ESM Term Sheet – “an unrealistically large [i.e., politically unviable] correction to its income and expenditure.”[16] In contrast, politics should play as minimal a role as possible in guiding the international community, whose job it is to derive from a technically robust debt sustainability analysis the mix of financing, conditionality, and eventual private sector involvement needed on a case-by-case basis. Politics will of course inevitably intrude here as well, but the governance mechanism and decision-making process of the EFSF and of the envisaged ESM are such as to exacerbate this problem, virtually ensuring that EU creditor countries’ domestic political interests will feature dominantly at every step.

In the ESM, the highest decision-making body will be a board of governors, which is essentially the Eurogroup in a different guise, being made up by the ministers of finance of the euro area member states, with decisions being by mutual agreement (i.e., by unanimity of voting members). Furthermore, “to ensure consistency with the EU multilateral surveillance framework,” it is also envisaged that policy conditionality accompanying ESM loans will be enshrined in full Ecofin decisions, i.e., underwritten by all 27 member states. The ESM’s more technical board of directors (to which each euro-area member state is to appoint one director and alternate) is left only with lesser “tasks as delegated by the board of governors.” This set-up is bound to replicate the scenario so often played out since the outbreak of the crisis, with Ecofin meetings dominated by politicians playing to domestic audiences in crowded post-Council press conferences. This is not the climate and setting that make for smooth crisis resolution, of which carefully crafted communication is a key component. At the international level, the global financial community has learned that key decisions on crisis lending and its related conditionality are best taken in a less politically charged environment, as exemplified by the IMF’s Executive Board, with a related organised communications strategy to properly shape market expectations.

15. Nor would it be prudent in today’s fast-moving financial world to draw inspiration from the experience of the Latin American debt crisis of 1982, when prolonged regulatory forbearance under the Baker Plan allowed banks to strengthen their balance-sheets sufficiently and build up the necessary loan-loss reserves required to withstand the write-downs implied by the Brady bonds introduced seven years later in 1989. See Jacob Funk Kirkegaard, “Euro Zone Should Look to Brady Plan to Solve its Crisis,” in *Spiegel OnLine*, 14 April 2011.

16. *Conclusions of the European Council*, 24-25 March 2011.

'Experience suggests that it is important for a debtor country to get ahead of the game and make a constructive debt exchange offer rather than wait until its hand is forced.'

Ideally, the ESM should replicate this model, with much greater delegation to its board of directors and with communications on delicate crisis management issues centralised in its managing director.

It would of course be naïve to think that even the advocated set-up would eliminate political considerations, and that the IMF Executive Board is not also subject to political direction from national capitals. But the day-to-day decision-making process is undoubtedly further removed from the high-pitched political positioning characteristic of EU ministerial meetings. Without some lowering of this pitch, as Wolfgang Münchau has warned, "politics will bedevil resolving the euro crisis."[17] And, with federal elections in Germany due in the autumn of 2013, politics will dominate even after the start-up of the ESM, delaying possibly needed restructurings.

4) Stay Ahead of the Curve via Pre-Emptive Exchange Offers

As noted, the international community still lacks a binding international mechanism for debt restructurings, and one will certainly not be devised in time (if ever) to be helpful in addressing the on-going euro area crisis. Hence, while ambitious schemes are worth pursuing, solutions in the foreseeable future need to rest on the instruments that are readily available.[18] Such instruments – and most notably bond exchange offers – have indeed been used successfully in a series of emerging country debt restructurings over the last decade. If properly handled, they offer a market-based way out in a world without an international bankruptcy law.

In 1999, Pakistan became the first country in the modern era to restructure sovereign bonds (albeit in a modest amount). It was followed by the Ukraine, Uruguay, and the Dominican Republic. These cases all made recourse to the traditional tool of a bond exchange offer. They did so in a pre-emptive manner, before an actual default, and successfully so. Their experience suggests the importance for a debtor country to get ahead of the game and make a constructive offer rather than wait until its hand is forced. By putting generally reasonable offers on the table, these countries managed to have between 90-99 per cent of bondholders participating, and within a relatively short time span (the Uruguay 2003 offer was one of the shortest restructuring processes, lasting only three months). The oft-voiced concern about "free riders" – creditors that let others accept an exchange offer but hold out themselves, waiting to be paid in full further down the road – was thus reasonably contained.

The euro area could usefully study these episodes.[19] Whether a market-based debt exchange can suffice will tend to depend on the size of the needed relief. This is the subject of debt sustainability analyses, and the contribution that such "soft" or "velvet" restructurings can make to restoring debt sustainability will vary across

17. Wolfgang Münchau, "Politics Will Bedevil the Eurozone Crisis," *Financial Times*, 03 April 2011. A glaring example of the dominance of politics was the refusal to reduce Ireland's untenably high interest rate on EFSF loans – at 6 per cent well above the country's likely growth rate, thus materially worsening its debt dynamics – unless it agreed to review its corporate income tax rate.

18. One such fully articulated proposal, advocating a European Crisis Resolution Mechanism, which "would likely need to be established by a treaty… [and] would, therefore, only apply to future debt issuance," may be found in François Gianviti, Anne O. Krueger, Jean Pisani-Ferry, André Sapir, and Jürgen von Hagen, *A European Mechanism for Sovereign Debt Crisis Resolution: A Proposal* (Brussels: Bruegel, 2010).

19. At the same time, other examples of bond exchange offers, which were not pre-emptive in character but made after the countries in question had defaulted (the "aggressive defaults" of Argentina, Russia, and Ecuador), are best spurned. For a detailed treatment of all these cases, see Nouriel Roubini and Brad Setser, *Bailouts or Bail-Ins: Responding to the Financial Crises in Emerging Markets* (Washington DC: Peterson Institute, 2004).

'Bond exchange offers have been used successfully in a series of emerging country debt restructurings.'

countries and circumstances depending on the size of the debt overhang. In the currently hotly debated case of Greece, for example, observers' views differ.[20] Those sceptical of the approach note that a voluntary restructuring will unlikely see creditors ready to go beyond a "lite" reprofiling of maturities with little impact on net present value (NPV), as in Uruguay in 2003 (a five-year lengthening of maturities, with no haircut to principal or change in coupons) – sufficient for Uruguay then (a liquidity problem), but not for Greece today (seen to be a solvency problem). This however need not be the case, and overstates the need for debtors to be "soft" in voluntary exchange offers; Table 1 below illustrates the non-negligible NPV reductions resulting from such offers in recent years.

20. For example, in putting forth a proposal in favour of market-based debt exchanges via the EFSF, Daniel Gros and Thomas Mayer argue that sustainability could be restored for Greece with a considerably smaller reduction in the face value of the debt than calculated by others, combined with a stable low interest rate; see Daniel Gros and Thomas Mayer, "Debt Reduction Without Default?" *CEPS Policy Brief* No. 233, February 2011. For a contrary view, see Alan Beattie, "Why Voluntary Bond Swaps Don't Work – The Lessons from Latin America," *Eurointelligence*, 21 April 2011.

Table 1: Net Present Value Haircuts in Voluntary Exchange Offers*

Restructuring Case	Average Haircut
Ukraine OVDPs-nonresidents	56.3%
Uruguay domestic debt, extension option	38.1%
Ukraine ING loan	38.0%
Pakistan 1999	31.0%
Ukraine Chase Manhattan loan	30.7%
Ukraine 2000	28.9%
Uruguay domestic debt, benchmark option	24.0%
Uruguay external debt, extension option	15.1%
Uruguay external debt, benchmark option	12.9%

*Uses bond yields observed immediately after exchange to compare old and new flows.

Source: Federico Sturzenegger and Jeromin Zettelmeyer, *Debt Defaults and Lessons from a Decade of Crises*

Steeper NPV haircuts were obtained in the Brady Plan's voluntary exchanges from 1989 onwards. Those cases covered bank (rather than bond) debt which furthermore was not being serviced, with IMF blessing via its policy of "lending into arrears." This constituted a clear incentive for creditors to sign up. Other, more market-friendly, incentives were also employed at the time – such as, for example, guarantees for the Brady bonds (with official lending provided to help countries purchase the long-term US Treasury securities used as collateral), value recovery warrants related to the country's future economic growth, and other similar "enhancements."

5) Do Not Place Too Much Stock in Collective Action Clauses

Looking forward, European policymakers seem to be placing much reliance on the inclusion, from July 2013 onward, of collective action clauses in all new euro area government securities with maturity of over one year.[21]

21. For the most complete official position regarding collective action clauses, see Group of Ten, *Report of the G10 Working Group on Contractual Clauses* (Basel: BIS, 2002).

'"Bail-ins" via collective action clauses might make "bailouts" politically more palatable, but will not much reduce their need or likely magnitude.'

Here, too, past episodes provide some pointers. A thorough review of experience of restructuring bonds with and without collective action clauses is provided in Roubini and Setser.[22] It in sum indicates that the absence of such clauses need not be an insurmountable obstacle to a successful sovereign debt restructuring. At the same time, their presence will not *per se* ensure an orderly debt restructuring. An example in the latter regard is provided by Russia, which traditionally issued its bonds under English law – where contracts have long allowed a supermajority of bond holders to amend the bond's financial terms (whereas a traditional New York law contract requires the unanimous consent of all creditors to change the bond's key financial terms). Still, the legal ability to bind in a minority of bondholders should in general help reduce bargaining stalemates and holdout litigation. But collective action clauses do so only for each single bond issue that they cover, with each issue having to be treated separately; the difficulty of restructuring the overall debt thus remains. With a view to overcoming this constraint, the ESM Term Sheet of end-March 2011 also envisages the inclusion of "aggregation clauses" across bond issues, drawing on the innovation introduced by Uruguay in 2003.[23]

In this context, it is also worth noting that the importance of collective action clauses is likely to be even less for Europe than it has been for emerging markets. A significant, and potentially important, difference with respect to the emerging markets' experiences is that, whereas their debt is largely governed by Anglo-Saxon law (New York or London), with tight safeguards protecting international creditors (especially under New York law), the euro periphery's debt is mostly issued under local law, with virtually no restrictions on restructuring. This is the case, for example, for about 90 per cent of Greek bonds. Legal scholars have argued that the euro area countries concerned consequently have much wider legal leeway; they could, for example, insert the equivalent of a collective action clause retroactively in their loan contracts, thereby binding all creditors to a deal agreed by a supermajority, or even impose, if needed, a fairly hefty haircut.[24] While the former approach could, to some degree, still be dubbed as "voluntary," insofar as it would still seek agreement with a supermajority, the latter would clearly be a coercive deal, risking disruption and longer-term adverse consequences for a country's return to the capital markets.

In sum, provisions such as collective action clauses, while helpful at the margin, are unlikely to significantly affect either the real economic costs of defaults or the call made on official resources. "Bail-ins" via collective action clauses might make "bailouts" politically more palatable, but will not much reduce their need or likely magnitude. The importance of collective action clauses should consequently not be overstated – as it is, for example, in the official European Stability Mechanism: Questions and Answers fact sheet, where the answer to the question "What happens in the extreme and unlikely case of insolvency?"

22. Roubini and Setser, *op. cit.*

23. Uruguay included so-called "aggregation clauses" in the bonds issued as part of its 2003 debt exchange, i.e., clauses that allowed the votes of different bonds to be pooled in assessing the success of a debtor's restructuring offer. The provisions' intention is to lower the threshold for the amendment of any one individual bond; they have not as yet been put to the test.

24. See Lee C. Buchheit and G. Mitu Gulati, "How to Restructure Greek Debt," *Social Science Research Network*, 07 May 2010, and Ibid., "Greek Debt – The Endgame Scenarios" *Mimeo* 18 April 2011.

‘Failing greater clarity and action, peripheral bond markets risk continuing in their tailspin.’

is wholly devoted to the planned inclusion of collective action clauses as from mid-2013 – a genuine *non sequitur*.

Carpe Diem

Past debt restructurings offer Europe a few, clear lessons. These apply to the debt restructuring process itself, and to the need for timeliness. To this end, the immediate exigency today is to lessen uncertainty and provide markets with the better information they crave on two fronts: rigorous bank stress tests and up-to-date debt sustainability analyses, accompanied by concrete action as needed to strengthen the banking sector and address any unsustainable debt situation. Failing such greater clarity and action, peripheral bond markets risk continuing in their tailspin, remaining virtually shut down, and rendering restructurings a self-fulfilling prophecy – even where those forced restructurings might arguably constitute a market over-reaction. And all of this needs to happen well before policymakers’ July 2013 deadline.[25]

25. For a discussion of structural reforms Europe would be well-advised to undertake, see Alessandro Leipold, “Structural Reform: Key Steps on the Road to Recovery” in Enrico Giovannini et. al. *An Action Plan for Europe 2020: Strategic Advice for the Post-Crisis World* (Brussels: The Lisbon Council, 2011).

Appendix: What the EU Says about Private Sector Involvement in Future Restructuring of Eurozone Debt

(Excerpt from Conclusions of the European Council, 24-25 March 2011)

Modalities for Involving the Private Sector

An adequate and proportionate form of private-sector involvement will be expected on a case-by-case basis where financial assistance is received by the beneficiary state. The nature and extent of this involvement will be determined on a case-by-case basis and will depend on the outcome of a debt sustainability analysis, in line with IMF practice (1), and on potential implications for euro-area financial stability.

(a) If, on the basis of a sustainability analysis, it is concluded that a macro-economic adjustment programme can realistically restore the public debt to a sustainable path, the beneficiary Member State will take initiatives aimed at encouraging the main private investors to maintain their exposures (e.g. a “Vienna Initiative” approach). The Commission, the IMF, the ECB and the EBA will be closely involved in monitoring the implementation of such initiatives.

(b) If, on the basis of a sustainability analysis, it is concluded that a macro-economic programme cannot realistically restore the public debt to a sustainable path, the beneficiary Member State will be required to engage in active negotiations in good faith with its creditors to secure their direct involvement in restoring debt sustainability. The granting of the financial assistance will be contingent on the Member State having a credible plan and demonstrating sufficient commitment to ensure adequate and proportionate private-sector involvement. Progress in the implementation of the plan will be monitored under the programme and will be taken into account in the decision on disbursements.

‘The exigency today is to lessen uncertainty and provide markets with the better information they crave.’

In negotiating with creditors, the beneficiary Member State will adhere to the following principles:

- *Proportionality:* the Member State will seek solutions proportionate to its debt sustainability problem.
- *Transparency:* the Member State concerned will engage in an open dialogue with creditors and share relevant information with them on a timely basis.
- *Fairness:* the Member State will consult creditors on the design of any rescheduling or restructuring of public debt with a view to reaching negotiated solutions. Measures reducing the net present value of the debt will be considered only when other options are unlikely to deliver the expected results.
- *Cross-border co-ordination:* the risk of contagion and potential spill over effects on other Member States and third countries will be duly taken into account in the design of measures to involve the private sector. The measures taken will be accompanied with a proper communication by the Member State concerned aimed at preserving the financial stability of the euro area as a whole.

(1) In line with the IMF, debt is considered sustainable when a borrower is expected to be able to continue servicing its debts without an unrealistically large correction to its income and expenditure. This judgment determines the availability and appropriate scale of financing.

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ISSN: 2031-0935

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