HSBC and the UN Financing for Development Office

Panel on Emerging Market Debt: Is the System Working Well Enough?

HSBC's offices in London, June 22 2009

Panelists included David Beers (Standards and Poors), Lee Buchheit (Cleary Gottlieb Steen and Hamilton) , Benu Schneider (UN-FFDO), Professor Marcus Miller (University of Warwick) and Robert Gray (HSBC)

David Beers led the discussion and provided an overview on sovereign ratings by Standard & Poor's Ratings Services (S&P).

The Global Recession and Fiscal Profile in Highly Rated Sovereigns

Highly rated sovereigns have been hard hit by the ongoing international economic crisis. S&P expects economic activity to fall in each of these sovereigns in 2009. Many of sovereigns' fiscal profiles have deteriorated recently because of the global recession and the need to recapitalize parts of their financial systems. In line with the deteriorating economic environment and financial sector pressures, public finances have also started to weaken in highly rated sovereigns, particularly those in Western Europe.

Mr. Beers explained that ratings have been under pressure in countries with rising bank recapitalization and significant fiscal injections to domestic financial systems, as sovereign fiscal profiles have been under strain. Rising fiscal deficits and debt levels reflect cyclical reductions in revenues and increases in expenditure, structural shifts in the underlying economies, fiscal stimuli delivered to cushion the impact of the contraction, and comprehensive support measures.

Furthermore, economic activity has been negatively impacted by a feeble financial services industry. Mr. Beers explained that the need to improve banking system balance sheets through capital requirements in developed countries had an indirect effect on third financial systems via reduced cross-border lending and diminishing credit growth. Domestic enterprises in the Baltic and some Eastern European countries were mentioned as facing growing challenges in procuring their financing needs.

Perspectives on Emerging Economies:

Sovereigns in Latin American were affected by the heightened risk aversion in global financial markets. A number of these sovereigns were able to implement counter cyclical policies with varying degree of success. The most significant sovereign rating actions occurrence was triggered by the unilateral default by the Government of Ecuador in

December 2008; it was stressed that such event was unrelated to the global economic crisis.

Sovereigns in South Asia had a less pronounced impact via the financial link as broadly resilient financial sector were built over the past years due to a combination of financial sector reforms and capital controls that insulate these economies from the risk of a financial crisis transmitted from abroad. Nevertheless, a potential rising in contingent liabilities was stressed.

The most prominent region to feel the impact of the global financial crisis is Central and Eastern Europe. Mr. Beers mentioned that the crisis revived the traditional conflict in ownership of banking systems in the region. The conventional wisdom was risk management by parent banking would also be present in period of financial stress. Such an assumption has been tested in the present conditions of liquidity constraints.

Benu Schneider

Benu Schneider discussed some of the gaps in the financial architecture made more evident with the financial crisis and discussed some possible solutions to these challenges based on the resolutions reached in the inter-governmental processes at the United Nations.

Inter-governmental resolutions at the United Nations

Ms. Schneider provided an update on the Follow-up to the Monterrey process on Financing for Development in Doha December 2008 which recognized the need to improve debt restructuring within existing frameworks and provide legal predictability in debt restructuring. Many countries that benefited from the HIPC initiative were unable to receive comparable treatment from all non-Paris Club creditors and some HIPC debtors faced litigation in courts from commercial creditors. The difficulty is that agreements reached with bi-lateral creditors at the Paris Club are not backed by international law to enable debtors to seek comparable treatment.

The crisis poses many challenges

Some of the challenges evidenced by the crisis 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 analyses in debt sustainability frameworks ; 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.

The G20 response to the crisis

The response of the G20 to the crisis was the provision of new resources to the IMF and flexibility in the Debt Sustainability Framework for low-income countries. The role of the private sector in crisis prevention and management remains largely ignored in the present discussions on crisis prevention and management. She emphasized that international financial mechanisms for crisis prevention and resolution must be enhanced in cooperation with the private sector.

Lee Buchheit

Lee Buchheit elaborated on legal innovations in sovereign bonds since the launch of Brady Bonds**.**

Amendment Clauses, Exit Consents, and Trustees Structures

He explained that the movement to majority auction clauses, which allow the control of a supermajority of bondholders to accept amendments to bond terms, has become common practice in emerging market sovereign bond issues.

A second innovation is the implementation of exit consents. Exit consents allow the use of amendment clauses in existing bonds to change certain non-payment terms - such as financial covenants or waivers of sovereign immunity. Exit consents provide incentive to prospective holdouts to participate in the exchange. Ecuador employed exit amendments in 1999 when it exchanged each series of its Brady bonds and Eurobonds for new, uncolletarized 2030 bonds.

He explained that the English practice is to issue sovereign bonds under a trust deed. American trust indentures differ from the English practice: most foreign sovereign bonds issued under US jurisdiction use a fiscal agent instead of a trustee indenture or trustee. The fiscal agent, such as a bank or trust company, does not concentrate enforcement rights. Mr. Buchheit explained that under the US model, individual bondholders retain those rights in respect to their bonds – including the right to sue. However, in recent years, trustee indentures have been introduced in foreign sovereign bonds issued under US jurisdiction: examples mentioned are the Philippines, Iraq and Ecuador.

Testing the role of trustee indentures under US Jurisdiction - The case of Ecuador

The recent debt exchange operation by Ecuador tested the role of trustee indentures in US jurisdiction. Lee Buchheit explained that a large part of the Ecuadorian success was due to lack of action by the trustee – in this case, US Bancorp -- in the face of extraordinary provocation (i.e. event of default). In this particular case, a threshold of 25 percent of bondholders under a trustee indenture was necessary for the bond to be accelerated.

Despite the formal request by bondholders to accelerate the bond, the trustee refused to take action. It has been reported that bondholders reached the 25 percent threshold in only one of the bonds repudiated by authorities. In the words of Buchheit, the passivity of the trustee in this case proved the weakness of the assumption that the trustee would act to represent the economic interests of the bondholders.

Marcus Miller

Argentina and Ecuador cases

Marcus Miller explained that Argentina could continue to borrow in NY even after it had defaulted because there were holders of Argentine bonds in Buenos Aires who had the power to punish and hence the bonds were regarded relatively safe. There are three players instead of two parties to the phenomena, the third being holders of bonds who have power. In his view the restructuring of Ecuador's debt which was being regarded as a case of market manipulation by some participants was unfair as this is how hedge funds have operated. He disagreed with some of the concern around the table that other EMs would go the Ecuador way as he felt that Ecuador had taken a political decision in which access to finance did not prevail as a factor in the decision as the country's prospects of accessing international financial markets was already considerably weak.

The present state of macroeconomic theory inadequate

Marcus Miller pointed to the gaps in the present state of macroeconomic theory which did not provide adequate explanations of the crisis or provide signals to its occurrence. General equilibrium models have no financial sector and are thus inadequate. The crisis has evidenced that models based on assumptions of rationality, efficiency, tastes and preferences are weak. Work done by economists such as Stiglitz, Krugman and Schiller based on behavioral markets and credit markets are gained coinage after the crisis.

Switching from private to public sector

He pointed to the new role of the State in crisis prevention and management that had emerged and agreed with Ms. Schneider on the lack of discussion on the role of the private sector in crisis prevention and management but felt that since the private sector had been at the root of the crisis, that issue has been overshadowed by other issues.

Lessons from past EM crises

Marcus Miller pointed to the damaging effects of sudden stops in capital flows especially on the debt liabilities in the system especially when the framework for debt restructuring was inadequate. Sudden stops in capital flows led to Keynesian type recessions evidenced in EM past crises and had largely been ignored by the IMF. The period of high commodity prices led to a feeling of security and diverted attention from flaws in the financial system. Going forward, China and Russia should me more active in providing support to EMs with the IMF and EU should look after the problems in Central European countries. Much work needs to be carried out in the reform of the financial architecture.

Mr. Robert Gray

Mr. Robert Gray briefed participants on the work of the Institute of International Finance (IIF) in his capacity as Chairman of the Working Group on Crisis Prevention and Resolution:

The IIF has advanced awareness among emerging market officials of the benefits of implementing sovereign investor relations programs (IRPs). Since the publication of the first assessment on investor relations practices by sovereign issuers back in November 2005 by the IIF, progress has been made in improving relations between country authorities and investors. A number of issuers have found the benchmark offered by the IIF useful, with many of these countries being now aware of the benefits of differentiating themselves through enhanced investor relations practices, and data/information provision. The Institute is currently in talks with authorities of two sovereigns that are particularly keen of benefiting from the IIF expertise in this important crisis prevention area.

Awareness of IRPs complement other areas of the IIF work, including advancing the implementation of the Principles for Stable Capital Flows and Sovereign Debt Restructuring in Emerging Markets (the Principles). Mr. Gray informed participants of important advances to implement the Principles through the operations of the Principles Consultative Group (PCG). The PCG, comprised of a diverse mix of creditors, investors and emerging markets officials, has been monitoring and encouraging practical implementation of the Principles in a number of country cases, including ways to address funding challenges for emerging market economies, particularly for EM corporate borrowers.

Mr. Gray briefed participants on recent Innovation in Collective Action Clauses (CACs). Together with the successful implementation of the Principles, CACs support a market-based approach to facilitating a prompt and equitable restructuring. Two recent sovereign bond issuances were mentioned in the meeting. In December 2007, Gabon tapped the Eurobond market with a ten-year, $1 billion bond (governed by New York law) with a coupon of 8.2 percent, its first bond issuance in the international market. Gabon's note secured more flexibility in its amendment provisions than the 2003 Mexican bond issuance, and the CAC implies a combination of English and New York law. In September 2007 Ghana secured $750 million for ten years with a coupon of 8.5 percent. Unlike Gabon's bonds, Ghana's issuance was governed by English law. Ghana's amendment provisions mirror Gabon's combination of New York and English law conventions. Creditors can vote to change Reserve Matters in writing, which requires 75 percent of outstanding principal, or meet and amend with 75 percent of the quorum (reduced to one-third by postponement).

Evolution on Creditor Committees

The Best Practices for the Formation and Operation of Creditor Committees are based on extensive discussions among members of the IIF's Working Group on Crisis Resolution. Additionally, these best practices have been broadly endorsed by the Principles Consultative Group. The PCG's input has been important in the shaping of these best practices in order to encourage participation from debtors who support the Principles. The Principles recommend the use of Creditor Committees in cases in which a debtor defaults on its debt to private creditors and investors.

Briefing on New Work on Debt Reconciliation of Past-due Sovereign Debt

Mr. Gray briefed participants on the progress of the IIF Working on Reconciliation of Past-due Sovereign Debt. The purpose of the reconciliation of past-due sovereign debt is to develop a methodology that can be used by the private sector to estimate the outstanding stock of commercial debt that is long-due. The process of reconciliation of distress debt can be painstaking and time consuming. Commercial debt can be held by a broad range of creditors including suppliers, trading firms, banks and other financial institutions, which complicate the debt reconciliation process. The purpose of the reconciliation of past-due sovereign debt is to develop a methodology that can be used by the private sector to estimate the outstanding stock of commercial debt that is long-due.

The benefits of an agreed methodology are straightforward. For the country facing rising arrears, it facilitates the assessment of the debt stock stance that will identify the magnitude of the debt overhang problem at stake. It enables countries eligible for debt relief accessing public funds in support of macroeconomic stabilization efforts and a venue for addressing relations with commercial creditors through rescheduling or partial debt forgiveness. In the cases mentioned above, the process of settling claims with private creditors followed after the agreement with Paris Club creditors. For creditors, a methodology that makes their claims comparable enhances the transparency of the process, minimizes misunderstandings among creditors, and increases the likelihood of a process considered in good faith.