Restructuring Sovereign Debt: Lessons from Recent History

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With the advent of the global financial crisis in 2008, the issue of restructuring sovereign debt returned as a key concern to governments and market participants. However, there still appears to be limited understanding of how restructurings work in actual practice, and detailed historical insights are often missing. This chapter provides an up-to-date overview of the process of restructuring sovereign debt in developing economies and emerging markets based on the broad survey by Das, Papaioannou, and Trebesch (2012). The main contribution of the chapter is to distill a set of stylized facts and lessons learned from emerging market restructuring episodes from the late 1990s (following the Brady exchange, see Box 19.1) through 2010. The existing literature includes an increasing number of studies on individual country cases, but very little on cross-country experiences for all major sovereign debt restructurings since the late 1990s.

The first section of this chapter sets the stage by providing an overview and addressing some basic questions: What is a sovereign debt restructuring and how is it defined in relation to concepts such as “default” and “credit event”? How often was sovereign debt restructured in recent decades? What are the determinants of default and debt restructurings?

The second section focuses on procedural aspects of debt restructuring in detail: What are the required operational steps in preparing and implementing a sovereign debt exchange? How did governments communicate with their creditor banks and bondholders? What are the most common debt-restructuring vehicles, in particular the Paris Club and the London Club? And how do modern-day sovereign bond exchanges work in practice? To answer these questions the section describes main insights from the existing literature and draws on newly available data.

The third section summarizes the main characteristics of emerging market sovereign debt restructurings between 1998 and 2010. Among others, the following questions are addressed: What are the typical pitfalls in the restructuring process? How long does it take to restructure sovereign bonds or loans? How frequent are creditor holdouts and litigation? What was the scope of debt relief, or “haircuts,” in past restructurings? How do domestic debt restructurings differ from external debt restructurings? And which legal clauses and remedies matter
most when sovereign debt is restructured? The existing literature provides limited evidence on these practical questions.

The chapter concludes by discussing the financial stability considerations and other spillover concerns of a sovereign debt restructuring. How do restructurings affect growth or private credit? How quickly did countries reenter capital markets after a debt crisis? What is the evidence of spillovers to the domestic financial sector? These questions are addressed by summarizing the related literature, particularly insights provided by the research of the past few years.

The findings and stylized facts should not be interpreted as providing a full analysis of the underlying causes of restructurings or of their macroeconomic consequences. Instead, the discussion provides new descriptive evidence and historical data in a field in which data are notoriously scarce. It should also be underscored that these insights are based on developing-economy experiences and may not apply to advanced economies or to sovereigns reliant on financing from interconnected financial systems. Nevertheless, the facts summarized here may be relevant for a broader audience interested in debt crises, their resolution, and outcomes.

OVERVIEW AND BASIC CONCEPTS

Definitions and General Considerations

While there is no universally accepted definition, a sovereign debt restructuring can be defined as an exchange of outstanding sovereign debt instruments, such as loans or bonds, for new debt instruments or cash through a formal process. Sovereign debt here refers to debt issued or guaranteed by the government of a sovereign state. One can generally distinguish two main elements in a debt restructuring: debt rescheduling, defined as a lengthening of maturities of the old debt, possibly involving lower interest rates; and debt reduction, defined as a reduction in the face (nominal) value of the old instruments. Both types of debt operations involve a “haircut,” that is, a loss in the present value of creditor claims.

Rating agencies, such as Standard & Poor's (2006), typically define distressed debt exchanges as restructurings at terms less favorable than the original bond or loan terms. However, it is important to distinguish distressed-debt exchanges from routine liability management operations aimed at improving the profile of public debt, such as debt swaps, which could occur in normal times (Papaioannou, 2009).

Default events and debt restructurings are closely related but not identical. A default is the failure of a government to make a principal or interest payment on time (beyond the grace period).¹ Defaults can be partial (i.e., when only parts of the country’s debt are not being serviced) or complete (a halt of all debt payments to creditors). In most cases, restructurings occur after defaults, and are known as

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¹ Different loan agreements may have different definitions of “events of default.”
postdefault restructurings. However, recent years have also seen a number of preemptive debt restructurings, in which outstanding debt instruments are exchanged before the government misses any payments.

The related concept of a “credit event” has gained increasing attention and is mostly used in the context of credit default swaps, which have grown in importance since early in the first decade of the 2000s. Not all sovereign debt restructurings automatically trigger a credit event. Debt exchanges that are not forced upon creditors or debt exchanges in normal times may not constitute a credit event. More specifically, the International Swaps and Derivatives Association (ISDA) considers a restructuring to be a credit event only if (1) it occurs as a result of deterioration in the creditworthiness or financial condition of the sovereign, and (2) it is “binding on all holders” (i.e., applies in mandatory form to all bondholders of a series). These criteria apply irrespective of whether the debt restructuring is pre- or postdefault.

**How Often Was Sovereign Debt Restructured?**

According to a new database by Trebesch (2011), sovereign debt–restructuring episodes have occurred throughout the world, with more than 600 individual cases in 95 countries since 1950. Of these, 186 were debt restructurings with private creditors (foreign banks and bondholders) and more than 450 involved restructurings with the Paris Club (government to government debt). Restructuring in low-income countries often proceeded differently from those in emerging markets, including through official-debt-relief initiatives, which makes their experience less relevant for emerging markets. Das, Papaioannou, and Trebesch (2012) provide a detailed classification of all sovereign debt restructurings that took place between 1950 and 2010. Of the 186 debt exchanges with foreign private creditors:

- 18 were sovereign bond restructurings, and 168 affected bank loans;
- 57 involved a cut in face value (debt reduction), while 129 consisted only of a lengthening of maturities (debt rescheduling);
- 109 cases occurred postdefault, and 77 were preemptive; and
- only 26 involved cash buybacks. Most buyback operations were implemented in the context of debt-relief initiatives in poor, highly indebted countries, and involved discounts of 80 percent or more.

Bond restructurings reentered the sovereign debt universe only after the Brady Plan of the mid-1990s (see Box 19.1 later in this chapter). Since 1998, with the debt crises in Pakistan, the Russian Federation, and Ukraine, 18 sovereign bond exchanges with foreign bondholders have occurred. In addition to the 186 debt restructurings with external creditors, there have been several bond restructurings aimed at domestic creditors. These include Ukraine (1998), Russia (1998),

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2 Although most credit default swap contracts rely on the form ISDA agreement (and, therefore, would rely on ISDA’s determination of a credit event), bilateral contracts in some instances can be different.
Argentina (2001), Uruguay (2003), the Dominican Republic (2005), and Jamaica (2010). Some of these exchanges were implemented in parallel with debt restructurings with foreign creditors.

**Determinants of Restructurings and Defaults**

A wide range of factors have contributed to default. Most defaults and restructuring episodes were triggered by one or more of the following factors: a worsening of the terms of trade; an increase in international borrowing costs (e.g., caused by tighter monetary policy in creditor countries); consistently poor macroeconomic policies, leading to a buildup of vulnerabilities; or a crisis in a systemic country that causes contagion across goods and financial markets (Sturzenegger and Zettelmeyer, 2006; and Manasse and Roubini 2009).

Additional factors include macroeconomic volatility (Catão and Kapur, 2006), banking crises and related contingent liabilities (Reinhart and Rogoff, 2011), and political and institutional factors (Kohlscheen, 2007; and van Rijckeghem and Weder, 2009). From a historical perspective, Reinhart, Rogoff, and Savastano (2003) identify the occurrence of past defaults as a main predictor of missed payments and restructuring events. They argue that some debtor countries may be “debt intolerant,” in that they are less able to sustain high levels of debt as a ratio of GDP without defaulting.

Market perception, too, may have influenced the timing and occurrence of sovereign debt restructurings. When markets perceive a government as being less likely to repay in the future, its borrowing costs can rise rapidly and, therefore, its likelihood of default. Common risk indicators include secondary market bond and sovereign credit default swap spreads, as well as changes in sovereign ratings. Under extreme circumstances, a sudden change in investor perceptions may even act as a default trigger. Debt crises and restructurings can be self-fulfilling and caused by contagion (Cole and Kehoe, 2000). In case of a “debt run” or the effective exclusion from capital markets, countries may have no alternative other than to halt payments. This risk is especially high when governments face large rollover risks (Detragiache and Spilimbergo, 2001).

The structure of the debt portfolio has also affected the likelihood and timing of default and debt negotiation. Factors that determine the debt profile (e.g., currency composition, fixed vs. floating interest rate, maturity, and creditor composition) may have implications for liquidity and solvency conditions and thus may influence the decision to restructure. However, sovereign debt portfolio risks are not always easy to assess, especially at times of generalized financial stress and heightened risk aversion. The decision to restructure often depends on a combination of factors, and the following considerations are broadly valid regarding each of these factors:

- **Currency composition.** Debt issued in foreign currency makes sovereigns vulnerable to exchange rate shocks and currency mismatches because governments typically collect most of their revenue in domestic currency.
The Process of Restructuring Sovereign Debt

This section presents key elements in the process of restructuring sovereign bonds and loans. For illustration, Figure 19.1 provides a stylized timeline from the start of distress to the final restructuring. The restructuring episode is triggered by a default on debt payments or the announcement of a debt restructuring. Thereafter, the government usually embarks on some form of negotiations with its creditors, either bilaterally or with the help of advisors. The key purpose of the debt renegotiation is to agree on the terms of a debt exchange that will provide some form of debt relief and solve the distress situation. The negotiations are also often used as forums for communicating key financial data and the government’s fiscal and debt-management plans.

The negotiation or “preparation” phase can take months or even years and usually goes hand-in-hand with a macroeconomic adjustment program and an evaluation of the country’s financial situation. Among the first steps a country needs to undertake when considering a debt restructuring is to verify its total debt claims, which means understanding the characteristics of the government’s

Figure 19.1 Stylized Timeline of a Sovereign Debt Restructuring

outstanding loans, bonds, and other debt instruments, including their legal and financial features.

Lim, Medeiros, and Xiao (2005) suggest verifying the following key characteristics:

- The face and market value of bonds or loans;
- The amortization schedule (bullet versus amortization, and the existence of a sinking fund);
- Interest rate and coupons (fixed versus flexible, and the existence of step-up or linked features);
- Currency (local or foreign) of denomination of the instruments;
- Enhancements, including embedded options or collateral; and
- Legal clauses, including collective action clauses (CACs) and nondefault clauses, and the ability to include exit consents (see the section titled “Financial Stability Implications of Debt Restructuring” for details).

The verification of claims allows countries to assess their debt stocks, debt-service profiles, and the value of the debt instruments. This information lays the foundation for the next crucial procedural step, a detailed debt-sustainability analysis, which provides an indication of the financing gap, the necessary macroeconomic adjustment effort, and the degree of required debt relief. On this basis, governments typically develop a set of restructuring scenarios and prepare a final restructuring proposal, often with the support of legal and financial advisors.

After the restructuring offer is presented to creditors, the creditors have to decide whether to accept or reject the offer. In most cases, a successful exchange requires a certain minimum threshold of acceptance by creditors. Creditor coordination problems and holdout risks are thus likely to be most acute during this period.

In most crisis cases, restructurings mark the end of a debt crisis episode, because the exchange of old for new debt puts the economy back on the path of debt sustainability. However, restructurings do not always put an end to debt distress. Some countries continue to incur arrears after a completed restructuring process and many examples can be found in which sovereigns implemented a series of subsequent restructurings, in particular during the 1980s debt crisis.

The next subsections briefly review the evidence on debt-restructuring processes for each type of creditor involved. Specifically, it summarizes the experience of restructuring processes with regard to bilateral (government to government) debt renegotiated under the Paris Club umbrella; commercial bank debt (London Club); and bond debt (sovereign bond restructurings). A more detailed presentation on debt-restructuring processes for these creditor groups is provided in Rieffel (2003).

Table 19.1 summarizes the differences in negotiation settings across creditors. Note that the restructuring of supplier and trade credits is not discussed in detail.
because it usually takes place on an ad hoc basis or is excluded from the restructuring exercise. The Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative to coordinate debt relief to the poorest countries are also not discussed (for more details on these two initiatives, see IMF and World Bank, 2009).

RESTRUCTURING BILATERAL DEBT: THE PARIS CLUB

The Paris Club is the main institutional framework for restructuring external bilateral sovereign debt, that is, public and publicly guaranteed debt that debtor countries owe to other governments. The origins of the Paris Club date back to 1956, when Argentina met its sovereign creditors in Paris in an effort to prevent an imminent default. With the 1980s debt crisis, the Paris Club became one of the key vehicles for resolving debt crises around the world and has since arranged more than 400 restructuring agreements.

In essence, the Paris Club is an informal group of creditors and an ad hoc negotiation forum. Like the Bank Advisory Committees (of the London Club; see next subsection), the Paris Club has neither legal status nor statutory rules of procedure. However, it has a small secretariat based in Paris and follows a set of established negotiation rules. The Paris Club members are the governments of 19 of the largest world economies, plus additional creditor governments that are invited to participate in the negotiations on a case-by-case basis, depending on whether they have relevant claims on the debtor in question.³

A country that wants to restructure its debt with the Paris Club has to approach the Club’s secretariat and demonstrate its payment difficulties and need for debt relief based on its economic and financial situation. Debtor countries are also required to agree to a structural adjustment program with the IMF. Once a country satisfies these criteria, it meets and negotiates with a group of its creditors at the Paris Club so as to come to an agreement on broad restructuring terms.

³ As of 2012, the permanent members of the Paris Club are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway, the Russian Federation, Spain, Sweden, Switzerland, the United Kingdom, and the United States.
This final agreement (the “agreed minutes”) is not legally binding, but establishes the minimum debt-relief conditions that will guide the bilateral negotiations required for the bilateral agreements to become effective.4

Usually, the level of debt relief granted in Paris Club restructuring depends on whether the country is a low-income country (LIC), and is often based on the financing gap identified in the related IMF program. Since the 1980s, the trend with regard to LICs has been toward granting more debt relief under increasingly concessional terms. The scope of maximum debt cancellation increased from 33 percent in 1988 (Toronto terms) to 67 percent in 1994 (Naples terms). In 1996, with the establishment of the HIPC initiative, concessional treatment became a standard practice of the Club, with cancellations reaching up to 80 percent in 1996 (Lyons terms) and up to 90 percent in 1999 (Cologne terms). In addition, the Paris Club adopted the “Evian approach” in 2003, offering debt relief to countries other than HIPCs. A key novelty of the Evian approach was its focus on long-term debt sustainability rather than exclusively on short-term debt relief. Thereby, the Paris Club formally recognized that non-HIPC countries may also face solvency problems.

A key principle of the Paris Club is the “comparability of treatment” clause contained in each agreement. The clause calls for equal burden sharing across all creditor groups, private creditors (banks, bondholders, and suppliers) in particular, but also by other official bilateral creditor countries that are not members of the Paris Club. In practice, this means that the scope of debt relief granted by Paris Club creditors will determine how much debt relief other creditors should also grant the country in question. As highlighted by IMF (2001b, p. 43), “comparability of treatment is more an art than a science” and ultimately the Paris Club must judge whether any agreement with banks or bondholders has comparable terms. However, a clear breach of the comparability clause can potentially lead to a cancellation of the Paris Club agreement and, in consequence, jeopardize the financing of the related IMF program.

Thus, the Club’s comparability of treatment rule significantly affects the leeway in negotiations with banks or bondholders because Paris Club agreements often precede restructurings with other creditors. Two examples are the Eurobond exchanges of Pakistan in 1999 and the Dominican Republic in 2005, which were, at least in part, motivated by the comparability of treatment clause. In Pakistan’s case, for example, only a small share of external debt was owed to private creditors. The Eurobond restructuring only had a volume of about 1 percent of GDP and was thus too small to have a sizable impact on debt sustainability. Despite this, the Paris Club required the government of Pakistan to show signs of “progress” in bondholder negotiations (Sturzenegger and Zettelmeyer, 2006, p. 141).

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4 For example, Iraq received 100 percent debt relief from Cyprus, Malta, the Slovak Republic, and the United States under bilateral agreements, although the agreed minutes required only 80 percent debt relief.
Restructuring Bank Loans: The London Club

The process of debt renegotiations between governments and commercial banks is typically labeled as “London Club” restructuring. Despite its name, the London Club is neither a statutory institution based in London nor a well-organized club. Instead, the term loosely describes the case-by-case restructuring routine developed between major Western banks and developing country governments in the late 1970s and early 1980s.

The core element of the London Club process was the Bank Advisory Committee (BAC), or Creditor Committee. Each BAC was a group of 5–20 representative banks that negotiated on behalf of all banks affected by the restructuring. The key aim of the BACs was to overcome coordination problems among hundreds of individual banks and to bundle restructuring expertise in the hands of large banks and their legal and financial advisors.

The members of the BACs were usually senior officials of those banks with the largest exposure to the sovereign. However, as highlighted by Reed (1987), these large banking committees represented only 25–35 percent of a country’s total external debt to commercial banks in the 1980s and 1990s. The rest was held by an often fragmented group of banks in a variety of countries.

London Club negotiations tended to proceed as follows: In the early stage of financial distress, a debtor government contacted its one or two major bank creditors asking them to organize and chair a steering committee. During the 1970s and 1980s, it was easy for the government to identify its major creditors because most lending took place via syndicated loans and barely any trading occurred on secondary markets. Also, banks were well informed about who held the debt, so that communication was easier than in dispersed bond markets.

Once the committee of major bankers was established, the banking representatives would meet the country’s government officials on a regular basis, often at monthly or weekly intervals. These negotiations typically covered the full spectrum of crisis resolution measures, including the provision of new financing, short-term liquidity support via rollovers or credit lines, as well as the restructuring of loans with maturity prolongation, outright reductions in face value, or both. The BACs were thus a key vehicle for addressing both the liquidity and solvency problems of sovereigns in distress.

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5 As highlighted by Rieffel (2003, p. 108) the origins of the “London Club” label remain obscure. The term is to some degree misleading because most meetings of Bank Advisory Committees during the 1980s and 1990s took place in New York, not in London.

6 Restructuring experience was also a criterion, as shown in the case of Algeria 1996. Although Japanese banks had the largest exposure, the French bank Société Générale was asked to head the committee given that Japanese banks were not experienced in heading steering committees and could not fully rely on their own workout negotiators.

7 Much of the work was done by legal advisors and subcommittees that focused on particular aspects of a deal. There were subcommittees for processing economic data and surveillance, subcommittees responsible for communicating with the Bretton Woods institutions, and subcommittees specially negotiating trade financing or interbank credit lines.
A key milestone for debt restructurings in the London Club process was the “agreement in principle,” which was signed between the representative BAC banks and government officials, once the main restructuring terms had been agreed upon. After the principle agreement had been signed, the terms were sent to all other banks for approval. In this step, unanimity was required for the successful finalization of a restructuring.⁸

Holdouts and intra-creditor disputes were a major problem in the era of bank debt restructurings of the 1980s and 1990s. According to data collected in Trebesch (2010), about 30 percent of London Club restructurings suffered from intra-creditor disputes that led to delays of three months or more in implementing the deal. In most cases, holdout problems were caused by groups of smaller banks, such as regional banks in the United States. However, in some cases, major creditors also refused to participate in agreements arranged by a representative group (e.g., Bankers Trust in Algeria in 1992, Lloyds Bank in Argentina in 1982, and Citibank in Chile in 1987 and in the Philippines in 1986). A further repeated problem was disagreement about the composition and leadership of creditor committees (e.g., in Algeria in 1994, the Dominican Republic in 1983, and South Africa in 1985).

In addition, the implementation of bank loan restructurings was plagued by technical and legal hurdles. The Yugoslav debt deal of 1983 is just one example of a technically very challenging restructuring. Reportedly, the deal required signatures on some 30,000 documents in up to eight international financial centers (see Das, Papaioannou, and Trebesch, 2012). Legal and technical issues also led to significant delays in finalizing deals, such as in Mexico in 1984–85 and in Vietnam's Brady deal negotiations in the mid-1990s. See Box 19.1.

More recent experience with bank debt restructuring has been mixed. Pakistan’s (1999) and the Dominican Republic’s (2005) restructurings were implemented quickly and took just a few meetings with major bank representatives. In contrast, the bank loan restructurings in Iraq (2006) and Serbia and Montenegro (2004) took much longer and were more disputed. Iraq, for example, faced a creditor group composed of banks, trade creditors, suppliers, and an array of individual companies and investors. Ultimately, the government had to settle more than 13,000 individual claims on Saddam Hussein-era debt, a process that took more than two years.⁹ A further example of a troublesome restructuring is the Russian London Club deal of 1998–2000. The domestic debt restructuring committee of 19 international banks was effectively dissolved in 1999 because creditors moved to exchange their debt on a bilateral basis. The process of external

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⁸This was often not an easy goal, because deals sometimes involved up to 1,000 banks, small and large, in many countries. Typically, each member of the steering committee would manage the reconciliation with a group of banks not in the committee, so as to convince them to sign up for the deal (Rieffel, 2003, p. 122). This was not always successful.

⁹Iraq reopened the private debt exchange of 2006 (so-called 688) in 2008 to try to cover the rest of the private creditors. The new process was called 688-08 and covered the remaining stock of debt. The cash buyback agreement was reportedly quite successful, with significant debt forgiveness. However, some debt remained unresolved.
By the late 1980s, many developing economies had been in default for nearly a decade. They had settled on a chain of rescheduling agreements with their bank creditors, granting short-term liquidity relief but no cuts in face value. The Brady Plan constituted a major policy shift, because the official sector started to encourage outright debt reduction so as to restore debtor solvency. The plan was first announced by U.S. Treasury Secretary Nicholas Brady in March 1989 and was later widely supported, including by the IMF and the World Bank.

The main elements of the Brady Plan were the following:

- **Exchange of bank loans into sovereign bonds.** The Brady Plan foresaw the exchange of outstanding bank loans into new sovereign bonds, which were partly collateralized by U.S. Treasury bonds. The issuance of new tradable instruments amounting to several billion U.S. dollars created a liquid secondary market for EM sovereign bonds, which had last existed during the interwar years. The Brady Plan can thus be seen as the start of modern-era sovereign bond trading.

- **Menu approach.** Participating creditors were offered a menu of options allowing them to choose between different new instruments, including discount bonds with a cut in face value, and par bonds with long maturities and below-market interest rates but no debt reduction. Banks could also choose to provide new money to the issuing countries, in which case they were offered new instruments with better terms, for example, higher coupons or shorter maturities.

- **Capitalization of arrears.** Interest arrears to commercial banks were partly written off but also partly capitalized into new short-term floating rate bonds.

In total, 17 Brady deals were implemented on a country-by-country basis, starting with Mexico in September 1989 and ending with the last Brady-type agreements in Côte d’Ivoire and Vietnam in 1997. Most Brady countries were in Latin America—Argentina, Bolivia, Brazil, Costa Rica, the Dominican Republic, Ecuador, Mexico, Panama, Peru, Uruguay, and Venezuela. The other six countries were Bulgaria, Côte d’Ivoire, Jordan, Nigeria, the Philippines, Poland, and Vietnam.a

The Brady Plan is widely regarded as a success. Debtor countries put an end to the “lost decade” of the 1980s debt crisis and normalized their relations with creditors for the first time after years of protracted debt renegotiations. The agreements also fostered a new wave of capital inflows to emerging markets. Sovereigns were able to re-access capital markets, stock markets rallied, and countries saw an increase in growth and investment, as documented by Arslanalp and Henry (2005). Based on their analysis, Arslanalp and Henry argue that debt relief can be efficient, particularly in countries that face debt overhang problems and that feature strong institutions and a viable private sector economy, thus attracting foreign investment flows.

However, not all hopes connected to the Brady Plan were fulfilled. As highlighted by Chuhan and Sturzenegger (2005), the step-up of interest payments inherent in some of the new bonds threatened the debt sustainability of some debtors 10 years later, thus contributing to renewed default risks. And the belief that Brady bonds were “undefaultable” turned out to be wrong. Ecuador was the first country to restructure its Brady bonds, in 2000, followed by Uruguay (2003), Argentina (2005), and Côte d’Ivoire (2010).

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aMorocco was also supposed to implement a restructuring under the umbrella of the Brady initiative in the early 1990s; however, the government did not fulfill the requirements of a related IMF agreement, so the Brady restructuring did not occur.
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bond restructuring was also delayed by many months, partly due to disagreements with a group of mutual funds and hedge funds that held up to 15 percent of debt but that were not represented in the BAC (see Trebesch, 2010, for details). All in all, however, the BAC process can be regarded as a successful debt-restructuring vehicle. The 1980s and 1990s saw more than 100 debt restructurings under the London Club umbrella (virtually all sovereign debt exchange operations of the time) and most were implemented without major hurdles or conflict.

Sovereign Bond Exchanges

The initial steps in preparing a bond exchange involve gaining a full understanding of the details of all outstanding bonds, including knowing who holds the bonds and possibly who bought credit default swaps on them. Typically, debtor governments also contact legal and financial advisors early on. Legal advisors may provide insights on possible legal hurdles of a restructuring, summarize the legal characteristics of bonds, and may help in drafting the bond exchange documentation and terms of the new bonds. Financial advisors can help identify and reach out to bondholders, and they can play an important role in designing the financial terms of the exchange, such as computing different bond exchange options, drafting “carrot” and “stick” features (see below), and assessing the required scope of debt relief. Similarly, member countries also frequently contact the IMF for advice on bond restructuring.

Bondholder Structure

The key difference between sovereign bond and bank debt restructurings is the creditor structure, which tends to be much more dispersed for sovereign bonds, especially if bonds were sold to retail investors. Some bond restructurings, such as those of Argentina in 2005 and Ukraine in 2000, affected thousands of individual creditors, with an estimated 600,000 and 100,000 retail investors, respectively. Thousands of minor bondholders were also involved in the bond exchanges in Dominica (2004), Pakistan (1999), Uruguay (2003), and Seychelles (2009).

However, bondholder numbers are not always large. In cases like Jamaica (2010), Belize (2007), Grenada (2005), and Ecuador (2000), sovereign bonds were held mostly by a relatively small group of institutional investors. Even more concentrated was the creditor structure in the restructuring of Moldova (2002), where one creditor held 78 percent of the outstanding Eurobonds.

Bondholder Communication and Negotiation

With dispersed creditor structures, identifying bondholders and communicating with them can be difficult, especially if they are retail investors. The main challenge is that bond trading occurs over the counter and no central agency registers the holders of bonds at each moment. Governments undergoing bond restructurings, therefore, need to identify the holders of bonds to initiate a dialogue with them.
In some cases, bondholder consultations have been so extensive that the exchange offers were jointly developed with bondholder representatives. This was the case in Uruguay (2003), but creditor consultations were also wide-ranging in other debt-restructuring cases such as Pakistan (1999), Ukraine (2000), Moldova (2002), Grenada (2005), Belize (2007), Seychelles (2009), and Jamaica (2010). Road shows are a popular communication strategy: senior country officials present the proposed debt exchange to investors and ask for feedback, as was done, for example, by the government of the Dominican Republic in 2004. Official press releases and clearly visible notices in leading financial newspapers are another popular way to keep investors informed.

On the creditor side, large, representative bondholder groups were formed only in a minority of cases, notably in Argentina (2005), Grenada (2005), and Belize (2007). Among these, the Global Committee of Argentina Bondholders was the most visible, claiming to represent more than 50 percent of the outstanding private bonds of Argentina, but it was never formally recognized by the Argentinean government. In Grenada (2005) and Belize (2007), creditor committees consisted of only a few major financial institutions (7 and 14, respectively), but they represented 50 percent or more of the outstanding private debt.

**Bond Exchange Offers**

One of the key objectives in designing an exchange offer is to achieve a high participation rate by bondholders. Most exchange offers, therefore, contain “carrot” features or “sweeteners” that generate incentives for participation (see the detailed overview in Andritzky, 2006). Sweeteners can take the form of up-front cash repayments, advantageous legal features of the new bonds, or add-ons to the new instruments, such as the GDP-linked warrants in the 2005 Argentine exchange. Liquidity risk can also generate incentives. Many governments exchange an array of old instruments for a small set of new bonds, as in Jamaica, where 356 bonds were replaced by 25 new instruments. These new bonds are likely to trade as benchmark bonds with higher liquidity, making them more attractive for bondholders who hold less-liquid claims. Regulatory sweeteners can also be used, particularly with regard to local bondholders. Argentina, for example, tried to convince domestic banks to participate in its 2005 exchange by allowing them to value the new instruments at par when fulfilling liquidity or capital adequacy requirements.

Another strategy for generating participation incentives is to design a menu of exchange options, allowing investors to choose among different new instruments when tendering their old claims, thus accounting for differing preferences across creditors. Lim, Medeiros, and Xiao (2005) underline that retail investors tend to

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10 There were small bondholder groups in the Dominican Republic (2005) and Seychelles (2009) representing only a minority of bondholders. In Ecuador (1999), the government convened the “Creditor Consultative Group” consisting of eight major debt investors; however, it held only two meetings.
prefer new bonds with no face value reduction (cut in principal) and are more willing to accept long maturity and low coupons. In contrast, many institutional investors that mark to market appear to prefer bonds with a principal haircut but a combination of shorter maturities and higher coupons.

Exchange offers can also contain “sticks,” which are intended to make the outstanding bonds less attractive. Sticks can be agreed upon by participating creditors via an exit consent, a legal vehicle that allows the removal of clauses from the old bonds, such as cross-acceleration clauses or the listing requirement. These actions effectively reduce the value of the old bond and central bank acceptance as eligible collateral after the exchange, thereby encouraging bondholders to accept the offer. The case evidence provided by Andritzky (2006); Enderlein, Trebesch, and von Daniels (2012); Rieffel (2003); and Roubini and Setser (2004) indicates that it is crucial to strike the right balance between stick and carrot features in preparing an exchange offer.

Once the offer is officially launched, the debtor government usually announces an exchange deadline as well as a minimum participation threshold for an exchange to take place. This minimum threshold has ranged between 75 percent and 85 percent of outstanding bonds in most cases (see Andritzky, 2010, for an overview). Sturzenegger and Zettelmeyer (2006) show that bondholders tend to wait until the last few days before the deadline to accept an offer. To encourage early participation, therefore, sweeteners are sometimes offered only until a certain deadline (e.g., in Uruguay 2003). To achieve higher participation, the exchange deadline is often extended by a few days or weeks. Extensions occurred in all three of Ukraine’s debt-exchange offers (1998, 1999, and 2000) and in Dominica in 2004, for which the deadline of its bond exchange was extended twice and by more than four months. Another way to spur higher participation is by using legal means, especially collective action clauses that ease the restructuring of bonds.

**STYLISTIZED FACTS ABOUT RECENT DEBT-RESTRUCTURING EPISODES**

This section discusses sovereign debt-restructuring episodes in EMs, focusing closely on restructurings that took place between 1998 and 2010. After summarizing the main characteristics across debt-restructuring cases, such as haircut size and the duration of renegotiation, domestic debt restructurings are compared with foreign debt restructurings and the relevance of legal clauses in exchange operations is reviewed.

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11 The same logic applied in some of the London Club debt renegotiations. Argentina, for example, introduced “early participation fees” in 1987. Banks accepting the government’s restructuring offer within 30 days were given a 3/8 percent fee, but only 1/8 percent thereafter.
Main Characteristics of Debt Restructurings since 1998

Table 19.2 provides an overview of the main bank and bond debt exchanges in emerging market economies involving foreign creditors that took place since the Brady deal, sorted by the date the restructuring was announced. The following stylized facts can be gleaned from the literature and the data cited therein:

Emerging market sovereign bond restructurings since 1998 were implemented relatively quickly. Of the 18 episodes listed in Table 19.2, seven restructurings took one year or less to complete. More generally, however, the duration of renegotiations varies widely: In some cases, such as Pakistan (1999), Uruguay (2003), and Jamaica (2010), restructuring occurred at record speed, in only three or four months. Other restructurings, such as Argentina (2001–05), took years to resolve. However, as shown by Trebesch (2010) the average duration of renegotiation has decreased compared with earlier decades: bond debt exchanges since 1998 took an average of only 13 months, which is less than half the average duration of bank debt restructurings in the 1980s and 1990s, which took more than 30 months, on average.

The extent of creditor losses (haircuts) shows a large variation, ranging from an estimated 5 percent (the Dominican Republic, 2005) to a nearly 90 percent (Iraq, 2006) reduction in net present value. The reported estimates are taken from a data set by Cruces and Trebesch (forthcoming) and can be interpreted as measuring the loss realized in the exchange from the perspective of a participating creditor. Specifically, the reported values are computed by averaging the loss across all instruments exchanged. Cruces and Trebesch (forthcoming) follow the methodology suggested by Sturzenegger and Zettelmeyer (2006, 2007), which compares the present value of new debt instruments in the exchange with the present value of the old outstanding debt (including past due interest) discounted at imputed exit yields.

The number of debt-restructuring episodes with face value reduction (nominal debt writedowns) has increased notably since the late 1980s. A reason for the increase in frequency of face value reductions is that bank and bond debt exchanges often have come to involve a menu of options, which explicitly includes the face value reduction option.

Postdefault restructuring cases on average show a higher net present value haircut than preemptive restructuring cases (Asonuma and Trebesch, 2012). Postdefault cases also take longer to resolve, on average.

The restructurings varied in complexity. Some restructurings involved only one or two individual bonds, while others, such as Argentina (2005) and Uruguay (2003), exchanged dozens of different instruments.

Domestic versus External Debt Restructurings

Recent case studies show that the negotiation process and the basic restructuring mechanics are very similar in a comparison of domestic debt restructurings to external

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12 This is consistent with Finger and Mecagni (2007).
### TABLE 19.2
Characteristics of Main Sovereign Debt Restructurings with Foreign Banks and Bondholders, 1998–2010

<table>
<thead>
<tr>
<th>Case</th>
<th>Preemptive or postdefault?</th>
<th>Default date</th>
<th>Announcement of restructuring</th>
<th>Start of negotiations</th>
<th>Final exchange offer</th>
<th>Date of exchange</th>
<th>Total duration (months)</th>
<th>Debt exchanged (million US$)</th>
<th>Cut in face value (percent)</th>
<th>Haircut estimate (Cruces/Trebesch) (percent)</th>
<th>Discount rate (Cruces/Trebesch)</th>
<th>Outstanding instruments exchanged</th>
<th>New instruments exchanged</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pakistan (bank loans)</td>
<td>Postdefault</td>
<td>Aug-98</td>
<td>Aug-98</td>
<td>Mar-99</td>
<td>May-99</td>
<td>Jul-99</td>
<td>11</td>
<td>777</td>
<td>0.0</td>
<td>11.6</td>
<td>0.132</td>
<td>trade credits and debt arrears</td>
<td>1 loan</td>
</tr>
<tr>
<td>Pakistan (ext. bonds)</td>
<td>Preemptive</td>
<td>Aug-99</td>
<td>Sep-99</td>
<td>Nov-99</td>
<td>Dec-99</td>
<td>4</td>
<td>610</td>
<td>0.0</td>
<td>15.0</td>
<td>0.146</td>
<td></td>
<td>3 Eurobonds</td>
<td>1 Eurobond</td>
</tr>
<tr>
<td>Ukraine (ext. bonds)</td>
<td>Preemptive</td>
<td>Dec-99</td>
<td>Jan-00</td>
<td>Feb-00</td>
<td>Apr-00</td>
<td>4</td>
<td>1,598</td>
<td>0.9</td>
<td>18.0</td>
<td>0.163</td>
<td></td>
<td>3 bonds, 1 loan</td>
<td>1 Eurobond</td>
</tr>
<tr>
<td>Ecuador (ext. bonds)</td>
<td>Postdefault</td>
<td>Aug-99</td>
<td>Sep-99</td>
<td>Jul-00</td>
<td>Aug-00</td>
<td>25</td>
<td>6,700</td>
<td>33.9</td>
<td>38.3</td>
<td>0.173</td>
<td></td>
<td>4 Brady bonds, 2 Eurobonds</td>
<td>2 Eurobonds</td>
</tr>
<tr>
<td>Russian Fed. (bank loans)</td>
<td>Postdefault</td>
<td>Sep-98</td>
<td>May-99</td>
<td>Feb-00</td>
<td>Aug-00</td>
<td>23</td>
<td>31,943</td>
<td>36.4</td>
<td>50.8</td>
<td>0.125</td>
<td></td>
<td>PRINs, IANs, debt arrears</td>
<td>1 Eurobond</td>
</tr>
<tr>
<td>Moldova (ext. bonds)</td>
<td>Preemptive</td>
<td>Jun-02</td>
<td>Jun-02</td>
<td>Aug-02</td>
<td>Oct-02</td>
<td>4</td>
<td>40</td>
<td>0.0</td>
<td>36.9</td>
<td>0.193</td>
<td></td>
<td>1 Eurobond</td>
<td>1 Eurobond</td>
</tr>
<tr>
<td>Uruguay (ext. bonds)</td>
<td>Preemptive</td>
<td>Mar-03</td>
<td>Mar-03</td>
<td>Apr-03</td>
<td>May-03</td>
<td>2</td>
<td>3,127</td>
<td>0.0</td>
<td>9.8</td>
<td>0.090</td>
<td></td>
<td>18 ext. bonds</td>
<td>18 + 3 new benchmark bonds</td>
</tr>
<tr>
<td>Serbia and Montenegro</td>
<td>Postdefault since 1990s</td>
<td>Dec-00</td>
<td>Sep-01</td>
<td>Jun-04</td>
<td>Jul-04</td>
<td>44 (since announcement)</td>
<td>2,700</td>
<td>59.3</td>
<td>70.9</td>
<td>0.097</td>
<td>bank loans, arrears</td>
<td>1 Eurobond</td>
<td></td>
</tr>
<tr>
<td>Dominican Rep. (bonds/loans)</td>
<td>Postdefault</td>
<td>Jun-03</td>
<td>Dec-03</td>
<td>Apr-04</td>
<td>Sep-04</td>
<td>15</td>
<td>144</td>
<td>15.0</td>
<td>54.0</td>
<td>0.092</td>
<td></td>
<td>2 bonds, short- and medium-term loans</td>
<td>3 bonds</td>
</tr>
<tr>
<td>Argentina (ext. bonds)</td>
<td>Postdefault</td>
<td>Oct-01</td>
<td>Mar-03</td>
<td>Jan-05</td>
<td>Apr-05</td>
<td>42</td>
<td>60,572</td>
<td>29.4</td>
<td>76.8</td>
<td>0.104</td>
<td></td>
<td>66 US$ and Arg$ denominated bonds</td>
<td>5 US$ and Arg$ denominated bonds</td>
</tr>
<tr>
<td>Country</td>
<td>Type</td>
<td>Status</td>
<td>Start</td>
<td>End</td>
<td>Period</td>
<td>Old Debt</td>
<td>New Debt</td>
<td>New Interest Rate</td>
<td>Exchange</td>
<td>Notes</td>
<td></td>
<td></td>
<td></td>
</tr>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dominican Rep.</td>
<td>Preemptive</td>
<td>Apr-04</td>
<td>Jan-05</td>
<td>Apr-05</td>
<td>May-05</td>
<td>13</td>
<td>1,100</td>
<td>0.0</td>
<td>4.7</td>
<td>2 bonds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rep. (ext. bonds)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dominican Rep.</td>
<td>Postdefault</td>
<td>Feb-05</td>
<td>Apr-04</td>
<td>Aug-04</td>
<td>Jun-05</td>
<td>Oct-05</td>
<td>18</td>
<td>180</td>
<td>0.0</td>
<td>11.3</td>
<td>0.097</td>
<td>bank loans, arrears</td>
<td></td>
</tr>
<tr>
<td>Rep. (bank loans)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1 loan</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Grenada</td>
<td>Preemptive</td>
<td>Oct-04</td>
<td>Dec-04</td>
<td>Sep-05</td>
<td>Nov-05</td>
<td>13</td>
<td>210</td>
<td>0.0</td>
<td>33.9</td>
<td>0.097</td>
<td>5 ext. bonds, 8 dom. bonds, 2 ext. loans, supplier credit, arrears</td>
<td></td>
<td></td>
</tr>
<tr>
<td>bonds/loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Iraq</td>
<td>Postdefault</td>
<td>since 2003</td>
<td>in 2004</td>
<td>Jul-05</td>
<td>Jul-05</td>
<td>Jan-06</td>
<td>20 (since announcement)</td>
<td>17,710</td>
<td>81.5</td>
<td>89.4</td>
<td>0.123</td>
<td>1 US$ bond and 1 EC$ bond mostly cash, 1 US$ bond, 1 Loan 1 bond</td>
<td></td>
</tr>
<tr>
<td>(bank/commercial loans)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Belize</td>
<td>Preemptive</td>
<td>Aug-06</td>
<td>Aug-06</td>
<td>Dec-06</td>
<td>Feb-07</td>
<td>6</td>
<td>516</td>
<td>0.0</td>
<td>23.7</td>
<td>0.096</td>
<td>7 bonds, 8 loans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>bonds/loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ecuador</td>
<td>Postdefault</td>
<td>Dec-08</td>
<td>Jan-09</td>
<td>Apr-09</td>
<td>June/Nov-09</td>
<td>12</td>
<td>3,190</td>
<td>68.6</td>
<td>67.7</td>
<td>0.130</td>
<td>2 Eurobonds none (cash settlement)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(bond buy-back)</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Seychelles</td>
<td>Postdefault</td>
<td>Jul-08</td>
<td>Mar-09</td>
<td>Mar-09</td>
<td>Dec-09</td>
<td>Feb-10</td>
<td>19</td>
<td>320</td>
<td>50.0</td>
<td>56.2</td>
<td>0.107</td>
<td>1 ext. bond, 2 ext. loans, notes 2 Brady bonds, arrears</td>
<td></td>
</tr>
<tr>
<td>(ext. bonds)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1 bond</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Côte d’Ivoire</td>
<td>Postdefault</td>
<td>Mar-00</td>
<td>Aug-09</td>
<td>Aug-08</td>
<td>Mar-10</td>
<td>Apr-10</td>
<td>21 (since announcement)</td>
<td>2,940</td>
<td>20.0</td>
<td>55.2</td>
<td>0.099</td>
<td>1 bond</td>
<td></td>
</tr>
<tr>
<td>(ext. bonds)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources: Cruces and Trebesch, 2011; Trebesch, 2011, and sources cited therein. The data on preemptive vs. postdefault restructurings are from Asonuma and Trebesch, 2012.

Note: Arg$ = Argentine peso; dom. = domestic; ECS = Eastern Caribbean dollar; ext. = external; IAN = interest arrear note; PRIN = principle. Debt exchanged refers to effective old debt exchanged in the deal, not eligible debt. Similarly, only old and new instruments that were actually exchanged are listed.
Restructuring Sovereign Debt: Lessons from Recent History

debt restructurings (Sturzenegger and Zettelmeyer, 2006; and Erce, 2012). However, there are also important differences. One difference is that domestic debt is adjudicated domestically, often leaving litigation in domestic courts as the only recourse available to investors. A second difference is that investors in domestic instruments are normally mostly residents (i.e., domestic banks, insurance companies, and pension funds), in which case a restructuring of domestic debt instruments will directly affect the balance sheets of domestic financial institutions and can affect the country’s overall financial stability. Finally, exchange rate considerations and currency mismatches play a lesser role in domestic debt than in external debt restructurings.13

Another difference is the duration of renegotiations. Since 1998, domestic debt restructurings have been implemented more quickly than external debt restructurings. Argentina’s domestic debt was restructured in November 2001, but the external bond exchange took four more years. Russia’s domestic GKO bonds were restructured within six months (between August 1998 and March 1999), whereas the restructuring of external bank loans took until 2000 to complete. In Ukraine, the domestic debt exchange was implemented in less than two months, with separate offers for resident and nonresident holders (see Sturzenegger and Zettelmeyer, 2006, for details). In Jamaica, the restructuring of a sizable stock of domestically issued debt took about two months.

In addition, in some instances domestic debt has been treated differently from external debt during restructurings. In Belize (2007), the government restructured only the external bonds. In Ecuador (1998–2000), the authorities restructured both short- and long-term bonds held by nonresidents, but not medium- and long-term domestic debt. In a similar vein, Ecuador’s (2008–09) default and debt buyback only affected two outstanding international bonds, but no domestic debt. The opposite occurred in Jamaica’s (2010) restructuring, which excluded externally issued Eurobonds.

New Evidence on Creditor Coordination Problems

The problem of creditor holdouts and litigation is widely seen as the main reason for delayed and inefficient debt restructurings. In a typical holdout scenario, a creditor will refuse to participate in a restructuring offer in an effort to enforce better terms later on, possibly by suing the sovereign in a court in London or New York. This type of free-riding behavior and other forms of creditor coordination failures are seen as increasingly important stumbling blocks, mainly due to the shift from bank to bond financing in emerging markets (e.g., Krueger, 2002). Intuitively, large bondholder groups may find it harder to coordinate and agree on a deal, compared with a small group of commercial banks in the London Club process.

However, as shown above, bond restructurings since the 1990s have been implemented more quickly than the bank debt exchanges of the 1980s. In addition, participation rates in sovereign bond exchanges have been very high, on

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13 Domestic debt can also be denominated in foreign currency.
average, surpassing 90 percent in most sovereign bond exchanges since 1998 (Das, Papaioannou, and Trebesch, 2012). Trebesch (2010) shows that there is no robust evidence that creditor characteristics play a dominant role in the duration of debt restructurings. He finds no correlation between the duration of renegotiations and the number of creditors involved. In addition, his case archive shows that troublesome holdouts have remained the exception, and that there is no evidence of an increasing trend in inter-creditor disputes since the 1980s. It is sometimes forgotten that London Club restructurings were frequently plagued by creditor coordination problems as well (see the previous section on London Club debt exchanges).

The number of creditor litigation cases in the context of sovereign defaults or restructurings has increased as the result of changes in legal doctrine and the emergence of the so-called vulture creditors. But the total number remains low, with 108 individual occurrences of litigation since 1980 (Schumacher, Trebesch and Enderlein, 2013). One reason for the low number of cases is the costly nature of holdout strategies and litigation and the need for specialized knowledge to carry out these strategies. At the same time, the study finds that the intensity of lawsuits has increased, meaning that the duration of cases has gone up, as have the amounts under litigation, and the number of attachment attempts.

Moreover, there are outlier cases, in which creditor coordination problems did pose a serious problem. The global bond exchange in Argentina (2005) and the restructuring in Dominica (2004) had large shares of holdout creditors, and the countries had difficulties re-accessing international capital markets after the exchange. These countries dealt with holdouts differently. Dominica gradually convinced individual creditors to accept its original exchange offer in the years between 2004 and 2007. Argentina, by contrast, launched a new public exchange offer in April 2010, which achieved a 66 percent participation rate, thereby bringing the total participation rate to 92 percent (Hornbeck, 2010). Many of the remaining 8 percent holdouts, including distressed debt funds, continue their litigation efforts to this day (as of late 2012).

**Legal Remedies and Clauses**

A bond’s governing law plays a major role in a debt restructuring because it pre-defines the contractual provisions for restructuring as well as the jurisdiction for potential litigation. A large majority of outstanding emerging market bonds issued in international markets are under New York law, with English law the second most common. The picture is different for the European Union (EU) countries

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14 Bi, Chamon, and Zettelmeyer (2011) develop a related model that rationalizes why coordination failures in past bond exchanges have been the exception and not the rule and why participation rates have typically been very high, even with dispersed bondholders.

15 In Dominica, the holdouts were mainly linked to three institutions, whereas in Argentina they included thousands of investors, including many retail bondholders. The latter were hard to identify and prone to litigation, and asked for special treatment.
Restructuring Sovereign Debt: Lessons from Recent History

where, since 2003, government bonds have predominantly been issued under
domestic laws. An important dimension in which the governing law makes a dif-
ference is that it gives a sovereign broader scope to seek to alter the substantive
terms of its sovereign debt contracts by changing relevant laws of the sovereign.

Although the inclusion of collective action clauses (CACs) has been the norm
under English law, their use has widened in recent years. It is often argued that
the presence of CACs can facilitate creditor-debtor negotiations in a restructuring
situation, because they reduce the hurdle of having to achieve unanimity on a
restructuring agreement (via the majority restructuring clause) and can limit the
potential threat of litigation from holdout creditors.

Mexico was the first country to include CACs in its sovereign bond issue in
the New York market in February 2003. Other countries quickly followed suit,
including Uruguay and Brazil (April 2003), the Republic of Korea and South
Africa (May), Belize (June), Italy (July), and Turkey (September). Since then, the
inclusion of CACs in New York law bonds has become the norm. During the
same period, EU countries agreed to update their bond documentation on interna-
tionally issued bonds to include CACs (ECFIN, 2004).

The triggering of CACs in past debt-restructuring episodes was not common,
and in the cases in which they were triggered the results were mixed. One example
of a successful application is Ukraine (2000), where the authorities took advan-
tage of CACs in the three Eurobonds governed under Luxembourg law. Use of
the CACs helped in the implementation of the restructuring and eliminated
potential holdout problems. Also in the cases of Moldova (2002) and Uruguay
(2003), CACs under English law contributed to quick restructurings. CACs were
also embedded in some of the instruments exchanged by Dominica (2004) and
Argentina (2005), but they did not prevent the serious holdout problems both
countries faced after restructuring.

Exit consents proved to be another type of legal provision with important
implications for debt restructuring. Exit consents were first used in Ecuador’s 2000

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16 In general, CACs cover the following two broad categories: (1) “majority restructuring” provisions,
which allow a qualified majority of bondholders of an issuance to change the bond’s financial terms
and to bind in all other holders of that issuance, either before or after default; and (2) “majority
enforcement” provisions, which can limit the ability of a minority of bondholders to enforce their
rights following a default.

17 On some occasions (e.g., Uruguay and Jamaica), explicit announcements of minimum participation
thresholds were used to solve coordination problems.

18 In addition to the IMF, the official sector (e.g., the Group of Ten [1996, 2002], the G-7, and the
U.S. Treasury) promoted the more widespread use of CACs (Taylor, 2002).

19 Although CACs gained considerable attention in the EU public debate, their inclusion in domestic
bonds in continental Europe continues to be the exception rather than the rule.

20 Holders of these bonds were invited to tender their instruments, and at the same time to grant an
irrevocable proxy vote to be cast at bondholder meetings. This ensured that bondholders who had
tendered proxies could not change their minds and reject the proposed amendments at the meetings
without incurring substantial civil liability (see IMF, 2001a, for details).

21 CACs were included in two Dominican bonds issued in the late 1990s for which Citibank and
RBTT Merchant Bank acted as trustees.
exchange of a sovereign bond issued under New York law (Buchheit and Gulati, 2000). The terms of the exchange offer required each participating bondholder to also agree to a list of amendments of nonpayment terms. The Uruguay (2003) exit consents were mainly aimed at avoiding litigation and limited the possibility of attaching any future payments on the new bonds via a court ruling (waiver of sovereign immunity). In comparison, Ecuador requested amendments on a broader range of terms. The use of exit consents in Ecuador was perceived as part of a “take-it or leave-it” strategy, whereas in Uruguay, participants could opt out of the exit consents (IMF, 2003, p. 23). Use of other clauses (e.g., aggregation, acceleration, cross-default, and cross-acceleration) in restructuring episodes since 1998 has been limited.

Nonpayment terms were amended in the bond restructurings of Dominica (2004), the Dominican Republic (2005), Argentina (2005), and Belize (2007). The exchange prospectus of Argentina, for example, points out that the country might delist the old securities. However, as of January 2012, this delisting had not taken place. Furthermore, it should be underscored that exit consents under New York law have generally withstood legal challenges in U.S. courts. For example, U.S. courts have refused to invalidate exit consents that removed important bondholder rights and protections in a few corporate restructurings, including financial covenants (see IMF, 2001a, for more details).

**IMPLICATIONS FOR THE REAL AND FINANCIAL SECTORS**

**Macroeconomic Implications of Debt Restructuring**

How did financial and macroeconomic conditions evolve around debt-restructuring episodes? This question is briefly addressed by plotting median values of a set of variables for a six-year interval around debt-restructuring years. The result is shown in Figure 19.2, with exact annual figures shown in the appendix of Das, Papaioannou, and Trebesch (2012). When interpreting these figures, it is important to highlight once more that a restructuring can occur many years after a country’s first payment default. In fact, restructuring episodes often mark the end of a crisis and not its beginning (Levy-Yeyati and Panizza, 2011).

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22 Specifically, these terms included “the deletion of the requirement that all payment defaults must be cured as a condition to any annulment of acceleration, the provision that restricts Ecuador from purchasing any of the Brady bonds while a payment default is continuing, the negative pledge covenant, and the covenant to maintain the listing of the defaulted instruments on the Luxembourg Stock Exchange” (IMF, 2001a, p. 35).

23 Ultimately, more than 90 percent of participants in the Uruguay exchange approved the use of exit consents. Only one small Brady bond did not reach the minimum approval rate of 50 percent of bonds outstanding necessary to activate the exit consents (see Uruguay “Article IV Consultation and Third Review under the Stand-By Arrangement 2003” available at http://www.imf.org/external/pubs/ft/scr/2003/cr03247.pdf).
As expected, restructuring periods are associated with a notable drop in total public debt as a percentage of GDP, from a median of more than 50 percent to about 35 percent, as well as an even stronger decline in the ratio of total external debt to GDP, from a median close to 80 percent to less than 50 percent. The ratio of external short-term debt to reserves also shows a steep drop from a median of more than 110 percent to slightly more than 55 percent in a single year.

Moreover, macroeconomic conditions also improved after restructuring. Median real growth was only about 1.5 percent three years before final agreements, but stayed consistently above 4 percent during the three years following the exchange.\(^{24}\) In a similar vein, median inflation decreased from about 20 percent

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\(^{24}\)Reinhart and Rogoff (2008) find that output declines associated with domestic debt default appear to be worse than for external debt crises. On average, the output decline in the year before a domestic default is 4 percent, compared with only 1.2 percent in the year before an external default.
three years before restructuring to just 7.5 percent three years after restructuring. However, the median budget balance improved substantially before restructuring (Figure 19.2, panel f).

However, the costs and consequences of defaults and debt restructurings should be carefully considered and compared with the alternative of not restructuring. There appeared to be reputational spillovers from sovereign default and restructurings on other parts of the economy, in particular foreign direct investment and access to credit. Countries that undergo debt restructurings typically see a drop in private sector access to external credit, of up to 40 percent in each year with ongoing debt renegotiations (Arteta and Hale, 2008; and Das, Papaioannou, and Trebesch, 2010). Other research suggests a drop in foreign direct investment flows of up to 2 percent of GDP per year (Fuentes and Saravia, 2010). However, causality is difficult to establish, so these results should be interpreted with caution.

Credit ratings also deteriorate notably before a default, and improve only slowly in the aftermath of debt restructuring. Figure 19.3 shows the evolution of Moody’s ratings across nine bond restructuring episodes (for which ratings data were available). Ratings decline markedly, by more than four notches in the three years before a sovereign default event, and start to recover after restructuring, but gained only an average of 1.7 notches in the three subsequent years. After one year, most sovereign bonds retained a C− rating (i.e., having a poor standing and subject to very high credit risk). It is also evident that restructurings rarely come as a surprise. All sovereigns in the list had low ratings in the speculative range one year before the default or restructuring event. One notable outlier is Uruguay,

![Figure 19.3 Ratings Evolution during Sovereign Restructuring Episodes](source)

*Figure 19.3 Ratings Evolution during Sovereign Restructuring Episodes*

*Sources: Moody’s; and authors’ calculations.
Note: Ratings evolution over time, averaged across the following nine bond restructuring episodes: Pakistan (1999), Ecuador (1999 and 2008), Argentina (2001), Moldova (2002), Uruguay (2003), the Dominican Republic (2005), Belize (2006), and Jamaica (2010).*
which had investment grade status (Baa3) up to March 2002 and restructured its debt only 14 months later.

Although largely dependent on the specifics of individual cases, market access has typically been restored in a relatively short period after debt restructuring. Gelos, Sandleris, and Sahay (2011) show that most defaulters regain access to new credit within two years of a crisis. The authors also show that the period of exclusion from capital markets during the more recent restructuring episodes has considerably shortened compared with the 1980s. Argentina’s restructuring perhaps remains the most extreme—as of 2012, the country had not been able to access the global markets since its 2001 default. Ecuador also suffered a protracted loss of access to international financial markets; it took the country five years after restructuring to regain access.

However, postrestructuring access could come at a cost. Research points out that defaults affect risk spreads only in the first and second year after the restructuring (Borensztein and Panizza, 2009). Other work, however, shows that the impact on market access postrestructuring may depend significantly on the outcome of the restructuring process. Cruces and Trebesch (forthcoming) show that larger haircuts are associated with much larger postrestructuring bond spreads, after controlling for fundamentals and for country and time fixed effects. The effect decreases over time but is still significant in years six and seven after the restructuring. The authors find evidence that haircut size is also highly correlated with the duration of capital market exclusion.

Financial Stability Implications of Debt Restructuring

Sovereign restructuring episodes can have an adverse impact on the financial sector of a debtor country for several reasons. First, the asset side of banks’ balance sheets may have to take a direct hit from the loss of value of the restructured assets, such as sovereign bonds. Second, on the liability side, banks can experience deposit withdrawals and the interruption of interbank credit lines. These issues can negatively affect their ability to mobilize resources at a time of stress. Finally, restructuring episodes have also triggered interest rate hikes, thereby increasing the cost of banks’ funding and affecting their income positions. Together, these factors may impair the financial position of domestic institutions to such a degree that financial stability is threatened and pressures for bank recapitalization and official sector bailouts are increased.

Recent history confirms that debt restructurings have adversely affected domestic financial sectors. Two main examples are the defaults of Russia and Ecuador, which contributed to the effective collapse of the domestic banking systems in these countries. In Russia, the large Moscow-based commercial banks were affected most owing to their significant exposures to domestic treasury bills and to currency mismatches on their balance sheets. This combination resulted in insolvency and the default of some banks on their external obligations. In Ecuador, the sovereign default had been preceded by a systemic banking crisis (accompanied by liquidation of five financial institutions), yet the restructuring process led to a further significant dent in banks’ capital.
In the Jamaica (2010) restructuring, concerns about financial sector stability prompted the government to adopt a preventive financial sector contingency plan. Specifically, with the help of international financial institutions, the government introduced a facility to provide temporary liquidity support to solvent banks that might be affected by sovereign restructuring. As it turned out, there were no requests for such liquidity assistance.

A final observation is that debt restructuring in one country can have cross-border implications. Banks and financial institutions exposed to sovereign risks in a country that undergoes restructuring could transmit the shock across borders, either directly by loss of value of government securities or indirectly through their exposure to the banking sector of that country. Among the larger restructuring episodes, German banks and funds were most heavily exposed to the Russian default of 1998, and U.S. financial institutions and European retail investors were most affected by the Argentine default and debt exchange of 2001–05.

CONCLUSION

This chapter reviews historical experience with debt-restructuring episodes and summarizes a number of lessons based on emerging market economy experience since 1990. A number of factors are identified that appear to have played a role in determining the outcomes of the restructuring process:

• “Twin restructurings” of external and domestic debt seem to have become the norm.

• Despite lengthy negotiations and delays in many debt-restructuring cases, creditor coordination and holdouts have not generally been a major problem. However, the number and intensity of creditor litigation cases has been on the rise.

• Bond restructurings, on average, have been implemented more quickly than bank debt exchanges, and participation rates have often exceeded 90 percent, even with dispersed bondholders.

• Some features embodied in bond contracts (e.g., CACs and other legal clauses) appear to have facilitated debt crisis resolution, but their presence alone did not guarantee a smooth restructuring process.

• Macroeconomic indicators tended to improve in the immediate years after debt restructurings. Credit ratings also tended to recover, although at a slow pace.

• Depending on the country’s circumstances, market access could be restored relatively quickly after restructuring. However, postrestructuring access could come at a cost because defaults affect credit risk spreads. Larger haircuts were associated with larger postrestructuring bond spreads, with the effect slowly decreasing over time.

• Debt restructurings in some cases were associated with spillovers into the financial sector, but at least in one of those cases a backstopping mechanism was established to minimize the impact.
Although the analyzed debt exchanges relate to EM economies, these experiences may also prove useful to any distressed country, including advanced economies.

REFERENCES


