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The Need to Strengthen the Sovereign Debt Restructuring Mechanism[1]

—A reference to Argentina's recent debt restructuring —

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1. Introduction

Through 2003 and the first half of 2004 the world economy has been growing at the fastest rate seen in three decades. Emerging-market economies have been growing quickly, surpassing the average growth rate of OECD countries, while financial crises have been absent in recent years. Emerging-market bond spreads have also been quoted at their lowest in recent years.

Under the generally favorable circumstances for emerging-market economies, Argentina has struggled to resolve a three-year-old default on its sovereign debts. Targeted for restructuring is US$104.1 billion owed to private creditors, consisting of principal (US$81.8 billion) and overdue interest (US$22.3 billion). The restructuring of sovereign debt involves more than a half-million individual investors, and more than 100 institutional investors, holding 152 different bond issues in seven currencies governed by eight jurisdictions. The government's debt restructuring exercise started on September 22, 2003, in Dubai, when Argentina formally announced its intention to propose a 75-percent reduction of the debt's face value. After sixteen months of strenuous preparations, the government finally launched an exchange offer in January this year, proposing an approximately 66-percent debt reduction on a present value basis.

The main characteristic of the Argentine restructuring was that the exchange offer was made unilaterally, and on the terms solely determined by the government, without negotiations with the representatives of such creditors as the Global Committee of

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Argentina Bondholders (GCAB).[2] Creditors were simply asked to "take it or leave it," and provided with information on the economy by the Argentine government. Since the IMF stand-by agreement was suspended and the IMF conditionality exercise was not functioning, creditors could not obtain information and analysis on such critical issues as long-term debt sustainability, primary budget surplus, and Argentina's capacity to pay.

The Argentine debt exchange appears to be an isolated case, as it has so far not had a negative impact on the bond markets of emerging-market economies. Argentina's case nonetheless has the potential to become a precedent for future sovereign debt restructuring, unless it is dealt with properly by the IMF. There have already been some movements in some countries which appear to have been influenced by the Argentina case: in Nigeria, the House of Representatives reportedly passed a resolution asking President Olsegun Obasanjo to repudiate the country's US$35 billion foreign debt; in the Philippines, a proposal was reportedly made by a senator to impose a unilateral moratorium, though this proposal was immediately rejected by the government.

This paper discusses the way to interpret the outcome of the exchange offer, the implications of Argentina's restructuring on the international financial system, and the role of the IMF.

2. Outcome of the Exchange Offer

On March 18 the government announced that eligible creditors holding approximately 76.15 percent of the aggregate eligible amount of defaulted debt had accepted the exchange offer proposed by the government.

	(millions of dollars)
Total amount of affected debts (principle)	81,836
Acceptance	62,318(76.15%)
Amount of new bonds to be issued	35,261
Par bonds	15,000
Discount bonds	11,932
Quasi-par bonds	8,329

The government will issue new bonds of US$35.3 billion in exchange for old bonds of US$62.3 billion that were tendered, while approximately US$19.6 billion of old defaulted bonds remain outstanding[3].

After obtaining an acceptance rate of slightly more than three-quarters of total affected debts, Argentina has claimed that the exchange offer was a success and that the

[2] The GCAB was formed in January 2004, consisting of members representing global bondholders in North America, Europe, and Japan, holding approximately US$37 billion in debt. Its objectives are to facilitate good-faith, market-based, equitable restructuring of Argentina's defaulted debt.

[3] New bonds are as follows:

Par bonds: due 2038, entailing full claims on principal

Discount bonds: due 2033, entailing a reduction of about 66 percent of principal

Quasi-par bonds: due 2045, entailing a reduction of about 30 percent of principal default is over. The outcome needs to be considered carefully, however, taking the following into consideration (among other issues).

- The debt exchange was proposed unilaterally by Argentina, without negotiations with its private creditors.
- The government deliberately used such tactics as, in particular, the threat not to honor those creditors who failed to tender the offer within the tender period that ended on February 25. Many creditors were forced to tender the offer, because of the fear that they might lose all their claims. Adding to this, worried that the acceptance rate of the exchange offer might not reach a desirable level, the government enacted a law in February that would prohibit itself from reopening the debt exchange offer after it expired on February 25. The ruling by the Congress made creditors feel they had to accept the offer.
- A large number of investors who did not accept the exchange offer were left holding approximately US$19.6 billion of defaulted debt, which implies that the default situation has not been remedied yet. Lawsuits against Argentina—such as a class-action suit in the US Southern District of New York court—by creditors will continue to be prosecuted. They are not considered to be holdouts, but rather legitimate investors who are trying to protect their rights. If Argentina's government does not honor the remaining creditors, it will be tantamount to a repudiation of its debt. This should be forcefully dealt with by the IMF, since this involves a serious systemic issue caused by a sovereign government.
- Although the acceptance rate appears high, many investors, particularly retail investors, sold their bonds to institutional investors during the offering period, because they did not want to hold new bonds.
- As a result of the exchange offer, it is estimated that Argentina will be able to reduce its external debt from US$165.6 billion as of December 2003, to US$142.7 billion in December 2005, which includes the bonds worth US$19.6 billion which failed to be tendered.[4] Accordingly Argentina's debt-to-GDP ratio would drop from 127.9 percent in December 2003, to 80.7 percent in December 2005, which is still higher than the estimated 30.4 percent for Brazil and the 53 percent for Turkey in December 2005[5].

3. Creditors' Response to the Exchange Offer

The bondholders of Argentina creditors are distributed among three regions.

Europe: Investors are mostly retail investors with some offshore private banking. There is a large concentration of retail investors in Italy, Germany, and Switzerland.

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4 Institute of International Finance (IIF) Country Report Argentina.

5 All figures for Argentina, Brazil, and Turkey are from the IIF, and figures for December 2005 are IIF forecasts.

North and South America: In the United States, investors are mostly institutional investors. In Argentina, investors are mostly pension funds and banks.

Asia: Investors are mostly Japanese, evenly distributed between retail individuals and institutional investors.

The largest group of creditors is Argentinean, mostly pension funds and banks, occupying about 38.4 percent of the total. Their participation in the debt exchange is not considered to be voluntary, but accommodative to the government's debt proposal. The second-largest is a group of nearly half a million Italian retail investors—holding some US$14 billion worth of Argentina bonds—who have reportedly taken a tough stance toward Argentina's debt proposal.

There are two distinctly different types of investors: retail and institutional. Retail individuals invested at the original offering prices, or in the secondary market before Argentina defaulted. The other group consists of hedge funds, institutional investors, investment funds, money managers, insurance companies, and other organizations. It is estimated that many of these accounts purchased Argentina bonds in the secondary market when they were cheap, even after Argentina defaulted in December 2001. They included Argentina bonds as part of the junk bonds allocated in their bond portfolios in order to increase the rate of return. Investment in these "high risk, high return" publicly offered bonds are risky, but can be very profitable.

It appears that many fund managers tendered the exchange offer, particularly those who could gain some profit by accepting the government's offer. Many retail investors accepted the offer or sold the bonds before the offering period expired, but some groups, such as Italian retail individuals, rejected the offer with the intention to take the matter to court.

For Samurai yen bonds, the acceptance rate of the mostly Japanese investors was as high as 94.4 percent. It is estimated that the bulk of Japanese resident investors decided to sell their yen bonds to overseas institutional investors through dealers during the offering period that ended on February 25, rather than accept the offer. This means that they refused to accept new bonds to be issued by Argentina. Those bonds purchased by overseas investors were tendered, as the high acceptance rate shows.

4. The IMF's Response

The IMF three-year standby facility was agreed upon in September 2003, under which the first disbursement was made in January 2004. The second disbursement was approved in March 2004, after Argentina declared in its letter of intent of March 10, 2004, that it would "engage in constructive negotiations with all representative creditor groups including the Global Committee of Argentina Bondholders (GCAB)." The IMF has repeatedly stated that a successful restructuring of Argentina's sovereign debt owed to private creditors is a prerequisite for the IMF program. The IMF further stated that, "The authorities are encouraged to work diligently to design a debt exchange offer that attains the highest possible creditor participation, reduces the risk of protracted litigation, and restores debt sustainability."

Although the IMF expressed its firm position with respect to good-faith negotiations, it has consistently maintained a hands-off policy, avoiding participation in Argentina's debt restructuring process. This is because, according to the IMF, the matter is to be resolved between the debtor government and its private creditors. As a result, the IMF was not forceful in carrying out its own lending-into-arrears policy[6]. Private creditors had expected the IMF to act as an enforcer, and when necessary, to act as a fair judge under its lending-into-arrears policy. It was particularly noticeable that the IMF did not take any action when Argentina unilaterally proposed a deep debt reduction plan in September 2003. In January 2004, the IMF approved the first disbursement under the stand-by agreement, when there was no prospect of good-faith negotiations between Argentina and its private creditors.

Now that the unilateral restructuring has been concluded, the IMF needs to respond to the question arising from the outcome of the debt exchange. First, how the IMF judges the acceptance rate of 76.15 percent, in light of an appropriate acceptance level.[7] Second, how to treat the private creditors holding the US$19.6 billion not tendered. Third, how the IMF is to resume lending in light of its lending-into-arrears policy. These questions need to be answered before the IMF contemplates how to normalize financial relations with Argentina after the suspension of its three-year stand-by agreement in August 2004.

Under the extremely tense relationship between President Kirchner's administration and the IMF, it is important to resume negotiations on the US$13 billion IMF standby agreement as soon as possible.[8] It is equally critical for the IMF to take a firm stance toward reaching an agreement on the difficult issues stated above, in order to minimize the potential negative impact of Argentina's case on the sovereign debt market. Because of the many difficult issues involved, the negotiations between Argentina and the IMF are likely to be tough and protracted.

5. Implication of Argentina's Restructuring on Emerging-market Economies

For the international financial system to work, emerging market economies need to secure smooth flows of capital, particularly long-term funds from international capital markets. The financial crises of the 1990s, particularly the Asian crisis of 1997-98 and its contagion to emerging economies in other regions, led the G7 and the IMF to the view that the international financial system needed to be reviewed.

The guiding principles for sovereign debt crisis prevention and resolution were

6 Tadahiro Asami (2004), "The IMF should be involved in the Emerging-Market debt restructuring process" http://www.iima.or.jp/pdf/newsletter_2004/050208No5eng.pdf

7 At an early stage, the IMF informally indicated that at least an 80-percent approval is needed for a successful restructuring, but later said that a sufficient amount of support is needed, refraining from indicating an exact figure. On the other hand, Minister of Economy Lavagna reportedly said that 50-percent participation would be sufficient, while the GCAB indicated that at least 90-percent approval is needed. The record of recent acceptance rates for restructuring were: Ukraine (1998-2000), 97 percent; Pakistan (1999), 99 percent; Russia (1999-2000), 98 percent; Ecuador (2000-2001), 97 percent; and Uruguay (2003), 92 percent.

8 Refer to The Evaluation Report of July 2004, "The IMF and Argentina 1991-2001", prepared by the Independent Evaluation Office of the IMF.

extensively discussed at the G7 Finance Ministers meeting held in Cologne in 1999. It was emphasized that, “We need to shape expectations so that private creditors know that they will bear the consequences of their investment decisions.” The G7 emphasized private investors’ responsibility in order to avoid bailouts by the official sector. The G7’s report states that, “In a crisis, reducing net debt payments to the private sector can potentially contribute to meeting a country’s immediate financing needs and reducing the amount of finance to be provided by the official sector.” In fact, private creditors have been taking responsibility by accepting Brady bond proposals in the early 1990s, and subsequent debt reductions. Examples of this include Peru (nominal reduction of 45 percent in 1996), Russia (38 percent in 1999-2000), and Ecuador (40 percent in 2000-2001).

The report also stated the importance of market-based cooperation and resolution, saying that, “Appropriate communication between debtors and creditors is important in both crisis prevention and resolution,” and that it is necessary to “encourage emerging economies to develop mechanisms for more systematic dialogue with their main creditors.” The report nonetheless fell short of emphasizing the importance of orderly good-faith negotiations between the debtor government and private creditors, although it stated that, “The approach to crisis resolution must not undermine the obligation of countries to meet their debts in full and on time.”

The lessons to be learned from the Argentina restructuring are therefore as follows:

- The IMF’s lending-into-arrears policy should be strengthened in a way that encourages both sovereign debtors and private creditors to enter into good-faith negotiations.
- Collective Action Clauses (CACs) provide clear, transparent legal arrangements that are required for altering payment terms. CACs would encourage debtors to negotiate instead of taking unilateral steps.
- The legal framework to protect bondholders needs to be strengthened.
- As in the case of Argentina, the IMF is the single largest creditor enjoying preferred creditor status, while it is in the best position to understand the debtor’s position. The IMF should therefore be more actively involved in the debt resolution process to the extent that the existing framework permits, departing from its hands-off policy, as was the case in the 1990s.

6. Conclusion

The Argentina case represents a unilateral debt exchange offer where the debtor did not enter into good-faith negotiations with its private creditors after a prolonged default of more than three years. Private creditors were frustrated by this prolonged default, during which they could do nothing but wait for the debtor to take action to remedy it.

Argentina’s case reveals the need to establish more effective, clear rules for a sovereign debtor and its private creditors, so that they will engage in constructive negotiations when sovereign debt restructuring is needed.

A fair outcome of the negotiations would be that such substantial concessions as the reduction of debt required of private creditors, is balanced with the efforts of sovereign debtors to maximize the recovery of private creditors. Except for rogue investors, private creditors prefer market-based good-faith negotiations to long and expensive litigation. The system should therefore be such that it encourages and provides an incentive to a sovereign debtor to enter into negotiations with its private creditors. At the same time, the system should also penalize the sovereign debtor if it refuses to negotiate.

In the absence of a framework for a sovereign and its creditors to reach a collaborative agreement on a restructuring of unsustainable debt—such as the Sovereign Debt Restructuring Mechanism, the only guiding principle that deals with a defaulted sovereign debtor and its creditors—is the IMF's lending-into-arrears policy.[9] In light of the experience with Argentina's debt restructuring, the IMF lending-into-arrears policy should be reviewed and expanded through due consultation with the representatives of various private creditor groups.

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[9] The SDRM was proposed by Anne Krueger, first deputy managing director of the IMF, in October of 2001. After a vigorous debate on the SDRM proposal, the International Monetary and Financial Committee of the IMF meeting held in April 2003 concluded that the proposal was not feasible at that time.