

September 25, 2009

## EMTA Panel on EM Debt: Is the System Working Well Enough?

On June 8, 2009, EMTA, in cooperation with the **UN Financing for Development Office**, hosted a panel on Emerging Market Debt: Is the System Working Well Enough? This event was held at EMTA's offices in NYC.

Intended as the first in a series of presentations in New York and London, this panel discussed the EM Debt market's strengths and weaknesses from the economic, policy and legal perspectives, with a focus on how well its architecture will meet the market's current and future challenges.

Panelists included representatives from the following firms: Joyce Chang (J.P. Morgan Chase), Lee Buchheit (Cleary Gottlieb Steen & Hamilton), Bruce Wolfson (The Rohatyn Group), Benu Schneider (UN-FFDO) and Elena Daly, an attorney in private practice.

Ms. Chang led off the panel discussion by providing a market background analysis of the global "synchronized" recession, noting that EM corporate borrowing and insolvencies have increased (as opposed to EM sovereigns, whose borrowings have declined), and that EM debt ratios had declined throughout 2008, but were expected to remain stable in 2009, which is evidence that the current crisis in EM is predominantly in the corporate sector. Ms Chang further noted that this characteristic of the crisis in EM contrasted with the more developed economies. She expected that some economic recovery would occur in 2010, but that regional growth prospects would likely be "highly variable", with Eastern Europe lagging behind Southeast Asia.

Looking more closely at the effect of the recession on corporate credits, Ms. Chang pointed out that the EM corporate default rate was about 6.1%, as compared with a US corporate default rate of nearly 25%. The prevailing method of restructuring EM corporate debt tended to be an exchange offer, and restructurings were getting completed quicker than before. Unfortunately, EM defaults were raising issues of both capacity and willingness to pay. In terms of particular risk areas, she noted the banking system throughout Eastern Europe, the country Latvia, and the various political uncertainties raised by some 35 national elections throughout the Emerging Markets in 2009/2010.

Against this background, Ms. Schneider then discussed some of the more specific challenges presented in this admittedly "risky environment", before concluding with some possible solutions to these challenges which are based on the current and/or contemplated changes in financial architecture.

Some of the challenges relate to the need for better information from the credit ratings agencies (where she indicated that both for corporate and sovereign ratings cross-agency ratings disagreements remain high with that of the former being more pronounced); the need for a review of flexibility analyses in debt sustainability frameworks (i.e., should constraints be relaxed for new borrowings, standardized frameworks probably do not work across various EM countries); the important implications for assigning default risk, while the spread variation is widening for sovereign debt putting an upward pressure on the level of future default rates; the problems with IMF “signals”; doubts that may be cast on new IMF programs that are viewed as too pro-cyclical, thus unnecessarily exacerbating downturns in some EM countries; the lack of recent discussion on “breathing space” in times of crisis; and the differing roles that the official and private sectors can play in debt restructuring and/or bail-ins or bail-outs, while the EM countries continue to pursue their efforts regarding sound macroeconomic policies and financial sector reforms, coupled with improved governance. She reiterated that international financial mechanisms for crisis prevention and resolution must be enhanced in cooperation with the private sector (although admittedly neither the G8/G20 nor the Bretton Woods institutions have requested much private sector involvement in this crisis). Fragile national bankruptcy court regimes remain untested, and it is not clear how the current framework for ensuring debt sustainability will accommodate situations in Emerging Markets where corporate debt distress and insolvencies are on the rise.

Mr. Buchheit surveyed sovereign debt restructuring trends over the past several decades, summarizing the era immediately following the initial “Bradies” as being dominated by a focus on rogue creditors, while more recently an era of rogue debtors has arisen, with Ecuador being the latest and best example of a sovereign exploiting many of the reforms adopted in prior years to deal with rogue creditors. He noted that since the Asian and Russian crises of a decade ago, developments in the area of exit consents and CACs (collective action clauses) had enabled sovereigns to complete restructurings with the majority of their creditors, despite the unwillingness of some holdout creditors to participate. Especially in the UK context, transactions were structured to include trustees (as opposed to fiscal agents), a mechanism that was designed to provide for collective action to enforce issuer obligations, on the assumption that trustees would enforce claims reasonably and distribute recoveries ratably. No comparable mechanisms were implemented to address the potential problems of rogue debtors.

Unfortunately, the tide has now seemed to turn, Mr. Buchheit suggested, with debtors who have the capacity, but lack the willingness to pay, now taking advantage of these collective action mechanisms to impose coercive restructurings, particularly in the context of “bovinely passive trustees” and when preceded by rumors and threats of default accompanied by the sovereign’s repurchase of its bonds, thus depressing bond prices in the market and creating the potential for the sovereign’s purchases to be counted in the restructuring voting. He further noted that the pendulum had perhaps swung too far toward protecting sovereign debtors from rogue creditors and the potential that such behavior on the part of rogue debtors, if successful, could become infectious. In particular, reviewing its history of serial restructurings, he observed that Ecuador’s record as a debtor was the “worst on the planet”.

Ms. Daly followed by a discussion of legal actions in the corporate context, displaying the complacency of investors who rely on the syndicated agents to pursue legal action so as not to risk their valuable relationships with the sovereigns. She portrayed this passivity and willingness to sell at a discount as being a short-sighted need for a speedy recovery of asset value. While the investors may not have the expertise and resources for a protracted litigation, she encouraged them to be mindful of when and how to engage the EM corporate debtors toward bankruptcy.

Mr. Wolfson discussed the conflicts, lack of credible information, and political coloring of debt sustainability analyses. He started with a history lesson. The Baker Plan in the early 1980's aided debtors by delaying debt repayment since their perceived problem was timing and liquidity, not insolvency and their ability to pay. The Brady Plan in the 1990's was meant not just to address liquidity and the timing of cash flow, but rather to forgive substantial debt entirely as a stimulus for economic growth means to restore solvency. Debt sustainability was seen in the wider context of implementing the Washington consensus, including the emphasis on fiscal responsibility which would ensure debt sustainability. Shortly prior to Argentina's impending default in December 2001, the IMF took steps to implement the Sovereign Debt Restructuring Mechanism, a bankruptcy regime for sovereigns, meant to discourage disruptive litigation and enable all debtor financings to be dealt with as a whole. This SDRM proposal was widely criticized as being ineffective in its ability to enforce such a regime on sovereigns, and it was viewed as impairing the ability of the parties to restructure the sovereign debt in the best interests of the debtor and creditor. The IMF was not acceptable as an impartial bankruptcy judge because it itself and its shareholders were creditors. In April 2003, U.S. withdrew its support for the SDRM proposal and announced its preference for collective action mechanisms (first fully implemented by Mexico) to facilitate restructurings. There was also more of a focus on loosening the sharing requirements, as well as bringing the relevant debtor and creditors to the table at the same time through engagement clauses (whereby the debtor would pay for the creditors' legal counsel). As time marched on, there was less discussion of fiscal responsibility and more on debt sustainability. So as to inform borrower and lending decisions, the IMF developed a framework (alluded to by Ms. Schneider) for analyzing whether a debtor can repay its debt. In his view, a standardized framework does not adequately demonstrate that sustainable levels and the ability to generate surpluses can vary from country to country. Borrowing and lending decisions based on thresholds derived from a standardized framework need to be revisited. The IMF 4 risk standards, while recognizing that one size doesn't fit all, may still not be the proper gauge for debt sustainability (which may require even more than 4 categories or benchmarks), and this raises the question of which third party's criteria can be relied upon, with investor confidence, for that analysis. And, even further, Mr. Wolfson concluded, maybe the focus in this crisis should not be on the vulnerability of the debtor, but rather on global fiscal imbalances, global liquidity, foreign exchange regimes and the impact on debt sustainability. He agreed with Ms. Schneider that a framework is missing for analyzing breathing space and standstills and discussion of this framework is important when dealing with this crisis.

Ms. Schneider responded to the panel discussion by suggesting that Argentina and Ecuador are the two outliers, with bail-ins not being so costly for the private sector (or at least the debtors are harmed even more by such actions) and the recent recovery values for investors are quite good. She acknowledged that creditors have difficulties in implementing legal decisions in their favor (i.e., relating to recent attachment procedures against Argentina), but suggested that maybe the time is more favorable now to build some debtor/creditor trust and review SDRM-type regimes that are binding and may provide fairer treatment to both creditors and debtors. Mr. Buchheit responded that the way to build such investor confidence in being repaid was for the sovereigns to adopt the overriding principle that they will pay if they can, a contract should be legally enforceable, not just morally enforceable. He also suggested that centralized enforcement through trustees is key. Mr. Wolfson agreed that the results of bankruptcy regimes for sovereigns may not be optimum, but possibly a review of such regimes at this time may be advisable for an orderly debt restructuring with international intermediation since he favored Ms. Schneider's underlying notion that most sovereigns are willing to pay their debts at least for reputational reasons to access the international markets. A speaker from the floor added that a

review should also cover the comprehensiveness of debt restructuring and the distribution of the haircut between official and private creditors.

Ms. Schneider concluded the panel discussion by maintaining that gaps in the financial architecture make defaults more costly for both debtors and creditors, and that it is now more reasonable to look for a balance among new resources, breathing space and debt restructuring through differing tools of crisis prevention and management to maintain the world's financial stability. Who will lead this endeavor remains to be seen.

[Click Here](#) for Ms. Chang's presentation and [Click Here](#) for Ms. Daly's recent article "Don't assume", or contact Aviva Werner at [awerner@emta.org](mailto:awerner@emta.org) for more information.