Financial Markets Law Committee

A E D B F

SOVEREIGN DEBT CONFERENCE

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INTRODUCTION

Graham Nicholson
Bank of England and FMLC Member

The Eurozone Debt Crisis: Is there a Solution?

Professor Elias Karakitsos
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The peripheral sovereign debt crisis is a core banking crisis in disguise

- Crisis started in Greece (weak link), but this is incidental.
- Divergence of real magnitudes (productivity, unit labour cost).
- Current account deficits in periphery with mirror image surpluses in the core.
- Core banks recycle surpluses through loans to periphery.
- Huge periphery borrowing appetite – one off adjustment.
- Housing bubble in Spain and Ireland; state bubble in Greece; erosion of living standards in Portugal.

The crisis in perspective

- An accident waiting to happen (increasing probability).
- The Eurozone crisis: a transformation of the credit crisis.
- Crisis triggered, perpetuated by collapse of confidence Policy response: too little, too late.
- Olli Rehn: We all know what to do, we just don't know how to do it and get re-elected.
- Deficient structure: monetary union with fiscal union.
- Lax monitoring, inadequate enforcement of rules and non-existence of crisis management framework.
- Minimalist approach to integration – survival of the fittest.
- Reform the union on more equitable terms or else face euro breakup.

An anatomy of the remedial treatment

- Moral Hazard and Private Sector Involvement (PSI)
  - Bailout or lender of last resort vs. moral hazard
  - Consensus is growing: bailout necessary short run, build regulatory framework to deter moral hazard in long run
  - Deauville summit (Oct 2010) – PSI, pari passu violated
  - ECB conditions for supporting PSI: no systemic risk (voluntary, no credit event, no CDS)

- PSI risk, by increasing the cost of borrowing, aims at:
  - Improving governance
  - Serve as a disincentive of fiscal profligacy
  - Guard against moral hazard
  - Reduce the risk of future crises

PSI 1 (July 2011)

- 21% reduction in NPV (assuming 9% discount yield).
- Bond swap (old for new up to 30Y, 5.5% coupon).
- New bonds under English law.
- Bonds up to 2020 included in pool.
- Banks write down 21% losses.
- No immediate savings for Greece (debt unsustainable).
- Greece borrows €30 b and buys EFSF 30Y zero coupon bond – repayment of principal guaranteed. Greece saves €70 b after 30Y.
- Scheme aborted as failure. Crisis escalates.

PSI 2 (Oct 2011)

- 50% haircut on face value. All bonds included.
- Voluntary process. Result low participation.
- Policy response: bring forward capital adequacy rules, recapitalise banks (take control).
- Free riding and low participation rate
  - ECB excluded (50% loss makes ECB go bust)
  - Hedge funds, vulture funds enjoy free riding on the back of ECB
- CAC as a means of forcing higher participation
  - Retroactive imposition of CAC on all bonds under Greek law
  - If ECB excluded, process triggers credit event, activates CDC
- PSI aborted in Dec 2011, but retained for Greece.

The verdict on the remedial treatment

- The PSI is misconceived, as it has had the opposite result of what was intended.
- It has not contained the crisis; instead it has spread the crisis, threatening a euro breakup.
- By threatening recapitalisation of banks with public money it has failed to act as a guard against moral hazard and save taxpayer money.
- Excluding the ECB from the PSI encourages free riding.
- Imposing CACs to increase the participation rate would most likely trigger a credit event and the CDS.

Is there a solution?

- Voluntary sell back of GGB for cash (30-35 cents).
- Buy back ECB holdings of GGB to avoid free riding at cost.
- ECB provides support in secondary markets so that Italy, which is too big to fail, can continue to roll over its debt in financial markets, which this year alone is €300 billion.
- Target better served if ECB introduced a ceiling on yields of different maturities (Swiss central bank model).
- Allow the ECB to provide infinite liquidity to the banking system to save it from a meltdown.
- Abandon austerity measures and adopt pro-growth policies.

The Eurozone Debt Crisis: Is there a Solution?

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The Concept of Default

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I. Default in Legal Terms

The meaning of default is **protean**:

- **In the strict sense** : “omission or failure to perform a legal or contractual duty; failure to pay a debt when due” (*Black Law Dictionary*)
  - All breaches of contract constitute a default.

- **In banking or financial agreements** : “default” has a limited meaning
  - A breach does not turn into a default automatically.

- **Need to study the concept of “default” for (A) the sovereign debt and (B) the related credit derivative agreement.**

A. Default under the Issuing Contract

- **No standardised legal framework for Sovereign Debt Issuance**
  - Sovereign Issuer in Europe does not have to comply with Prospectus Directive, it just produces "**Offering Circular**" which is a non-harmonized information document.
  - No common definition of default.

- **To identify the concept of default:**
  - To focus on Sovereign Issuer's obligations under the agreement.

- **Default: ICMA definition**
  - **Failure to pay.**
  - **Trigger events**": breach of an obligation under a key clause.
  - Concept of "trigger" has to be studied case by case.

- **Under the issuing contract, default is limited to the obligations from the contract itself.**

B. Default under Derivatives Agreement

- **Standardized documentation for credit derivatives market on Sovereign Debt: ISDA master agreement**

- **Default: CDS is exercised when an "Event of Default" occurs:**
  - **Failure to pay**: More or less similar to the "default" in the issuing contract
  - **Repudiation/moratorium**
  - **Restructuring**: "any one or more of the following events occurs in a form that binds all holders of such Obligation" and "sufficient number of holders [give their agreement to the restructuring] to bind all holders of the Obligation".

- **Under the derivatives agreement, default has a broader sense than under issuing contract.**

II. "Selective Default"

- **European institutions as the Council or the ECB mention the concept of "selective default" or "partial default"**
  - This concept has **no legal meaning**

- **Criteria: Possibility for a partial repayment of the debt**

- **Consequences**: "In case of a 'selective default', the ECB and the Eurosystem ask for recapitalisation of the banks and for credit enhancement of our collateral in order to have sound counterparties and eligible collateral" (J-C Trichet, 23/07/11).

- **Selective default is essentially a hot topic for banks and the private sector**

III. Default in Accounting Terms

- **In accounting, the relevant criteria to impact the accounting records is impairment.**

- **IFRS standards (IAS 39.59** - ***Financial instruments: Recognition and Measurement***) provide a financial asset must be impaired in regards to **objective evidence** called "**loss events**":
  - Financial difficulty of the issuer
  - Breach of contract
  - Concession granted to borrower
  - Probability for the issuer to enter bankruptcy
  - Disappearance of an active market
  - Decrease in the estimated future cash flows

- **When a "loss event" occurs, consideration should be given to the fact that default risk is related to the issuer and not to a specific financial instrument issued by that party.**

- **IFRS standards (IAS 39.60):** a credit downgrade is not evidence of impairment, nor is a decline in the instrument's fair value.

Accounting for Greek Sovereign Debt

- **ESMA's Public Statement "*Sovereign Debt in IFRS Financial Statements*":**

- **Objective evidence of impairment for Greek sovereign bonds according to IAS 39.59:**
  - **Significant financial difficulty of the issuer** (decrease in the fair value of the investment)
  - **Concession granted by private investors** (July International Institute of Finance (IIF) plan July 2011)

- **Greek sovereign bonds with maturities before July 2020**
  - Indicators available as part of the haircut indicated in the July IIF plan, in which a number of financial institutions confirmed their participation
  - Transaction observed in the market
  - Impact on the **estimated future cash-flow**

- **Greek sovereign bonds with maturities after July 2020** (included in the July IIF plan). Contractual cash-flows were at risk of being impacted by the financial difficulties. The estimation of the size of such an **impact on the future cash flows** is a **matter of judgment**.

IV. Default in Rating Agencies' Terms

- **For Sovereign Debt, the relevant criteria is downgrading.**
- **Default**:
  - Economic risk: the issuer's ability to repay its obligations on time and function of both quantitative and qualitative factors
  - Political risk (specific criteria for sovereigns) : **willingness to repay debts**, while continuing to gear up
  - Market risk (new criteria) : **risk that the market prevents the Sovereign Issuer from gearing up** (E.g. Greece)
- **Restructuring** :
  - Criteria : "forced" restructuring or not:
  - If "forced" restructuring : "**Distressed restructuring**" (Event of Default) only if restructuring is carried out
- **"Selective Default"**:
  - Standard & Poor's and Fitch : Concept of selective default
  - The default **only affects a part of the Sovereign Debt**
  - Moody's : No concept of selective default

Remarks

- **In legal terms: after 27 October bail-out, the Greek Sovereign Debt would not be at the moment:**
  - In default in the meaning of issuing contract,
  - In default in the meaning of ISDA,
  - In selective default.

- **Whereas Greece faces impairment in accounting terms and downgrading by the rating agencies.**

- **In rating terms**: Restructuring constitutes an “Event of Default”, it was implemented to avoid a “default” in its classic meaning.

The Concept of Default

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Sovereign Debt

Collective Action Clauses

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Collective Action Clauses

- What are they?
  - Bonds only
  - Key element - majority provisions to revise payment terms

- History
  - Mexican Tesobonos crisis mid 1990s – local law governed
  - English law bond terms
  - New York law bond terms
    - Trust Indenture Act 1939 - bondholder unanimity right
  - Pakistan 1999
  - SDRM April 2002
    - Chapter 11 approach
    - Stay on proceedings
  - Mexico 2003
  - EU statement April 2003 – international issues
  - ICMA recommended form of sovereign CAC, October 2004

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Collective Action Clauses

❑Eurogroup Statement of 28 November 2010

- Context: establishment of ESM; burden sharing
- All Eurozone sovereign issues from mid-2013 onwards to have identical CACs with aggregation – New ESM Treaty signed on 2 February 2012 – Article 12.3:
  - ➢more than 1 year
  - ➢1 January 2013
  - ➢the legal impact will be identical
- CACs are an Anglo Saxon creature
- SDMG and final official approval of the proposed language for model clauses

❑Where are we now?

- English law and NY law sovereign issues routinely include CACs
- Generally absent in German and Swiss law sovereign issues
- Most EU sovereign issues do not have CACs; not the norm for domestic issues or issues by auction in Continental Europe
- For most EU sovereigns the majority of their bonds are outstanding under local law
- Not a solution to this Eurozone crisis
- Limited use of Trustee structures in sovereign context
- Generally not have aggregation

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- Considerations
  - What problems can CACs address
    - Holdouts
    - Different series of bonds – aggregation
  - Not prevent litigation before a vote on payment terms
  - Trustee or trust like structure
    - Only the trustee can sue
    - Proceeds distributed pro rata
  - Combined effect of CACs plus aggregation plus trust like structures for this category of debt
  - CDS

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Sovereign Debt

Collective Action Clauses

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Voluntary Sovereign Debt Exchange Offers
and
Participation Enhancing Techniques

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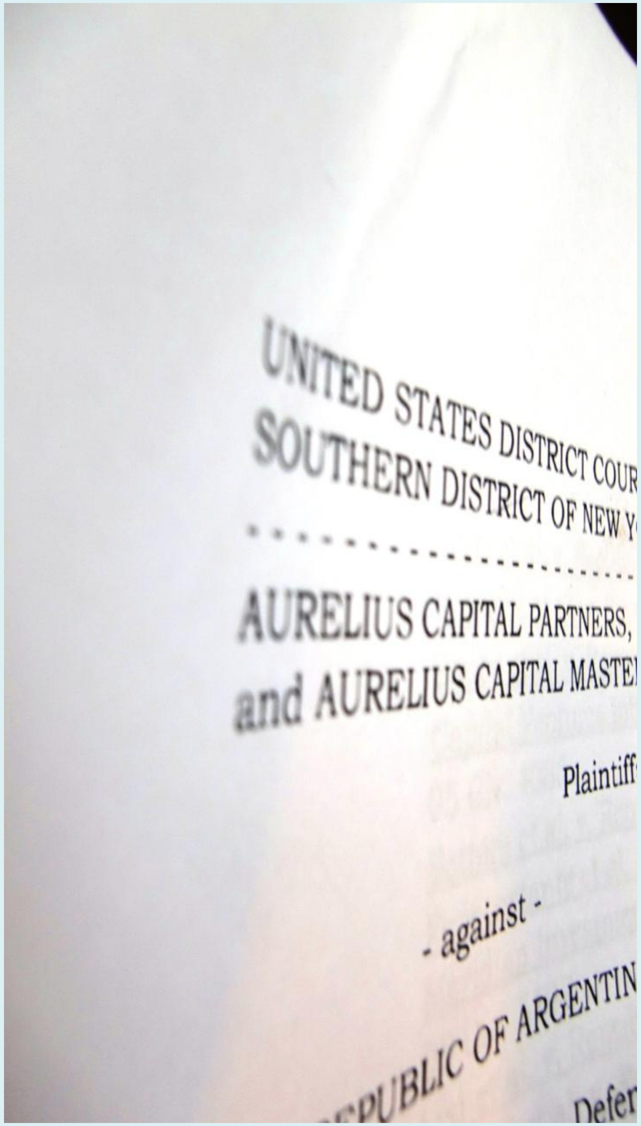
Voluntary v. Involuntary



•<u>Exchange offer</u>:- a voluntary process where holders of an outstanding bond may agree to exchange their "old" bonds for newly issued bonds, usually with less attractive financial terms.

•<u>Use of CACs</u> (i.e. a contractual feature of the bonds):- a voluntary process where a majority cram-downs a dissenting minority.

•<u>Retrofit of CACs</u> (not seen before):- an involuntary process, there is a change of the law but not the contractual terms.

•If majority is reached through negotiation the restructuring will be voluntary. If NOT, the exercise is irrelevant because either the exchange is not enough or CACs cannot be used.

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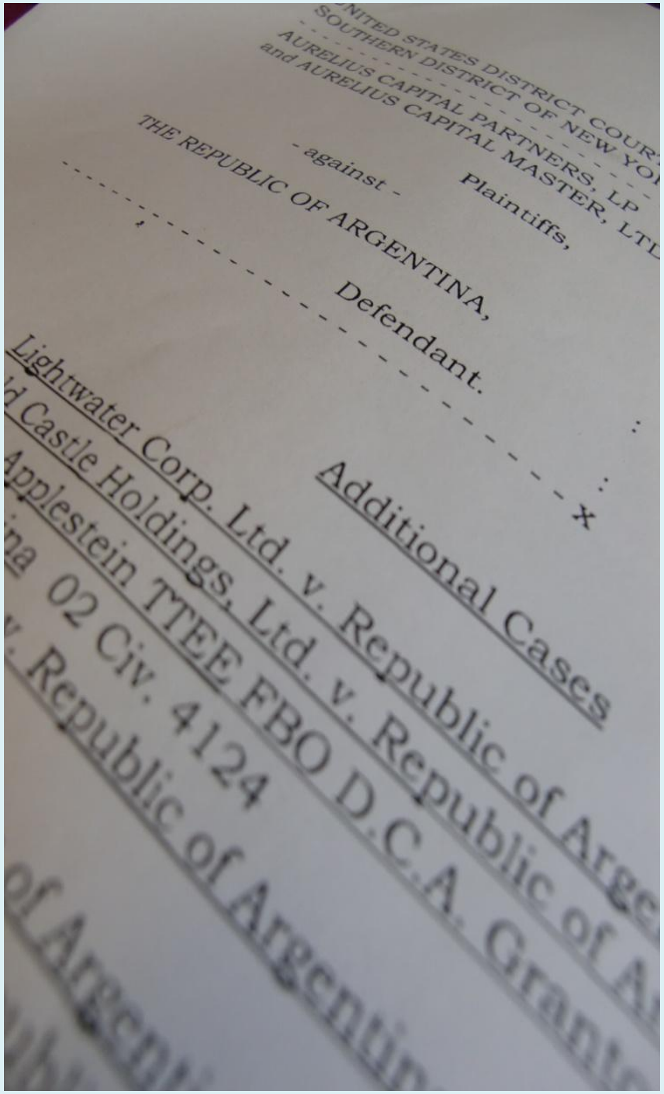
Participation Enhancement Techniques

- CACs are a contractual mechanism to overturn the holdout problem.
- Many bonds do not include CACs = exchange offer
  - Prior to default: debt reprofiling (e.g. Uruguay 2003)
  - Post default: debt restructuring (e.g. Argentina 2005)
- Lack of CACs
  - Exit consent
    - Ecuador 2000
    - Uruguay 2003 (tick-the-box-exit-consent)
    - Dominican Republic 2005
  - Contractual Enhancement Techniques (Ecuador 2000)
    - Mandatory Prepayment Arrangements
    - Mandatory Reinstatement of Principal Cl.
  - Credit Linked Notes (Argentina 2005)
  - Guarantee (Seychelles 2010)
  - Collateral
    - Principal Defeasance (Greek PSI 1 - 2010)



Recent Restructuring Experiences

Relevant Aspects	Ukraine	Ecuador	Pakistan	Uruguay	Argentina	Belize
Amounts Restructured (in USD)	2.6 bn	6.5 bn	USD 0.6 bn	USD 5.3 bn	USD 87bn	USD 0.4 bn
No. of Bonds to be restructured	5	6	3	62	152	7
New Bonds Issued	2	2	1	34	4	1
Cash Payment/Incentive	No	Yes	No	Yes	Yes + CLNs	Yes
Exchange Offer Acceptance	95%	97%	99%	93%	93% (76 + 17)	97%
Applicable Laws	3	2	1	6	8	2
Duration of the Default (months)	3	11	2	0	38	6
Face Value Reduction	0%	40%	0%	0%	75%	0%

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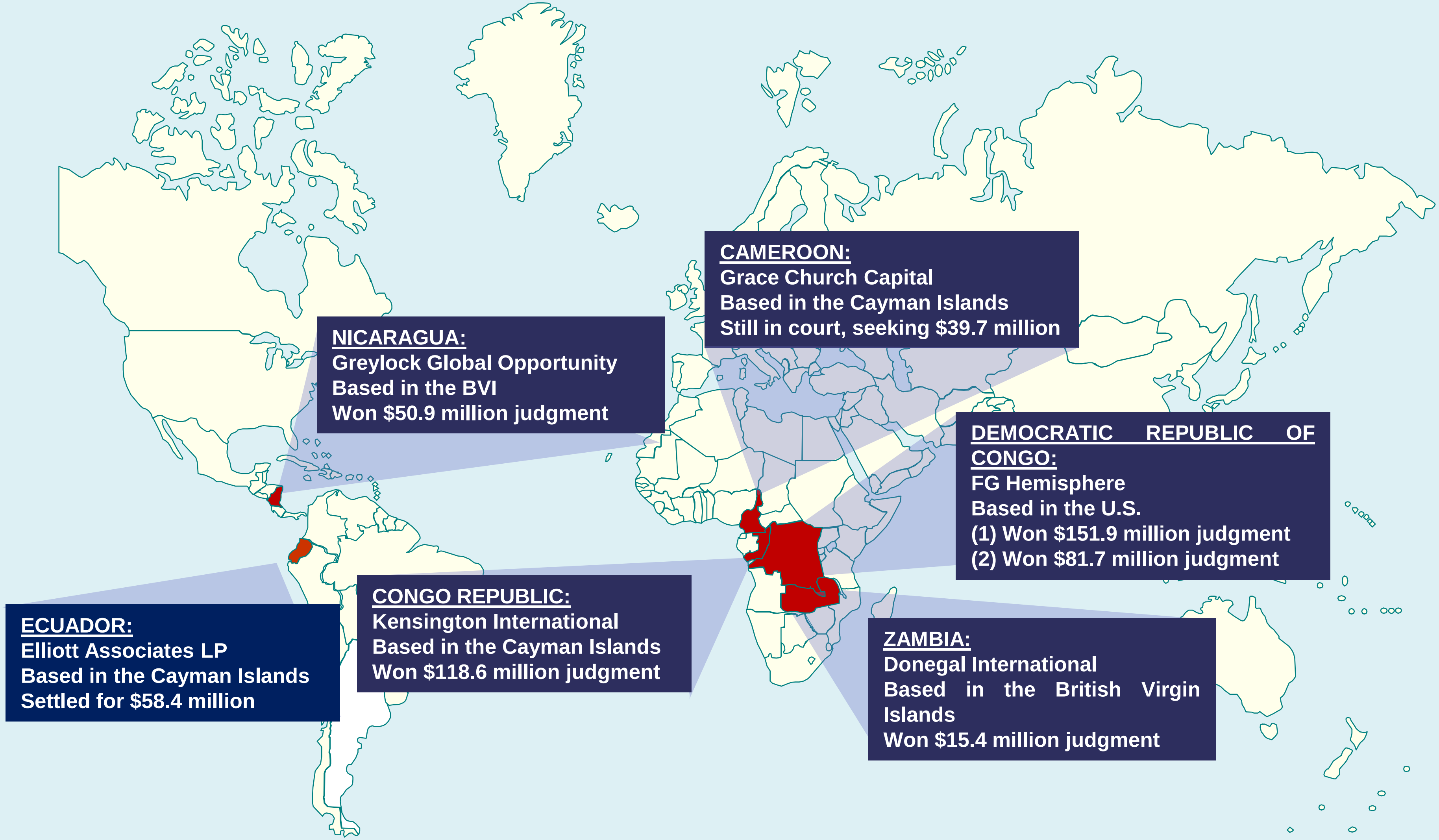

- Vulture funds purchase defaulted debt to satisfy the seller's liquidity requirements (offer v. demand).
- Take risk in exchange of face value reduction.
- Vulture funds provide a floor for the value of the debts of many poorly graded borrower countries.
- Illegal actions should be pursued with all the weight of the law.

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✂ Restructuring debt is an art.

✂ If the haircut is too little, there is no benefit to the issuer.

✂ If the haircut too much, bondholders have no incentive to accept the offer.

Voluntary Sovereign Debt Exchange Offers and Participation Enhancing Techniques

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The Legal Case for Eurosystem Sovereign Bond Purchases

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The Legal Case for Eurosystem Sovereign Bond Purchases

- Why Are Certain Bonds Eligible?
- Eurosystem Securities Market Programme
- The Legal Case
- Greek Sovereign Debt Restructuring

Why Are Greek, Irish and Portuguese Bonds Eligible?

- Use & Eligibility Criteria
- Exceptional Decisions
- Legal Controversy



Eurosystem Securities Market Programme

- Description
- Legal Controversy

The Legal Case

- History
- Eurosystem Mandate
- Monetary Financing Prohibition

The Legal Case

- Sterilisation of Liquidity
- Fiscal Discipline
- Neither Eternal or Infinite

Greek Sovereign Debt Restructuring

- Eligibility of Greek Bonds
- Eurosystem Holdings

The Legal Case for Eurosystem Sovereign Bond Purchases

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Credit Default Swap Credit Events and Settlement

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CDS Triggers

- CDS can be triggered when a Credit Event occurs in respect of the Reference Entity
- What are the Credit Events?
- 2003 ISDA Credit Derivatives Definitions, as amended
- Typically for Western European Sovereigns
  - Failure to pay
  - Repudiation/moratorium
  - Restructuring

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Credit Events

- Failure to Pay – failure by Reference Entity (after grace period) to pay at least relevant amount on a relevant kind of obligation
- Repudiation/Moratorium – disclaimer or repudiation of relevant amount of relevant obligations or declaration or imposition of a moratorium, standstill or roll-over

Restructuring

- Reduction in interest or principal payable
- Postponement or deferral of payment of principal or interest
- Subordination of relevant obligation
- Change in currency to currency other than G7 or AAA OECD country currency

Except where the relevant event does not result from the deterioration in credit worthiness or financial condition of Reference Entity

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Restructuring – Voluntary or Not?

"""Restructuring" means that, with respect to [relevant amount of relevant] Obligations, any one or more of the following events occurs <u>in a form that binds all holders of such Obligation</u>, is agreed between the Reference Entity or a Governmental Authority and a sufficient number of holders of such Obligation <u>to bind all holders of the Obligation</u> or is announced (or otherwise decreed) by a Reference Entity or a Governmental Authority <u>in a form that binds all holders of such Obligation</u>, and such event is not expressly provided for under the terms of such Obligation"

C L I F F O R D
C H A N C E

Settlement

- Cash Settlement
- Physical Settlement
- Auction Settlement
  - gives the market a market derived price at which to cash settle triggered CDS
  - reduces the number of transactions that need to be physically settled, so addresses the problem of shortage of supply

Determinations Committee

- Determination of whether there is a Credit Event

- Determination of Auction Settlement

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Credit Default Swap Credit Events and Settlement

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Is there a case for a more standardised approach to sovereign debt restructuring?
What is the role for the CDS market?

Professor Emilios Avgouleas
Professor of International Banking Law and Finance
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A macroscopic look at the evolution of the sovereign debt contract

- Minimisation of easy default (defined here as non-payment)
- Pay or restructure (defined here as amendment of the essential terms of the contract, especially amendment of terms relating to payment) — but do not default
- Unilateral — Argentina, Greece?
- Voluntary restructuring
- CAC minimises possibility of unilateral action and leaves little scope for exploitation of creditor divisions
- Prevention of creditor preferential treatment: negative pledge and pari passu (incorporating the lessons of the 1970s and 1980s)

The evolution of the sovereign debt contract

- CAC — restructuring becomes easier — also a weapon designed to restructure without being shut out from the capital markets
- In the 1990s-2000s clauses were amended to increase the possibility of attachment of sovereign assets — e.g. the jurisdiction clause
- Jurisdiction clause — domestic courts are reluctant to enforce the contract (yet attachment orders are still an issue)

Recent developments

➢ CDS trading

Rationale:

- Apart from opening up opportunity for speculation, (effective ?) creditor protection from the imperfections of the sovereign debt contract and the risk that it may not be enforced

➢ Bail-ins

Rationale:

- Creditor recovery
- Allowing sovereign creditors to default may trigger contagion; Brazil’s economy in 1998 was not really in such a bad shape as to trigger a currency run and push it to the verge of bankruptcy

Cost benefit analysis of CDS trading

- Hedging the risk of non or partial payment
- Mechanism to express contrarian beliefs enhancing the market’s information efficiency, e.g. CDS trading (even naked CDS trading) can lead to better evaluation of political risk
- Tailor made CDS could even compensate for uneven creditor treatment
- Increased credit spreads may curb irresponsible borrower behavior and their wide availability might lead to lower borrowing costs

BUT

- Creditors have an incentive not to cooperate in any restructuring
- Once restructuring talks have started CDS trading has no information value

Where do we stand now?

- Restructuring prevents default
- It is the best way for a debtor country that follows sound economic policies to return to fiscal soundness and access capital markets again
- But if it is unilateral access will be denied
- If it is voluntary CDS owners have incentives to hold out

Could there be a case for standardisation?

- Admission: the evolution of the terms of the sovereign contract is driven by events (widespread use of pari passu, negative pledge, jurisdiction)
- Standardisation would minimise choice yet the many exit/amendment models often lead to chaos
- *What it should involve?*
- A treaty-based (bankruptcy/reorganisation) model with CACs and the IMF acting as neutral bankruptcy administrator (IMF sovereign debt restructuring mechanism (SDRM) model plus)

Essential reforms?

- A specialised court of arbitration dealing with sovereign debt disputes?
- CDS markets may no longer be seen as operating independently of the restructuring imperative — a modified SDRM would allow IMF, issuers of other restructuring models, and ISDA to synchronise the terms of their contracts
- Naked CDS trading suspended once restructuring negotiations have started

Cost — benefit analysis

- Restriction of contractual freedom
- If treaty-based it is binding on debtor countries
- Minimises hold outs
- Involves both public and private sector creditors, thus it minmises the moral hazard of PSI type restructurings
- The rules of the game are known ex ante making more likely creditor compliance and facilitating the drafting CDS contracts
- No distinction between developing and developed country creditors

Is there a case for a more standardised approach to sovereign debt restructuring?
What is the role for the CDS market?

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IMF Lending to Sovereigns

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Financial
Markets
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Q&A Session
– and –
Summing up and Closing

Dr Dimitris Tsibanoulis, AEDBF Chairman
Sir John Gieve, FMLC Deputy Chairman