Sovereign Debt Restructurings: Parity of Treatment between Equivalent Creditors in Relation to Comparable Debts

1. Introduction

The most basic principle in sovereign debt restructuring is the principle that there should be parity of treatment between equivalent creditors in respect of comparable debt to be restructured. I would like in this paper to focus on this basic principle and show the ways in which the principle is applied in different situations.

Two preliminary comments are called for. Firstly, it has often been said that the modern sovereign debt crisis started in earnest with Poland in 1981 (although there had been immediate precursors like Turkey) and that there was a first phase to the crisis lasting from 1981 until 1984. This first phase was characterized by the rapid development of techniques to deal with medium-term restructurings, raising what is best described as involuntary new money and the rearrangement of short-term debt. In 1984, a second phase started to emerge with the concept of multiyear restructurings and the further sophistication of the earlier techniques particularly in relation to alignment of restructurings with a continuing role of the International Monetary Fund (IMF). The principle with which we are concerned was basic to both the first and second phases of the modern sovereign debt crisis.

Secondly, it is possible to adduce general norms that have been applied throughout the different restructurings carried out for the different countries. But it must be borne in mind that there are no absolute rules handed
down which have to be applied to every restructuring nor is there any form of code or convention regulating the requirements country by country of the restructuring process. The form of the restructuring for each country is worked out on a pragmatic ad hoc basis, albeit using various general principles which have been applied to different restructurings. Every country arrangement is individual.

II. Principle of Parity of Treatment

It had become axiomatic in the 1970s to assert that sovereign states cannot go bankrupt. The 1980s have proved this axiom up to a point. Clearly there are no formal insolvency or liquidation rules that apply to sovereign states. There is no method by which the assets of a sovereign state can be distributed among the creditors. Creditors have not scrambled to obtain security for their debts as they usually do in domestic work outs. Instead the creditors have resorted to long, patient negotiations to put their debts on a more orderly footing, essentially a footing on which interest payments will be maintained.

It is on this account that the principle of parity of treatment is so basic. Sovereign debt restructuring is only successful if it is the product of a successful negotiation with the sovereign debtor and if all relevant creditors subscribe to it. It will be noted that the principle enunciates that parity of treatment will be afforded to:

1) equivalent creditors in relation to
2) comparable debt.

I would like to analyze these two issues.

A. Types of Creditors

When a country runs out of foreign currency and cannot service its debts, a variety of different creditors are affected. It is possible to draw up a list of the sorts of creditors who are likely to be affected: (1) banks and other financial institutions; (2) international financial creditors (such as the IMF and the Bank for International Settlements and the World Bank); (3) government creditors—either as direct creditors or alternatively as guarantors (through relevant export agencies) in relation to credit provided by others; (4) trade supply creditors; and (5) individual investors.

Which of these creditors should be made subject to the restructuring process? Which of these creditors should be regarded as equivalent creditors for the application of the principle that equivalent creditors should have parity of treatment?

The one category of creditors which is always part and parcel of the restructuring process is the first category addressed above, namely the
banks and financial institutions. The fundamental concern is that all (or practically all) banks and financial institutions have to be part of the restructuring arrangement. Recently the Philippines' restructuring was delayed for months because one bank was reluctant to agree to the package. How is this achievement of critical mass organized? There is no formal forum. There is no equivalent to the Paris Club which operates for government creditors. What basically happens is that the banks select a small group of banks ranging from about eight to twenty which acts as the representative body of the bank creditors for the purposes of discussing with the country concerned the shape of the restructuring package applicable to the circumstances of the country. Usually this will be done in liaison with the IMF. The representatives of the banks are frequently called a Steering Committee and this committee frequently constitutes subcommittees like economic subcommittees and documentation subcommittees. The outcome of the deliberations of the steering committee with the country concerned is submitted to the banking community at large. Often there are banks which act as national coordinators for banks in different regions. Then a great deal of discussion and effort goes on to achieve adherence by the banks to the proposed restructuring arrangements. Even if a bank refuses to sign a restructuring arrangement, it will usually find itself subject to a de facto restructuring since the banks which do restructure will effectively make the continuance of their restructuring dependent upon the de facto restructuring of nonparticipant banks. I will comment in more detail on the tool for achieving this, namely the mandatory prepayment clause, later.

Often the restructuring arrangements will involve the raising of involuntary new money from the banks. Here parity of treatment between the banks and the requirement for all banks to participate is most pronounced. Usually the parity of treatment is achieved by requiring all banks to participate in a set percentage of their relevant outstandings to the country on a specific historic date.

It is generally accepted that the providers of soft loans, basically international financial creditors like the IMF and World Bank, are exempt from the restructuring process. There is a recent development which may strain the application of this understanding. This is the cofinancing program of the World Bank. This involves the provision of hard loans to troubled countries by a syndicate involving the World Bank and commercial banks. These arrangements contain a provision stipulating that they are exempt from restructuring. So far it has not been tested whether this will be upheld.

Government creditors are made subject to the restructuring process. The government-creditor restructuring happens in a formal way insofar as there is a specific forum in Paris called the Paris Club where the
government-creditor representatives formulate the appropriate restructuring arrangements with the country concerned. Sometimes, however, a country will seek to bypass the Paris Club in order to seek to avoid the formal confirmation of default that application to the Paris Club implies.

It should be noted that the Paris Club only deals with the restructuring of debt. It is a rule of the Paris Club that the provision of new credit will not be discussed as part of any Paris Club arrangement. The most recent instance where this has been a problem is the case of Poland. Poland has sought to obtain new credits from the government creditors, and the inability of the Paris Club to deal with that request led to conditional signing of the relevant Paris protocol followed by individual negotiations between the Polish representatives and the different government creditors concerned. This sort of formality does not apply to the bank restructurings where the Steering Committee will formulate whatever program is necessary for the country concerned.

Both the Paris Club and the steering committee of the banks will be at pains to ensure that there is compatibility between the terms of the government-creditor restructuring and the commercial-bank restructuring.

The case of trade creditors is rather interesting because it has received very different treatment. Usually the trade creditors do not subscribe to any coordinated formal agreement. Also, the requirements laid down in the bank restructuring agreement as to how they should be treated have varied from country to country. In certain exceptional circumstances, trade debt has been exempted from restructuring. In certain cases trade credit has been made subject to precisely the same requirements as the bank restructuring arrangements, i.e., there has been a requirement that it should only be paid off at the same rate that the restructured debt due to the banks is paid off. In other cases, a trade credit program has been initiated under which the country is required to have outstanding trade credit of certain volumes over certain periods of time. These requirements can be satisfied either by the lengthening of existing trade credit or the obtaining of new trade credit.

There is only one example of the trade creditors organizing themselves along similar lines to the bank creditors and subscribing to an overall arrangement; usually individual trade creditors make their own individual arrangements with the country concerned. The exception is the case of Nigeria where a Steering Committee of the trade creditors was formed and, in negotiations with the representatives of Nigeria, a detailed structure concerning the issuance of promissory notes by the Central Bank of Nigeria was formulated and the restructuring offer was sent to the trade creditors worldwide with arrangements for acceptance and appropriate reconciliation of debt.
The treatment of individual investors has also been the subject of a lot of discussion and some different treatment. Generally, individuals are exempted from the restructuring process. The way that individuals would usually be affected is if they were to hold publicly issued bonds or floating rate notes. In most of the European and African restructurings, bonds and floating rate notes are restructured if they are held by banks and other financial institutions. If they are not held by banks or other financial institutions, e.g., if they are held by individuals, then they are exempt from the restructuring requirement. In many of the Central and South American restructurings, bonds and floating rate notes are exempt from the restructuring process whether or not they are held by banks. In each case, individuals holding the bonds or floating rate notes will not be subject to the restructuring process.

The country which has given rise to the most intense investigation of the problems relating to bonds and floating rate notes is Costa Rica. In the original restructuring, the problem became so intense that a special pari passu study group was set up with representatives of the country and the banks and an independent chairman to report generally concerning the problem to the two sides. That group reported that there were two ways in which bonds and floating rate notes could be restructured. The first way was the way used in the European and African restructurings of requiring the banks and other financial institutions to restructure their debt. The second way was by formulating an exchange offer under which securities similar to the securities to be restructured are offered to the holders of the old securities in replacement of those old securities. The new securities would contain the provisions for the new restructured debt. Costa Rica has now embarked on the second of these arrangements, having initially carried out a restructuring exercise entailing the first element. Under the exchange-offer route, individuals would be caught up within the restructuring process.

One final comment is called for on this issue of what creditors are equivalent. The extent of any restructuring depends upon the amount of foreign currency available to the country concerned. At one extreme, if a country has absolutely no foreign currency whatsoever and creditors will not provide any new money, then worries about precedent and worries about principle, as to who should be subject to the restructuring process and who should not, become academic. In that situation, all the debt would be restructured because there would be nothing available to service it. So far the problem has not arisen in such an extreme form.
B. Types of Debt to be Subject to the Restructuring Process

Should all the debts due to the creditors who are to be subject to the restructuring be restructured? Usually there are exempted from restructuring certain categories of debt.

One preliminary point: what is made subject to restructuring is basically categories of debt falling due for payment within a specified capture period. During the first phase of the restructuring crisis, the capture period was kept short. Frequently it was one year. The prime distinguishing feature of the second phase of the restructuring crisis is that the capture periods have been made considerably longer, and this has involved a great deal of concern about the conditionality for restructuring usually focusing on the IMF and appropriate review procedures.

The first category of exempted debt is secured debt. Usually the security has to exist over tangible movable assets to be excluded. In other words, security over immovables situated in the country carrying through the restructuring is not regarded as other than sovereign risk and is not excluded from the restructuring process.

It is often the case (and I think it is absolutely right) that there should be exempted from restructuring new credits provided to the country after the commencement of the capture period for the first restructuring of a country. The provision of new money to the country is what will lead in the long run to normalization of credit arrangements, which is in everybody’s interest. The restructuring process should not contain within it any form of disincentive for the provision of new credit to the country.

A further exempted category is debt subject to guarantees from guarantors outside the country concerned if the guarantee has been issued by someone other than a bank or financial institution. The result of this exemption is that the relevant debt will be subject to a call under the guarantee but the subrogated rights of the guarantor will or will not be subject to restructuring depending upon the category of the creditor concerned.

Debt incurred under a foreign exchange contract is usually exempt as is indebtedness arising out of contracts for the purchase or sale of precious metals.

Indemnity payments for increased costs will be exempted as will top-up and top-down requirements under multicurrency facilities.

It has also now become generally accepted that interbank deposit debt should be excluded from restructuring. In some of the earlier restructurings, this sort of debt was made subject to the restructuring requirement. The Bank of England and other regulators expressed concern about interbank deposits being restructured because of the adverse impact it could
have on the interbank market. Accordingly, all the modern restructurings exempt interbank deposits from the restructuring.

Different arrangements treat short-term debt differently. This basically comprises trade credit from banks in the form of letter of credit outstandings, acceptances and so on. Sometimes this sort of debt is restructured, and sometimes it is not. Why is there no uniform treatment? Again it basically depends upon the amount of foreign currency available to the country concerned. If trade credit is made subject to restructuring, then it might be possible in some cases to avoid the need to provide new credits to the country. Alternatively, it may reduce the amount of new money that needs to be lent into the country at the relevant time. Brazil was the first case to implement a restructuring of trade credit. It has been made subject to restructuring in various recent arrangements including the Philippines and Morocco. The techniques for restructuring trade credits are quite complicated, and those techniques are still in the process of development.

III. Provisions of the Bank Restructuring Agreement
Setting out the Requirement for Parity of Treatment

Perhaps the most obvious method of achieving parity of treatment for differing categories of comparable indebtedness would be to ensure that the debtor country covenants with the bank creditors not to pay comparable indebtedness owed to other creditors without the consent of the bank creditors. This path, however, has not been pursued in most of the restructurings. Basically, the reason for this is concern that a provision of this sort might be construed as inducing breach of contractual arrangements.

Therefore, there has been developed a technique of what has become called the mandatory prepayment clause. In essence, the mandatory prepayment provisions state that if a given proportion of an item of comparable indebtedness owed to a third-party creditor is paid, then the same proportion of the rescheduled indebtedness owed to the bank creditors must also be paid. Put another way, the provision requires that reduction in exposure of another creditor or class of creditors must be accompanied by a pro rata reduction in the exposure of the bank creditors.

In practice, the relevant provision in the rescheduling agreement will be somewhat more complex than the foregoing remarks suggest. In particular, the provision is likely to provide that payments to the bank creditors will be required only if they (or a majority of them) request a reduction and the reduction in third-party creditor exposure was made without the consent of the bank creditors (or a majority of them).
This mandatory prepayment provision effectively entails that equivalent creditors outside the formal restructuring process are also involved de facto.

Between the banks that formally subscribe to the restructuring agreement, there is then a very complex and thorough set of provisions regulating equal treatment in relation to receipts and recoveries if the country defaults on its payments under the agreement.

IV. Some Consequences of the Parity of Treatment Clauses

The principle of parity of treatment and the detailed provisions of the mandatory prepayment clause mean that some of the standard provisions in credit arrangements have to be considerably rethought insofar as they are incorporated into restructuring agreements. I would like briefly to mention the way in which two fundamental clauses of credit arrangements are subject to reformulation in the context of a restructuring. These are the cross-default and the negative pledge provisions.

Ordinarily in a voluntary credit situation, a cross-default clause is contained within the documentation. It is in the interests of the creditors to make that cross-default as wide-ranging as they can insofar as the intention is to provide an early warning signal of a prima facie credit risk. Default on other debt by a borrower is a most obvious prima facie credit risk. The intention is to put the creditors in the same position as any other creditor is in if the debt of that other creditor is defaulted. It is important to get to the negotiating table as early as possible. However, restructurings take place in the situation where early warning signals are a luxury long since dispensed with. All that will be achieved by incorporation of the ordinary cross-default provisions into a restructuring agreement is continuing default in relation to debt that should have been put on an orderly footing. Therefore, one will find in restructuring arrangements that the cross-default does not operate in respect of all other types of debt due from the country concerned. Most usually, it is restricted to debt owed to the bank creditors party to the restructuring agreement. It is all a matter of incentives and disincentives. The prime incentive that the banks have is to seek to get the country to pay them on debt due to them. There is certainly a disincentive on making any provision which entails that the country has an interest in paying other sorts of creditors.

There is also a philosophic difference in the way that the negative pledge works between the ordinary voluntary credit and the restructuring arrangement. In an ordinary voluntary credit, the concern is to tie up the negative pledge fairly widely to prevent other creditors obtaining any form of preferential security position. In a restructuring, however, there is an
advantage to the creditors and to the country if new money is provided albeit on a privileged, secured basis. Lending on a secured basis will be one of the first ways in which new creditors will provide new money to the country. Another way is the emergence of trade lines. Therefore, it is important to allow a reasonable amount of room in the negative pledge clause for new debt to be provided to the country on a secured basis. Sometimes that relaxation lies in allowing trade lines to be secured. Sometimes provisions are inserted to allow project financing to be provided on the basis that the project is evaluated as self-financing and the financing concerned is secured over the assets involved in the project.