SOVEREIGN DEBT RESTRUCTURING

Search for an Optimum Voting Threshold

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ABSTRACT

Sovereigns have been defaulting on their debts over decades now. A sovereign debt default necessitates a restructuring of the debt instrument in order to reduce the size of the debt or lengthen the maturity period. One of the methods of debt restructuring is an ‘exchange offer’ where the old debt instrument, for example the bond, is exchanged for new debt instruments with altered terms and conditions, particularly the payment terms. Whereas some investors may agree to such restructuring and accept the exchange offer, others might have different aspirations for their investments. A successful sovereign debt restructuring takes place when the debtor has acquired the consent of a pre-determined number of creditors, or the restructuring threshold. The restructuring threshold is, however, a function of two critical variables – (i) investor confidence: low threshold percentage reflects low investor confidence in the issuer; (ii) success of the restructuring: high threshold percentage makes it difficult to achieve the required number of consenting investors. Thus, maintaining a balance between the two becomes crucial for the debtor country. In this article, previous sovereign debt restructuring episodes have been analyzed to study the different threshold levels prescribed by different countries, and an attempt has been made to study whether there is a possibility of an optimum threshold level that can be prescribed as a supra-national code for all sovereign debt restructurings.

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INTRODUCTION

I. Why Sovereigns Borrow!

Borrowing of money has remained a universal phenomenon throughout the history of mankind, and can be traced back to about 9000 years ago when man invented counting tokens to keep track of trades and obligations.1 With the advancement of trade and commerce, features of debt and credit have become exponentially widespread and complex. Now borrowing is not limited to only individuals or commercial entities, but even sovereign states resort to commercial borrowing to fulfil their financial requirements. Until about the 20th century, borrowing by sovereigns was limited to emergency measures for a short-term to cover particular large expenditures (such as natural calamities, war, etc.). Borrowing has become a perpetual feature for most governments, where new loans are also used to repay old loans. As long as governments are able to keep the country’s level of indebtedness in check, borrowing to service old loans is considered sustainable.2 This essay is limited only to the study of sovereign borrowings.

With the vision to develop and grow, the developing countries have been in constant need to borrow, and during the last half a century, the largest source of capital flow has been Debt.3 Due to the frenzy of modernisation and major railroad and industrial projects, there were drastic lending by commercial banks in the 1970s and 1980s. Most lending was by way of syndicated bank loans, until the debt crisis of 1980s, when there was a shift from syndicated loans to bonds.4 Since the outset of the Brady Plan in 1989, Argentina, Brazil, Bulgaria, Costa Rica, the Dominican Republic, Ecuador, Ivory Coast (Cote d’Ivoire), Jordan, Mexico, Nigeria, Panama, Peru, the Philippines, Poland, Russia, Uruguay, Venezuela and Vietnam were able to restructure their unsustainable debt mostly in syndicated loans by the issuance of Brady bonds, which has also been the genesis of an era of sovereign bond defaults and restructuring.

“In general terms a bond is a loan by one party (an investor or holder) to another party (the issuer)”.5 The issuer normally undertakes to pay the investor a fixed interest on the loan on a periodical basis, and at the end of a specified time (term), repay the loan amount (principal). Depending on the terms of the loan agreement, a failure to pay any amount of interest or principal on time could be considered an event of default, triggering strict financial and legal penalties, one

of them could be bankruptcy of the borrower. One of the world’s leading financial research and analysis firm - Moody’s Investors Service defines a sovereign default when one or more of the following situations happen:⁶

1. There is a missed or delayed disbursement of interest and/or principal, even if the delayed payment is made within the grace period, if any.

2. A distressed exchange occurs, where:
   a. The issuer offers bondholders a new security or package of securities that amount to a diminished financial obligation such as new debt instruments with lower coupon or par value.
   b. The exchange had the apparent purpose of helping the borrower avoid a “stronger” event of default (such as a missed interest or principal payment).

Sovereign defaults results in huge costs to both the debtor country and its creditors, ‘in terms of lost economic activities and lost value of claims’.⁷ The sovereign debtor’s inability to service its debt may result in loss of market confidence, and eventually lose access to borrowing from financial markets.⁸ Defaults may also result in output losses to the domestic economy, and it could also be an important incentive for debt repayment.⁹ Creditors have the obvious monetary loss of their investments. Therefore, it is of utmost importance that a bond be serviced continually in order that the debtor does not default on it.

II. Need for Restructuring

Countries face various forms of crises from time to time, like war, civil unrest, natural calamity, epidemic, etc. which result in unforeseen financial constraint on the economy, as a result of which default on bonds becomes imminent. At other times, countries amass unsustainable debt burdens which become impossible to service even if there is no sudden and unforeseen crisis.¹⁰ In such circumstances it becomes pertinent for sovereign borrowers to restructure their debt and achieve a sustainable debt levels. Among other things, restructuring involves rescheduling of

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⁹ Id. 8 at p.5.
interest and principal payments as well as write-down on the debt principal or interest rate.\textsuperscript{11} Since bankruptcy or liquidation is not a viable option in the case of a sovereign borrower, therefore, creditors would consider renegotiating with the debtor for the amount owed. Bond and Eraslan\textsuperscript{12} illustrate the process with an example:

“…consider a debtor who owes $100 and values staying in business at $100. Suppose moreover that creditors would obtain only $50 from liquidation. The obvious problem for the creditors is that if the debtor defaults on the $100 owed, and then suggests restructuring the debt so that only $50 is owed, it is in the creditors’ best interests to accept.”

In simpler terms, the creditors could consider giving a second chance to the debtor to pay the debt owed (usually a reduced amount), rather than liquidate the debtor and share the proceeds, which carries more often than not a reduced value than what the debtor would be worth if it stayed in business. The premise that an ongoing concern has more economical value than a liquidated one (and that a sovereign cannot be liquidated) is a predominant reason for a sovereign’s debt restructuring initiative. In any case, a debt restructuring certainly reduces the utility or monetary value of the creditor’s claim, compared to the existing debt he holds. Some of the recent sovereign debt restructuring processes has been carried out in Russia (1998), Ecuador (1999), Pakistan (1999), Ukraine (1999) and Uruguay (2003).\textsuperscript{13}

\section*{III. Methods of Restructuring Sovereign Debt}

Unlike corporate debt restructuring methods, there is no international statute that is applicable to all nations. The two major approaches that have been put forward for sovereign debt restructuring are:\textsuperscript{14}

A. Establishment of a statutory framework for International Bankruptcy -

This contemplates an internationally recognised statute in the form of ‘Sovereign Debt Restructuring Mechanism’ (SDRM) proposed by the International Monetary Fund (IMF).\textsuperscript{15}

B. Voluntary & Contractual Arrangements such as Exchange offers, Collective action Clauses and other devices.\textsuperscript{16}

\\textsuperscript{11} Supra Note 3.


\textsuperscript{14} Arora et al: Supra Note 4.

\textsuperscript{15} Anne O. Krueger ‘A New Approach To Sovereign Debt Restructuring’, International Monetary Fund, April, 2002.
The SDRM proposed by IMF, analogous to the Chapter 11 bankruptcy procedure in the US, is still at conceptual stage and seems to be a herculean task, requiring the amendment of the Articles of the IMF and then drafting the proposal and seeking the ratification of all the member states. Even if the SDRM was to see the light of the day, sovereigns would not be eager to subject themselves to an international statute. Unofficial sources and news reports claim that the SDRM project has been shelved due to the uncertainty of its success. However, the voluntary and contractual methods have been in use and so far are the topics of current debate and analysis revolves around these. These methods have been greatly advocated and discussed widely among international institutions and scholars, and ‘focuses on writing of bond and loan documents to include clauses that would prevent a minority of creditors from blocking negotiations with the debtor’.  

IV. Contractual Restructuring

Most sovereign bonds issued by emerging market follow either the New York law documentation or the English law documentation. Contract terms of the bonds issued under the New York law may not be amended unless a near unanimity of the bondholders is achieved. However, English law is more flexible in this account and allow greater ease of restructuring (requiring an approval of a supermajority of 66⅔% or 75%). This poses a distinct problem to sovereign issuers when they need to restructure their bond, where they have to deal with both New York law and English law. In such situations sovereign issuers carry out an exchange offer or debt swap, whereby an offer is made to the creditors of sovereign bonds to exchange their old bonds in return of new bonds in which the restructuring has been carried out. An exchange offer seeks to replace an outstanding debt with relatively low-risk securities. Countries like Argentina announced its exchange offer for its bonds in 2005, Ukraine in 1999 and Ecuador in 2000. A restructured bond may therefore include clauses such as collective action clauses and exit consents in order to ward off the problem discussed above.

Collective Action Clause

Collective Action Clause (CACs) are designed in a way which would bind the minority creditors, including any holdout creditors / vulture funds to a restructuring agreement which has

16 Ibid 14.
17 Dodd: Supra. Note 3.
been arrived at by a pre-established holding majority.\textsuperscript{19} Variants of CACs may include \textit{Majority Action Clauses, Collective Representation Clauses} and ‘Cooling Off’ period Clauses.\textsuperscript{20} A two step approach is adopted in this method\textsuperscript{21}: initiate negotiations with creditors and commit them to a consensus, and implement the terms of the negotiated instrument. Majority action clauses enable a super-majority of bondholders to change the payment terms of the contract, and such change becomes binding for all bondholders.\textsuperscript{22} Such majority action clauses also regulate the conduct of bondholder meetings and set quorum requirements, which becomes crucial in amending terms of the bonds.\textsuperscript{23} Such clauses may also be tailored to restrict bondholders from accelerating the bond or taking recourse to litigation.

Exit Consent

In an \textit{Exit Amendment} or \textit{Exit Consent} a pre-determined majority of bond holders participating in a debt exchange would be required to consent to amendments of certain terms of the old bonds. This will render the old bonds less attractive, hence discouraging hold out problems. For example, the bonds could be delisted, the legal jurisdiction could be changed, and acceleration or default clauses could be eliminated.\textsuperscript{24}

In a debt exchange, a super-majority of bond holders is a crucial element to the debt restructuring. In past sovereign work-outs, the levels of acceptance were different, e.g. Russia 98\% (1998-2000), Ukraine 95\% (1998-2000), Ecuador 97\% (2000), Pakistan 95\% (1999), Uruguay 93\% (2003) and Argentina 76\% (December 2004).\textsuperscript{25} Recently, Mexico has sold about US$ 5.5 billion in bonds prescribing a super-majority of 75\%, soon after Brazil, Belize, Guatemala, and Venezuela issued bonds with 85\% super-majority threshold, a level closer to the 95\% proposed by the private sector trade associations (Emerging Market Credit Association, 2002).\textsuperscript{26} Uruguay’s exchange of the

\textsuperscript{20} Arora et al: Supra Note 4.
\textsuperscript{21} Ibid.
\textsuperscript{23} Id. 22.
\textsuperscript{24} Luisa Palacios, Ph.D. ‘Sovereign Bond Defaults and Restructurings in Emerging Markets: A Preliminary Review’, JBIC Institute, July 2002.
\textsuperscript{26} Seki: Infra Note 40.
Samurai Bonds required consent of 66⅔% bond holders of a series to amend the payment terms. The above examples illustrate that although the use of a super-majority vote has been in place, but there is no consensus on a percentage which could be considered as an ‘optimum threshold’.

This paper analyses previous works and attempts to determine why sovereigns choose different thresholds in an exchange offer and whether an optimum threshold for sovereign debt restructuring could be devised.

THE OPTIMUM VOTING THRESHOLD

I. The Holdout Problem

The creditors are free to decide whether they want to participate in any restructuring proposed by a sovereign debtor, which means an exchange offer is not binding on all creditors. Thus, non-participating creditors may hold on to their old bonds and claim full payment. Several sovereign debt restructurings have run into trouble during the early 1990s because of such non-participating creditors, who are called ‘holdout’ or ‘rogue’ creditors, who seek preferential settlements by dissenting. It is most probable that there will be some holdout creditors to every sovereign restructuring, and as long as their number is few, the sovereign may carry on with the restructuring, allowing the holdouts to retain the old bonds or settle their claim. But when they are large in number this does not remain as a viable option. In such cases, the only alternative is to bind all creditors to the vote of the majority. And this is where the debate for sovereign debtors’ optimum choice of voting threshold started, which can be used as a supermajority and bind even the dissenting creditors.

Ever since voluntary and contractual methods have been used for sovereign debt restructurings, numerous doubts were raised about the elusive optimum threshold. Hamilton et al

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28 Buchheit: Supra Note 18.

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describes the threshold as the ‘magic number’ to be achieved by sovereign debtors in order to carry out a successful restructuring. Some of the standard threshold limits being adopted have been compiled by Roubini et al.\textsuperscript{30} and are discussed below.

\section*{II. Suggested Voting Threshold Limits}


2. Bond Contracts based on English Law – 75\% - to be present and voting ‘for’ the restructuring.

3. The G-10\textsuperscript{31} recommendation of – 75\% – to amend financial terms, similar to the English system.

4. The G-6\textsuperscript{32} recommendation of – 85\% – bondholders to amend a bond’s financial terms, so long as no more than 10 percent of the bondholders object, effectively making it 90\%.

Roubini \textit{et al} further goes on to describe the problems with the sovereign restructurings and suggests methods to deal with them.


\textsuperscript{31} The ‘Group of Ten’: The Group of Ten is made up of eleven industrial countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States) which consult and co-operate on economic, monetary and financial matters. Following an invitation to the Ministers and Governors of the Group of Ten by the Heads of State and Government of the Group of Seven in Halifax in June 1995, the Deputies of the Group of Ten established a Working Party to consider the complex set of issues arising with respect to the orderly resolution of sovereign liquidity crises. A report titled ‘\textit{The Resolution of Sovereign Liquidity Crises}’ prepared under the auspices of the Deputies, was submitted to the Ministers and Governors of the G-10 countries, in May 1996. (Source: OECD)

\textsuperscript{32} The ‘Group of Six’. The concept of a forum for the world’s major industrialized democracies emerged following the 1973 oil crisis and subsequent global recession. In 1974, the United States created the Library Group, an informal gathering of senior financial officials from the United States, the United Kingdom, West Germany, Japan and France. In 1975, French President Valéry Giscard d'Estaing invited the heads of government from West Germany, Italy, Japan, the United Kingdom and the United States to a summit in Rambouillet. The six leaders agreed to an annual meeting organized under a rotating presidency, forming the Group of Six (G6). The Group of Six or \textit{G-6} countries went on to become the G-7 with the addition of Canada in 1976 and G-8 with the addition of Russia in 1991.
II. Empirical Studies on Threshold

Eichengreen & Mody

Eichengreen and Mody \(^{33}\) carried out their research to understand if there is any relation between the borrowing costs of a debtor and its creditworthiness. Although their data set contained only private bonds, but it nevertheless revealed a strong correlation between CAC and borrowing costs. Their study reveals that more creditworthy borrowers enjoy greater confidence in the market; and in contrast debtors with low creditworthiness invite moral hazards\(^{34}\) and higher borrowing costs by including CACs.

Catao & Kapur

In 2004, Catao and Kapur \(^{35}\) published their study on sovereign borrowings and debt intolerance \(^{36}\) based on two assumptions: a sovereign either borrows to smooth its own consumption when revenues become volatile, or to support the consumption of its citizens when income levels drop. They assume that sovereigns are likely to default in the event of a large negative shock to their economy. They examine the countries’ repayment histories and the historical evidence of negative shock and the extent of trade volatility. They concluded that “cross country differences in underlying macroeconomic volatility is at least part of the answer and a key missing link that reconciles the standard theory of sovereign borrowing with the empirical evidence on the ‘debt intolerance’ phenomena.”

Haldane, Penalver, Saporta & Shin

One of the relevant empirical studies carried out to identify the determinants of CAC threshold was published by Haldane, Penalver, Saporta and Shin in 2005.\(^{37}\) The findings of the


\(^{34}\) ‘Moral Hazard’ is a concept whereby borrowers and lenders in financial markets take risks in the present based on their understanding of their gains in the future should an eventuality arise.


\(^{36}\) Analogous to the term ‘lactose intolerance’ (the inability to metabolize lactose, a sugar found in milk and other dairy products, because the required enzyme lactase is absent in the intestinal system or its availability is lowered), ‘debt intolerance’ refers to the state of a sovereign whose economy is in so much duress that it may not be able to sustain any further debt.

paper that “there are costs to a policy of the ‘lower the better’ ”. Haldane et al.’s uses an economical model and their study reveals that a lower threshold ensures that higher level of holdout creditors were held in check, but this increases the risk of a moral hazard on the part of the debtor, whereby creditors may flee, resulting in higher *ex-ante* interest rates.

**Figure 1.** *Variation of Interest rates with Fundamentals.*

\[(kappa – \text{voting threshold})\]

“Intuitively, the debtor cares about three things: the probability of crisis (which depends on its economic fundamentals and on the expected rollover behaviour of creditors); its pay-off in the event of non-crisis (which depends on the markset interest rate); and its pay-off in the event of a crisis.\(^3^9\) Haldane *et al* argue that where the threshold is low, in the event of a crisis, the pay-off for the debtor is high, at the same time it also results in a higher interest rate (see Figure 1 above). Thus, an optimum threshold balances the costs and benefits between the debtor’s risk inclination and the threat of losing creditworthiness. It can be inferred that the risk taking capacity of the debtor country would be directly related to the threshold limit it sets upon for its restructuring. It also implies that a country’s creditworthiness also determines the rate of interest, as evident from Figure 1 above, as creditworthiness increases, the interest rates for different thresholds begin to narrow.

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\(^{38}\) *Ibid* 37, at page 19.

\(^{39}\) *Ibid* 37.
Jenna Seki

Building upon Eichengreen & Mody, and Haldane et al, Jenna Seki carried out a study which was based on ‘the idea that restructuring procedures stipulated in a CAC are a type of insurance for the sovereign’. Seki considers that the decision of private borrowers may be influenced by various external factors, like various legal jurisdictions they have to deal with, size and spread of their creditors, periods of the debt, etc., and has therefore restricted his data only to sovereign borrowers, which makes the study more relevant for our purposes since it provides a larger estimate of the impact of CACs on debt restructuring. Considering the overwhelming application of New York and English law in sovereign issues, Seki has excluded bonds governed by other laws (Luxembourg, Japan, Germany, etc. consisting about 18% of the sample) from the study. Further, his sample consists of those borrowers who have issued securities under both New York and English laws.

Seki concludes that “a combination of maturity length of the bond, national inflation, external debt ratios, and high yield spreads dictate optimal threshold for sovereigns”. Optimal threshold was found to be dependent on the issuer country, the creditworthiness of the issuer, and the specific security being issued. Domestic economic conditions like inflation, credit tightening, and trade deficit signified greater risk and were associated with high optimum threshold.

CONCLUSION

In this paper, we have discussed the necessity for a sovereign to borrow from private creditors, its need to restructure the payment plans of its debt obligations, the methods of restructuring, and the potential of an optimum voting threshold required to make an exchange offer successfully. Further, an analysis was made of different empirical studies carried out to establish a sovereign debtor’s choice of an optimum threshold.

Whereas there is widespread agreement on the standardization of the required threshold for a sovereign debt restructuring, there is also a divergence on the voting threshold employed. As


42 Ibid 40 at page 19.
discussed above, different countries have restructured their debts at different threshold levels, and at the same different voting threshold are being employed in the newly issued debt contracts. A viable framework needs to be arrived at by involving active negotiations and agreement between creditors and debtors. A failed restructuring has enormous costs to both the debtor and the creditor.

Although with the use of CACs and exit consents a supermajority of creditors would bind a dissenting minority, but this technique could be employed only in future issues. Unless currently outstanding debts are exchanged for newer debts containing CACs and exit consents, they would be subject to the prevailing limitations.

Empirical study tends to suggest that the creditworthiness and the risk taking capacity (in terms of keeping the threshold low or high) of the borrower is directly related to the borrowing costs (Eichengreen & Mody; Haldane et al). Further, macroeconomic factors and previous credit history is also significant in determining the borrowing capacity of a sovereign (Catao & Kapur). Buchheit and Gulati are of the opinion that it is not wise to stress upon majority action clauses which would bind the minority creditors in future sovereign debt restructurings. According to them, a sovereign’s decision to undertake a restructuring is influenced by larger political, social and economic factors and the costs associated with such a decision. Gulati argues that Belize was able to restructure its debt at a much higher threshold (95%) since it is a smaller country with limited exposure to the complexities of the financial market, compared to other emerging economies, like Argentina or India.

Not only the performance of the sovereign, but also the nature and characteristics of the issue will be crucial in deciding the threshold. These literature tend to assume that the threshold choice of every sovereign is influenced by numerous factors, which are not only country specific, but also depends on the time of the issue; the characteristics of the issue; the previous history of the debtor; the creditor base; governing laws; political, social and economic conditions of the debtor, among other things. It does not require any elaboration that all these factors, and many more, could sometimes be mutually exclusive, leaving very little scope of generalization and standardization of a threshold number.

Studies have established that a country with low creditworthiness must keep the threshold low, in order that the restructuring goes through. Consequently, a low threshold restructuring further carries with it the risk of lowering the country’s creditworthiness. Ironically therefore, it implies that once a country defaults, or is facing financial constraints which would force it to default, it is bound to take a hit on its creditworthiness, and thus be forced to keep the threshold low, and thus would enter into a ‘threshold-trap’. And only a miracle or a supremely benevolent international
support could then turn the tables around for it. Prescribing a standard threshold would not only be misguided but also largely inappropriate. One would wonder what happens when a sovereign further defaults on a restructured bond after it has employed the standard threshold! Would it then be required to raise the threshold further? Until the time when the world community agrees upon a supranational statute to govern sovereign debt restructuring (as proposed by Krueger, IMF), sovereigns would be inclined to prescribe threshold keeping in view all the factors relevant and specific to the country’s need of the hour.

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