The role of markets in sovereign debt crisis detection, prevention and resolution

Hung Q Tran[1]

I would like to thank the BIS for inviting me to speak to you on an important and timely issue. Given the prospect of slow growth, large budget deficits and high public sector debt, the challenges of managing and resolving sovereign debt crises in many countries, including advanced economies, will be with us for some time to come. As part of the wide range of issues being discussed at this Seminar, I would like to focus my remarks on the role of markets and market infrastructure in sovereign debt crisis detection, prevention and resolution.

I will consider briefly crisis detection and prevention, and will devote most of my remarks to the issues of crisis resolution and sovereign debt restructuring.

Crisis detection

Market pricing has been viewed as being able to discount investors' expectations of future events. In recent years, in addition to the cash markets for government securities, Credit Default Swap (CDS) markets have become more developed. Generally speaking, the deeper and more liquid markets become, the more efficiently they can reflect the collective views of numerous market participants. Indeed, in some instances, the markets for CDS have become much more liquid than cash markets, as CDS contracts can make it easier for investors to express their views on credit risk.

In addition, ratings by Credit Rating Agencies (CRAs) can also reflect and influence market views, but the relationship between market prices and rating actions is complex. Usually, market prices are sensitive, quick-moving and tend to discount investor expectations well in advance. Ratings have tended to change more gradually and therefore are viewed as lagging market pricing on many occasions. If done in single notches and within the investment grade category, rating changes may not elicit much price reaction. However, multi-notch rating changes – particularly those moving across the investment grade borderline – can trigger more substantial price moves, mainly because many investment funds must observe eligibility requirements, such as those allowing them to invest only in investment grade securities.

In principle, *both market prices (for cash securities and CDS contracts) and rating actions can be expected to provide early detection of sovereign debt crises*. A forensic analysis of the period leading up to the Greek sovereign debt crisis in early 2010 is useful to evaluate the effectiveness of the market's role in crisis detection, especially

[1] First Deputy Managing Director, Institute of International Finance (Washington D.C.). The views expressed here are personal and do not necessarily reflect those of the IIF. I would like to thank my colleagues for their helpful comments and suggestions, with particular appreciation to Thilo Schweizer for his assistance.

against the background of guidance and regulatory parameters set by policymakers and regulators.

Greece joined the Euro Area on January 1, 2001, having missed being part of the first wave of those countries joining in 1999, due to non-compliance with the Maastricht criteria. Right from the start, celebratory statements were tempered with misgivings about Greece joining the monetary union, from both public and private sector observers. Wim Duisenberg, the inaugural President of the ECB, perhaps best reflected sentiment by noting just prior to Greece's entry that: "...Greece has made great and commendable efforts in order to reach this stage. It shows the extent to which entry into Monetary Union and, therefore, complying with the Maastricht criteria have acted and are still acting as a catalyst for moves towards more sound public finance policies, an environment of low inflation and appropriate monetary policies...(However), it (Greece) still has a lot of further work to do."[2] Some investors worried that admitting Greece could send the wrong signal – that the Euro Area might accept weak members which would not fully comply with membership conditions.

Nevertheless, the formal acceptance of Greece as the twelfth member of the Euro Area – against a background of enthusiastic statements by European leaders lauding the launch of the euro, as well as a very profitable track record of convergence trades on Italy, Spain, Ireland and Portugal in the years leading to EMU – unleashed strong investment and credit flows to Greece. A regulatory regime under which Greek government bonds (GGBs) were accorded zero risk weight (under the Basel capital framework), were encouraged to be held as part of banks' liquidity pools, and were accepted at full face value at the ECB financing facility added allure to GGBs, particularly for Euro Area banks. Unsurprisingly, spreads between GGBs and Bunds collapsed from over 400 basis points in late 1998 (and 100 basis points just prior to joining EMU) to below 20 basis points in late 2001, staying in a low range around 15–40 basis points until well into 2008 – similar to developments seen in other periphery Euro Area countries.

In 2004, Eurostat announced that it had audited Greece's statistical releases from 1993 to 2004 and had fixed the deficiencies in their compilation. Statements from the official sector, including the IMF, continued to be mixed. While urging Greece to reduce its twin deficits, bring down inflation and continue to reform, official statements applauded Greece's strong growth experienced since 2001, attributing it not only to low interest rates but also to the early fruits of structural reform and convergence. In fact, as late as March 2010, several European leaders, as well as Dominique Strauss-Kahn, then-Managing Director of the IMF, still maintained that Greece did not need financial aid from Europe, let alone from the IMF, and should just concentrate on cutting its budget deficit.[3] In fact, by May 2010 the first EU-IMF program for Greece was launched, and the rest is history.

In contrast to the muted reaction from the official sector, the CRAs had started to downgrade Greece, with Fitch downgrading Greece from A+ to A in December 2004, due mainly to its deteriorating fiscal position. After a period of stability over the subsequent several years, ratings downgrades resumed in early 2009 and became more pronounced after the Greek elections in October 2009 and the

[2] Duisenberg (2000).

[3] See e.g. Balmer (2010).

announcement by the new government of revised/corrected fiscal data showing larger than previously announced budget deficits and government debt. In the spring of 2010, Greece was downgraded to below investment grade (Chart 1, page 16).

Greek yield spreads started to widen somewhat from low levels in spring of 2008, and rose further in late 2008 as the Lehman Brothers crisis hit. Following a period of relative stability at higher levels during most of 2009, the real blowout in spreads did not happen until early 2010. However, Greek CDS spreads seem to have lagged bond spread movements throughout 2007, afterwards moving more or less in tandem with bond spreads (Charts 2 and 3, page 16). It is important to note that the outstanding volume of CDS contracts on Greece during this time period was very small – around $9 billion (net), with infrequent trading (Chart 4, page 17). This contrasts sharply with the outstanding volumes in the GGB market at the time of some $400 billion. Hence there is little evidence to support the claim by some officials that the CDS market triggered turmoil in the GGB market.[4]

In summary, about a year before the crisis broke, spreads in the GGB market had started to widen, reflecting an expected increase in the probability of distress – which later materialized. In addition, rating agency commentary and market opinions began to focus on fiscal deterioration and debt sustainability, leading to gradual rating changes. While these market signals were rather modest prior to November 2009, in the next six months through May 2010, they worsened significantly in response to official data and policy announcements revealing the scale of fiscal imbalances amidst rapidly deteriorating economic conditions. As such, it can be said that *market pricing and rating actions provided a measure of advance warning*, by 3–6 months or so, of the impending sovereign debt crisis, with Greece's ultimate loss of access to international capital markets amidst sharply widening spreads marking the sovereign debt crisis itself.

Crisis prevention

If markets exhibit signs of turmoil before a crisis erupts, they generally fail to prevent crises from happening. This is mainly because in many instances the authorities of the debtor country and others, including in regional groupings and international financial institutions, tend to ignore market signals. In some cases, authorities try to suppress market signals by "shooting the messenger" – including by banning short positions in securities markets or the purchase of "naked" CDS contracts on sovereign names. CRAs have also been subject to more scrutiny and regulation, including in the sovereign ratings arena, with official demands for regulation sometimes triggered by a downgrading action.[5]

4 As ISDA has noted, there was no surge in open interest in Greek CDS during 2009 and early 2010, and the relationship between government bond and CDS spreads was "essentially in line", underpinning ISDA's assertion that "the CDS market has had little or no impact on the government market"; ISDA (2010).

5 For example, against the backdrop of the European Commission's ongoing amendments to existing CRA regulation, EU Internal Market Commissioner Barnier has indicated that CRAs could be banned from downgrading countries participating in the Eurozone's bailout scheme. See e.g. Gow/Treanor (2011).

The rating agencies' failures in other areas, notably subprime mortgage securitization, have contributed to demands for further regulation. However, this has confused the issue, as there is little indication that the deficiencies in rating subprime securitization had any bearing on sovereign or corporate ratings.

A number of ideas have been advanced to improve the framework for crisis prevention.

In particular, the *Joint Committee on Strengthening the Framework for Sovereign Debt Crisis Prevention and Resolution* was set up after the March 2012 Greek debt exchange to assess and draw lessons learned from the Euro Area's recent experience with sovereign debt crisis management. It enhanced the guidelines contained in the 2004 *Principles for Stable Capital Flows and Fair Debt Restructuring*, a voluntary code of conduct between sovereign debtors and their private creditors that was endorsed by the G20 Ministerial meeting in November 2004 in Berlin.

In its recommendations – issued as an *Addendum to the Principles – the Joint Committee* emphasized that *effective sovereign debt crisis prevention is a shared responsibility*, requiring – in addition to data and policy quality and transparency and open dialogue between creditors and sovereign debtors – sustained surveillance efforts by regional and international institutions and private sector groups, such as the IIF's Market Monitoring Group. Effective crisis prevention also requires appropriate action by regulatory agencies, accounting and other international standard setters, as well as vigilance and enhanced risk management by private creditors and market participants in general.

A concrete recommendation is that *more structured fora for consultation between a sovereign debtor and its investor base can be useful*, judging from the experience of several major emerging market countries that have adopted such practices. Regular and organized consultations, in the context of a regular investor relations program, can facilitate the ability of investors to share their concerns about perceived economic or financial imbalances and other policy deficiencies with relevant policymakers. This process can enable investors to better understand policymakers' intentions, thus avoiding having to assume the worst-case scenario when the economy deteriorates. At the same time, feedback from investors can help galvanize timely actions by policymakers to avert potential crises.

Crisis resolution

Sometimes it becomes unavoidable that private creditors and investors need to be involved as part of crisis resolution. Private Sector Involvement (PSI) encompasses a rich menu of options, ranging from standstill to rollover (of maturing sovereign debt) to changing the terms and conditions of the debt, including extending maturities, lowering interest rates and reducing the face amount of the debt, or sovereign debt restructuring. This would relieve the cash flow and stock-of-debt burdens on the sovereign debtor, contributing to its adjustment and recovery process.

According to a recent IMF working paper[6] there were 633 cases of sovereign debt restructuring in 95 countries over the last 60 years. The bulk of the restructuring (447 cases) was with bilateral official creditors in the framework of the Paris Club, while only 186 cases were with private creditors. Of the latter, the lion's share was for bank loans, until recently, when sovereign bond restructuring has become more frequent, with 16 cases to 2010. To that list we can add the Greek debt exchange; St. Kitts and Nevis in 2012; and the second Belize Super Bond exchange (agreement in principle likely in 2013).

Based on this body of experience, I would like to make several observations, highlighting instances where market mechanisms have worked relatively well and where they were weak and needed strengthening. These are key components of market-based sovereign debt restructuring and the Report of the *Joint Committee* includes recommendations to enhance their efficacy.

Fair burden sharing through good-faith negotiation

First and foremost, it is essential to keep in mind that sovereign debt restructuring means asking private creditors, especially long-term investors, to give up parts of their property rights and agree to debt forgiveness for the sake of the greater good – helping the recovery of the sovereign debtor and restoring financial stability – from which they benefit only indirectly as market participants. Understandably, an incentive for creditors to behave cooperatively is the threat of default, in which case creditors could stand to lose more. However, a defaulting sovereign debtor also pays a heavy price in terms of reputation damage and being shut out of international capital markets until the default is cured. Moreover, as the severity of haircuts in sovereign debt restructuring has shown a tendency to increase over time, the difference between the residual value in restructuring and the expected recovery value after default could diminish, weakening the potency of the threat of default. All things considered, *a balanced approach is important in achieving voluntary agreement to a fair burden sharing among the three key partners in the adjustment program: the sovereign debtor country, the official sector and private creditors*.

Concretely, the debtor country has to implement meaningful fiscal and structural reforms to improve its economic performance and prospects. The official sector – traditionally meaning the IMF and other international financial institutions, but also the Eurogroup in the context of the Euro Area debt crisis – has to provide official financing to support the adjustment program because of its overall responsibility to maintain a stable international monetary system. In the case of the Euro Area, the financing is also to support a key policy objective – namely, sustaining the euro. In the context of the adjustment program, private creditors would agree to make their contributions in the form of debt relief to lighten cash flow and stock-of-debt burdens on the debtor. ***Given the different interests of the three partners, good-faith negotiation is obviously the only way to achieve a voluntary, orderly and effective debt restructuring*** – one which contributes meaningfully to the adjustment program, respects creditor rights, minimizes litigation risk and allows the sovereign to quickly regain access to international capital markets (without which debt is clearly not sustainable). Access to market

6 See Das/Papaioannou/Trebesch (2012).

financing is also necessary to allow the official sector to gradually unwind its adjustment lending exposure to the country. Improving market confidence and restoring good relations with private investors is therefore prudent and in the best interests of both the sovereign debtor and the official sector.

Moreover, an agreement on fair burden sharing is not sufficient on its own. *All three partners must perform their respective commitments within the "grand bargain" for the crisis to be resolved.* For example, in the case of the second Greek program of February 2012,[7] which offered a reasonable chance at that juncture for a gradual recovery of the economy (reaching a debt-to-GDP target of less than 120% by 2020 – considered by the official sector as essential to attain debt sustainability), private creditors and investors promptly performed their part of the bargain by participating in the March debt exchange. This debt exchange provided Greece with an unprecedented €107 billion of debt reduction, or a 53.5% nominal haircut and a 74% NPV reduction (at an assumed discount rate of 15%). However, Greece failed to implement the agreed reforms in full and on time and the official sector delayed the second disbursement for about six months – during which time the Greek economy collapsed further and its debt-to-GDP ratio jumped to 160% by the end of 2012. The actual sequence of events shows that it is erroneous to say that the March PSI was not "deep" enough to allow Greece to recover. In fact, given what has happened since March, even 100% debt forgiveness by private creditors would not have helped Greece. As a side note, with the debt buyback in December 2012, the share of private sector holdings of new GGBs has declined to less than 10% of total Greek public debt (estimated to be about €310 billion).

Assessment of debt sustainability

Central to an adjustment program is the assessment of how different configurations of fiscal and structural reforms, official financing and private debt relief would lead to debt sustainability in the medium term. The concept of debt sustainability is a matter of judgment and not "hard science". It rests on numerous assumptions and is closely linked to the ability of the sovereign debtor to re-access international capital markets on reasonable terms.

Traditionally, the assessment of debt sustainability was done on an iterative basis, with the IMF acting as an "honest broker", providing the analytical framework and analysis for discussion between the sovereign debtor and its creditors. This approach has been more conducive to good-faith negotiations, which the Fund requires a sovereign debtor to conduct with its private creditors as part of the Fund's Lending into Arrears policy. More recently, however, in the context of large fiscal imbalances, declining output, and fairly large and rising debt burdens, the IMF has espoused a medium-term target for the nominal debt-to-GDP ratio which has driven everything else to meet such a target. When combined with the fact that in some cases (such as the Greek debt crisis) both domestic reform measures and

[7] "The Hellenic Republic today announced the key terms of a voluntary transaction in furtherance of the 26 October 2011 Euro Summit Statement, known as the Private Sector Involvement, and in the context of its economic reform programme that has been agreed with the European Union and the International Monetary Fund. The transaction is expected to include private sector holders of approximately EUR206 billion aggregate outstanding face amount of Greek bonds (excluding treasury bills)"; Hellenic Republic – Ministry of Finance (2012).

official financing from both the Fund and Euro Area countries appear to have been predetermined by political considerations, private debt relief has become the only free variable in the game. In other words, *private investors have become the financier and debt relief provider of first, second and last resort!* However, the more private investors are treated this way, the less likely the sovereign debtor would be able to regain access to international capital markets within a reasonable time frame. Generally speaking, the reluctance to reengage with such sovereign debtors might be expected to be stronger among long-term institutional investors, while some short-term investors may behave more opportunistically.

Furthermore, the maturity and coupon as well as the ownership composition of sovereign debt are quite important to an assessment of sustainability. Debt of long maturity and low or concessional interest rates is much less of a burden than a similar nominal amount of medium-term debt at higher market rates. A focus on the nominal debt-to-GDP ratio misses this point completely. More importantly, *if domestic financial institutions such as banks hold a significant share of outstanding sovereign debt, restructuring this debt would substantially impair the capital base of the domestic banking system*. In many cases, this would necessitate a public recapitalization of domestic banks, raising sovereign debt levels. Furthermore, the economy could be weakened by the banking system coming under distress. The total economic cost could thus far exceed the benefit of a reduction in the nominal value of debt. Generally speaking, experiences from many emerging market countries exiting from sovereign debt crises show that sustained improvement in the debt-to-GDP ratio has largely resulted from a recovery of nominal GDP and not just a reduction in nominal debt.

Given that assessment of debt sustainability could have a direct bearing on the severity of debt restructuring, it is even more *important that private investors have an opportunity to engage with the official sector on a timely basis in a discussion about economic scenarios and key parameters of the adjustment program, including assessment of debt sustainability*. Without private investors' input and "buy-in" for the economic framework of the adjustment program, it is difficult to achieve a voluntary agreement on fair burden sharing and an appropriate debt restructuring.

Creditor coordination problem – role of the creditor committee

One of the most important sources of skepticism about the feasibility and efficacy of market-based sovereign debt restructuring is the coordination problem, both in the sense of the difficulty of getting thousands of bondholders to coalesce in a timely fashion into a representative creditor committee – as opposed to the ability of one or two dozen major international banks to quickly form such creditor committees in the sovereign bank debt restructuring of the 1980s and 1990s – and dealing with the free rider problem.

Looking at the 19 or so cases of sovereign bond restructuring in the past 20 years, it is clear that *coordination concerns have been exaggerated*. In most if not all of these cases, a bondholder committee has been able to take shape within a reasonably short time frame, representing somewhere between 30 and 60% of the value of bonds outstanding. In addition, many institutional investors may decide not to formally join a bondholder committee for various reasons, but are prepared to give serious consideration to the committee's recommendations. Bondholder committees can also claim to be representative as they act in the interest of all bondholders in general. Reflecting the constructive role of creditor committees, market practices have evolved to include the sovereign debtor recognizing and negotiating with such committees as well as paying for their reasonable expenses, including for legal and financial advice.

Recently, progress in communications technology and data retrieval, especially from bond depositary databases, has greatly facilitated the identification of and communication among major bondholders, accelerating the formation of bondholder committees. The IIF has contributed to this process, mainly through the work of the Principles Consultative Group (PCG) – a unique public-private sector group charged with monitoring implementation of the *Principles*. The PCG monitors and discusses all sovereign restructuring cases (including potential ones) among its members, supplemented by observers invited from major stakeholders in particular cases. As such, the PCG offers a natural base for concerned bondholders to come together to form a representative committee. In some cases, the IIF has also been invited by the official sector and bond-holding institutions to act as intermediary in a PSI process. This was the case with Greece – the IIF was asked by the Eurogroup Ministers in June 2011 to organize and represent private investors to engage with the official sector to discuss PSI for Greece.

Concerns about the free rider problem have also been exaggerated. According to the IMF, of the 16 cases of sovereign bond restructuring it has examined, only two saw holdout creditors representing more than 10% of the value of outstanding bonds, and only one resulted in persistent litigation. This is the case of Argentina, which hopefully should remain a unique example of a sovereign debtor pursuing a unilateral and coercive approach to debt restructuring, willfully ignoring its own obligations to official creditors and international financial institutions such as the IMF and the World Bank's International Centre for Settlement of Investment Disputes.

In fact, a more serious obstacle to the smooth functioning of creditor committees as an essential part of an orderly sovereign debt restructuring has in some cases been the approach taken by particular sovereign debtors. Some have refused to recognize the creditor committee and in some instances have worked to undermine it, preferring to talk bilaterally with selected investors to market their unilaterally-determined debt exchange plans. While a sovereign debtor can and should talk directly to any and all investors, doing so as a pretext to avoid good-faith negotiations with a representative bondholder committee is equivalent to pursuing a unilateral and coercive approach to debt restructuring. Such an approach has been resisted by private creditors, and has led to a low participation rate in debt exchanges and high litigation risk – basically failing to achieve an orderly and effective debt restructuring.

Collective action clauses – *pari passu* clause

To address coordination problems, Collective Action Clauses (CACs) were first proposed by major advanced countries (and endorsed by the G10) in the early 2000s as an alternative to the top-down administered sovereign debt restructuring mechanism (SDRM) suggested by the IMF. CACs were first included in their modern form in the prospectus of a global bond issue by Mexico in March 2003.[8] Since then, most new sovereign bonds issued on global capital markets have included CACs.

It is important to keep in mind the fact that CACs also represent a weakening of creditor and property rights, in the sense that investors agree on an ex-ante basis to be bound by the decision of a qualified majority of fellow bondholders to change the terms and conditions of their bond investments to their detriment. By comparison, creditors to corporations undergoing U.S.-style bankruptcy proceedings at least have the comfort of the process being supervised by an impartial judge, otherwise any substantial modification of the terms of the debt requires the unanimous consent of creditors. As such, it is only fair that *when unavoidable, CACs should be used in a comprehensive way, meaning that the sovereign debtor recognizes and engages in good-faith negotiation with a representative bondholder committee to reach a voluntary debt restructuring agreement*. The agreed plan would then be submitted to bondholders for a vote – an affirmative decision by a qualified majority would bind the minority to the proposed changes in terms and conditions of the bonds. (Incidentally, this imposition on minority bondholders constitutes a credit event in CDS contracts on sovereign names, triggering a settlement of outstanding contracts. A completely voluntary restructuring would not constitute a credit event in the sovereign CDS market.) In this context, an attempt to use only the voting mechanism specified in CACs to implement unilaterally-determined debt exchange offers or liability management plans would be abusive and likely to encounter investor resistance.

In essence, using CACs only as a voting mechanism is similar in spirit to the use of “exit consent” in an attempt to impose a debt exchange plan on non-participating investors. If the terms are deemed to be onerous and punitive, investors can now appeal to the courts, based on a recent ruling of the London High Court.[9]

Overall, it is to be welcomed that sovereign bonds issued by Euro Area member countries will carry model and identical CACs from the beginning of 2013, implementing the ESM Treaty. In addition, the Euro Area CACs contain an aggregation clause for cross-series modification – which was also recommended by the *Joint Committee* in the *Addendum to the Principles* to facilitate the orderly implementation of an agreed debt exchange by making it more difficult for non-participating investors to build blocking positions in individual bond series. However, *it is regrettable that the Euro Area CACs deviate from market practices* – as reflected in guidelines set out by the International Capital Market Association (ICMA) – in two areas: lower thresholds for qualified majority (66.6% instead of 75%) and no coverage of bondholder committees.

8 On March 3, 2003 Mexico successfully issued its 6.625% Global Notes due 2015, governed by New York law that included both majority restructuring and majority enforcement provisions. The spread at issue was in line with the Mexican yield curve, suggesting that any premium paid for CACs was negligible. The bond continued to trade well in the secondary market. Although this was not the first bond issue governed by New York law to include majority restructuring provisions, this issuance is of particular significance because the existence and design of these clauses was the subject of extensive discussion at the time the bonds were issued; see IMF (2003), SEC (2004), p.2, Fn.3.

9 Assénagon Asset Management S.A. v. Irish Bank Resolution Corporation Ltd., July 2012. [2012] WLR(D) 243, [2012] EWHC 2090 (Ch).

More recently, the issue of *pari passu* clauses has received a lot of attention following the decisions of the District Court of the Southern District of New York in the case of Argentina v. NML Capital Ltd. (February and November 2012),[10] and the U.S. Court of Appeals for the Second Circuit (October 2012).[11] The concept of *pari passu* is more meaningful and clear-cut in the context of corporate bankruptcy, where the proceeds from the liquidation of corporate assets are distributed equally to unsubordinated debt holders before any residual amount can be used to pay more junior claims. For many years prior to the 1990s, the pari passu clause in the context of sovereign bank loans and bonds had the formal meaning of the sovereign debtor promising not to proclaim any new debt or parts of its outstanding unsubordinated debt as senior to other unsubordinated debt. However, *since the 2000s, the pari passu clause in sovereign debt contracts has evolved to contain a second sentence referring to "equal ranking of payment obligations" among the debtor's unsubordinated debts*. By now, about half of the sovereign bonds in international capital markets contain both the first sentence about formal ranking and the second sentence about "*equal ranking of payment obligations*" in their *pari passu* clauses.

Under such an extended *pari passu* clause, and in the opinion of the U.S. Circuit Court of Appeals for the Second Circuit, a sovereign debtor has an obligation as a bond issuer not to create any debt senior to the outstanding stock of unsubordinated debt. The debtor also has the obligation as a bond payor to refrain from paying some holders of unsubordinated debt while not paying others. Using this argument, the Second Circuit reaffirmed the decision of the District Court that Argentina had violated the *pari passu* clause in its bond contract in both senses, by passing the Lock Law and by not honoring its "equal ranking of payment obligations" to all bondholders.

However, *having a sovereign debtor judged to have violated its bond contract is one thing, how to remedy the situation is quite another*. At present, it is not clear how this can realistically be done. The payment instruction specified by the District Court in November 2012 (namely, that Argentina must pay holdout claims in full when it makes payments on restructured bonds; that the injunction applies to the intermediaries such as trustee banks and clearing organizations in the payment process; and that Argentina must deposit $1.33 billion in an escrow account pending appeal) is being stayed, pending review by February 2013. This payment instruction – especially extending the injunction to intermediaries in the payment process – has given rise to concern about possibly incentivizing holdouts in future sovereign debt restructuring, even within the context of activating CACs, and disrupting payment systems in general. The outcome will very much depend on how the Second Circuit decides, and if its ruling is presented specifically for the unique case of Argentina and not to be interpreted more generally.

Generally speaking, investors have found it quite difficult and costly to recover court judgments in their favor against sovereign debtors determined to exercise their sovereignty and ignore foreign court orders. Clarification of the payment sentence of *pari passu* clauses and a strengthening of the Waivers of Immunity

[10] NML Capital, Ltd. v. Republic of Argentina, United States District Court for the Southern District of New York, Dec. 14, 2011, No. 03-cv-8845, ECF No. 452.

[11] NML Capital, Ltd. v. Republic of Argentina, United States Court of Appeals for the Second Circuit, August 20, 2012, No. 11-4065-cv (L).

clauses could offer opportunities to address the difficulty in enforcing court judgments against a sovereign debtor – which is an important deficiency in sovereign debt markets.

Subordination – the Securities Market Program (SMP) and Outright Monetary Transactions (OMT)

The Euro Area sovereign debt crisis and in particular the Greek debt exchange have resulted in yet another erosion of the rights of private investors in the sovereign bonds of those countries: de facto subordination. Specifically, the GGB holdings of the ECB and the Euro Area national central banks were exempted from the Greek debt exchange, on the grounds that participation in the exchange would have been tantamount to "monetary financing", which is prohibited by the Treaty on the Functioning of the EU. Unfortunately, such subordination meant that private holders of identical GGBs were put under more pressure to come up with a more onerous haircut to achieve the targeted debt relief for Greece.

In addition, one of the recitals in the ESM Treaty also claims seniority for ESM loans, second only to the preferred creditor status of the IMF. In other words, when a problem member country receives such ESM loans, its sovereign bonds in the hands of private investors and other official creditors outside the Euro Area will become subordinated instead of unsubordinated, as specified in outstanding bond contracts – a possible violation of the pari passu clause of existing sovereign debt.

The *subordination problem is a serious concern for international investors* (including both private sector firms and public sector entities such as foreign central banks and sovereign wealth funds). Specifically, *it adds another complication to the assessment of credit risk for those Euro Area countries under fiscal stress and can make it more difficult for some of them to access capital markets on reasonable terms*. Aware of this problem, the Euro Area authorities have taken some steps to assuage investor concerns. When launching the OMT scheme to buy short-term sovereign bonds on secondary markets, the ECB emphasized that bonds purchased under the OMT will be treated equally with those held by private investors. This clarification is welcome. However, it still leaves standing the preferred creditor status claimed for sovereign bonds held in the SMP, as was the case in the Greek debt exchange.

Going forward, it is important that the Euro Area authorities clarify this important source of uncertainty so as to help restore normalcy to their sovereign bond markets.

Litigation and "vulture funds"

Against the backdrop of sovereign actions to impose *de facto* subordination on private holders of sovereign bonds and some attempts to pursue a unilateral approach to debt restructuring, it is important to realize that *litigation is crucial to defend creditor rights and to help achieve a balanced approach to sovereign debt crisis resolution*. Otherwise, allowing creditor rights (including litigation rights) to be weakened, even under the exigencies of crisis resolution, would have long-term negative effects on credit markets to the detriment of all market participants, mainly by undermining the legal certainty of sovereign securities, especially in mature markets.

In this context, it is important to put the debate about litigation by distressed debt funds, or so-called "vulture funds", into perspective. According to research notes prepared by the Emerging Markets Trade Association (EMTA) and the IIF for the Paris Club-IIF Annual Meeting in June 2010, incidents of litigation against emerging markets, as well as low-income/HIPC sovereign borrowers have been relatively few in number and covered a small share of the outstanding value of restructured sovereign debt.[12]

According to EMTA, since the early 1980s, 59 emerging market and non-HIPC countries have defaulted and/or restructured their sovereign debt, worth more than $600 billion in total. Of this sample, nine countries were identified as being subject to litigation by one or more of their creditors. Excluding the unique case of Argentina, which defaulted in 2001, the face value of debt subject to litigation has amounted to about $1.5 billion and resulted in recoveries totaling about $230 million. Creditor plaintiffs have tended to be successful in asserting their claims and obtaining judgments in U.S. courts under basic principles of contract law, including waivers of sovereign immunity. However, actual recoveries appear to have been difficult and time-consuming – a trend which has become more pronounced over the past decade.

According to the IIF review of litigation in low-income and HIPC countries, out of the 47 lawsuits identified by the 2008 HIPC Initiative and MDRI Status of Implementation Report by the IMF/IDA, 32 cases have been settled. Most of the remaining 15 cases have been brought by trade creditors such as suppliers to governments rather than by distressed debt or "vulture funds", which now account for only three cases (two new cases involving the Democratic Republic of Congo and one old case involving Liberia).

These facts should be kept in mind in the debate about possible legislation to deal with the perceived problem of litigation by "vulture funds", especially in low-income/HIPC countries, so that a remedy to an exaggerated problem does not end up doing significant damage to the integrity of international credit markets, mainly by depriving investors of their legitimate recourse to litigation in case of disputes.

Debt buybacks

Sovereign bonds of a country in distress typically trade at a significant discount on secondary markets. Buying back such debt at current market prices (or with a small premium) crystallizes losses for participating investors, especially long-term investors, and precludes any chance of later recovery, while reducing the nominal value of debt for the borrower. As such, buybacks can have a role to play in the liability management toolbox to help a sovereign debtor manage its debt and provide an exit for investors in impaired markets. However, there are several considerations relating to the use of buybacks:

[12] See IIF/EMTA (2009).

1. Most importantly, *buybacks should be carried out on a voluntary basis based on market terms*. Attempts to use CACs to impose a buyback at a specified price, especially if the price is below market, constitute a coercive approach to sovereign debt restructuring. Besides the fact that such tactics may encounter investor resistance, they represent an abusive use of CACs.

2. Secondly, *the financing needed for such buybacks should be on substantially better terms than the debt being bought in terms of maturity and interest rates*.

3. Thirdly, *buybacks are best managed in a discreet and opportunistic fashion*. Publicly announcing a buyback target and price, or even worse, making it a pre-condition for granting official financing to a debtor country (as was the case in the December 2012 Greek debt buyback) affords investors an almost one-way bet to push prices up. This results in a higher cost for buybacks and correspondingly less benefit in terms of nominal debt reduction for the borrower.

4. Last but not least, *it is important to analyze the potential costs and benefits of alternative uses of official financing* – a scarce resource for the sovereign debtor in distress. In the case of Greece, the buyback cost of €11.3 billion comes from squeezing the official financing package – precluding a more productive use of such financing to alleviate the acute liquidity shortage which has caused severe economic dislocation. Partly because of continued liquidity shortages, Greek nominal GDP is estimated in the program to shrink by another 5% in 2013, on top of the 20% decline since 2008. Such a decline in nominal GDP would increase the debt-to-GDP ratio by 9 percentage points, almost equivalent to the amount of debt (9.6% of GDP) retired by the buyback!

Credit enhancements and GDP-linked instruments

The Greek debt exchange has also provided concepts and techniques that can be used to enhance the credit quality of the exchange instruments so as to gain support from investors without increasing the upfront cost to the sovereign debtor or the official sector.

- *Cash sweeteners*, such as the €30 billion in short-term notes provided by the EFSF to participants in the March 2012 Greek debt exchange, are valued by investors for their lack of credit risk compared to collateral in the form of securities which may have equivalent costs to the official sector but whose value to investors varies according to market conditions.

- *Co-financing structures* such as that between the EFSF's €30 billion loan to Greece and the new GGBs can give some protection to investors at no cost to the official sector or the sovereign debtor.

- The *use of foreign law and jurisdiction in new domestic bond issues* can minimize the risk of a sovereign debtor changing domestic law so as to alter unilaterally and retroactively the terms and conditions of its outstanding bonds, potentially subjecting private investors to significant haircuts.

- The *use of GDP-linked instruments with proper safeguards* to produce a win-win situation so that the sovereign will pay more when it can afford it, in cases of higher-than-anticipated output growth.

Conclusions

I would like to conclude by again drawing your attention to the conclusion of the IMF Working Paper cited above:

> *"We find that most recent sovereign debt exchanges could be implemented quickly and without severe creditor coordination problems. Since 1998 only 2 out of 17 bond exchanges had a share of holdout exceeding 10% of the debt. Similarly, creditor litigation in the context of bond restructuring has been rare, with the exception of the default of Argentina after 2001. Overall the system of ad-hoc debt exchanges seems to have worked reasonably well for emerging market countries. These experiences may also prove useful to any distressed country, including advanced economies."*[13]

Given such a track record, the current "reasonably effective" system of ad-hoc sovereign debt exchanges should be further developed and enhanced by adherence to the *Principles*, in order to serve as the preferred framework for voluntary and good-faith negotiation to reach a fair burden sharing arrangement which – together with the use of CACs – can facilitate an orderly and effective debt restructuring. This in turn will contribute to sovereign debt crisis resolution and help restore financial stability.

I appeal to you to lend your support to this endeavor.

Thank you very much for your attention.

[13] Das/Papaioannou/Trebesch (2012), p.96.

Appendix

Chart 1:

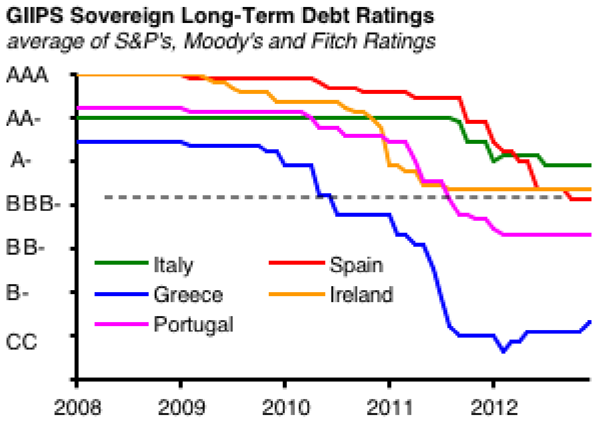


Chart 2:

Chart 3:

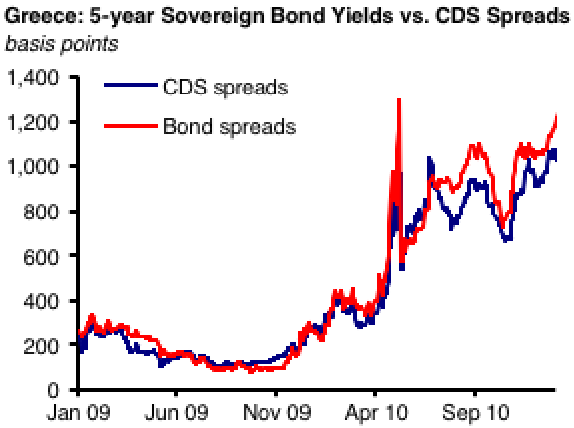
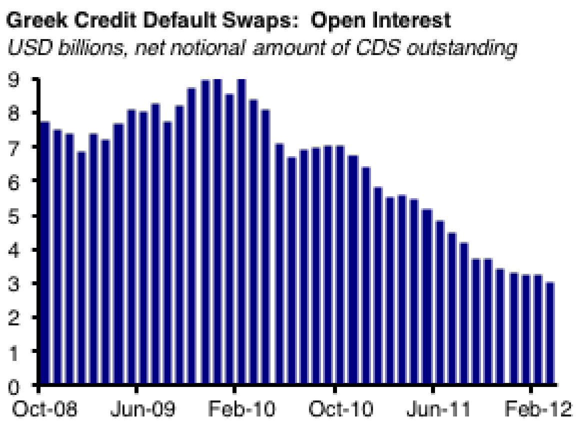


Chart 4:



Sovereign Bond Restructurings

Table 1

Country	Year	Participation Rate
Pakistan	1999	99%
Ecuador	2000	98%
Russia	2000	99%
Ukraine	2000	97%
Moldova	2002	100%
Uruguay	2003	93%
Dominica	2004	72%
Argentina	2005	76%
Dominican Republic	2005	97%
Grenada	2005	>90%
Belize	2007	98%
Ecuador	2009	n.a.
Seychelles	2009	89%
Argentina	2010	93% cumulative (76% in 2005)
Cote d'Ivoire	2010	99%
Jamaica	2010	98%
Greece	2012	93%
St. Kitts and Nevis	2012	100%
Belize	2013	Agreement in principle; announcement of terms and debt exchange offer pending.

Sources: IIF, Das/Papaioannou/Trebesch (2012), Cruces/Trebesch (2011).

References

Balmer, Crispian (2010), IMF working perfectly with EU on Greece – Strauss-Kahn, 29 March 2010, http://www.reuters.com/article/2010/03/29/imf-strausskahn-greece-idUSLDE62S0Z920100329.

Cruces, Juan J. / Trebesch, Christoph (2011), Sovereign Defaults: The Price of Haircuts, CESifo Working Paper No. 3604.

Das, Udaibir S. / Papaioannou, Michael G. / Trebesch, Christoph (2012), Sovereign Debt Restructurings 1950–2010: Literature Survey, Data, and Stylized Facts, IMF Working Paper (WP/12/203).

Duisenberg, Wim (2000), Duisenberg comments on Greek EMU entry at ECB press conference, 14 December 2000, http://www.centralbanking.com/central-banking/news/1429133/duisenberg-comments-greek-emu-entry.

Gow, David / Treanor, Jill (2011), Downgrading countries in bailout could be banned, says EU, 20 October 2011, http://www.guardian.co.uk/business/2011/oct/20/downgrading-countries-in-bailout-ban.

Hellenic Republic – Ministry of Finance (2012), PSI Launch Press Release, 21 February 2012, http://www.minfin.gr/portal/en/resource/contentObject/id/7ad6442f-1777-4d02-80fb-91191c606664.

Institute of International Finance (IIF) / Emerging Markets Trade Association (EMTA) (2009), Creditor Litigation in Low-Income Countries Benefiting from the Enhanced-HIPC and MDRI, June 2009, Preliminary Analysis, http://www.clubdeparis.org/sections/communication/evenements/rencontre-avec-secteur/secteurprive2009/rencontre-avec-secteur/document-iif-emta/downloadFile/file/IIF-EMTA_Study_on_Creditor_Litigation_against_Sovereigns.pdf?nocache=1265362021.63

International Development Association (IDA) / International Monetary Fund (IMF) (2011), Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) – Status of Implementation and Proposals for the Future of the HIPC Initiative.

International Monetary Fund (IMF) (2003), Public Information Notice (PIN) No. 03/53, April 18, IMF Continues Discussion on Collective Action Clauses in Sovereign Bond Contracts, http://www.imf.org/external/np/sec/pn/2003/pn0353.htm.

International Swaps and Derivatives Association (ISDA) (2010), ISDA Comments on Sovereign CDS – News Release, 15 March 2010, http://www.isda.org/media/press/2010/press031510.html.

United States Securities and Exchange Commission (SEC) (2004), Order Granting Application for Exemption: Petroleos Mexicanos and the Pemex Project Funding Master Trust, October 13, 2004 (File No. 22-28755), http://www.sec.gov/divisions/corpfin/cf-noaction/pemex101304.pdf.