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EMTA Hosts Special Seminars on Sovereign Debt Restructuring in NYC: Argentina Situation Identified as an "Outlier"

Michael Chamberlin, EMTA's Executive Director, welcomed the audience of the third in a series of five panels for a Special Seminar that EMTA held at its offices in New York on December 18, 2013: "Sovereign Debt Restructuring: A Better Way Forward?" This series of panels discussed sovereign debt, the international architecture to restructure it and proposed reforms, particularly in response to developments in the European sovereign debt markets and pending litigation against Argentina.

Chamberlin summarized the first panel, "The Road Ahead" on October 16 (which included representatives from the IMF, the UN and the International Capital Market Association (ICMA)), as providing a number of ideas to "improve" the architecture for restructuring sovereign debt (notably, proposals regarding the pari passu clause, so-called aggregation collective action clauses (CACs) in non-euro area sovereign bond issues and bailing in private sector bondholders as a condition of IMF support). In general, these proposals are designed to address serious concerns that many in the official sector, and in academia, have about the effect, or potential effect, that holdout creditors may have on future restructurings, especially in Europe. In essence, there is a prevailing official sector view that sovereign debt is still too difficult to restructure because of the inability to bind all creditors, despite the introduction of CACs over the course of the past decade.

He summarized the second panel market reaction discussion on November 5, "Private Sector Reaction to Current Proposals" (this time composed of private sector market participants), by noting that the private sector generally agreed that market-based restructurings generally worked well enough and that implementing the official sector's proposals would tend to weaken creditor rights and were unnecessary. In particular, the second panel expressed the view that the Argentina holdout situation was an outlier, in large part because Argentina's actions toward its creditors had been extreme. Also, the second panel was generally critical of the proposed Sovereign Debt Forum and expressed concerns about proposals for mechanisms that might "chase investors away". He concluded by noting that one sentiment that tends to summarize the views of the second panel was that "sovereign debt restructurings are not supposed to be easy".

For more information on the first two panels, Click Here.

Chamberlin remarked that much of the development of these types of policies occurs behind closed doors, in rooms which tend to be well-insulated from private sector involvement. EMTA's goal is to provide a forum for the discussion of these important issues by market participants, with a view to ascertaining market sentiment and possibly strengthening private sector input into the policymaking process.

The third panel summarized the above proposals and the private sector's reactions to them, and then articulated a sensible path forward. The panel was moderated by Arturo Porzecanski (American University), and included the following panelists: Bruce Wolfson (Bingham McCutchen), Claire Husson-Citanna (Franklin Templeton Fixed Income Group), Hans Humes (Greylock Capital Management) and Ben Heller (Hutchin Hill Capital). Relevant documents made available to the audience can be located at: http://www.emta.org/template.aspx?id=8413.

The third panel, with a view to strengthen private sector input into the public sector process, discussed both the underlying assumptions of the official sector's proposals (e.g., the present system is badly functioning, holdouts and litigation are serious threats), as well as the reasonableness and workability of the main recommendations.

Arturo. Porzecanski summarized the proposals, which he believed were primarily in response to the Greek and Argentine experiences, as follows:

1) Establish a presumption that some form of a creditor bail-in measure would be implemented as a condition for IMF lending in cases where, although no clear-cut determination has been made that the debt is unsustainable, a government has lost market access and prospects for regaining market access are uncertain. In such cases, the primary objective of creditor bail-in would be designed to ensure that creditors would not exit during the period while the IMF is providing financial assistance, giving more time for the Fund to determine whether the problem is one of liquidity or solvency.

2) Prevent holdout problems by adopting stronger CACs that operate across all new debt contracts, giving a supermajority among all bondholders the right to restructure against the will of a minority (in the aggregate, and regardless of the votes of individual bond series), as long as the restructuring leads to identical payment terms for all bondholders.

3) Create a European Sovereign Debt Restructuring Regime through an amendment of the European Stability Mechanism (ESM) treaty that defines conditions under which the ESM is allowed to lend, which would be implemented only if the member country also restructures its debt, and that gives guidelines as to the minimal amount of restructuring. The treaty change would also make the assets and payments of a euro area member that has undertaken an ESM-sanctioned restructuring immune from attachment by holdouts.

4) Set up a version of the dispute-settlement mechanism of the WTO, a system in which there are panels of experts who would host negotiations, subject to a deadline; if no agreement is reached, the second stage would involve the panel serving as an arbiter; and if agreement is still lacking, the panel would settle the dispute with a decision which would be binding on all.

The following were some of the questions Porzecanski posed to the panelists:

- If the IMF were to proceed with its proposal, how would it change the way you react to news of a government seeking financial assistance from the Fund? Would the potential proliferation of defaults for the purpose of reprofiling debts and introducing aggregation clauses change the risk/return expectations for this asset class? And might this proliferation tend to foster more holdouts, because once the reprofiling and aggregation is done, holding out would become less of a viable option? Would it be a better idea for the IMF to insist on the early formation and recognition of creditor committees for the purpose of fostering a negotiation, rather than to insist on a reprofiling per se?

- Why haven't aggregation clauses become more prevalent in bond indentures and even in restructurings? What are the pros and cons of strong aggregation clauses becoming increasingly common as a result of the European precedent and pressure from the official community?

- What are the pros and cons of setting up a European Sovereign Debt Restructuring Regime? Is this a case of shutting the stable door after the Greek horse has bolted? What is your assessment of the ESM as it stands, in terms of its capacity to deal with sovereign solvency problems?

- What are the pros and cons of setting up a WTO-like dispute-settlement mechanism to deal with sovereign debt problems? To begin with, are there serious problems with the current best practice of direct negotiations between sovereigns and their leading creditors, as represented by a committee? And what are the main practical difficulties of introducing such a dispute-settlement mechanism?

There followed a wide-ranging discussion of these questions.

With respect to the IMF proposal, Porzecanski described it as akin to the Fund demanding that countries in trouble which come to its Emergency Room agree to sign an "organ donor card" before getting any help, because the Fund wants the right to harvest an organ (namely, to force sovereigns to default and restructure their debts even if there is the slightest doubt of about their solvency) prior to providing the assistance to which its members are entitled.

Ben Heller noted that the IMF proposal would make the situation more unstable and uncertain, provoking unnecessary defaults and restructurings and giving more power to the IMF. Instead of carrying out a proper, ex-ante credit analysis of a sovereign's fundamentals and debt sustainability, research analysts in investment firms will instead spend their time trying to guess what the IMF may be thinking vis-à-vis such a sovereign. He also questioned why the proposal required an unseemly emphasis on hasty, preemptive restructurings, when there is no failure to pay and other conditions warranting a default are not being triggered. This demonstrates a bias because the IMF is lending in the interim and it is in its interest not to prolong the process, while creditors are not as concerned about the timing as they are about the need for good-faith negotiations to get underway. This element of the IMF's proposal is problematic, "like theology without hell". It's a "Rube Goldberg contraption to recalibrate the eco-system of the restructuring process". He concluded by positing that the whole IMF proposal was "pre-textual", meant to "defang creditors" and change the whole system of debt restructurings.

Hans Humes decried the lack of actual hands-on restructuring experience by IMF officials who, while truly believing there were problems that needed fixing, were prescribing solutions to a non-existent problem. He noted the irony of the IMF's precipitating the very financial ccrises that it was seeking to avoid by its proposal, showing a complete lack of understanding as to the proposal's ramifications for the financial markets. Market participants who see that the IMF is involved in a particular sovereign's affairs will likely exit their debt holdings in such a sovereign in order to avoid being subjected to an inevitable haircut or even a standstill. This will increase volatility in the market without really addressing the underlying problem. It was all a "distraction". He concluded that the IMF should spend time maintaining its senior-creditor status instead of worrying about the holdout "problem".

While the IMF proposal has the merit of bringing all the parties to the table, Claire Husson-Citanna considered it a non-starter and was more concerned with its negative consequences, such as the writing of a "blank check" to the IMF if investors are going to be subject to the proposal, since the terms and conditions of the new restructured bonds will not be conclusively determined until much later in the process. She posited that any sovereign with liquidity problems would not be issuing Eurobonds that may fall within the purview of the IMF. She also noted that, if the IMF wants a super-holdout status, its proposal lacks any mechanical specifications to that end, and that holdouts seemed to be the privilege of the official sector and other supranational bodies. Also, the IMF seemed to be using creditors to send a message to the sovereigns: "when there's a last supper and nothing to eat, everyone needs to be at the table and not in the corridors".

Bruce. Wolfson viewed the IMF proposal as a "full employment act" for lawyers and others and as an ill-conceived attempt to solve a problem that doesn't seem to exist. What is the central issue and challenge should not be a focus on holdout debtors, but rather on holdouts like the IMF and Paris Club and holdout borrowers. Attempting to coerce every last creditor is a misguided endeavor. Energy should be placed in creative solutions and determining a sustainable level of debt when a sovereign can't pay, so creditors can collect on their debt. The proposal's message is that sovereigns are not the villains, but rather the creditors, who try to enforce what courts have already granted to them, are the problem. He agreed with Husson-Citanna that having all affected parties discuss the issues together was crucial, but noted that creditor committees can more easily and less intrusively serve that function.

Heller agreed that some would dispute there is a real holdout creditor problem. Given the low Argentina restructuring participation rate of 76% (which would not be deemed a successful restructuring), he suggested that 90-95% participation should be a condition for closing every restructuring deal. Humes agreed as well, noting that the 3% of creditors in the Greek restructuring that did not participate was not a problem for the other creditors or for the sovereign, so why did the IMF deem it a systemic problem - especially when other bodies were holding out on a 30% share of the debt? He also referenced the Moodys' analysis and wondered why the IMF willfully ignored the study, which to him "telegraphed another agenda, with the private sector as the IMF's soft problem".

In response to the pros and cons of aggregation clauses, Wolfson noted that, in order to get a 90% acceptance rate, sovereigns sometimes need to agree to programs that are not very sustainable. While noting that a framework like bankruptcy is necessary to bring creditors into the fold (which works relatively well in the domestic context), an effort to cram-down creditors without enforcement on sovereign debtors is not effective, especially when there's no impartial tribunal to determine what is a realistic plan of restructuring.

Husson-Citanna stated that some holdouts are not a problem (although the biggest issue is with European banks and NGOs), and that while CACs may solve some issues, the legal solution of aggregation clauses will not provide the right incentives for debtors and bondholders to move forward in the proper direction. Instead of discussing aggregation of CACs or worrying about changing existing documents, market participants should decide which sovereign bonds to purchase through an auction mechanism that matches buyers' and sellers' preferences. She also parenthetically noted that it was relatively easy to purchase a blocking position in a bond issue on its issue date to avoid a future cram-down of aggregation clauses, and that any aggregation clause design would ex-ante be insufficient to solve the majority of potential ex-post dissidence cases. Thus, ad-hoc financial incentivization is more efficient than ex-ante legal coercion.

Humes stated that there were too many layers in aggregation and that the system can be "gamed". He also didn't think the issue is all that relevant, given the possibility of creditor committees that can act in good faith in conjunction with borrowers. A debt restructuring that has a 95% acceptance rate is successful in that the 5% excess payment to holdouts can easily be absorbed. Further, he noted that the authors of these clauses have a conflict of interest, given the retroactive application of CACs to Greek law governed bonds designed by sovereign counsel who was also trying to design the new restructuring process. While seeming balanced, sovereign counsel is still representing borrowers' interests, while severely impacting creditors' rights.

Heller was more positive on aggregation clauses, which he thought can be useful. The private sector should be more involved in the design of contract provisions, rather than leaving it up to academics and lawyers who don't have "skin in the game". It may also be useful to use a section of the bankruptcy regime, while not the full-blown cram-down by a judge. The Sovereign Debt Restructuring Mechanism (SDRM) was problematic not because the market objected to rules or the notion that the majority can override the minority, but rather because there was no forum that creditors could rely on for enforcement. The IMF being "hostile to the private sector" was not a trustworthy option. This is a good opportunity to put the larger issue of attention to contract language in context, as well as to shore up inter-creditor issues, engagement clauses and information sharing.

Wolfson noted that the problem was not with cram-downs per se or with alternative dispute resolution mechanisms, which have been used across many areas. Aggregation clauses have not gained much traction because creditors have no real indicia of a good process. It is a creative proposal that represents borrowers and should be considered in that light; it should not be embraced as an objective solution to the problem. Instead, having representatives from both sides discussing options has statistically worked best for prior restructurings.

In response to the WTO-like arbitration panel, Heller said that he wouldn't rely on the IMF or the UN to head it up, and what's needed is a commensurate enforcement mechanism on sovereigns. "A panel that can with a stroke of a pen extinguish my debt versus having no enforcement power on borrowers [is not worthy of consideration]; let them come back to me when they have an army [to compel sovereigns]". A forum can't be convened if the end game doesn't require enforcement on both parties; that power imbalance compromises the whole process.

Humes stated that, given the range of options, the IMF may not be the worst choice, but structurally it's not the right body since its membership is comprised of representatives from only one side of the table – namely, sovereigns -- and it's too political a group. Also, if the tribunal can't bind both parties, there's no point in continuing the discussion. Possibly borrowers could post bond as an ameliorating condition. He concluded that it's good for the process to expose both views through creditor committees and otherwise. ABC, the creditor committee for the Argentine restructuring, would have been more successful in rounding up support for a reasonable proposal had the sovereign engaged with it, but the IMF should not use the bad example of Argentina as a reason not to promote such creditor committees as part of its proposal.

Wolfson was more positive on the objective panel, with an arbiter role to adjudicate what was a reasonably sustainable level of debt, together with an ability to provide adequate and transparent information, but he agreed that binding both sides was necessary -- although he did later on suggest that, even if there was an enforcement mechanism at the end of the process, it may still be worth considering this proposal more carefully. He also proclaimed that it seemed to be "a big solution to a small problem, and too much psychic energy and bandwidth" had been spent thus far in discussing it.

Husson-Citanna cited it as an innovative proposal, but suggested that an expert panel should be convened with representatives from the IIF and sovereign wealth funds who are also creditors. While the proposal has the advantage of providing a forum, it should not be left in the hands of debtors to run through their financial advisors; rather, the forum can "run the books" through auctions.

Remarks from the audience included the following:

Benu Schneider, moderator of the first panel discussion on sovereign debt restructuring, clarified that the tribunal was never proposed to reside at the UN. She echoed Porzecanski's three proposed stages of this "shadow courthouse" and stated that the hope was not to reach the last stage, but rather have the restructuring negotiated within the first two stages.

Mikis Hadjimichael, a panelist on the upcoming DC panel from the IIF, informed the audience that the IIF will be publishing a paper on sovereign debt restructuring in mid-January, and that negotiations in good faith pre-default for any pre-reprofiling are an absolute necessity.

Tim DeSieno, a panelist on the second panel from Bingham McCutchen, questioned why the IMF was so fixated on holdouts, given investors' lack of appetite for spending lots of money and time litigating to enforce their rights.

Porzecanski concluded the panel discussion by suggesting that it may be difficult to switch to an arbitration procedure when the market is used to NY, UK or local law, and there was nothing to stop a creditors' committee from asking an objective third-party source about its views on debt sustainability issues. He viewed the real fight to be among the proliferation of official sector creditors vying for preferential treatment so they won't be dragged into another European restructuring problem, like Greece.