

Two-step Sovereign Debt Restructuring

A Market-based Approach in a World without International Bankruptcy Law

While a good deal of progress has been made in the last few years on defining measures to help prevent financial crises, much less has been made on creating procedures to resolve such crises. There is broad concern, in both the official and private sectors, with the process for restructuring sovereign debt in the extreme situation of an actual or imminent payment cessation. The official sector would like to see a prompt and orderly process that avoids “bailing out” private creditors, that ensures inter-creditor equity, and that minimizes or eliminates the problem of “free riders”.

Private financial institutions share these same objectives. There is a wide and by now frequently stated acceptance that private creditors should bear full responsibility for their investment decisions. Indeed, there is support for a policy of more limited official financing and more clearly defined limits for IMF support. Private creditors, for obvious reasons, also favor an orderly system for resolving crises over a chaotic one; and they put perhaps an even higher priority than the official sector on expeditious action. And finally, as investors in emerging markets debt have become more diverse, inter-creditor equity in debt restructuring has become a major concern.

Despite this broad similarity of stated objectives between the official sector and private creditors, little has been done to explore how an approach based on market incentives might achieve these objectives.

Some have suggested that a sovereign debt restructuring mechanism that is prompt, orderly and fair would require “the force of law universally” (i.e. international bankruptcy law). Even under the best of circumstances, it would take many years to create such a global legal framework.. And it might never happen. Meanwhile we know that new crises will occur. This note provides an outline of how a market-based system might achieve the results that are generally desired. The proposed approach seeks to resolve some of the difficulties that bankruptcy law typically addresses, principally free riding and delays caused by the attempts of some creditors to advance their interests at the expense of creditors as a group. To address these difficulties, the first step of our proposed two-step approach aligns creditors’ interests and commits them to an expeditious renegotiation of the debt, and the second implements the exact terms of an agreed restructuring.

Contributing authors: Ernest Stern Angela Liuzzi
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Background: Difficulties in Restructuring Sovereign Debt

Once the market begins to lose confidence in the ability of a debtor to service its obligations, that debtor's access to additional financing tends to disappear rapidly. Maturing debt cannot be rolled over and short-term creditors refuse to renew credit lines. Barring an official intervention with new financing or debt guarantees, the debtor is forced into default.

When the defaulting debtor is a corporation in a country with well developed bankruptcy laws, debtor and creditor both know there is a legal process to be followed. This process is designed to avoid a costly "free for all" where efforts by individual creditors to enforce their claim destroys value and reduces the total available to creditors as a group. This process is also designed to ensure that whatever assets are available for distribution are distributed equitably and that holding out for full payment is not an option. And in many cases, just the existence of a bankruptcy process enables a debtor and its creditors to come to agreement on a debt restructuring.

When the debtor is a sovereign, the loss of investor confidence and market access is a more complex and protracted process than for a domestic corporation. Ultimately, however, a sovereign debtor also may have no alternative but to suspend payments and to seek a restructuring of its debt. But there is no generally accepted legal process for resolving sovereign default situations. Each case requires negotiations with creditors. In the past when the debt was held by a relatively small number of creditors with similar interests, a club approach proved workable. This is how sovereign defaults on loans owed to international banks were restructured in the 1980's and early 1990's. But with the rapid growth of the international capital markets as a source of medium-term finance for sovereign borrowers, the club approach is no longer a viable option. There are too many creditors, with different interests and operating under different regulatory frameworks.

A further complication is that the legal language in international bond terms typically requires near-unanimous consent to implement an effective debt restructuring (especially when the documentation follows New York or German practice). Some Eurobond issues (when the documentation follows UK practice) have more flexible provisions; but unless most of an issuer's bonds have these provisions, inter-creditor equity concerns make these de facto inoperative.

Some have proposed "restructuring-friendly" legal language that could be included in future bond prospectuses to make restructuring easier.¹ With a "collective action" provision, for example, hold-out investors could be forced to participate in any restructuring that was favored by a super majority of bondholders. With a "sharing" provision, go-it-alone holders

¹ See for example, a series of articles by Lee Buchheit in International Financial Law Review, July, August, and September 1998.

would be prevented from attempting to collect what is owed by recourse to the courts (because they would have to share any funds collected). And with a “representation” provision, there would be a formal mechanism for establishing a committee to negotiate on behalf of all creditors. These provisions would make the debt restructuring process easier, but only if included in all an issuer’s bonds. Little progress has been made in convincing issuers to start including such legal language in their bond prospectuses. In part, this is because such provisions really are a benefit only once all or most of the issuers outstanding bonds have them. And in part, this is because most issuers believe that investors would penalize an issuer that innovates in establishing better default procedures.

Creating a universally accepted legal process (i.e. international bankruptcy law) for dealing with sovereign defaults will take many years at best and may not be practical at all. Even introducing restructuring language in bond prospectuses for the total stock of sovereign debt would take a long time. The two-step approach outlined below, however, seeks to create a voluntary market-based framework to achieve the same results. One objective of this two-step approach is to introduce such restructuring language, and so to better align investors’ interests. Once creditors’ interests are aligned, it will be easier for them to focus on realizing the interests they have in common with the sovereign debtor. Specifically, both creditors as a group and the sovereign would wish to:

- ***Restructure the debt under terms that are sustainable over time.*** Default is costly for both issuer and investor; so both would want to be sure that another restructuring anytime soon is unlikely. Investors, of course, will trade this off against the size of any debt service reduction.
- ***Minimize the length of time between default and restructuring.*** Issuers cannot usually regain normal financial market access while in default. And for investors, debt value is obviously impaired until some sort of credible payment stream is re-established. Speed of execution obviously needs to be balanced against the need to “do it right”. The time for the sovereign to regain market access will depend not only on how quickly its debt can be restructured, but also by the markets perception of how that process was managed and on having an economic program in place that supports the new debt profile.

Bringing order to the process. Simplifying the restructuring process and limiting the free-rider problem would benefit both debtor and creditors. This might be done using the two-step exchange offer outlined below. The purpose of the first step would be to create an intermediate restructuring instrument—an “Interim Debt Claim” (IDC)—that aligns investors’ interests and provides a legal mechanism for collective action, sharing, and representation. The actual restructuring (i.e. size of the debt reduction “haircut” and the specific terms and conditions for the new bonds) comes in the second step when the IDCs are exchanged for new securities.

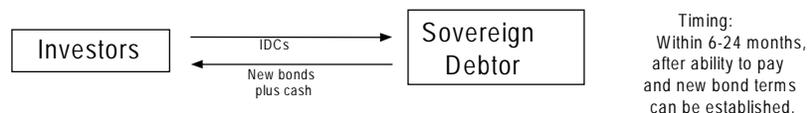
Mechanics of the Two-Step Exchange Process and Description of the Interim Debt Claim (IDC)

Exhibit 1: Exchange Mechanics

Step 1: Exchange old bonds for Interim Debt Claims



Step 2: Exchange Interim Debt Claims for new bonds



Step 1 Exchange: This should occur as soon as possible after default. The first time this process is used, developing the appropriate documentation might take some time. But once the process is established, the first step should occur almost immediately following default.

In this step, the sovereign would offer investors the opportunity to exchange their old bonds for these new IDCs, plus some cash as an additional incentive if deemed necessary. The objective in step 1 is to achieve the highest possible participation rate. A high participation rate will make step 2 that much easier. The size of any cash incentive could only be decided after considering what funds would be available to pay it and how important it would be in drawing investors into the first step of the exchange. The government presumably would have some funds available from the cessation of its debt service payments. If necessary, these might be augmented by multilateral financing. The amount of cash offered might be the accrued interest (up to the time of default) and maybe an additional amount (say up to 5% of the par claim). In addition, in the case of Brady bonds, the cash value of any collateral would be passed through to investors, funded by the sale of the collateral itself. The nominal value of the IDCs offered would then equal the difference (i.e. par value plus accrued interest on the old bonds less the cash). For example, a bond with a \$100 par value and \$2 of accrued interest would be exchange for \$7 cash (\$2 accrued interest plus an extra \$5) and an IDC with a nominal value of \$95.

Finally, as an additional incentive to participate, exit consents would be used, wherever possible, to remove non-financial covenants from the old bonds. So, non-participants, in addition to forgoing the cash incentive, would be left holding a small, illiquid, hard-to-finance issue stripped of standard covenant protections. Participants, by contrast, would get the up-

front cash and would be holding a liquid issue (the IDCs as described below) that they could hold or sell as they wished.

The IDCs serve to:

- Convert numerous outstanding issues, with different coupons and maturities into a common security. Actually, for reasons given below (See “Description of IDCs”), there would need to be two types of IDC per currency. This creates a small number of liquid instruments that can be traded while the restructuring is being negotiated.
- Settle up front that par value will be the basis for the ultimate (i.e. step 2) restructuring.
- Establish a common “currency” to exchange for the new bonds to be issued (under step 2).
- Introduce the legal language (as described below) to facilitate a quicker settlement.
- Isolate holdouts early in the process, so that they can suffer the disadvantages of their strategy from the beginning.

Description of IDCs: These IDCs would be denominated in the major currencies of the old debt exchanged (probably in most cases USD and EUR). They would pay no cash interest but would accrue and capitalize interest until the ultimate (step 2) restructuring is implemented. To avoid trapping IDC holders in a perpetual security without the normal recourse available to bondholders, IDCs should have a very short nominal maturity (perhaps six months). While a negotiated settlement might well take longer, this nominal maturity would serve to give IDC holders (collectively) legal parity with other bondholders in terms of recourse to international courts.

Since investors would be reluctant to accept a lower rate of interest accrual, it is important to structure the IDCs so that the rate of interest accrual is the same as the bonds given up. This could be achieved by issuing two types of claims: "C" type, which capitalize interest at a high rate (equal to or higher than the highest coupon bond outstanding, say 15%), and "N" type, which don't capitalize at all. Proportions of "C" and "N" type claims exchanged for each old bond would be set to maintain the rate of interest accrual. As described below, by using just these two types of claims the rate of interest accrual would be maintained versus old bonds with many different coupon rates, *and equity among bondholders would be maintained.*

In Exhibit 2 below, we show how three hypothetical bonds would be treated in step 1. For example, \$100 par value of Bond A with a 12% coupon would be exchanged for \$80 par value of "C" type 15% claims and \$20 par value of "N" type 0% claims. By doing this, the average rate of accrual on the combined position would be kept at 12%, the same as Bond A (since $[\$80 \times 15\% + \$20 \times 0\%] / \$100 = 12\%$). In our example, interest accrual rates for

investors giving up Bonds B and C are also maintained, by taking different proportions of the “C” and “N” claims.

Exhibit 2: Example illustrating an allocation of “C” and “N” claims to maintain rate of interest accrual

	Bond A		Bond B		Bond C	
	Par Value	Interest Rate	Par Value	Interest Rate	Par Value	Interest Rate
Old Bond	\$100	12%	\$100	7.5%	\$100	6%
Exchanged for:						
“C” claims (15%)	\$80	15%	\$50	15%	\$40	15%
“N” claims (0%)	\$20	0%	\$50	0%	\$60	0%
Total IDCs	\$100	12%	\$100	7.5%	\$100	6%

Note also, that the maturity of the old bonds exchanged has no effect on the allocation of “C” and “N” claims. It is assumed that once default has occurred all bonds have the same maturity (i.e. immediate) and that IDCs should reflect this.

Legal Features of Interim Debt Claims: These IDCs would also have the "restructuring friendly" legal language, including:

- **Sharing clause:** Any money recovered by any IDC holder would be shared with other holders on a proportional basis.
- **Collective action clause:** Any restructuring terms approved by a defined super majority (e.g., 85%²) of IDC holders would have to be accepted by the remaining holders.
- **Representation clause:** A creditor committee appointed by IDC holders would be empowered to negotiate on their behalf with the sovereign.

Step 2 Exchange: This would take place after debt sustainability had been determined and the terms of any new instruments had been agreed by the issuer and by the creditor committee (and ratified by the defined super majority of IDC holders). Step 1 holdouts could still participate in the step 2 exchange, but they would not get the up-front cash payment they had rejected in step 1, and they could not get any deal not also offered to IDC holders.

² This number needs to be high enough to give prospective IDC holders comfort that the ultimate step 2 restructuring deal has a strong consensus behind it and that investors under the influence of the sovereign (e.g. local institutions) on the margin cannot influence the outcome. At the same time, it should not be so high that a small number of investors could block a good settlement.

In Exhibit 3 below we show how “C” and “N” claims would be handled in a hypothetical step-2 exchange that occurs exactly one year after default. In this illustration, we have assumed that IDC holders in the step-2 exchange may choose either: a “par-for-par” exchange, where they would take no reduction in par claim and would receive a 20-year bond with a 7% coupon, or (2) a “discount” exchange, where they would accept a 30% reduction in par claim and would receive a 15-year bond with a 10% coupon. In the illustration, note that though the par values and market prices of the new bonds received under the two options are different, the market values received (i.e. new bond par value x market price) are the same³, as they would need to be.

This is just an illustration, of course, and the actual exchange choices available in step 2 could be anything agreed between the bondholders and the sovereign. Note, however, that whatever is agreed, the “C” and “N” claims would be treated the same (per unit of IDC par claim). And note also how the mechanics of step 2 are simplified by using the IDCs, rather than the old bonds, as the “currency” to buy the new bonds: a one-to-many exchange is much easier than a many-to-many.

Exhibit 3: Example illustrating a hypothetical step-2 exchange of “C” and “N” claims one year after default for new bonds

	<u>“C” type IDCs</u>	<u>“N” type IDCs</u>
IDC par claim at Step 1	\$100.00	\$100.00
12-months of capitalized interest (semi-annual)	\$15.56 ⁴	None
IDC par claim at Step 2	\$115.56	\$100.00
<u>Options in Step 2</u>		
Option 1: Par-for-Par	\$115.56	\$100.00
No principal reduction	par value	par value
7% coupon, 20-yr maturity	(\$56.62 market value,	(\$49.00 market value,
Market Price = 49%	or 49% of IDC par)	or 49% of IDC par)
(at yield = 15.18%)		
Option 2: Discount	\$80.89	\$70.00
30% principal reduction	par value	par value
10% coupon, 15-yr maturity	(\$56.62 market value,	(\$49.00 market value,
Market Price = 70%	or 49% of IDC par)	or 49% of IDC par)
(at yield = 15.11%)		

³ Assuming that yields on the two bonds were 15.18% and 15.11%, respectively, the price of the option-1 bond would be 49%, and the price of the option-2 bond would be 70%. Given the 30% par claim reduction assumed on the second option, the market values of both options would be 49% of IDC par.

⁴ The 15% annual capitalization rate compounded over two semi-annual periods.

Role of IMF: The proposed two-step approach assumes the sovereign will have agreed to a credible reform program with the IMF, one that allows for a resumption of growth after completion of the initial adjustment and restructuring. This program would be the basis for IMF financial support, augmented by the lending programs of the multilateral development banks. The economic projections must include an assessment of a sustainable debt profile, and this would help define the scope of the restructuring and the menu of the new securities offered.

The IMF program does not necessarily have to be completed and agreed to in advance of step 1. The government must have begun discussions with the IMF, however, and there must be a reasonable expectation that the government's proposals would be the basis of an agreed program within a fairly short period. The IMF program would have to be agreed to before the final exchange in step 2 could be structured and agreed, since the new debt stock and structure must be consistent with debt service level in the IMF program.

Handling of holdouts: First, note that only step 1 holdouts could be step 2 holdouts (because IDC holders are bound by the collective action clause). Depending on how successful covenant stripping is in step 1 and whether payments on the new bonds can be protected from attachment, the sovereign might be able to delay resuming payments on the unstructured debt for awhile. Realistically, however, debt service on these old bonds probably would have to be resumed eventually, if the sovereign wants to completely normalize its access to international capital markets. The two-step exchange cannot eliminate holdouts, but it can make holding out a much less attractive option.

Benefits of the Two-Step Exchange

Benefits to the Issuer: The sovereign, if it defaults on its debt, faces a long and difficult process in negotiating a restructuring terms with bondholders. No agreement will be acceptable to 100% of all bondholders, and maneuvering for advantage among different types of investors will not benefit the issuer. Further, the less orderly the process, the more likely it is that "restructuring-oriented" holders will want to sell; and this could cause prices to drop to a level that would be attractive to vulture funds who are perhaps more likely to pursue a legal strategy. So, the primary benefits to the issuer of this two-step exchange are:

- By uniting investors, it gives the sovereign a single credible party with whom to negotiate.
- It locks investors into a "constructive" strategy early (step 1), reducing the risk that holdouts cause any deal to come unraveled.

Benefits to Investor: Investors as a class benefit from a more orderly process that reduces free rider costs (i.e. that makes being a free rider less attractive). Those who would pursue a legal strategy will have to commit to that strategy earlier and suffer the disadvantages of that strategy for a longer period of time. For other investors, the benefits of a two-step exchange include:

- **Up-front cash.** This only goes to those who participate in step 1. So step 1 participants should always do better than step 1 holdouts that participate in step 2.
- **Reduced risk** that their claim will be treated less favorably than other claims in the ultimate restructuring (i.e. step 2).
- **Liquidity.** IDCs will be part of a much larger issue, and as such should have a more reliable two-way market. Liquidity for old bonds after a successful step 1 would likely decline sharply.

The proposal also benefits emerging markets debt as an asset class, by establishing an orderly process than can stand as a good precedent for future restructurings, and by stabilizing the market for debt of countries going into a restructuring. In cases where a sovereign debtor is on the brink of default, its bonds trade at very low prices (typically 20-30% of par). A chaotic default with no clear direction indicated will likely lead to even lower prices and a very volatile and illiquid secondary market. This not only hurts investors in the defaulting country's securities, who are faced with mark-to-market losses and who cannot easily manage risk positions; but it also hurts higher-risk sovereign borrowers generally, who will be faced with higher borrowing costs to compensate investors for this risk. While a borrower in default may perceive low market prices for their debt as a benefit⁵, their longer-term interests are also served by making default less difficult for investors. Extremely low prices compound the damage to a sovereign's long-term reputation and further establish in investors' minds the downside risk associated with lending to them.

⁵ The issuer may believe that it benefits from low prices on its defaulted debt, because it makes investors more willing to accept an agreement with generous debt service reductions. By this argument, if market prices go low enough, it is easier to design a restructuring deal that offers investors a mark-to-market gain off those lows, and so investor participation would be high. We agree that the prospects for an agreement are enhanced when market prices reflect a realistic consensus valuation of a fair and sustainable debt restructuring deal. But unreasonably low and volatile prices and a very illiquid market more likely reflect a lack of consensus, and in any case the reputation and borrowing costs for the borrower post restructuring will be hurt by a more chaotic market.

Conclusion

The approach outlined above is intended to demonstrate that a market based process to resolve sovereign debt defaults is conceivable. By building on the common interests of investors and the sovereign creditor, the approach would bring some order to the process, simplify the negotiations, reduce the time needed to agree on the composition of the restructured debt, ensure inter-creditor equity, and require no exceptional official sector financing.

The approach will not eliminate completely the vulture funds or creditors who do not participate for other reasons. Short of concerted legal action, neither can any other approach. But it does reduce the incentives for such holdouts considerably.

The proposal needs to be refined and details need to be worked out in the context of a real sovereign restructuring. But if an approach like this proves to be successful, it will evolve with experience and gradually define the “best practice” approach to sovereign debt restructuring.

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