WHITE & CASE

LEADERS' SERIES

Which way forward for the sovereign debt crisis?

Six thought leaders in sovereign debt restructuring share their observations of the current situation and provide guidance on the complex challenges ahead

A crisis far beyond anything experienced in recent memory

The way in which regulators, investors, banks and governments respond to the current sovereign debt challenges will echo for many years. Decisions made today will, for better or worse, continue to have consequences far beyond our current time horizon. Getting it right will not be easy.

As the experts outline in the following pages, there is no doubt that the world financial system has some very real issues to resolve: how to manage the unprecedented levels of sovereign debt to the satisfaction of those concerned, and how to design a system of arbitration, testing and resolution that will prove robust enough for even the thorniest dispute.

To achieve this, there must be recognition of some truths: First, holdouts—bondholders who withhold their consent and retain their right to seek the full payment of original bonds—are not the primary problem in the sovereign debt debate. Certainly they can slow down the refinancing process, but to focus on holdouts would be to miss the central elements of concern.

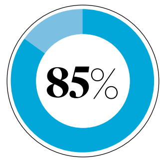
Second, despite the work already done, the eurozone remains in very serious trouble. Governments have made commendable efforts to tackle the systemic fiscal and political weaknesses, but that work has only just begun. Much more remains.

Governments and central banks cannot do all that work themselves. For their proposals and efforts to have a genuine impact, markets and investors must also reconsider their response to government and supervisory action, and to engage in the debate in a mature, constructive way, otherwise they could find their right to participate in future restructurings may be diluted.

The good faith of all concerned is critical. As all our observers note, the new normal is anything but. The world economy is now experiencing levels of volatility unseen for decades. Markets are concerned by the uncertainty created by the policy vacuum in Brussels and other national capitals.

In that atmosphere, then, what is the likelihood of a coherent strategy emerging? Without doubt, achieving lasting reform is made more difficult by different interested parties, and we are concerned by some of the more outlandish and extreme commentary coming from certain quarters.

Of course, those concerns are in some ways allayed by the knowledge that some of the world's best minds are hard at work designing solutions to these problems. However, to succeed, those engaged in the effort must combine pragmatism with intellectual rigour, and realism with principle. This is a crisis far beyond anything experienced in recent memory. Solving it will not be easy. ■



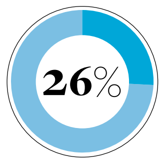
EU 27 public debt as a % of 2009 GDP

Source: Eurostat

€205bn

Greek debt restructuring in February 2012

Source: IMF, April 2013

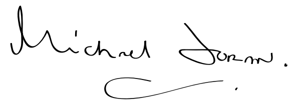


growth in EU 28 sovereign debt 2009 – 2013

Source: Eurostat

Gavin McLean
Partner, White & Case

Michael Doran
Partner, White & Case



Ian Clark
Partner, White & Case

WHICH WAY FORWARD FOR THE SOVEREIGN DEBT CRISIS?

Greek Prime Minister Antonis Samaras, Luxembourg Prime Minister Jean-Claude Juncker and Irish Prime Minister Enda Kenny at a recent European Council meeting

Hung Tran 01/06

Executive Managing Director,
Institute of International Finance

Believing in good faith

Delivering a fair and effective framework for restructuring sovereign debt means building on the foundations of good faith negotiations.

When we're looking at tackling the problems of sovereign debt, there are two key points. First, this must be a process of good faith, transparent negotiations between the sovereign debtor and international private sector creditors and bondholders to arrive at a fair burden sharing in terms of helping the country to recover. And second, this fair burden sharing means everyone involved in the debt has to participate and contribute to the solution for the country.

So the country itself has to undertake corrective measures, including fiscal consolidation measures and reform efforts to improve the performance of the economy. It involves international financial institutions providing short-term emergency financing to help the country through their adjustment process. And the private sector creditors must participate by backstopping relief and agreeing to take "haircuts", either nominally or on net-present-value terms so that the country can be given some support in trying to recover.

As we look at the situation now, there are a variety of issues, and different country cases will require their own approaches. But by and large, if you look back at the past 16 years and the history of sovereign bond restructuring, it is different from the sovereign bank debt restructuring of the '80s. And many studies, including that by Moody's released earlier this year and by IMF working papers released in 2012, clearly show that the absolute majority of cases have been successfully restructured on a timely basis thanks to good faith discussions between sovereign debt and international bondholders.

So this market-based voluntary discussion approach to that restructuring has worked. History is behind it. The only single case where there is a very long period of resistance and continued litigation is the case of Argentina, where the sovereigns chose to have a more unilateral approach to restructuring.

> **"The aggregation clause is the right way to move forward and improve the working of the contractual market-based framework for restructuring**

13.1 months

Average restructuring duration of sovereign bonds since 1998

Source:
Sovereign Debt Restructurings 1950–2010

120 cases

of litigation following a restructuring of sovereign debt since 1976

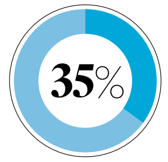
Source:
Sovereign Defaults in Court: The Rise of Creditor Litigation, April 2013

So going forward, the lesson seems to be clear. Voluntary good faith negotiations by debtors and bondholders have worked in the past and should be the main framework for debt restructuring in the future. Of course, it is certainly the case that the market-based contractual framework can be improved and strengthened.

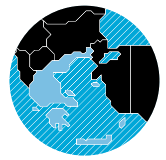
And we are collaborating, working with the International Capital Markets Association in London, in trying to strengthen the language of the collective action clauses, particularly the aggregation clauses, to make it more difficult for a small group of institutional investors to try to build up a position in a single series of bonds that will frustrate the smooth restructuring process. In our view, the aggregation clause is the right way to move forward and improve the working of the contractual market-based framework for restructuring.

Things are looking more positive. In the case of the euro area sovereign debt crisis. A lot of progress has been made, both by the individual countries in correcting for the macroeconomic imbalances that brought them into crisis in the first place, and also on the European level. Moves such as strengthened economic and fiscal policy co-ordination and the European Stability Mechanism, as well as the European Central Bank's outright monetary transactions programme, which has significantly reduced the risk of a euro failure, as well as progress on the banking union, are all helping.

This progress has edged the European sovereign debt crisis on to the back burner and that can only be a good thing. However, while the glass is more than half full, the remaining empty space is substantial and needs to be filled. ■



of sovereign debt exchanges relied on the use of collective action clauses



157%

Greek public debt as a proportion of 2012 GDP

Source:
Eurostat

Taking the eurozone's financial temperature

A successful outcome of the European Central Bank's audit of the eurozone banking system promises to bring calm to financial markets

Glenn Kim 02/06

Managing Director, Moelis & Company

The recent publication by the European Central Bank (ECB) outlining its planned health check of major European banks, referred to as the Comprehensive Assessment, is a definitive first step in the EU's planned European Banking Union, and will no doubt lead to better reform and improved banking supervision within the eurozone. To understand why, we have to remember the experiences of the previous sets of tests and why they proved to be less than effective.

In short, the previous tests did not address the central issues facing Europe's banks and, within a few short months, several of those deemed "safe" were on a crash course towards bankruptcy. In fact, a number of the top 15 of the 90 banks reviewed by the authorities received the all-clear signal and yet faced bankruptcy only months later.

Fast-forward three years and we find ourselves at a new crossroads. Facing the ECB is a number of pressing issues. There has to be a single supervisor, a single resolution mechanism in case a bank fails whereby, if it does fail, it can be wound up or recapitalised. And we need to protect depositors through either local or European oversight. All these steps are necessary, but the first critical step is the introduction of a single supervisor.

Before the ECB takes over that responsibility, it must determine the state of the banks it will oversee, which is precisely the point of this new bank assessment. With its three sets of checks, which will form the basis of its tasks over the coming year, the ECB has demonstrated that it too has learnt from the previous exercise and is asking the right questions to get the right answers.

Few will doubt that the task, which can be described as a full-scale root-and-branch audit of the eurozone banking system, will be prodigious in both scale and complexity.

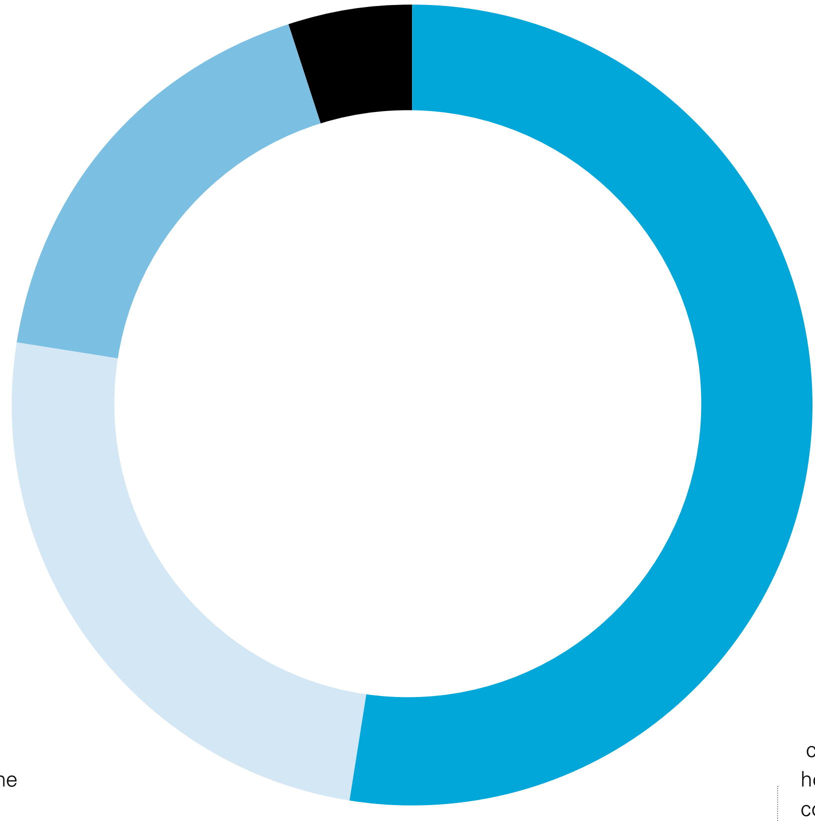
To bring coherence to this enterprise, it is understood that the ECB will employ a single bank supervisory handbook when reviewing banks to serve as a unifying element between all the national regulatory supervisors and authorities. The European Banking Authority has made meaningful contributions here in its efforts to harmonise definitions throughout the European banking landscape.

Ultimately, this supervisory book is not a fixed one, but rather an evolving organic undertaking, which will become more sophisticated in its analysis.

Perhaps it is unreasonable to expect the ECB to get it absolutely "perfect" the first time, but the will is there and, with its reputation on the line, we can expect it will err on the side of caution.

Because pitfalls await. What if a common public backstop is not ready or agreed upon in the event individual banks or countries cannot raise the cash themselves? What if the exercise uncovers gaping holes in the bank balance sheets requiring massive recapitalisations or if it precipitates another crisis?

The aims of providing greater transparency on the state of Europe's banking system, identifying those in need of assistance and enhancing the overall confidence in the lending markets will not be easily achieved. But if the ECB gets this right and navigates the minefield of pressing issues, we can expect the impact to be manifold throughout Europe and hopefully bring this part of the crisis to an end. And that can only be a good thing.



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Litigation cases by type of creditor since 1976

52.5% Fund

25% Bank

17.5% Other

5% Unknown

Source:
Sovereign Defaults in Court: The Rise of Creditor Litigation, 2013

Positive signs, but work remains

Jeromin Zettelmeyer 03/06

Senior Fellow, Peterson Institute For International Economics

There are two dimensions in the sovereign debt debates that we are currently witnessing. One has to do with the question of how to deal with the existing debt overhang, particularly in Europe. The other is about sovereign debt restructuring regimes for the long run.

There will be a protracted period, maybe as long as a decade, when the advanced countries will have to worry about how to reduce high debt. You could say it is analogous to what happened in Latin America in the mid-'80s to mid-'90s. And given that, how exactly the reduction will happen is not clear. It may or may not involve additional sovereign debt restructurings. But for the most part, it will consist of a combination of policies to manage debt down without debt restructuring, through some combination of fiscal adjustment and economic recovery.

Alongside these deleveraging discussions, there has begun a parallel debate on sovereign debt restructuring regimes and how we can improve the system. This is normal—every major sovereign debt crisis triggers calls for an international bankruptcy regime for sovereigns. Usually these debates come too late to deal with the problem at hand. But because the problem will be protracted, I could imagine that some of the legal and structural changes that are currently being debated could still have some relevance for the ongoing problems, particularly in Europe.

A core motivation of the second debate is the difficulty of distinguishing crises that can be resolved with a combination of adjustment and traditional lending, and unsustainable debt situations that may require a restructuring, and questions about how to deal with intermediate cases. It is an issue that has been there from the beginning of the eurozone crisis. Because it remains a hot issue in Europe—particularly after the Greek crisis, which left the European taxpayer in a very exposed situation—I think that something tangible will come out of this. This could involve statutory or treaty-based changes at the eurozone level. Together with some colleagues, dubbed the Committee on International Economic Policy and Reform, I have made some proposals on this, which came out in a report published in October this year.

At the global level, the situation is somewhat different. As in the beginning of the 2000s, I expect to see a debate on the merits of an international sovereign debt restructuring regime. Just like then, I do not expect this debate to actually lead to the introduction of a statutory regime, but instead to tangible changes in related areas. Back then it was the introduction of collective action clauses in New York law sovereign bonds. This time it could involve a move towards one-tier aggregation in collective action clauses.

We could also see a significant change in International Monetary Fund (IMF) lending policies. This is driven by concern that, with so much sovereign debt in the advanced world, solvency problems could continue to drive international crises. The IMF will want to have an instrument which helps prevent Greece-type situations, that is, financing private capital outflows in crises that ultimately require a debt restructuring. ■

> **"There will be a protracted period, maybe as long as a decade, when the advanced countries will have to worry about how to reduce high debt**

Making history at a time of crisis

Otto Heinz, who is in charge of monetary policy and foreign reserves operations at the European Central Bank, tells how the financial crisis has transformed the ECB and central banking.

Otto Heinz 04/06

Principal Counsel, European Central Bank

When I joined the ECB in 2003 from investment banking, it was a very different place to what it is now and, in a way, central banking had a different meaning. Now the financial crisis has undoubtedly changed and redefined several aspects of the institution.

In the early years of the single currency, the focus was on setting up and centralising systems for the purposes of single monetary policy. But since 2007, the crisis has taken centre stage as the ECB has been actively involved in all developments.

For a while, there were entirely new situations and problems cropping up, with unprecedented responses, year in, year out. Working out a significant asset-backed security (ABS) collateral portfolio following the collapse of Lehman Brothers was, for example, an entirely unexpected scenario.

I never thought I would have witnessed the ECB providing liquidity in US dollars instead of euros, being involved with the biggest debt restructuring in history, designing country programmes with the Troika or tackling issues relating to the risk of the eurozone breaking up. After a while, however, people realised that we were slowly running out of unprecedented situations.

Clearly, it's a global phenomenon that considerations of financial stability have come to the fore in addition to classical monetary objectives. But in general, the ECB has had to take into account many more angles when combatting the crisis.

The central bank has also moved closer to the markets. We have seen the impact of certain decisions on the credit default swap (CDS) market, and investor sentiment concerning sovereign bonds and movements in the ABS market become part of daily discussions, whereas previously such considerations were less prominent.

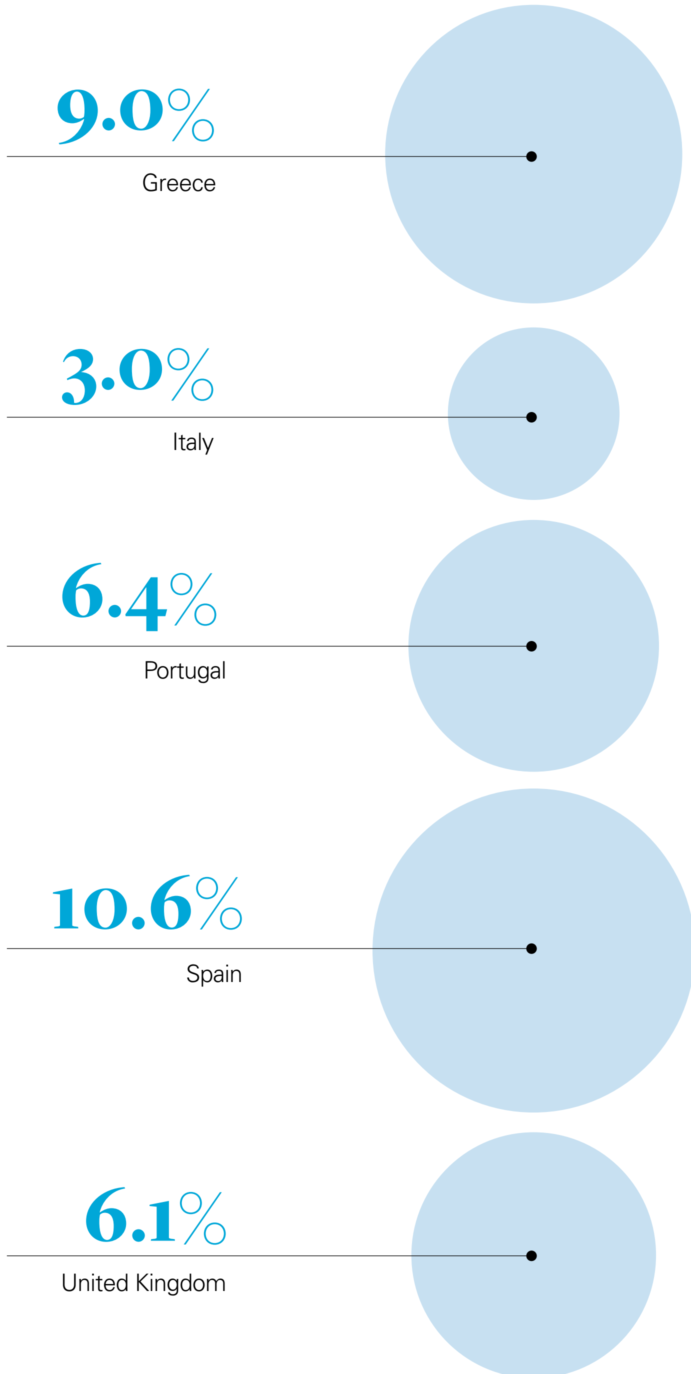
Another new development has been the increased international co-operation among central banks in tackling common problems. While at certain stages of the eurozone crisis there was an inevitable inward focus, regular interaction between the ECB and major central banks around the world has nevertheless become much more frequent.

The public also turned its attention to the ECB and central banking as never before. Previously, members of the public were largely unaware of what central banks do. But since 2007, actions by central banks have been scrutinised by the press and public. Explaining ourselves became of key importance and at times a real challenge, given the current litigious environment, with people having suffered significant losses.

Problems often had to be tackled frenetically. However, the ECB and the central banks became actively involved in formulating a long-term vision for reforming the eurozone. Part of this involvement was assisting with the inception and the implementation of the Banking Union. Accordingly, there is no immediate end in sight to the changes. The ECB's new supervisory role is bound to have an impact, as is the challenge of seeing through the introduction of the new Banking Union. ■

> **"I never thought I would have witnessed the ECB involved with the biggest debt restructuring in history**

▼ General government deficit as % of GDP – 2012



Source: *Eurostat*, 2013

Don't cry for Argentina

Hans Humes 05/06

Chief Executive, Greylock Capital

Looking at the debate currently swirling around sovereign debt restructuring, the solutions being proposed seem to be more geared towards preventing Argentina-style holdouts. In my view, this should be an illustration that there are consequences for a country that decides to go rogue when it comes to its debt obligations.

I find it amazing that the lesson we learn from all this comes as the result of a country that has been gaming the system every which way it can and, because they couldn't completely game everybody, a group like Elliott Management Corporation has pursued them.

And it is telling that some of the larger institutions, which did file suit against Argentina, many of whom would never usually sue a country, were finally frustrated enough to do so. This is because Argentina was so adversarial in its approach to debt restructuring. It barely paid any lip service to good faith negotiations, except in the testimony its officials submitted in various court proceedings.

Now, the effects of that policy are being felt across the board. Countries are a little less willing to play games, since they understand that the courts might have some teeth in punishing them for doing so, which can only be good.

But it needs to be said that the case law, which will come out of this, is not going to be broad. Instead it will be tailored to the specific circumstances of the Argentina proceedings. If we're lucky, it's going to have an impact and make countries think twice about trying to abuse and manipulate the system as much as Argentina did.

Given that, there are a number of other countries which have unresolved debt floating out there that they need to retire if they want to re-access the markets, and we can already see they're playing more by the rules. So I think it's clear the Argentina-NML Capital Ltd case has had an impact on the behaviour of sovereign states that are concerned with restructuring their debt.

I recently worked on the Belize restructuring, as well as Grenada's. These are small countries, but their experiences and approach to the issues are instructive. Their restructurings are panning out in a relatively productive way because there is unity among creditors and the end result we agree works for the country. With this approach, we're able to push back against the legal advisers and carry out straightforward bilateral negotiations.

So it's very difficult dealing with the number of advisers floating around the process. Sometimes in these large advisory organisations, the interest of the organisation prevails over the interest of the client, so things can end up being tricky. However, the more of these examples you can come up with, by making sure they work, the more difficult it is for countries and investors to argue against them. ■

> **"Argentina was so adversarial in its approach to debt restructuring**

Beware of political unrest

Europe's ailing economies are showing signs of life. However, the broader ramifications of the sovereign debt crisis are still unfolding.

Spencer Jones 06/06
Partner, Newstate Partners

Recently, we've seen a combination of successful issuances for Italy and Spain in particular, with the first 30-year issue in four years. We've also seen Portugal re-entering the markets earlier in the year and, more recently, their ten-year yields falling 150 basis points. And then, in the case of Greece, you've got ten-year yields down substantially to below 9 percent from levels above 12 percent earlier in the year. So all of this seems to suggest that the markets believe that these countries are on the right track.

However, I see two significant areas of concern. One is ongoing economic weakness in the eurozone, although we have clearly seen some recent signs of improvement; for example, the Bank of Spain has now released figures showing a very small return to growth in the third quarter. It's not new to say, but I think it needs to be re-emphasised, that a return to sustainable growth is essential in order to cope with the elevated debt levels that persist in Europe.

The second area of concern is what impact the continuing austerity programmes and very high unemployment levels—particularly youth unemployment in Spain and Greece at more than 50 percent — will have on political stability and the risk of political change.

I think people forget that, if you look back to the Greek elections last year, Syriza came very close to winning: they were fewer than 3 percent behind New Democracy. And you would probably have seen a very different outcome, over the last 18 months to developments in Greece, and Europe more broadly, if Syriza had indeed won that election.

If you take the view that Europe is slowly getting better and, as a result, we're not likely to see real distress leading to further restructurings of private sector debt, what other impact will there be from what's happened in Greece and elsewhere in Europe? I believe the broader ramifications are going to be felt elsewhere.

Certainly, the official sector is very concerned about the 3 percent of bondholders that did not participate in the Greek bond exchange. This and the consequences of the Argentinian *pari passu* litigation are, in the official sector's view, likely to lead to an increased risk of creditor holdouts in future sovereign bond restructurings.

And that's very significant because in two key ways it might lead to a change in the balance of debtor-creditor rights. First, the International Monetary Fund (IMF) has raised the possibility, in a recent staff paper, of "bailing in" the private sector when a country requests funding from the IMF in circumstances where it has lost access to the markets and it's questionable whether the country's debt is sustainable.

The second issue that the IMF's paper raises is the possibility of more flexible collective action clauses in bond documentation to limit the ability of creditors in any single bond to hold out or not participate in a restructuring.

And that's important in the context of the global macroeconomic situation. Although in the United States the Federal Reserve's tapering of its quantitative easing programme may be put off a few months because of recent events, looking beyond a three- to six-month horizon, we are likely to see rising US Treasury yields and countries with significant external financing needs vulnerable to rising rates, and potentially some countries more at risk of debt distress.

> **"The International Monetary Fund has raised the possibility of "bailing in" the private sector when a country requests funding**

The private sector is concerned about what the IMF is proposing in its paper, fearing that the proposals might make it more difficult for sovereigns to regain market access and be destabilising, contrary to the IMF's objectives. Many would also argue that the history of sovereign external bond restructurings over the last 16 years is one of relative success, with no material creditor holdout problem, with the exception of one or two cases where issues arose for very specific reasons.

If we bring these issues together, it leaves us with a greater possibility of more sovereign debt restructuring in the coming years, but perhaps not in Europe, and possibly under a changed framework for resolving sovereign debt problems, partly because of what has happened in the eurozone. ■

Employees of the social insurance system gather outside the Ministry of Health in Athens, during a demonstration against job suspensions and layoffs

Louisa Gouliamaki/AFP/Getty Images

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