Issued: 11 August 2020

MARKET COMMENTARY

Ashmore

Insights from recent EM sovereign debt restructurings

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Ecuador recently undertook a successful sovereign debt restructuring in record speed, followed by Argentina after a somewhat more long-winded and volatile process. These are the first two major EM sovereign debt restructurings, since the breakout of the COVID-19 pandemic. Why were they successful? What insights do these two restructurings provide?

The first part of this report identifies the five key factors that contributed to successful restructurings in Ecuador and Argentina.

The second part of the report discusses two refinements in the framework of Collective Action Clauses ('CACs') embedded in the indentures of the new bonds from the Ecuadorian and most likely also the Argentinean exchanges. The refinements eliminate important loopholes that made previous versions of CACs vulnerable to potential abuse by issuers. As such, the new CACs should ensure that sovereign issuers have the freedom they need to propose when they have the required majority, while forcing them to continue to negotiate with bond holders if they do not have the required majority. We expect the innovations to the CACs to become part of the new legal standard for EM sovereigns going forward, to the benefit of issuers and bond holders alike.

Key factors in rapid and efficient restructurings

1 **CACs work.** The introduction of CACs into most of the Ecuadorian and Argentinian bonds prevented blocking actions of small groups of holdout investors. In the past, such groups have held up resolutions for as long as a decade or more during which governments were cut off from global capital markets and therefore unable to engage in fiscal policy, while bond holders received no payments. Today, the holdout problem on the bond holder side has been dramatically reduced due to CACs. Moreover, going forward CACs are likely to prove even more effective due to the refinements to CACs discussed in the second half of this paper.

2 **The restructuring process is aided significantly if sovereign issuers are serious in their desire to regain market access, willing to engage with bond holders in good faith, and prepared to take firm actions to address their structural issues.** The Ecuador restructuring in particular is a good example. From the start, the Moreno Administration engaged with bond holders in a spirit of good faith. Negotiations were extremely tough, but always professional, fair and open, without any press leaks, negative PR campaigns, or back-channel criticism of counterparties, which ensured the quality of discussions. The trust established between the parties enabled an agreement to be reached in record time and led to a very high percentage of bond holders voting to accept the deal. In fact, this is the first restructuring to be conducted in the post-COVID world, where all negotiations were conducted virtually, not face to face. This testifies to the good lines of communication and high level of trust that exist between the parties.

3 **Bond holders can provide material financial relief for EM countries, when they have real needs, while still performing their fiduciary duties for their investors.** More than 90% of bond holders and 82% of bonds in each series accepted Ecuador's consent solicitation to postpone USD 800m in coupon payments in April 2020. This postponement enabled the Ecuadorian government to manage a severe coronavirus outbreak in the country and gave the government extra time to look into a comprehensive plan for debt relief and new financing, while not facing the risk of default in the near term. Moreover, when the final deal was presented Ecuador received more than 98% bond holder support, which is also a record. This demonstrates that under the current market infrastructure bond holders are perfectly willing to and capable of working with issuers to find mutually acceptable debt resolutions.

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This last point is worth re-emphasising in light of strong voices in the media, the academic world, certain governments, and even from within the International Monetary Fund (IMF) that portray bond holders as contributors to EM countries' problems rather than part of the solution. These voices claim that the existing market infrastructure fails EM issuers and call for a more hostile restructuring approach. However, the recent experiences in Argentina and Ecuador illustrate that the current framework can deliver solutions that are acceptable for issuers and bond holders alike in a very short time.

It is particularly important that bond holder groups have strong representation from large EM-dedicated institutional managers with a strong institutional investor base. They bring to the negotiation table a long-term investment horizon, deep engagement with issuers, and in-house experience and capabilities, including critical legal skills, to ensure that solutions maximise the long-term benefits for both parties. In turn, this deepens ties between bond holders and issuers, so that future investments are less risky for bond holders and issuers can access financing more readily and on better terms. The real progress achieved in recent EM restructurings should not be sacrificed on the altar of ideology.

4 **Private bond holders can act much faster to provide material payment relief than the official sector.** In both Ecuador and Argentina, the restructurings with private bond holders were not only meaningful in size, but also took place with astonishing speed (more so in Ecuador than Argentina). Deals were achieved far ahead of any debt re-profiling with bilateral and multilateral lenders. In reality, governments often get bogged down by political considerations or even simply bureaucracy, which can prevent cross-country agreement as richly illustrated by the recent well-meaning, but so far ineffective G20 debt relief proposal for the least developed countries.[1] Bond holders and sovereign issuers on the other hand have a common singular focus; to re-establish access to markets on a sustainable basis.

5 **It is always useful to get the IMF on board, even if private lenders take the lead in restructurings.** The IMF is often a major lender without whose involvement it is simply not possible to achieve meaningful cash flow relief and debt sustainability. For example, in Argentina the bulk of the government's near-term payment obligations are to the IMF. At the same time, IMF's framework regarding lending into arrears means that it is more difficult to conclude a new IMF standby agreement without a deal with private bond holders. One interesting innovation was that the conclusion of an IMF staff level agreement by a specified date was made a condition for the April 2020 stand-still agreement between bond holders and Ecuador, which was then followed by the final deal, which cannot settle without Ecuador reaching a new staff level agreement with the IMF. The Moreno government's commitment to the IMF clearly provided an important source of reassurance to bond holders. In contrast, in the case of Argentina, the absence of an IMF programme to underpin the private sector restructuring process created uncertainty about the future direction of government policy that complicated the negotiations. In addition, IMF data and analysis conducted in the context of negotiating or executing a programme can often serve as useful references for a successful restructuring.

Improvements in the legal framework governing EM sovereign bond restructurings

In 2014, the International Capital Markets Association (ICMA) developed the latest version of CACs for EM sovereign bonds (see the appendix for a discussion of the role of CACs in sovereign restructurings). The purpose of CACs is to prevent small minorities of bond holders from blocking restructuring deals between sovereign issuers and the majority of bond holders. While the 2014 version of the CAC framework was a vast improvement on previous versions, it suffered from flaws that go against the core CAC principles of ensuring transparency and supermajority support, namely the so-called 'Pacman' and 'redesignation' problems.

As part of the recently concluded sovereign debt restructuring negotiations with the governments of Ecuador and Argentina, new refinements are being added to the CAC framework to address these problems effectively.

[1] See: *'The well-meaning misguided G20 proposal'*, Market Commentary, 7 May 2020.

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Specifically, the 'Pacman' problem, in which the issuer uses ICMA CACs in successive iterations to force bond holders to accept the commercial terms of a restructuring that was not capable of achieving supermajority support in the first iteration, has been largely eliminated. This has been achieved by provisions, which state that in circumstances where 75% supermajority support was not achieved in the first iteration, the issuer is prohibited for three years from using the voting power of any restructured bonds to help compel the restructuring of bonds that held out in the original process.

The new CAC refinements also solve the so-called 'redesignation' problem. This problem arises when issuers are free to alter the composition of a basket of bonds designated for restructuring at any time (including after the votes have been cast). The new CACs solve this problem by introducing a provision that a minimum of five business days' notice must be given to investors to revoke or change their votes, before any redesignation takes effect. The only circumstance in which this provision could be bypassed is where two thirds of the bonds included in the original scope of the proposal have voted in favour of the restructuring offer.

The two improvements to the CAC framework, which are now embedded in the new Ecuadorian and potentially Argentinian bonds, could become the new legal standard for all EM sovereign bond indentures going forward, and will help ensure sovereign restructurings are implemented through a fair, transparent and smooth process achieved with supermajority bond holder support. This is clearly beneficial for issuers and bond holders alike. After all, the objective of any successful restructuring is to enable issuers to regain sustainable access to markets as quickly and efficiently as possible in order that they may be able to raise funding for key development needs.

Conclusion

The recent experiences of sovereign restructurings in Ecuador and Argentina show that private bond holders and sovereign issuers are able to reach agreement quickly in a way to uphold the fiduciary obligations of bond holders while at the same time granting significant relief for issuers in the post-COVID world. CACs have dramatically reduced the problem of holdouts, while governments in EM appear to recognise the benefit of regaining market access as quickly as possible. IMF support is clearly also a major positive for chances of a successful debt restructuring. Meanwhile, the refined CAC framework embedded in the bonds coming out of the Ecuador and potentially Argentina exchanges introduce major enhancements to close important loopholes in the existing architecture. This should ensure even fairer and more transparent restructurings in the future.

The old antagonistic stance between issuers and bond holders seems to have had its time. There appears to be a growing maturity among investors and borrowers alike, perhaps reflecting a greater understanding of their mutual dependence, which we expect will only increase in the post-COVID world. If so, the riskiness associated with sovereign distress situations will have declined meaningfully. This should be good not just for those owning bonds in distress, but also for the asset class as a whole.

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Appendix

Emerging Markets (EM) sovereign issuers sometimes get into trouble. The reasons range from external shocks to domestic political crises, or simply economic mismanagement under, say, a populist leader. When trouble strikes, countries may find themselves unable to meet their debt service obligations.

However, sovereign Eurobonds are issued under foreign jurisdiction, so in reality enforcement is extremely difficult. While countries cannot really walk away from unresolved debt issues, which soon become a permanent drag on growth, investors cannot easily seize assets either. The result is that legal battles between sovereign issuers and bond holders can drag on for years, which is clearly highly inefficient. Since a sovereign debt resolution rarely relies simply on a court decision, issuers and bond holders ultimately have to engage in a negotiation process. Such negotiations have often proved extremely difficult in the past.

Apart from the antagonism between issuers and bond holders, there was often major disagreement among the latter too. This is why Collective Action Clauses, or 'CACs' were invented. The most recent CACs include aggregation rules that allow issuers to restructure multiple outstanding series of bonds in a single transaction, employing either a single or double limb voting structure. For example:

- A single limb CAC could state that a minimum of 75% of bonds of all affected series are required to approve a restructuring.
- A double limb CAC could state that two thirds of bonds of the affected series plus a minimum of 50% of the bonds of each series is required to approve a change in terms. In short, CACs limit the power of a minority to hold out and as such they significantly improve the odds of resolving bond restructurings by overcoming divisions among bond holders.

Restructurings typically take the form of 'consents', 'debt exchanges', or a combination of both, whereby creditors either vote to modify the terms of their existing bonds and/or exchange them into new ones to offer debt payment relief in the form of a combination of principle reduction, lower coupons, and/or longer maturities. There may be sweeteners attached to incentivise creditors to participate.

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