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Reprofiling Sovereign Debt

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Key Points:

- The IMF staff's 2013 proposal to reprofile (i.e., stretch out for a short period without haircutting principal or interest) the maturing debt of a country that has lost market access is a sensible policy in cases where the IMF is uncertain whether the country's debt stock is sustainable.

- The motivation for the policy is to avoid situations, such as occurred during the Eurozone debt crisis, in which Fund resources are used to bail-out commercial creditors in full.

- But a debt reprofiling is a species of debt restructuring and as such is susceptible to holdout creditor behaviour.

- By allowing a small portion of its loans to the debtor country to be used to neutralise some or all of the additional credit risk caused by the reprofiling, the IMF could minimise holdout creditors in these operations.

- The authors propose a technique for minimizing the risk that certain creditors may elect to decline a reprofiling proposal, no matter how lenient its terms.

As a term of art, "debt reprofiling" describes a transaction in which maturities of debt are extended for a prescribed period without attempting to reduce the principal of, or in some cases even the interest rate on, the extended debts. The classic example of sovereign debt reprofiling is Uruguay (May 2003) when the maturity dates of 18 series of Republic of Uruguay bonds issued in the international markets were extended by a period of five years. The principal and interest rate on those extended bonds remained untouched; only the maturity dates were affected by the reprofiling. The net present value loss caused by the Uruguay extension was relatively mild. It was estimated at the time to be about 19 percent.

Reprofiling in IMF Packages

In April 2013, the staff of the International Monetary Fund released a paper captioned "Sovereign Debt Restructuring -- Recent Developments and Implications for the Fund's Legal and Policy Framework" (the "Fund Paper").[1] Among other things, the Fund Paper raised the question of whether the IMF, when it is asked to assist countries whose existing debt stock *may* prove to be unsustainable, should first require that the maturities of that country's debt falling due within the period of the Fund's adjustment program be stretched out so that Fund resources are not used to repay the holders of those claims at par. The motivation for this proposal appeared to be a desire to avoid being put in a situation where the Fund either had to bail out existing lenders with claims maturing during the program period, or else force the debtor to commence a full-scale restructuring of its debt stock as a condition to receiving IMF financial assistance. Reprofiling is the intermediate step; it locks in existing lenders for a short period (say, 2-4 years), thus giving the Fund and the debtor country time in which to assess the situation and formulate an appropriate response.[2]

There was nothing novel about the Fund Paper's suggestion of a tactical reprofiling of near-term maturities in these circumstances. During the Latin American debt crisis of the 1980s and early 1990s, the principal amounts of commercial bank loans maturing during IMF program periods were repeatedly stretched out. Fund resources were *never* used to repay the principal of commercial bank loans.

The logic behind the Fund staff's reprofiling proposal seems self-evident: new lenders coming into a distressed debt situation do not buy out existing creditors at par. Ever. Not if they are behaving in a commercially rational manner. The fact that the IMF has in recent years been prepared to take this commercially irrational step suggests that other motivations are at work. In the Eurozone debt crisis, for example, the Fund allowed itself to be persuaded that a restructuring of any portion of the debt of Greece, Ireland or Portugal threatened to set off a chain reaction dragging down the whole of the Eurozone. It therefore participated with the European Union in financing packages for those countries in which much of the money simply bled out to repay existing bondholders at par (the belated Greek debt restructuring of 2012 being the sole exception).

Explicit in the Fund Paper is an acknowledgment that sovereigns often wait far too long before commencing a necessary debt restructuring. Implicit in the Paper, however, is an acknowledgment that any geopolitically important country will always have powerful friends who may see it as in their interest to avoid a debt restructuring. Sometimes the motivation is a desire to cushion undercapitalised financial institutions in neighbouring countries from the effects of a default (Europe 2010-13). Sometimes it is to avoid adding a debt crisis to a political or military crisis

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[1] The IMF April 2013 Paper is available at http://www.imf.org/external/np/pp/eng/2013/042613.pdf

[2] For additional detail on the IMF Proposal, see Douglas Baird et al., *The Role of the IMF in Future Sovereign Debt Restructurings*, USC Law School Working Paper (2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2360274

(Ukraine 2013-14). Sometimes it is just a fear that permitting a debt restructuring in one country will focus the attention of investors on the financial fragility of sovereigns elsewhere in the region (Europe again).

Criticisms

Several criticisms have been lodged against the suggestion that the near-term maturities of a country with a potentially unsustainable debt stock should be reprofiled as part of a Fund program.[3]

- Criticism -- requiring a reprofiling of near-term maturities would spook investors and cause them to exit sooner and in greater numbers than they otherwise would.

- Response --

Investors will know about the country's financial distress long before the finance minister visits Washington, D.C. Lenders who perceive an unbalanced risk/reward will flee because they have lost confidence in the credit. Any investor so minded who stays put simply because he believes the official sector will pay him out in full if the credit risk materialises is not an investor the official sector should wish to encourage. This behaviour embodies creditor moral hazard.

Also, the specter of "fleeing creditors" means in practice a deepening discount in secondary market sales of the sovereign's paper. That process affects the sovereign only to the extent that it raises the cost of any new borrowing undertaken, as they say, in the shadow of the sovereign's insolvency. Higher borrowing costs may indeed force a sovereign to seek IMF assistance earlier than it otherwise might have done, but in most situations this will be altogether salutary. Desperate, ruinously expensive Hail Mary financings undertaken in an attempt to defer difficult political decisions for a few more months or a few more weeks are almost always regrettable and eventually regretted.

[3] *See* Gabriel Stern & Charles Blitzer, *The IMF Approach to Sovereign Debt Restructuring*, FT Alphaville, April 4, 2014, http://ftalphaville.ft.com/2014/04/04/1819992/guest-post-the-imf-approach-to-sovereign-debt-restructuring/ ; Douglas Rediker & Angel Ubide, *The IMF is Courting New Risks With a Change in Policy on Debt Restructuring*, PIIE Blog, January 28, 2014, http://blogs.piie.com/realtime/?p=4220

- Criticism -- The knowledge that an IMF program might require a reprofiling of near-term maturities will deter sovereigns from seeking a Fund program.

- Response --

  This is debtor moral hazard. The implication of this criticism is that sovereigns should be affirmatively encouraged in the belief that the official sector (and its taxpayer funders) will always indemnify them for their imprudent debt management policies as a means of attracting them to the front door of the IMF building.

- Criticism -- a reprofiling will trigger the credit default swaps written on the sovereign's paper.

- Response --

  True, but so what? CDS are a species of insurance policy entered into by third parties (naked sovereign CDS have been banned in the European Union). A CDS "credit event" does not increase or decrease the size of the sovereign's debt stock.

- Criticism -- some countries (such as Brazil in 2002, Turkey in 2000 and Ireland in 2011) have received IMF assistance and recovered market access without either a reprofiling of near-term maturities or a full-scale debt restructuring.

- Response --

  True but missing the point. The Fund's reprofiling policy would be triggered only in cases where the Fund is *in doubt* about the country's ability to recover its footing. Naturally, in some cases that doubt will prove to be well founded, in others not so. But the important question is who bears the risk of this uncertainty? The Fund (by paying out existing creditors at par), or the lenders (by agreeing to defer near-term maturities for short periods)? If the Fund takes the risk and gets it wrong, it increases the likelihood that its own exposure -- some of which will have displaced existing creditors -- will need to be restructured or may not be repaid. If the existing lenders assume the risk by deferring near-term maturities and the country recovers quickly, very little harm has been done. If the country does not recover and needs a more durable

debt restructuring, the existing lenders are no worse off than they would have been had the country fully restructured at the outset.

- Criticism -- a policy of "when in doubt, reprofile" erodes the Fund's flexibility to address situations on a case-by-case basis.

- Response --

The flexibility resides in the "when in doubt" part of the equation. The sole objective of the policy is to safeguard Fund resources. If the Fund concludes that proceeding without a reprofiling would not materially increase the risk to the Fund as a new lender (because, for example, near term maturities of commercial debt are trivial), it need not ask for a reprofiling.

Most criticisms of the reprofiling policy are specious, but there is one legitimate concern related to this policy. A reprofiling is a type of debt restructuring, just the mildest type. As such, it is inevitably susceptible to holdout creditor behaviour. When the IMF tells a client country that Fund assistance will be conditioned on the debtor reprofiling its near-term maturities, the Fund is implicitly telling the country to restructure those debts and take the risk of hostile creditor legal action if some lenders cannot be brought along. This unsettling prospect may indeed result in the country deferring the decision to seek Fund assistance longer than it should.

Most sovereign bonds governed by the laws of New York or England now incorporate collective action clauses. CACs permit a supermajority of holders (typically 75%) to agree to a debt restructuring with the consequence that any dissenting minority holders will be bound by the restructured terms. The difficulty will therefore lie in securing the consent of holders of 75% of each series of bonds affected by the reprofiling, not an easy task if those holders believe that official sector monies will be used to pay them out in full and on time should they decline the invitation to reprofile their claims. As things now stand, the inducement for creditors to vote in favour of a reprofiling is wholly negative -- the threat of an outright default possibly precipitating an ugly debt restructuring. A certain number of lenders, post-Europe and post-Ukraine (where official sector lenders have once again been bailing out commercial creditors), will call that bluff if the debtor country is geopolitically important.

This places the Fund in a tough spot: either lend the debtor all of the money needed to pay off maturing debts at par during the program period or potentially force the country into a messy, litigious debt restructuring.

Incentives

There is an alternative. A reprofiling inflicts two hardships on an investor. First, it prolongs the investor's credit exposure in the country for the period of the reprofiling (the "Extension Period"). Second, it increases the amount of the lender's credit exposure to the extent of the additional interest amounts accruing during the Extension Period.

An example -- Ruritania, a country seeking IMF financial assistance, has a $100 million bond maturing in 6 months. As part of its IMF program, Ruritania asks the holders of this bond to use the collective action clause in the bond to extend the maturity date of the bond for three years. This requires the bondholders to increase their exposure to Ruritania by the amount of six additional semi-annual coupon payments. (Let's assume a 5% p.a. coupon, so that's an additional $15 million, or 15%, increase in bondholder exposure.)

Nothing can be done about the first effect (prolonging exposure), although in comparison with a full-scale debt restructuring, a reprofiling locks in the exposure for only a short time. The second effect (increasing the size of the exposure by the amount of interest accruing during the Extension Period), however, is remediable. The IMF could permit a portion of its lending to the debtor country to be used to neutralise, in whole or in part, the additional credit exposure resulting from the extension.

The simplest way to achieve this would be to use a portion of the borrowings under the Fund program as a prepayment of the coupons falling due during the Extension Period. Those monies could be given to the trustee or fiscal agent for the issue with irrevocable instructions to apply the funds toward the additional interest accruals resulting from the extension. The issuer would offer this arrangement to the holders as an inducement for them to vote in favour of the reprofiling.

Other transaction structures are also possible but more complicated. A special purpose vehicle could be established and funded with a portion of the IMF disbursements. The SPV would then guarantee a pre-agreed number of coupons falling due under the reprofiled bonds. Alternatively, the issuer could purchase a cash-collateralised letter of credit covering those coupons. The objective, however, would be same -- to neutralise some or all of the additional credit exposure resulting from the reprofiling.

The architects of this credit enhancement must prepare for the possibility that the sovereign debtor and the IMF will throw in the towel and accept the need for a full-scale debt restructuring even before the extension period has run its course. What, in this circumstance, is to become of the money that has been set aside to secure coupon payments during the extension period? In fairness, the creditors should not be deprived of the benefit of those funds; the money was, after all, part of the bargain offered to creditors in order to induce them to vote in favour of the initial reprofiling proposal. But the arrangement could be structured so that, in the event of a premature termination of the extension period, any unused monies that had been set

aside to cover coupons during the extension period would be applied as a cash downpayment in the eventual restructuring of the affected obligations.

Positions of the Actors

As long as bondholders believe that a full IMF bailout will not be forthcoming, this arrangement should be attractive. There is, of course, always the possibility that a deeper debt restructuring will be required when the Extension Period ends. But balanced against that *potential* debt restructuring down the road is the dead certainty of a debt restructuring today if the debt is *not* reprofiled. Faced with this alternative, most lenders will take their chances down the road.

From the Fund's standpoint, this is an efficient use of Fund resources in comparison with lending the debtor the full amount necessary to repay the maturing bonds. In the example above, the Fund need disburse only $15 million to neutralise the additional credit risk caused by the reprofiling as opposed to the $100 million that would have been required to allow the debtor to repay the bond in full.

The IMF has crossed this policy bridge once before. As part of the Brady Bond process in the 1990s, the Fund allowed a portion of its program disbursements to be used by the debtor countries to purchase collateral that was then pledged to secure Brady Bonds. The Brady Bonds were exchanged for commercial bank loans as part of the restructuring. In effect, official sector money was employed to induce commercial creditors to join a debt restructuring.

For its part, a consensual reprofiling means that the debtor country borrows far less from the IMF than it otherwise would ($15 million versus $100 million in the Ruritania example above). That said, use of the collective action clauses in the sovereign's bonds to approve a reprofiling would trigger credit default swaps and probably result in a temporary ratings downgrade. The whole point of the reprofiling exercise, however, is to obviate the need for the country to refinance maturing debts in the near term so these events should have limited repercussions.

By the very act of publishing the Fund Paper and starting this debate, the IMF has arguably achieved its most important objective -- disabusing investors of the assumption that sovereign lending has become risk free. One unfortunate legacy of the Eurozone debt crisis and more recently the Ukraine bailout is the widespread perception that the official sector fears, and will not tolerate, sovereign debt restructurings, at least in countries that can be argued to pose some danger of becoming contagious or destabilising. Puncturing the assumption that an implicit official sector guarantee has quietly been wrapped around the commercial debt of all countries meeting this criterion should be a high priority for the institutions who would otherwise be expected to make good on that guarantee.

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