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SOVEREIGN DEBT CHALLENGES IN THE EUROZONE
AND THE LOOMING CHALLENGE OF REFORMING SOE’S

Greek Debt – The Endgame Scenarios

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GREEK DEBT -- THE ENDGAME SCENARIOS

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At about this time last year, we wrote a short paper entitled “How to Restructure Greek Debt.” The intervening months have seen the following major events in the Eurozone debt crisis:

- In May 2010, Greece concluded an agreement with the Eurozone member states, with the backing of the IMF, for access to a €110 billion facility (€80 billion from the Eurozone and €30 billion from the IMF). That amount was judged to be sufficient to allow Greece to repay -- in full and on time -- all public sector debts maturing during the three-year IMF program period and to cover anticipated budget deficits during that period. One objective of this total bailout of Greece was to staunch any risk of contagion to the other European peripheral countries.

- The European Central Bank promptly embarked on a program of open market purchases of Greek and other Eurozone periphery debt in order to “ensure an orderly monetary policy transmission mechanism.” This program continues, in fits and starts, as of this writing. The ECB is thought now to own €40-50 billion of Greek sovereign bonds purchased in the secondary market.

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1 Partner, Cleary Gottlieb Steen & Hamilton LLP (New York) and Professor, Duke Law School, respectively.
2 Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1603304. The published version of this paper can be found at Lee C. Buchheit & Mitu Gulati, Restructuring a Nation’s Debt, Int’l Fin. L. Rev. 46 (June 2010). A copy is attached to this document.
On October 18, 2010, German Chancellor Angela Merkel and French President Nicholas Sarkozy took a stroll on a beach in Deauville, France. When they returned holding hands (in a figurative sense, naturally), they announced plans to alter the EU treaty to put in place a permanent “crisis management system” that would include provisions to ensure the “adequate participation of private creditors”. Unfortunately, Mr. Sarkozy and Mrs. Merkel did not confide to the markets precisely what this “adequate participation” entailed. Predictably, the markets assumed the worse, resulting in a sell-off of Eurozone periphery sovereign debt. Yields on that paper moved sharply higher.

In late November 2010, Ireland asked for, and received, its own €85 billion bailout package, also with IMF conditionality.

To calm the markets after the Deauville adventure, the finance ministers of the five biggest EU member states announced on November 28, 2010 that “any private sector involvement [in Eurozone sovereign debt restructurings] … would not be effective before mid-2013”. In other words, investors were assured -- or thought they had been assured -- that all existing Eurozone sovereign debt instruments would be immune from a debt restructuring.

On March 8, 2011, Greece filed a registration statement with the U.S. Securities and Exchange Commission enabling the country to issue bonds to “diaspora” Greek investors at rates significantly below market.

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On April 6, 2011, as this paper was being written, Portugal asked the European Union for financial assistance.\(^\text{10}\)

March 23, 2011 saw the release of a term-sheet for a permanent facility to assist distressed Eurozone sovereigns after 2013, the European Stabilization Mechanism (“ESM”). The term sheet makes clear that ESM loans will be given preferred creditor status.\(^\text{11}\) A similar claim to preferred creditor status has not been made (or at least not yet been made) for the €80 billion EU contribution to the Greek bailout package.

Last month, the Greek Finance Minister said publicly that even the €110 billion EU/IMF facility might not be enough to tide Greece over until 2013.\(^\text{12}\)

To date, one or more of the following concerns about permitting a restructuring of Eurozone sovereign debt have induced the official sector to continue a policy of total bailouts of all afflicted countries.

- **Contagion.** Confronted with a debt restructuring in one country, will the markets recoil from all peripheral Eurozone countries, perhaps sparking a general crisis?

- **Effect on banks.** Eurozone commercial banks hold the lion’s share of Greek sovereign bonds. A debt restructuring that significantly reduced the balance sheet valuation of these assets could threaten the solvency of some institutions, perhaps requiring a recapitalization from the host government.

- **Honi soit qui mal y pense.** Would a Eurozone sovereign debt restructuring indelibly stain the reputation of the Euro and perhaps even undermine the foundations of the monetary union itself?

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\(^{10}\) See Peter Wise and Peter Spiegel, *Portugal appeals for EU bail-out*, Financial Times, April 7, 2011.


\(^{12}\) *Id.*
Although each of these constraints is still present to some degree one year after the Greek debt crisis erupted, it is no longer obvious that they, individually or in aggregate, continue to justify complete paralysis. The markets have had an opportunity to focus on the differences in the financial positions of the various peripheral Eurozone countries. Putting aside the obvious fact that the policy of total official sector bailouts has not prevented contagion (see Ireland and Portugal), blind indiscriminate contagion has diminished as a risk. As for the commercial bank holders, they have been given a year to sell or hedge exposures, or otherwise provision against an eventual hit to the value of their Greek positions. Some are no doubt still uncomfortably exposed, but this list should be smaller than it was a year ago. (It is not clear to us whether all banks have in fact made hay while this sun has been shining, but they have at least been given a chance to do so.)

We have now been asked to update our earlier assessment of the Greek debt situation in light of these developments. In particular, we have been asked to speculate on possible endgame scenarios for the Greek debt crisis.

We divide these scenarios into three groups: (i) Greece goes the distance with the current IMF/EU program and a debt restructuring is avoided altogether, (ii) a debt restructuring of some kind becomes unavoidable after June 2013 when the EU’s “read my lips -- no restructuring until 2013” promise lapses by its terms, and (iii) a liability management transaction affecting some or all of the Greek debt stock is launched before 2013.

**The Official Scenario -- Greece Goes the Distance**

Under this scenario -- which enjoys the public support of Greece’s official sector sponsors (the IMF and the EU) as well as the Greek authorities themselves -- Greece will stick with its program of fiscal austerity for the full three years. At the end of that period (apparently the initial prediction of renewed market access in 2012 has now been withdrawn), Greece returns to the capital markets to refinance its maturing debt and fund amortizations due on the EU/IMF bailout loans. The markets, this theory contends, will be so impressed with the turnaround in Greece’s fiscal position that private sector monies will be advanced in sufficient quantities and at tolerable interest rates to permit Greece to resume normal rollovers of its maturing debts. Over time, Greece will run primary budget surpluses and will begin to nibble at its (admittedly) colossal debt stock. This, says the official sector, is the benignant future that awaits both Greece and all of its lenders.
The Risks

- On its current path, the Greek public sector debt in 2013 will represent 150-170% of GDP. Moreover, more than half of that debt stock will by then be in the hands of official sector creditors (the EU, the ECB and the IMF), at least one of which (the IMF) claims for itself preferred creditor status. Will the private capital markets really be eager to resume financing a country in this precarious position?

- Two more long years of fiscal austerity lay ahead for Greece. Will the Greek politicians be able to hold the social/political consensus together that long?

- What happens if Greece begins to miss its IMF performance targets? Will the IMF and EU casually relax the conditionality so that drawdowns can continue under the €110 billion facility, or might German parliamentarians insist on taking a harder line? Waiving compliance with the fiscal performance targets in order to avoid a debt default, of course, risks sending this message to other prospective borrowers from official sector bailout facilities: “Eurozone countries in financial distress can expect assistance from the EU and IMF in two -- but only two -- circumstances: (i) when those countries adopt and stick to stern fiscal austerity programs or (ii) when they don’t”.

- The €110 billion facility was intended by its authors to be an overwhelming demonstration of financial firepower -- a veritable Hank Paulson bazooka. If this was the antidote to contagion, however, it failed. Ireland has succumbed. So has Portugal. If one of these other countries decides to pursue a debt restructuring before 2013, might not that precedent fuel calls for something similar in Greece?
Post-2013 Scenarios

We see four possible scenarios if Greece is unable to regain market access in late 2013. Three involve a post-2013 restructuring of the Greek debt stock, while one envisions that Greece muddles on for an indefinite period as a ward of the official sector.

Scenario One: The Official Sector Takes the Spear. By June 2013, more than one-half of the Greek debt stock will be in the hands of official sector lenders. By significantly restructuring their own claims against the country, these official sector lenders could attempt to render Greece presentable to the private markets.

The Risks

- It is difficult (read, nearly inconceivable) to envision a political environment that would permit the EU and ECB -- much less the IMF -- to sacrifice their taxpayers’ money in order to ensure full and timely repayment of commercial creditors, some of whom are earning yields in excess of 12%.

- Will the EU carry the burden of such a restructuring alone, or will it expect the IMF to chip in? And if the latter, what, if anything, will be left of the IMF’s sacrosanct “we never restructure” status?

Scenario Two: The Private Sector Creditors Take the Spear: Under this scenario, the holders of the remaining Greek debt stock still in private hands in mid-2013 will be presented with a restructuring proposal that effectively eviscerates the value of their paper.

The Risks

- Even a total write-off of that remaining one-third to one-half of the debt stock may not be enough to return Greece to creditworthiness.

- These creditors will never go gentle into the good night of a total loss of value. Something coercive, something truly ugly, will be needed to prod them into the abattoir. What effect would this have on future lending to Greece or, for that matter, to other Eurozone sovereigns?
Scenario Three: All Together Now. The third alternative involves a joint debt restructuring by both official and private sector lenders sometime after the middle of 2013. With private sector involvement, the official sector can't be accused of mollycoddling commercial lenders; with official sector involvement, those commercial lenders would not face a total write off of the value of their claims.

The Risks

- Some might argue that this demonstration of fraternal solidarity will only end up alienating the affections of both groups, the official and the private lenders. Would it not be better, they might argue, to keep one camp sweet for future borrowings?

- Unless the terms of the two restructurings were calibrated to be equivalent in a net present value sense, this approach risks intercreditor jealousy and suspicion.

Scenario Four: Wardship. Perhaps the paralyzing fear of a Eurozone sovereign debt restructuring will persist even after 2013 has come and gone. If so, Greece could be relegated to the status of a ward of the official sector for an indefinite period. The remaining bonds in the hands of commercial lenders, and the amortizations due on the first round of EU/IMF loans, would presumably all be paid with the proceeds of drawings under successor official sector credit facilities. After the passage of a few more years, virtually all of the Greek debt stock will then be owed to its official sector rescuers.

The Risks

- This could be politically unpalatable to the Greeks. Someone is bound to say that when Greece took the first €110 bailout, this was equivalent to a bibulous landlubber accepting the King’s schilling from the sergeant of a Royal Navy press gang in order to buy one more round of drinks: when the poor fellow wakes up in the morning he will be facing ten years before the mast in His Majesty’s service.

- It can’t be a very pleasant alternative for the official sector either.
Pre-2013 Restructuring Scenarios

If for any reason Greece cannot, or does not wish to, wait until mid-2013 before addressing its debt stock (a decision that presumably would require at least the passive acquiescence of the EU, the IMF and the ECB), broadly speaking we see two possible scenarios.

The EU’s post-Deauville assurance that there will never be a restructuring of an existing Eurozone sovereign debt instrument (at least until 2013) presents something of an obstacle to any pre-2013 restructuring of Eurozone sovereign debt instruments. The face-saving solution may be linguistic. A voluntary liability management transaction undertaken by the debtor country before 2013, the argument goes, is not a “restructuring” as that term was used in the post-Deauville assurance. Restructuring, it may be claimed, connotes a degree of coercion on the affected creditors. But if the creditors themselves elect voluntarily to participate in a liability management transaction to improve the creditworthiness of their debtor, who in the official sector can or should gainsay that decision?

Scenario One -- A Light Dusting. One possibility would be to approach the private sector (principally northern European commercial bank) holders of Greek bonds with a mild restructuring proposal that limits, or even neutralizes altogether, any net present value loss they would suffer as a result of participating in the transaction. A simple Uruguay-style\textsuperscript{13} reprofiling of the debt stock with no haircut to principal would fit this bill. To ensure widespread creditor acceptance, some might urge that any new instrument issued to effect the restructuring benefit from credit enhancement (a partial guarantee from the official sector, for example, or collateral security \textit{à la} Brady bonds) so as to neutralize the negative NPV consequences of the stretch-out of maturities. One obvious motivation for a mild restructuring of this kind would be to cushion its effect on the balance sheets of overexposed northern European commercial banks. A second motivation, of course, would be to move existing debt maturities beyond the current program period so as to liberate a portion of the €110 billion bailout facility for other purposes.

\textsuperscript{13} In 2003, Uruguay “reprofiled” its external debt stock by extending the maturity of each of its 18 series of bonds by five years. There was no haircut to principal; coupons were kept the same. See Lee C. Buchheit and Jeremiah S. Pam, \textit{Uruguay’s Innovations}, 19 J. Int’l Banking L. and Reg. 28 (2004).
The Risks

- Will such a light dusting of the debt stock return Greece to a sustainable position, or will it be just the first of a two stage restructuring with the real blood-letting deferred to stage two?

- Neutralizing the negative NPV effect of a maturity stretch out by adding credit enhancements is expensive and contraindicated for a country facing a severe debt crisis. But asking bondholders voluntarily to accept an NPV loss, however, will surely test the sponsors’ powers of persuasion.

- Overexposed commercial banks that currently hold Greek sovereign paper in their “hold to maturity” book at or near par value may want an assurance that a transaction of this kind will not require an immediate marking of their positions to market values.

Scenario Two: The Full Monty. For the sake of completeness, the final option would involve a full restructuring of the Greek debt stock prior to 2013 in order to give the country a visibly sustainable debt profile as soon as possible. Such a restructuring would presumably look to cut the size of the debt stock in nominal terms as well as to iron out the maturity profile, all to the end of positioning Greece to return to the capital markets within a reasonable period of time following the closing of the transaction.

The Risks

- A Full Monty approach would require all concerned to jettison any illusions about sponsoring a wholly voluntary transaction.

- This will lead to the usual discussion about how -- in the odious patois of investment bankers -- to “incentivize” the bondholders to participate. Change local law to compel participation (more than 90% of the debt stock is governed by Greek law)? Threaten a payment default on any untendered bonds (the “abandon all hope ye who do not enter here” tactic)? Declare any non-tendered bonds ineligible at the ECB discount window?

- Having spent billions of Euros of taxpayer money to stave off any restructuring of Eurozone sovereign debt, will the political class in Europe really be prepared now to careen to the other extreme of countenancing a savage debt restructuring?
• A major tremor of this kind affecting the Greek debt would indeed be felt in Lisbon, Madrid and elsewhere in peripheral Europe.

The Historical Perspective

We have all been here before.

In August of 1982, Mexico was forced to declare a moratorium on the repayment of its external debt owed to commercial banks. Over the course of the next two years, more than twenty other countries followed suit -- it later came to be called “the global debt crisis” of the 1980s.

Then, as now, the lenders to these sovereigns were primarily commercial banks. Then, as now, some of those banks were dangerously overexposed and could not have endured any significant writedown of the value of their sovereign credit portfolios. Then, as now, the banks approached the official sector institutions asking that the official sector either lend the sovereign borrowers the money to continue normal debt service on their bank credits or, failing that, guarantee the banks’ loans.

Then, unlike now, the banks were rebuffed. The official sector flatly refused to bail the banks out of their bad credit decisions in the early 1980s. But, in recognition of the balance sheet fragility of some of those institutions, the official sector (and in particular the U.S. Treasury Secretary) agreed to use its influence over the sovereign debtors to promote a debt restructuring technique that avoided any need for the banks to write down the value of their sovereign portfolios.

This technique, later named after U.S. Treasury Secretary James Baker, had four components.

• The debtor country was required to sign up to an IMF stabilization and adjustment program.

• The principal of the banks’ loans was rescheduled over relatively brief periods -- 18 to 24 months.

• Interest payments on those rescheduled loans, however, had to be kept current to avoid negative accounting consequences for the banks.
Because many countries lacked the resources even to pay interest, the banks were compelled to lend the debtors “new money” which was then recycled back to the banks as interest payments on their existing exposure.\textsuperscript{14}

As the 1980s rolled sweetly on, the four elements of this Baker Plan debt restructuring technique were repeated, sometimes four or five times, in the afflicted debtor countries. In public, Secretary Baker and others expressed fathomless confidence that the banks would never experience a loss on their sovereign credits. Why? The debtor countries, it was predicted, would after years of IMF tutelage “grow” out of their debt problems. In private, however, the official sector players warned the commercial banks to begin provisioning their loan loss reserves against the possibility that a loss might someday materialize.

After seven years of the Baker Plan, a new U.S. Treasury Secretary, Nicholas Brady, announced (on March 10, 1989) a shift in U.S. Government policy toward the management of the global debt crisis. Secretary Brady encouraged the banks to write off a portion of their exposure to the debtor countries, and to stretch out repayment of the balance for 30 years, as a means of ending the global debt crisis in a single stroke. And, more or less, the Brady Initiative did just that. Banks swallowed (modest) losses on their sovereign portfolios; debtor countries regained (modest) market access; the banks’ loan loss reserve provisions (built up over the prior seven years) cushioned the balance sheet effect of the losses. A banking crisis in the developed countries did not follow the launch of the Brady Initiative.

The debt management technique adopted by Secretary Baker and his official sector colleagues in 1982 therefore had the effect of grabbing the commercial bank creditors by their noses and holding them in place as the lenders of record until a more durable solution to the problem could be implemented. The concession made to the bank lenders at the time was a restructuring technique that avoided accounting losses while the banks were provisioning their loan loss reserves. When the day of reckoning eventually arrived with Secretary Brady, the losses were felt by the bank creditors that had made the loans in the first place.

Contrast this to the debt management technique being used in Europe in 2010-2011. This time around, the official sector players are *not* holding the original lenders by the nose; the official sector is actually buying out the original lenders in full and on time as each existing bond matures and is paid by drawing down an official sector credit lines. The difference is this -- if the sword of a debt restructuring must eventually fall in order to render Greece’s debt stock manageable (something that most economists view as inevitable), that sword will fall principally on the neck of the official sector lenders. The original creditors will have swapped places in the tumbrel with official lenders quite literally in the shadow of the guillotine.

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Attachment: