

Restructuring Sovereign Debt: Lessons from Recent History

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Abstract:

This paper summarizes lessons learned from the recent history of sovereign debt restructurings in emerging markets and developing countries. Our main contribution is to present a set of stylized facts on the outcome and process of debt restructurings since 1998, including on the size of haircuts, creditor participation, and legal issues such as creditor litigation and collective action clauses. In addition, the paper provides an overview of basic concepts, on the frequency and type of debt restructurings in the last decades and explains the main procedural steps in implementing a debt exchange. We conclude by summarizing the implications of defaults and restructurings for financial intermediation and economic activity.

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I. INTRODUCTION

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

Part one 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 compared to related concepts such as “default” or “credit event”? How often was sovereign debt restructured in recent decades? Furthermore, what are the determinants of default and debt restructurings?

In the second part, we focus 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 London Club and the Paris Club? And how do “modern day” sovereign bond exchanges work in practice? To answer these questions we describe main insights from the existing literature and draw on newly available data.

Part three summarizes the main characteristics of EM sovereign debt restructurings between 1998 and 2010. Amongst other, we address the following questions: What are the typical pitfalls in the restructuring process? How long did it take to restructure sovereign bonds or loans? How frequent are creditor holdouts and litigation? What is 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 key 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 re-enter capital markets after a debt crisis? What is the evidence of spillovers to the domestic financial sector? We address these questions mainly by summarizing the related literature, in particular insights of research of the past few years.

Our 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, we

provide new descriptive evidence and historical data, in a field in which data are notoriously scarce. It should also be underlined that our insights are based on developing country experiences and may, therefore, 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.

II. OVERVIEW AND BASIC CONCEPTS

A. 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 (LMOs) aimed at improving the profile of public debt, such as debt swaps, which could occur in normal times (see 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 (involving a halt of all debt payments to creditors). In most cases, restructurings occur after a default, and are known as post-default restructurings. However, recent years have also seen a number of preemptive debt restructurings, where outstanding debt instruments are exchanged before the government misses any payments.

Relatedly, the concept of a “credit event” has gained increasing attention in recent years and is mostly used in the context of credit default swaps (CDS), which have grown in importance in recent years. Importantly, 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

¹ It should be noted that different loan agreements may have different definitions of “events of default”.

Association (ISDA) considers a restructuring a credit event only if: (i) it occurs as a result of deterioration in the creditworthiness or financial condition of the sovereign; and (ii) it is “binding on all holders” (i.e., applies in mandatory form to all bondholders of a series).² These criteria apply irrespective of whether the debt restructuring is pre- or post-default.

B. How often was Sovereign Debt Restructured?

According to a new database by Trebesch (2011), sovereign debt restructuring episodes have been widespread around the world, with more than 600 individual cases in 95 countries during the past 60 years alone. 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 LICs often proceeded differently from those in EMs, including through official debt relief initiatives, which makes their experience less relevant for EMs. 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, while 168 affected bank loans;
- 57 involved a cut in face value (debt reduction), while 129 implied only a lengthening of maturities (debt rescheduling);
- 109 cases occurred post-default, while 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 re-entered the sovereign debt universe only after the Brady plan of the mid-1990s (see Box 1 below). Since 1998, with the debt crises in Pakistan, Russia, and Ukraine, there have been 18 sovereign bond exchanges with foreign bondholders. 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), Argentina (2001), Uruguay (2003), Dominican Republic (2005), and Jamaica (2010). Some of these exchanges were implemented in parallel to debt restructurings with foreign creditors, with Jamaica (2010) involving only domestically issued and held debt.

C. Determinants of Restructurings and Defaults

A wide range of factors have contributed to default. Most defaults and restructuring episodes

² While most CDS contracts rely on the form ISDA agreement (and, therefore, would rely on ISDA’s determination of a credit event), there exist bilateral contracts that can in some instances be different.

were triggered by one or more of the following factors: (i) a worsening of the terms of trade; (ii) an increase in international borrowing costs (e.g., due to tighter monetary policy in creditor countries); (iii) consistently poor macroeconomic policies, leading to built up of vulnerabilities; and (iv) a crisis in a systemic country that causes contagion across goods and financial markets (Sturzenegger and Zettelmeyer, 2006, Manasse and Roubini 2009).

Additional factors include macroeconomic volatility (Catao and Kapur, 2006); banking crises and related contingent liabilities (Reinhart and Rogoff, 2011), and political and institutional factors (Kohlscheen, 2007; van Rikceghem and Weder, 2009). From a more 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 to GDP without defaulting.

Market perception, too, may have influenced the timing and occurrence of sovereign debt restructurings. When markets perceive a government as less likely to repay in the future, this can rapidly raise its borrowing costs and, therefore, the likelihood of default. Common risk indicators include secondary market bond and sovereign CDS 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 than to halt payments. This risk is especially high when governments face large rollover risks (Detragiache and Spillimbergo, 2001).

The structure of the debt portfolio has also impacted 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, as well as solvency conditions and, therefore, 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. While often the decision to restructure or not depends on a combination of factors, the following considerations are broadly valid regarding each of these factors:

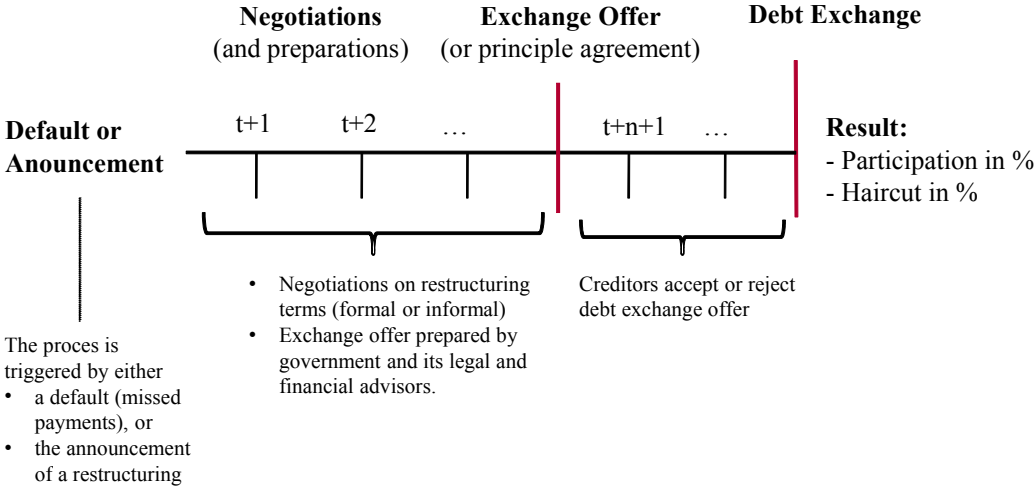
- *Currency composition.* Debt issued in foreign currency makes sovereigns vulnerable to exchange rate shocks and currency mismatches because governments typically collect most of their revenue in domestic currency.
- *Floating rate debt.* A high share of floating rate debt can increase the likelihood of severe debt distress due to the impact of interest rate shocks on countries’ average borrowing costs.
- *Maturity structure.* Longer average maturity implies less rollover risks and, therefore, a lower likelihood of debt distress when credit markets shut down.

- *Creditor composition.* In addition to being more challenging politically, restructuring of mostly domestically- (as opposed to externally-) held debt may lead to a pile-up of contingent liabilities and bank bailouts. A decision to restructure may also depend on the share of debt held by official (bilateral) creditors and/or multilateral creditors, as these creditors may be approached in a different way than banks or private sector bondholders (see next section).

III. THE PROCESS OF RESTRUCTURING SOVEREIGN DEBT

This section presents key elements in the process of restructuring sovereign bonds and loans. For illustration, Figure 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 renegotiations 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 a forum to communicate key financial data and the government’s fiscal and debt management plans.

Figure 1: Stylized Timeline of a Sovereign Debt Restructuring



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 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/or the existence of a sinking fund);
- Interest rate and coupons (fixed versus flexible, and/or the existence of step-up or linked features);
- Currency of denomination of the instruments (local versus foreign currency);
- Enhancements, including embedded options or collateral; and
- Legal clauses, including CACs and non-default clauses, and the ability to include exit consents (see section V.B for details).

The verification of claims allows countries to ascertain their debt stock, debt-service profile, and the value of debt instruments. This lays the foundations for the next crucial procedural step, a detailed debt sustainability analysis, which provides an indication of the financing gap, the 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, they 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 into new debt puts the country 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 there are many examples in which sovereigns implemented a series of subsequent restructurings, in particular during the 1980s debt crisis.

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

Table 1 summarizes the differences in negotiation settings across creditors. Note that the restructuring of supplier and trade credits is not discussed in detail, as it usually takes place on an ad hoc basis or is excluded from the restructuring exercise. We also do not discuss the recent Heavily Indebted Poor Country (HIPC) initiative or the Multilateral Debt Relief Initiative

(MDRI) to coordinate debt relief to the poorest countries (for more details on the HIPC and MDRI, see IMF and World Bank, 2009).

Table 1: Overview of Debt Restructuring Vehicles by Type of Creditor

Sovereign Debt Restructuring by Type of Creditor					
<i>Creditor</i>	Commercial Banks	Bondholders	Bilateral (Governments)	Multilateral (World Bank, IMF)	Suppliers, Trade Creditors
<i>Restructuring Vehicle</i>	London Club (Creditor Committees)	Exchange Offers	Paris Club	Preferential Treatment; Debt relief only for poorest countries	Ad hoc

A. Restructuring Bilateral Debt: The Paris Club

The Paris Club is the main institutional framework to restructure external bilateral sovereign debt, referring to 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 to resolve 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 (“London Club”), 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

³ Currently, the permanent members of the Paris Club are: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, Norway, Russian Federation, Spain, Sweden, Switzerland, United Kingdom, and United States of America.

with a group of its creditors at the Paris Club so as to come to an agreement on broad restructuring terms. 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 the debt relief granted in Paris Club restructuring depends on whether the country is a low income country (LIC) or not, and is often based on the financing gap identified in the related IMF program. Since the 1980s, there has been a clear trend towards granting more debt relief and increasingly concessional terms with regard to LICs. 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 foresees equal burden sharing across all creditor groups, in particular private creditors (banks, bondholders and suppliers), 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 to the country in question. As highlighted by the IMF (2001a, p. 43), “comparability of treatment is more an art than a science” and it is ultimately the Paris Club that must judge whether any agreement with banks or bondholders has comparable terms or not. 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, also because Paris Club agreements often precede restructurings with other creditors. Two recent examples are the Eurobond exchanges of Pakistan 1999 and the Dominican Republic 2005, which were at least in part motivated by the comparability of treatment clause. In the case of Pakistan, 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 to GDP and was thus too small to have a sizable impact on debt sustainability. Despite this, the

⁴ For example, Iraq received 100 percent debt relief from Cyprus, Malta, Slovak Republic, and the United States under bilateral agreements, while the “agreed minutes” required only 80 percent debt relief.

Paris Club required the government of Pakistan to show signs of “progress” in bondholder negotiations (see Sturzenegger and Zettelmeyer, 2006, p. 141).

B. 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.⁵ 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 is the Bank Advisory Committee (BAC), or Creditor Committee. The BAC is a group of 5–20 representative banks which negotiate on behalf of all banks affected by the restructuring. Its key aim 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 banking committees are usually senior officials of those banks with the largest exposure to the sovereign.⁶ 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 tend to proceed as follows: In the early stage of financial distress, a debtor government contacts 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 their major creditors, as most lending took place via syndicated loans and there was barely any trading on secondary markets. Also, banks were well informed about who held the debt, so that communication was easier than in today’s more 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

⁵ As highlighted by Rieffel (2003, p. 108) the origins of the “London Club” label remain obscure. The term is to some degree misleading, as 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 work-out negotiators.

the restructuring of loans with maturity prolongation and/or outright reductions in face value. The BACs were thus a key vehicle to address both the liquidity and solvency problems of sovereigns in distress.⁷

A key milestone for debt restructurings in the London Club process is the “agreement in principle”, which was signed between the representative BAC banks and government officials, once the main restructuring terms had been agreed. 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 restructuring 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 3 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 U.S. 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, Citibank in Chile in 1987 and in the Philippines in 1986). A further repeated problem was disagreement over the composition and leadership of creditor committees (e.g., in Algeria in 1994, 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 the signature of some 30,000 documents in up to eight international financial centers (Financial Times, September 2, 1983). 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.

Box 1: The Brady Plan

By the late 1980s, many developing countries 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. In this situation, the Brady plan constituted a major policy shift,

⁷ Much of the work was done by legal advisers 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, or subcommittees specially negotiating over trade financing or interbank credit lines.

⁸ This 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 by a group of banks not in the committee, so as to convince them to sign up for the deal (see Rieffel, 2003, p. 122). This was not always successful.

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 US Treasury bonds. The issuance of new tradable instruments amounting to several billions of US\$ created a liquid secondary market for emerging market 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, e.g., 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, namely Argentina, Bolivia, Brazil, Costa Rica, Dominican Republic, Ecuador, Mexico, Panama, Peru, Uruguay and Venezuela. The other six countries were Bulgaria, Côte d'Ivoire, Jordan, Nigeria, Philippines, Poland and Vietnam.⁹

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, the authors argue that debt relief can be efficient, particularly in countries that face a debt overhang problem and which 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. Relatedly, 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).

⁹ Originally, also Morocco was supposed to implement a restructuring under the umbrella of the Brady initiative in the early 1990s. This, however, did not occur because the government did not fulfill the requirements of a related IMF agreement.

In recent times, the experience with bank debt restructuring has been mixed. Those of Pakistan (1999) and the Dominican Republic (2005) could be implemented quickly and after 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 era debt, a process that took more than two years.¹⁰ 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, as creditors moved to exchange their debt on a bilateral basis. Also the process of external bond restructuring was 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 which were not represented in the banking committee (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.

C. 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 CDSs 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 in identifying and reaching 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.

¹⁰ Iraq reopened the private debt exchange of 2006 (so-called 688) in 2008 to try to cover the rest of 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, there is still some remaining unresolved debt.

Bondholder structure

The key difference between sovereign bond and bank debt restructurings is the creditor structure, which tends to be much more dispersed, especially if bonds were sold to retail investors. Indeed, some bond restructurings of recent years, 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 recent 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 mostly held 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 it can be difficult to identify bondholders and to communicate with them, especially if they are retail investors. The main challenge in this regard is that bond trading occurs over the counter and no central agency registers the holders of bonds at each point in time. Governments undergoing a bond restructuring, therefore, need to identify the holders of bonds to initiate a form of dialogue with them.

In some cases, bondholder consultations have been extensive, to a degree that the exchange offer is 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), Moldova (2002), Ukraine (2000), Grenada (2005), Belize (2007), Seychelles (2009), and Jamaica (2010). A popular communication strategy is roadshows, in which 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 a further popular vehicle to keep investors informed.

On the creditor side, large, representative bondholder groups were formed only in a minority of recent cases, notably in Argentina (2005), Grenada (2005), and Belize (2007).¹¹ 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

¹¹ There were small bondholder groupings in the Dominican Republic 2005 and the Seychelles 2009 representing only a minority of bondholders. In Ecuador 1999, the government convened the “Creditor Consultative Group” consisting of 8 major debt investors, which however held only two meetings.

recognized by the Argentinean government. In Belize (2007) and Grenada (2005), creditor committees consisted of only a few major financial institutions (13 and 7, respectively), but these did represent 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 upfront 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 Argentinean exchange. Liquidity risk can also generate incentives. Many governments exchange an array of old instruments into a small set of new bonds, e.g., 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. Also, regulatory sweeteners can 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 to generate incentives for participation is to design a menu of exchange options. This means allowing investors to choose among different new instruments when tendering their old claims, thus accounting for differing preferences across creditors. Lim et al. (2005) underline that retail investors tend to 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 have a preference for bonds with a principal haircut but a combination of shorter maturities and higher coupons.

Exchange offers can also contain “stick” features, which are intended to make the outstanding bonds less attractive. Stick features can be agreed upon by participating creditors via exit consents, a legal vehicle that allows the removal of clauses from the old bonds, such as cross-acceleration clauses or the listing requirement. This will effectively reduce the value of the old bond and central bank acceptance as eligible collateral after the exchange and, thereby, encourage bondholders to accept the offer. Overall, the case evidence provided by Andritzky (2006), Enderlein et al. (forthcoming), Rieffel (2003) or Roubini and Setser (2003) 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). Interestingly, 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, sweeteners are therefore sometimes offered only until a certain deadline (e.g., in Uruguay 2003).¹² To achieve higher participation, the exchange deadline is often extended by a few days or weeks. This was the case in all three of Ukraine's debt exchange offers (1998, 1999, and 2000) and in Dominica in 2004, where the deadline of its bond exchange was extended twice and by more than four months. Another way to spur higher participation is via legal means, especially via collective action clauses that ease the restructuring of bonds.

IV. STYLIZED 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 restructurings cases, like haircut size and the duration of renegotiation, we compare the experiences of restructuring domestic debt versus foreign debt and discuss the relevance of legal clauses in recent exchange operations.

A. Main Characteristics of Debt Restructurings since 1998

Table 2 provides an overview of main bank and bond debt exchanges in EM economies involving foreign creditors that took place since the Brady deal, sorted by the date the restructuring was announced. From the literature and data cited therein, we can summarize the following stylized facts:

First, we find that most recent EM sovereign bond restructurings were implemented within a short time period. Of the 18 episodes listed in Table 2, seven restructurings took one year or less to complete. More generally, we find a large variation in the duration of renegotiation: In some cases, such as Jamaica (2010), Uruguay (2003) or Pakistan (1999), restructurings occurred at record speed, i.e., in only three or four months. Other restructurings, such as Argentina (2001–2005), took years to resolve. However, as shown by Trebesch (2010) the average duration of renegotiation has decreased compared to earlier decades: Bond debt exchanges since 1998 took an average of only 13 months. This is less than half the average duration of bank debt restructurings for the 1980s and 1990s, which took more than 30 months, on average.

Second, we find that the range of creditor losses (or "haircuts") shows a large variation, ranging from an estimated 5 percent (in Dominican Republic, 2005) to nearly 90 percent (in

¹² The same logic applies 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.

Iraq, 2006) reduction in NPV. The reported estimates are taken from a new dataset by Cruces and Trebesch (2011) 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 (2011) follow the methodology suggested by Sturzenegger and Zettelmeyer (2006, 2007), which compares the present value (PV) of new debt instruments in the exchange with the PV of the old outstanding debt (including past due interest) discounted at imputed exit yields.

Third, the number of debt restructuring episodes with face value reduction (nominal debt write-downs) has notably increased since the late 1980s. A reason for the increase in frequency of face value reductions is that bank and bond debt exchanges now often involve a menu of options, which explicitly includes the face value reduction option. Cuts in face value ranged from 0–82 percent of total debt affected.

Fourth, we find that post–default restructuring cases on average show a higher NPV haircut than preemptive restructuring cases (see Asonuma and Trebesch 2012).¹³ Post-default cases also take longer to resolve, on average.

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

¹³ This is consistent with Finger and Mecagni (2007).

Table 2. Characteristics of Main Sovereign Debt Restructurings with Foreign Banks and Bondholders (1998–2010)

Case	Preemptive or Post-Default?	Default Date	Announcement of Restruct.	Start of Negotiations	Final Exchange Offer	Date of Exchange	Total Duration (Months)	Debt Exchanged in m US\$	Cut in Face Value	Haircut Estimate (Cruces/Trebesch)	Discount Rate (Cruces/Trebesch)	Outstanding Instruments Exchanged	New Instruments
Pakistan (Bank Loans)	Post-Default	Aug-98	Aug-98	Mar-99	May-99	Jul-99	11	777	0.0%	11.6%	0.132	Trade credits and debt arrears	1 Loan
Pakistan (Ext. Bonds)	Preemptive		Aug-99	Sep-99	Nov-99	Dec-99	4	610	0.0%	15.0%	0.146	3 Eurobonds	1 Eurobond
Ukraine (Ext. Bonds)	Preemptive		Dec-99	Jan-00	Feb-00	Apr-00	4	1,598	0.9%	18.0%	0.163	3 Bonds, 1 Loan	1 Eurobond
Ecuador (Ext. Bonds)	Post-Default	Aug-99	Jul-98	Sep-99	Jul-00	Aug-00	25	6,700	33.9%	38.3%	0.173	4 Brady Bonds, 2 Eurobonds	2 Eurobonds
Russia (Bank Loans)	Post-Default	Dec-98	Sep-98	May-99	Feb-00	Aug-00	23	31,943	36.4%	50.8%	0.125	PRINs, IANs, debt arrears	1 Eurobond
Moldova (Ext. Bonds)	Preemptive		Jun-02	Jun-02	Aug-02	Oct-02	4	40	0.0%	36.9%	0.193	1 Eurobond	1 Eurobond
Uruguay (Ext. Bonds)	Preemptive		Mar-03	Mar-03	Apr-03	May-03	2	3,127	0.0%	9.8%	0.090	18 Ext. Bonds	18 + 3 New Benchmark Bonds
Serbia & Monten. (Loans)	Post-Default	since 1990s	Dec-00	Sep-01	Jun-04	Jul-04	44 (since announcement)	2,700	59.3%	70.9%	0.097	Bank Loans, Arrears	1 Eurobond
Dominica (Bonds/Loans)	Post-Default	Jul-03	Jun-03	Dec-03	Apr-04	Sep-04	15	144	15.0%	54.0%	0.092	2 Bonds, short- and medium-term Loans	3 Bonds
Argentina (Ext. Bonds)	Post-Default	Jan-02	Oct-01	Mar-03	Jan-05	Apr-05	42	60,572	29.4%	76.8%	0.104	66 US\$ and AR\$ denominated Bonds	5 US\$ and AR\$ denominated Bonds
Dom. Rep. (Ext. Bonds)	Preemptive		Apr-04	Jan-05	Apr-05	May-05	13	1,100	0.0%	4.7%	0.095	2 Bonds	2 Bonds
Dom. Rep. (Bank Loans)	Post-Default	Feb-05	Apr-04	Aug-04	Jun-05	Oct-05	18	180	0.0%	11.3%	0.097	Bank Loans, Arrears	1 Loan
Grenada (Bonds/Loans)	Preemptive		Oct-04	Dec-04	Sep-05	Nov-05	13	210	0.0%	33.9%	0.097	5 Ext. Bonds, 8 Dom. Bonds, 2 Ext. Loans	1 US\$ Bond and 1 ECS Bond
Iraq (Bank/Comm. Loans)	Post-Default	since 2003	in 2004	Jul-05	Jul-05	Jan-06	20 (since announcement)	17,710	81.5%	89.4%	0.123	Loans, Supplier Credit, Arrears	Mostly Cash, 1 US\$ Bond, 1 Loan
Belize (Bonds/Loans)	Preemptive		Aug-06	Aug-06	Dec-06	Feb-07	6	516	0.0%	23.7%	0.096	7 Bonds, 8 Loans	1 Bond
Ecuador (Bond buy-back)	Post-Default	Dec-08	Jan-09	no neg.	Apr-09	June/Nov-09	12	3,190	68.6%	67.7%	0.130	2 Eurobonds	None (cash settlement)
Seychelles (Ext. Bonds)	Post-Default	Jul-08	Mar-09	Mar-09	Dec-09	Feb-10	19	320	50.0%	56.2%	0.107	1 Ext. Bond, 2 Ext. Loans, Notes	1 Bond
Cote D'Ivoire (Ext. Bonds)	Post-Default	Mar-00	Aug-09	Aug-08	Mar-10	Apr-10	21 (since announcement)	2,940	20.0%	55.2%	0.099	2 Brady Bonds, Arrears	1 Bond

Note: Debt exchanged refers to effective old debt exchanged in the deal, not eligible debt. Similarly, we only list old and new instruments that were actually exchanged. Sources: Cruces and Trebesch (2011), Trebesch (2011) and sources cited therein. The data on preemptive vs. post-default restructurings is from Asonuma and Trebesch (2012).

B. Domestic versus External Debt Restructurings

Recent case studies show that the negotiation process and the basic restructuring mechanics are very similar when comparing domestic debt restructurings to external debt restructurings (see Erce and Diaz-Cassou, 2010, and Sturzenegger and Zettelmeyer, 2006). 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. Furthermore, exchange rate considerations and currency mismatches play a lesser role in domestic debt than in external debt restructurings.¹⁴

Another difference is the duration of renegotiations. Since 1998, domestic debt restructurings were implemented in less time than external debt restructurings. Argentina's domestic debt was restructured in November 2001, while the external bond exchange took four more years. Russia's domestic GKO bonds were restructured within six months (between August 1998 and March 1999), while 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 non-resident 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, there have been instances of differential treatment of domestic versus 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 non-residents, but not medium- and long-term domestic debt. In a similar vein, Ecuador's (2008–2009) default and debt buyback only affected two outstanding international bonds, but no domestic debt. The Jamaica (2010) restructuring is the opposite case, where externally issued Eurobonds were excluded from the restructuring.

C. 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, so as 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 (see e.g. Krueger, 2002). Intuitively, large

¹⁴ Domestic debt can also be denominated in foreign currency.

bondholder groups may find it harder to coordinate and agree on a deal, compared to a small group of commercial banks in the London Club process.

However, as shown above, bond restructurings since the 1990s have been quicker to implement than the bank debt exchanges of the 1980s. In addition, participation rates in sovereign bond exchanges were very high, on average, surpassing 90 percent in most recent sovereign bond exchanges (see Das et al. 2012). Relatedly, 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 indicating 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 section III-B. above).

The problem of creditor litigation has not been pervasive either. Case numbers in the context of sovereign defaults or restructurings have been increasing, also because changes in legal doctrine and the emergence of the so-called “vulture” creditors. But the total number remains low, with only 108 individual litigation occurrences since 1980 (see Enderlein, Schumacher and Trebesch, 2012). Moreover, the number of litigation “successes”, i.e., settlements or successful attachments of sovereign assets, remains very small. This is perhaps explained by the costly nature of holdout strategies and litigation and the need for specialized knowledge to carry out these strategies. In particular, litigation is cumbersome because sovereign debt is typically not backed by any collateral and there are few attachable government assets located outside national borders that could potentially be seized.

Taken together, these facts indicate that creditor coordination and holdouts may be less of a problem than commonly believed. Bi, Chamon and Zettelmeyer (2011) develop a related model, which 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.

Nevertheless, there are outlier cases. The global bond exchange in Argentina (2005) and the restructuring in Dominica (2004) are two recent cases that had a large share of holdout creditors and difficulties in re-accessing international capital markets after the exchange.¹⁵ 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, in turn, launched a new public exchange offer in April 2010, which achieved a 66 percent participation rate, thereby

¹⁵ In the case of Dominica, the holdouts were mainly linked to three institutions, while in Argentina they included thousands of investors, including many retail bondholders. The latter were hard to identify and prone to litigate, and asked for special treatment.

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.

D. Legal Remedies and Clauses

A bond's governing law plays a major role for debt restructurings as it predefines the contractual provisions for restructuring as well as the jurisdiction for potential litigations. 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 looks different for the European Union (EU) countries where since 2003 public bonds have been predominantly issued under domestic laws. An important dimension where the governing law makes a difference 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.

While the inclusion of Collective Action Clauses (CACs) has been the norm under English Law, their use has widened in recent years.¹⁶ It is often argued that the presence of CACs can facilitate creditor-debtor negotiations in a restructuring situation, since 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.¹⁷

Mexico was the first country to include CACs in its sovereign bond issue in the New York market in February 2003.¹⁸ Other countries quickly followed suit, including Uruguay and Brazil (April 2003), 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 internationally issued bonds to include CACs (ECFIN, 2004).¹⁹

The triggering of CACs in past debt restructuring episodes was not common and in the cases they were triggered the results were mixed. One example of a successful application is Ukraine (2000), where the authorities took advantage of CACs in the three Eurobonds governed under

¹⁶ In general, CACs cover the following two broad categories: (i) "*majority restructuring*" provisions, which allow a qualified majority of bondholders of an issuance to change the bonds' financial terms and to bind in all other holders of that issuance, either before or after default; and (ii) "*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 announcement of minimum participation thresholds were used as another mechanism to solve coordination problems.

¹⁸ In addition to the Fund (the role of which in this regard will be discussed in an upcoming joint SPR, MCM, and LEG paper), the official sector (e.g., the Group of Ten (1996, 2002), G7, as well as the US Treasury), had promoted a more widespread use of CACs (Taylor, 2002).

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

Luxembourg law. This helped in the implementation of the restructuring and eliminated potential holdout problems.²⁰ Also in the case of Moldova (2002) and Uruguay (2003), CACs under English law contributed to a quick restructuring. CACs were also embedded in some of the instruments exchanged by Dominica (2004)²¹ and Argentina (2005), but they did not prevent the serious holdout problem both countries faced after the 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 exchange of a sovereign bond issued under New York law (see 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.²² The use of exit consents in Ecuador was perceived as part of a "take-it or-leave-it" strategy, while in Uruguay participants could opt out of the exit consents (IMF, 2003, p. 23).²³ Use of other (e.g., aggregation, acceleration, cross-default, and cross-acceleration) clauses in recent restructuring episodes has been limited (see Annex for the definition of these clauses).

More recently, non-payment terms have been 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 has not taken place. Furthermore, it should be underlined 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, 2001b, for more details).

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 insured 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, 2001b 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.

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, 2001b, 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>).

V. IMPLICATIONS FOR THE REAL AND FINANCIAL SECTOR

A. Macroeconomic Implications of Debt Restructuring

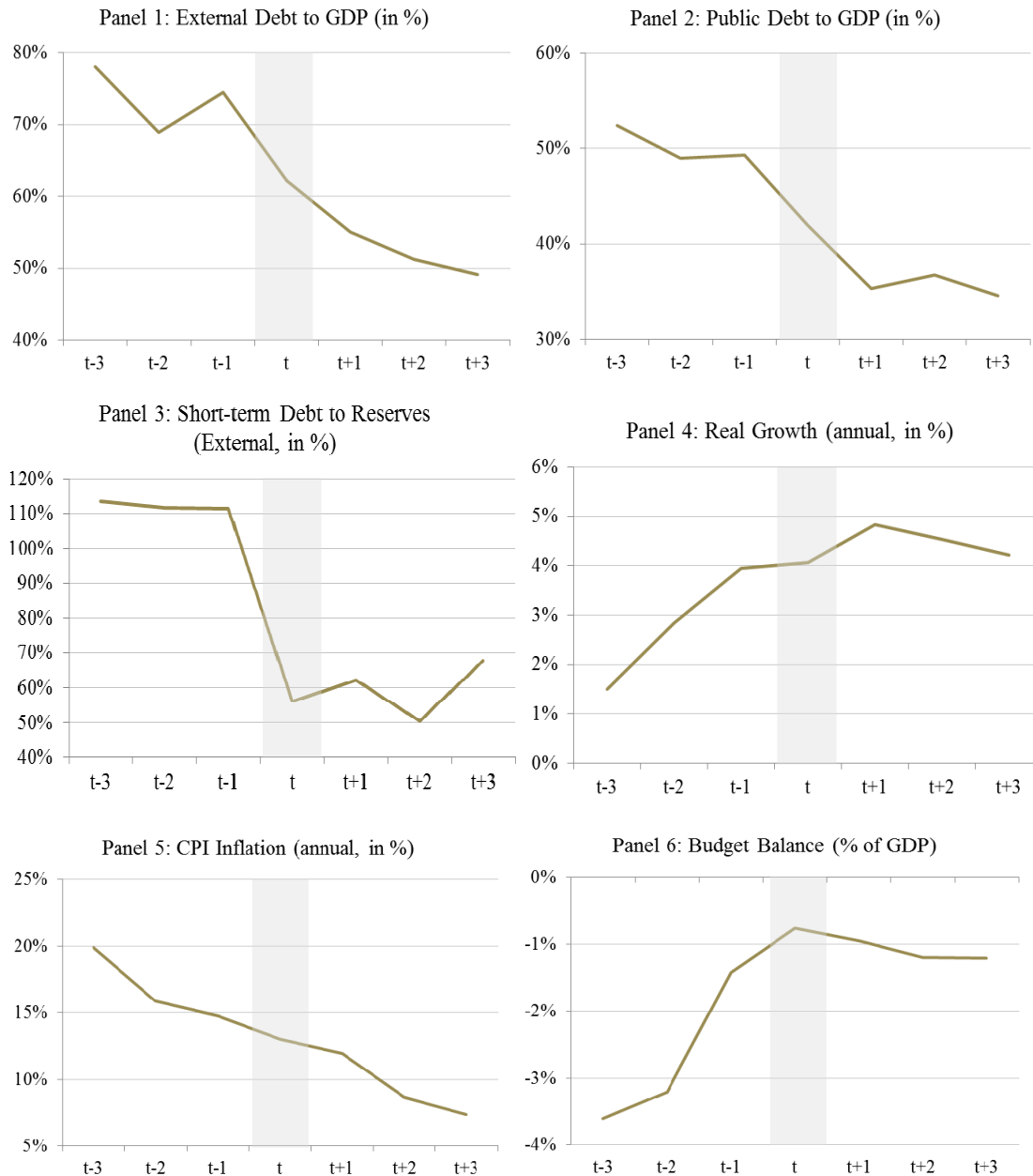
How did financial and macroeconomic conditions evolve around debt restructuring episodes? We address this question briefly by plotting median values of a set of variables for a six-year interval around debt restructuring years. The result is shown in Figure 2 below, with exact annual figures shown in the Appendix of Das et al. (2012). When interpreting these figures, it is important to underline once more that a restructuring can occur many years after the first payment default of a country. In fact, restructuring episodes often mark the end of a crisis and not its beginning (see also Levy-Yeyati and Panizza, 2011).

As expected, restructuring periods are associated with a notable drop in total public debt to GDP, from a median of over 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 below 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 just over 55 percent in a single year.

Moreover, macroeconomic conditions also improved post restructuring. Median real growth was only around 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, the median inflation decreased from around 20 percent three years before restructuring to just 7.5 percent three years after restructuring. However, the median budget balance improved substantially prior to restructuring (Figure 2, panel 6).

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 prior to a domestic default is 4 percent, compared to only 1.2 percent in the year before external defaults.

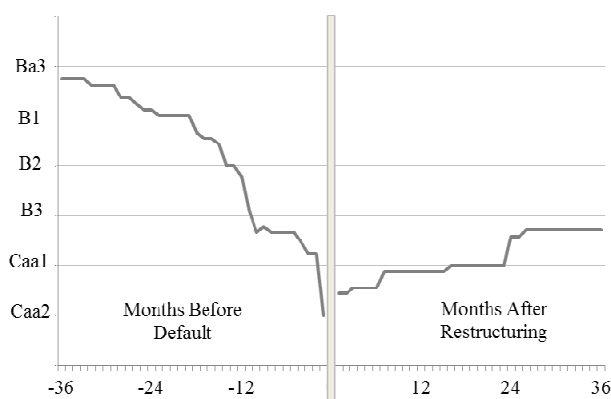
Figure 2: Financial and Macroeconomic Indicators in Restructuring Periods



Note: The Panels plot median values for a six-year time interval around the restructuring year. The sample considered here covers 44 “final restructurings” with banks and bondholders since the 1980s and excludes low income and highly indebted poor countries as defined by the World Bank. The data are taken from the IMF’s IFS dataset, from the World Bank’s GDF and WDI datasets, and from country data by the Economist Intelligence Unit. External debt to GDP covers both public and private external debt.

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

Figure 3. Ratings Evolution During Sovereign Restructuring Episodes



Note: Ratings evolution over time, averaged across the following nine recent bond restructuring episodes: Pakistan (1999), Ecuador (1999 and 2008), Argentina (2001), Moldova (2002), Uruguay (2003), Dominican Republic (2005), Belize (2006), and Jamaica (2010).

Relatedly, credit ratings deteriorate notably prior to a default, while improving only slowly in the aftermath of debt restructurings. Figure 3 shows the evolution of Moody's ratings across nine recent bond restructuring episodes (for which ratings data was available). Ratings decline markedly, by more than four notches in the three years prior to a sovereign default event, and started to recover after restructurings, 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 prior to the default or restructuring event. One notable outlier is Uruguay, which had investment grade status (Baa3) up to March 2002 and restructured its debt only 14 months later.

While largely depending on the specifics of individual cases, market access has typically been restored in a relative short period after debt restructuring. Gelos, Sandleris, and Sahay (2011) show that most defaulters regain access to new credit within one or two years after a crisis. The authors also show that the period of exclusion from capital markets during recent restructuring

episodes has considerably shortened compared to the 1980s. The case of Argentina perhaps remains the most extreme, where the country has not been able to access the global markets since its 2001 default. Ecuador is a case of a protracted loss of access to international financial markets, where it took the country five years (in 2005) after restructuring to regain access.

However, post-restructuring 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). More recent work, however, shows that the impact on market access post-restructuring may depend significantly on the outcome of the restructuring process. Cruces and Trebesch (2011) show that greater haircuts are associated with much larger post-restructuring bond spreads, after controlling for fundamentals as well as 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.

B. 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. This 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 position. Altogether these factors may impair the financial position of domestic institutions to a degree that it threatens financial stability and raises pressures for bank recapitalization and official sector bail-outs.

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 currency mismatches on their balance sheets. This resulted in insolvency and default of some banks on their external obligations. In Ecuador, the sovereign default had already 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 recent 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. In the event, 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, be it directly via loss of value of government securities or indirectly via their exposure to the banking sector of that country. Among the larger recent restructuring episodes, German banks and funds were most heavily exposed to the Russian default of 1998, while the U.S. financial institutions and European retail investors were most affected by the Argentinean default and debt exchange of 2001 to 2005.

VI. CONCLUSION

This paper has reviewed historical experience with debt restructuring episodes and summarizes a number of lessons based on EM country experience over the past two decades. A number of factors can be identified that appear to have played a role in determining the outcomes of the restructuring process. These can be summarized as follows:

- It seems that “twin restructurings” of external and domestic debt have become the norm in recent years.
- Despite lengthy negotiations and delays in many debt restructuring cases, creditor coordination and holdouts have not generally been a major problem.
- Bond restructurings have on average been quicker to implement than bank debt exchanges and participation rates have often exceeded 90 percent, even with dispersed bondholders.
- Creditor characteristics did not appear to play a major role in the duration of debt restructuring, although there is evidence that domestic restructurings were implemented in less time than external restructurings.
- Some features embodied in the bond contracts (e.g., CACs and other legal clauses) appeared to facilitate 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, post-restructuring access could come at a cost, as defaults affect credit risk spreads. Greater haircuts were associated with larger post-restructuring bond spreads, with the effect slowly decreasing overtime.

- 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 emerging market countries, these experiences may also prove useful to any distressed country, including advanced economies.

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