Sovereign debt defaults: Paradigms and challenges

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It is an unfortunate fact that a sovereign nation defaulting on its debt is now just a matter of ‘when’ not ‘if’. Therefore, it is important to briefly review the case of those sovereigns that have recently defaulted or faced a serious threat of a crisis. These include Argentina, Ecuador, Iceland and Greece. These sovereign debt crises are useful to comprehend the complexities and possible implications of a sovereign default.

Argentina’s debt crisis started in late 2001 and is still barring this sovereign nation from accessing the international capital markets. Argentina’s default has certain particular characteristics. It is the biggest default ever, in terms of monetary amounts (more than USD 90 billion) and number of creditors (more than 700 000).¹ Moreover, it has other complex characteristics, that is the number of applicable laws (eight)² and the geographical distribution of its creditors.

The role played by the Argentine Government created a new precedent in the international markets because it (1) adopted a defiant position; (2) lacked dialogue with creditors;³ (3) proposed the biggest write-off in recent bond restructuring’s history;⁴ and (4) exceeded the precedents of the 1990s regarding the time elapsed between the default and the date in which the restructuring was finally announced.⁵ Nonetheless, it is worth mentioning that Belize, Grenada and Dominican Republic – three subsequent restructurings – did not follow the Argentine path and streamlined the dialogue with creditors and the availability of information avoiding disruptive situations.

Argentina has recently been planning to re-open the exchange offer closed in 2005 to see whether it is able to increase the number of participants from 76.15 per cent to a more respectable percentage in line with other sovereign restructurings⁶ to re-gain access to the international capital markets at competitive interest rates.

The case of Ecuador is also interesting. A recently elected President incorporated an audit commission – known by its acronym CAIC – with the mandate of analysing the debt incurred by Ecuador to determine its legitimacy, legality, efficiency and so on.⁷ The audit report produced by the CAIC includes several findings, mainly that there were several cases in which Ecuador’s debt was incurred by illegal and/or illegitimate means.

Some of the findings are as follows: (1) the increase of the interest rates by the US Federal Reserve in the late 1970s constitutes an illegal practice;⁸ (2) the conversion of accrued interests in arrears in Past Due Interest Brady Bonds and Interest Equalization Brady Bonds resulted in anatocism and therefore is illegal;⁹ (3) submission to foreign court jurisdiction is contrary to Ecuadorian law;¹⁰ (4) waiver of sovereign immunity is contrary to Ecuadorian law;¹⁰ (5) maintenance of a relationship with multilateral organizations (for example International Monetary Fund (IMF)) is contrary to Ecuadorian law;¹⁰ (6) the lack of registration of certain bonds with the US Securities and Exchange Commission are against the law;¹¹ and (7) the choice of foreign governing law is illegal under Ecuadorian law.¹²

As result of the findings, Ecuador defaulted on its external debt and launched a cash buy-back offer. Although the buy-back offer can be considered successful in relation to the degree of participation, the price that Ecuador will pay is very high. Ecuador's reputation has been seriously affected not only for defaulting again (previously in 1995 and 2000), but also because this default has been considered a political rather than a financial default.¹³

In addition, Ecuador allegedly performed an aggressively secondary repurchase via intermediaries when the price for the defaulted 2012 and 2030 bonds hit rock bottom.¹⁴ To a certain extent this reputational effect has been acknowledged by Ecuador itself. In the Buyback Circular, Ecuador – as if holding a glass ball to foresee the future – stated: *[g]iven the history of defaults, and more recently, selective defaults, the Republic may not be able to access the international markets on favourable terms.*¹⁵ Ecuador's default and buy-back transaction has been helpful to keep on improving sovereign debt instruments. New sovereign debt issuances will include strict contractual provisions increasing the standard of trustee responsibility in post-default scenarios and prohibitions against a borrower repurchasing its defaulted debt.¹⁶

Iceland and Greece are two 'very alive' and ongoing cases. The case of Iceland involves the recent collapse of Kaupthing, Glitnir and Landsbanki, three internationally active Icelandic banks. The collapse of these banks has faced us with a different type of banking crisis: a banking crisis that developed in a currency crisis and escalated to a sovereign debt default crisis with severe international connotations.

The Icelandic government did not have the capacity to bail-out these institutions. This inability of the government to save the troubled banks led to a currency crisis that put Iceland on the brink of a sovereign debt crisis. These banks were both too big to fail and at the same time too big to be saved.

In the recent global financial crisis, we have seen various bailouts of troubled financial

entities. Although these bailouts have contributed to restoring confidence in the financial system in the short term, the question is at what price. By reducing bank default risk, sovereign default risk is increased in the long term. Iceland is a small country with only 300 000 inhabitants, with a large internationally exposed banking sector and with a limited fiscal capacity. The central bank of Iceland could have been an effective lender of last resort if the banks were only exposed in domestic currency, where printing money or taxing its inhabitants would have been two possible solutions but at a dear cost. However, the case of Iceland is a case in which private financial institutions were bigger than the country's own economy.

The Icelandic case has severe connotations as Iceland can be used to reassess the whole theoretical notion of countries not being able to become insolvent. Despite the fact that sometimes it is said in a figurative manner that a country is insolvent or bankrupt, technically speaking, a country cannot reach this situation. First and foremost, a sovereign state always has the possibility of taxing its citizens, to dispose of its resources (for example natural resources or even part of its territory as it had happened in the past with Alaska or Louisiana in the United States), or even in extreme circumstances it can recourse to the expropriation of assets from its citizens.

In this assessment of recent sovereign debt crisis, Greece is the latest addition. Greece is facing a 13 per cent annual deficit and has a 75 per cent debt/GDP ratio reaching a very delicate situation with the potential of spillovers to other Euro-zone members. This case provides some additional difficulties as it touches upon sensible political issues. The Greek situation has raised two main questions: (1) if the European Union possesses the powers to rescue Greece despite the no-bailout clause of the Treaty of Lisbon (articles 122 and 125); and (2) if an IMF intervention is possible, in other words what would happen if the IMF provides assistance to Greece and in exchange

demands certain monetary policy or the restructuring of its external debt? Would not that conflict with the monetary policy of the European Central Bank (ECB)? The first question seems simpler because if there is political will it can be argued that the 2008–2009 financial crisis constitutes an ‘exceptional occurrence beyond control’ despite any alleged political manipulation and book-cooking of the macroeconomic data. Although the second question seems more difficult to answer, it ends up being resumed to political will again. The IMF and the ECB can design a monetary policy that suits Greece’s needs and, which, at the same time, complies with the ECB policy toolkit.

As the Greek debt crisis rumbles on, with Argentina expected to make a new offer to its creditors imminently and Iceland still trying to find a way out of their difficult situation, it is also worth considering what a creditor can do when a default occurs.

There are no international statutes to deal with a sovereign debt default that leaves creditors with a stark choice: to pursue litigation in court or to enter into a restructuring deal (exchange offer) with the sovereign debtor.

Litigation might seem an attractive proposition at first as it offers debt holders the prospect of obtaining favourable court rulings against a sovereign debtor. However, in practice it is very difficult to force the hand of a sovereign debtor as, unlike proceedings against a company, there are no practical sanctions that can be placed on a sovereign nation within its own territory. For example, it is not possible to put a sovereign nation into liquidation or replace the officials like the management in a corporation.

In addition, many sovereign assets held outside a sovereign nation’s jurisdiction are protected by sovereign immunity or under international law such as embassies and consulates and therefore cannot be cashed or taken advantage of. Unprotected assets would be quickly repatriated, which would make them much harder to gain access to.

The risks and difficulties involved with funding years of litigation, often across several jurisdictions, means that legal action is only appropriate for the most sophisticated distressed debt funds who have both the time and money to see the litigation through. For the majority of creditors though, attempting to enforce a ruling to gain assets through litigation may prove to be a futile and hopeless labour.

Therefore, for most creditors, the best way forward will be to enter into a market-based solution with the debtor nation. So far the market has managed to find solutions for almost all sovereign debt defaults. Successful restructuring episodes include Russia, Ukraine, Pakistan, Ecuador (2000), Uruguay, Belize, Grenada and so on.

Thankfully, future negotiations are increasingly likely to succeed as ‘collective action clauses’ (CACs) have become more prevalent in bonds. A CAC allows a majority of bondholders to agree to a debt restructuring that then becomes binding on all bondholders. This stops a minority of bondholders endlessly preventing a restructuring from going ahead – often in the hope of getting better terms for their portion of the debt. However, based on IMF data, more than half of tradeable bonds do not include ‘collective action clauses’ (55.8 per cent in 2005), which could make things harder for a creditor.

With or without a CAC in place, a potential obstacle in any future sovereign debt restructuring will be the introduction of new debt holders such as China, India or Middle East countries whose sovereign wealth funds are now huge providers of liquidity and are therefore likely to be stakeholders in any negotiation they participate in. The same applies to the case of bilateral lending.

However, as the status of these countries as major creditors is new, they have not been active participants in a sovereign debt restructuring before. This, combined with the frequently voiced concern that China’s policy on lending is partly driven by geopolitics, could see future sovereign debt restructuring taken

into completely uncharted territory should they become involved as creditors in a default.

REFERENCES AND NOTES

- 1 Santiago Fittipaldi. (2003) Argentina: Bankers add uncertainty to Argentina debt restructuring. *Global Finance* December.
- 2 See Dr Nielsen, G. (2003) Speech of secretary of finance: Argentina's restructuring guidelines, http://www.argentine.debtinfo.gov.ar/ing_presen.htm, 51 per cent of Argentine debt is subject to New York law, 18 per cent to English law, 17 per cent to German law, 11 per cent to Argentine law, 2 per cent to Japanese law and the remaining 1 per cent to Italian, Spanish and Swiss law.
- 3 See *Financial Times*. (2005) Editorial titled Argentina's foolish debt gamble. 14 January.
- 4 If a comparison is made between the 75 per cent obtained in terms of par value (66 per cent net present value) against Ecuador's 40 per cent or Russia's 36 per cent (Ukraine, Pakistan and Uruguay made no haircut), Argentina's haircut was much larger, and this could have discouraged participation by certain creditors, who opted to recover their claims through court actions.
- 5 On 13 January 2005 – after 36 months of default – Argentina released, by means of Resolution 20/05 issued by the Ministry of Economy, the final offering prospectus and supplement including the terms and conditions of the exchange offer.
- 6 For example, in the exchange offers performed in the late 1990s or early 2000s, Russia managed to obtain 98 per cent participation, Ukraine 95 per cent, Ecuador 97 per cent, Pakistan 99 per cent and Uruguay 93 per cent.
- 7 See Ecuador's Presidential Decree No. 472, article 2.
- 8 See Comisión para la Auditoría Integral del Crédito Público, Final Report of the Integral Auditing of the Ecuadorian Debt Audit, pp. 26 and 150, http://www.auditoriadeuda.org.ec/index.php?option=com_content&view=article&id=89.
- 9 See Comisión para la Auditoría Integral del Crédito Público, Final Report of the Integral Auditing of the Ecuadorian Debt Audit, pp. 42 and 151, http://www.auditoriadeuda.org.ec/index.php?option=com_content&view=article&id=89.
- 10 See Comisión para la Auditoría Integral del Crédito Público, Final Report of the Integral Auditing of the Ecuadorian Debt Audit, p. 42, http://www.auditoriadeuda.org.ec/index.php?option=com_content&view=article&id=89.
- 11 See Comisión para la Auditoría Integral del Crédito Público, Final Report of the Integral Auditing of the Ecuadorian Debt Audit, pp. 42 and 150–151, http://www.auditoriadeuda.org.ec/index.php?option=com_content&view=article&id=89.
- 12 See Comisión para la Auditoría Integral del Crédito Público, Final Report of the Integral Auditing of the Ecuadorian Debt Audit, pp. 28 and 51, http://www.auditoriadeuda.org.ec/index.php?option=com_content&view=article&id=89.
- 13 The Ecuadorian default has even been referred as 'idiotic'. See Felix Salmon, Market Movers, Portfolio.com, dated 12 December 2008, <http://www.portfolio.com/views/blogs/market-movers/2008/12/12/ecuadors-idiotic-default/>.
- 14 Miller, B. (2009) Ecuador restructuring: Inside job. *Latin Finance* 1 July.
- 15 Ecuador Noteholder Circular dated 20 April 2009 to submit in a modified Dutch auction to sell Bonds for Cash, p. 18.
- 16 See Buchheit, L. and Gulati, M. (2009) The coroner's inquest. *International Financial Law Review* September: 4.

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