Collective action clauses in sovereign bonds

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Introduction

The universal adoption of collective action clauses (CACs) was the most promising reform proposal in recent debates on sovereign debt crisis management. Academics and the public sector had been promoting CACs since 1995, yet market practice did not begin to change until 2003. This delay is often attributed to the opposition of investors and sovereign borrowers to CACs.

This article evaluates the publicly stated as well as the suspected private motives of the two sides to block the spread of CACs. It draws on a wide range of existing evidence and adds some new theoretical considerations to show that there is no reason to be sceptical of CACs unless bailouts exist as an alternative crisis resolution mechanism. This conclusion may be of interest purely for the sake of historical accuracy. But more importantly, it may help to better understand and to assess any potential future resistance from market participants, e.g. in the process of introducing CACs in bonds governed by German law.

Background

When a sovereign government finds itself unable to service its bonds, it will ideally engage the bondholders in negotiations for debt relief according to a pre-defined, orderly procedure. Alas, until recently the majority of bonds would not provide for any such procedure. To change the payment terms of the bond – such as coupon rate, principal, or maturity – would usually require the consent of each and every bondholder, which is practically impossible to achieve. A debtor country would therefore typically resort to an exchange offer. Bondholders would be asked, under the implicit or explicit threat of default, to tender the existing bonds in exchange for ones with less stringent payment terms.

Bondholders may of course elect not to participate in the exchange. Free-riding on the debt relief provided by their peers, they may gamble for full repayment according to the old terms later on. Such 'holdout' creditors can be a great nuisance to debtors because they retain their full legal rights under the old bond, which they may use in court, for example to interfere with the borrower's trade and finance flows. The debtor therefore has the unpalatable choice between facing potential legal action and paying the holdouts in full. The latter option is expensive, unfair to mainstream bondholders, and an outcome whose existence the debtor should deny in order to discourage holdouts in the first place. Given the holdout problem, the borrowing country will strive for as high a participation rate as possible. The exchange offer will thus have to be very

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attractive for bondholders, which implies it cannot bring much relief. Alternatively, the debtor may try to artificially boost participation by means of so-called exit consents (Buchheit and Gulati 2000) which are, however, regarded as coercive by investors and accordingly liable to making the debtor unpopular with the market.

Anticipating these troubles and potentially messy outcomes, debtor countries have tended to admit default only at the last possible moment, thereby aggravating the crisis up to the point where outside help becomes inevitable. Other countries and international financial institutions such as the IMF have regularly felt compelled to provide assistance to avert even larger damage to the debtor country and contagion to other regions – or so the official justification usually goes.

Such 'bailouts' are perhaps the worst of all crisis resolution mechanisms in terms of equity and efficiency. Accordingly, there ensued a search for alternatives which yielded, besides the still-born 'Sovereign Debt Restructuring Mechanism (SDRM)' (Krueger 2002), the rediscovery of CACs. These provisions had long been a regular feature of sovereign bonds governed by the laws of England, Japan, and Luxembourg (Liu 2002), which together accounted for less than 40% of the bonds outstanding in 2003 (IMF 2003). The clauses were generally not used in the two other popular jurisdictions, New York state and Germany. This omission was rooted in tradition and, arguably, market preferences, rather than in any legal impediments to collective action (Liu 2002). The universal adoption of CACs thus presented itself as a logical step.

Used wisely, CACs can facilitate an orderly, efficient restructuring process: A troubled debtor will approach bondholder representatives at an early stage to negotiate a proposed amendment of the bond terms. The proposal will then be put to the vote at a bondholder meeting. Approval by anywhere between two-thirds and 85% of the eligible principal, depending on the specifics of the clauses, will effectuate the amendment for the entire bond issue, including any dissenting creditors. The outcome of this process can be considered fair because all bondholders are treated equally; it is consultative in nature and thus more creditor-friendly than an exchange offer; and most importantly it eliminates the holdout problem. Moreover, CACs are a natural complement to the appointment of a trustee, an institution which can suppress harmful individual bondholder action before a CACs-induced restructuring becomes effective (Häseler 2010).

Despite the evident advantages of collective over individual action, the universal adoption of CACs began to appear on the policy agendas only in the mid-1990s. Eichengreen and Portes (1995) can be credited with rediscovering CACs but were soon followed by a series of public sector (G10, G22, IMF) reports that called for the inclusion of CACs in New York law bonds. These calls remained unheard for several years until March 2003 when Mexico made what was widely perceived to be the first major issue with CACs in the US market. The effects of this precedent were dramatic: Within a year, market practice was reversed; issuing with CACs under New York law went from being the exception to being the norm. Figure 1 below illustrates the shift.

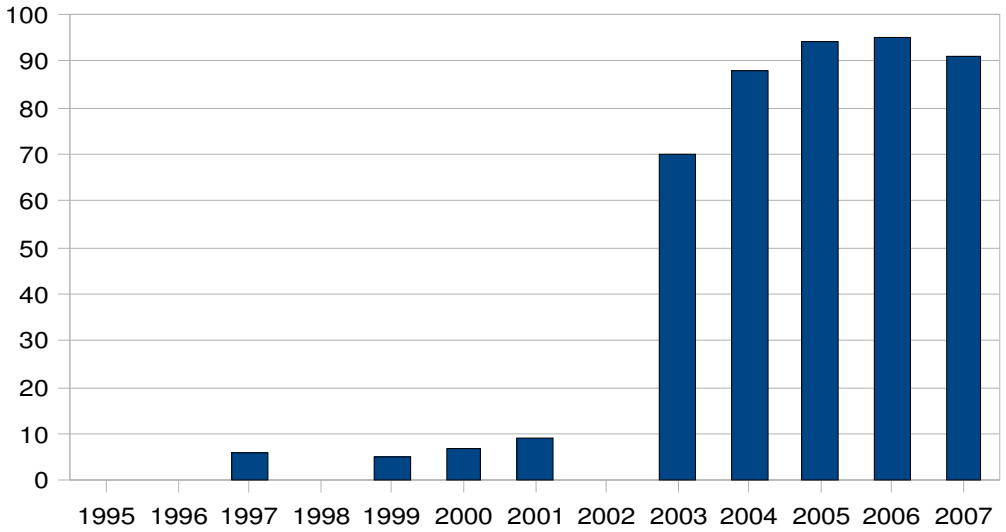

Figure 1: Percentage of new issues that contain CACs – source: Bradley et al (2008)

Gelpern and Gulati (2007) investigate, primarily through interviews with market participants, the factors that eventually led to these events. The authors emphasise the importance of politics and public symbolism. This paper, by contrast, asks why the change did not materialise sooner. Several sources report scepticism on the part of borrowers and outright opposition to the spread of CACs on the part of investors (Häseler 2009). We ask whether this discomfort with collective action was ever justified.

This question is relevant in at least two respects. Firstly, we hope to shed some more light on a somewhat obscure episode of financial market history. But more importantly, it is imperative to understand the incentives of investors and sovereign borrowers for the sake of pending reforms. Bonds are still being issued without CACs. And little progress has been made towards the proliferation of trust structures, which also hinges on the individual versus collective action divide (Häseler 2008). With this dual purpose in mind, we proceed to scrutinise in turn the position of investors and sovereign borrowers.

Investors' Perspective

Moral Hazard

"Sovereign bondholders are genuinely concerned that making sovereign bonds easier to restructure will make restructurings (even) more likely", said Michael Chamberlin (2002, p. 8), Executive Director of the Trade Association for the Emerging Markets. The possibility that CACs might exacerbate the moral hazard problem already inherent in sovereign lending was indeed the most common apprehension about the spread of the clauses. We will comment on this concern from two perspectives.

First, it is not at all clear that there is a connection between the organisational ease and the incidence of restructurings. Fears about moral hazard appear to be premised on the assumption that the unpleasant prospect of a disorderly restructuring is a major factor in deterring borrowers from default. Häseler (2008) categorises various views of sovereign default to argue that such a deterrence effect cannot be very large. A sovereign debtor who defaults opportunistically has

much to lose besides the costs of restructuring, namely first and foremost its reputation with the financial markets.

Second, even if more CACs were to result in more restructurings, it is not quite clear why that should necessarily hurt investors. Existing bonds would be unaffected. New issues would conceivably trade at higher yields, which means investors are compensated for any additional risk. Those who are not prepared to bear that risk have an almost infinite number of alternative investments to choose from.

Esho et al (2004) empirically test for a moral hazard effect. Sadly, their study is based on corporate bonds only and the methodology is not entirely convincing (Häseler 2009).

Fear of Abuse

Bondholder representatives have expressed concerns that majority action provisions could be abused by debtors who buy back a sufficient share of a particular issue to vote for a restructuring that runs squarely against the interest of the remaining bondholders (IMF 2002). This concern ignores the fact that CACs typically specify that bonds held by the issuer or by entities under its control are excluded from voting. And once again, the borrower's behaviour is constrained by what the market deems fair, much rather than by how the courts will read the provisions of the bond. Abuse of CACs is not an option for any issuers who value their reputation.

Ideology

Sovereign bonds issued under New York law traditionally followed the provisions of the Trust Indenture Act (TIA) of 1939, which postulates that no bondholder may be forced to cede any claims she has under the bond contract. The fact that the TIA applies only to corporate bonds but was nevertheless adhered to also in the sovereign bond market may be indicative of a dislike, particularly by US investors, for being part of a minority upon whom a restructuring with CACs is imposed (Buchheit and Gulati 2002). Accordingly, Michael Chamberlin (2002, p. 5) speaks of the "legitimate right of creditors not to be bound to chances in debt payments made against their will." In that sense, opposition to collective action may be seen as a mere expression of individual freedom. Like the right to carry a gun, individual rights of action against a sovereign debtor have little practical value but the potential to do much social harm.

If ideology really played a role in the market's hesitation to embrace CACs, this reveals a certain degree of hypocricy. Even before 2003, investors would have had to choose their bonds very carefully if they wanted to avoid being subject to CACs. Given their prevalence under English law, any larger sovereign debt portfolio likely contained the clauses. Furthermore, New York was never the sanctuary from collective action that some said it was. Gugiatti and Richards (2004), Gelpern and Gulati (2008), and Häseler (2010) all document large volumes of pre-2003 New York law bonds that nevertheless contained CACs. In all likelihood, the vast majority of investors are ignorant of the contractual details of the instrument they hold, which is inconsistent with their having any strong sentiments on the clauses.

Investor Surplus

In 2002, creditor representative organisations published a set of model collective action clauses. This move has been variously interpreted as a waning of investor opposition, or as bid to take the wind out of the public sector's pressure for the market to adopt measures that would encroach even more upon creditor rights than CACs, such as the SDRM.

These model clauses envisaged a voting threshold of 95%, which the drafters regarded as necessary to curb moral hazard. We impute an alternative motivation for the high voting threshold: It can be seen as a desperate attempt to achieve second best at a time when the political debate heralded the end of the first best - unanimous consent. Loosely speaking, the higher the voting threshold, the greater the creditors' bargaining power in a restructuring. This point can be illustrated graphically, as in Figure 2 below.

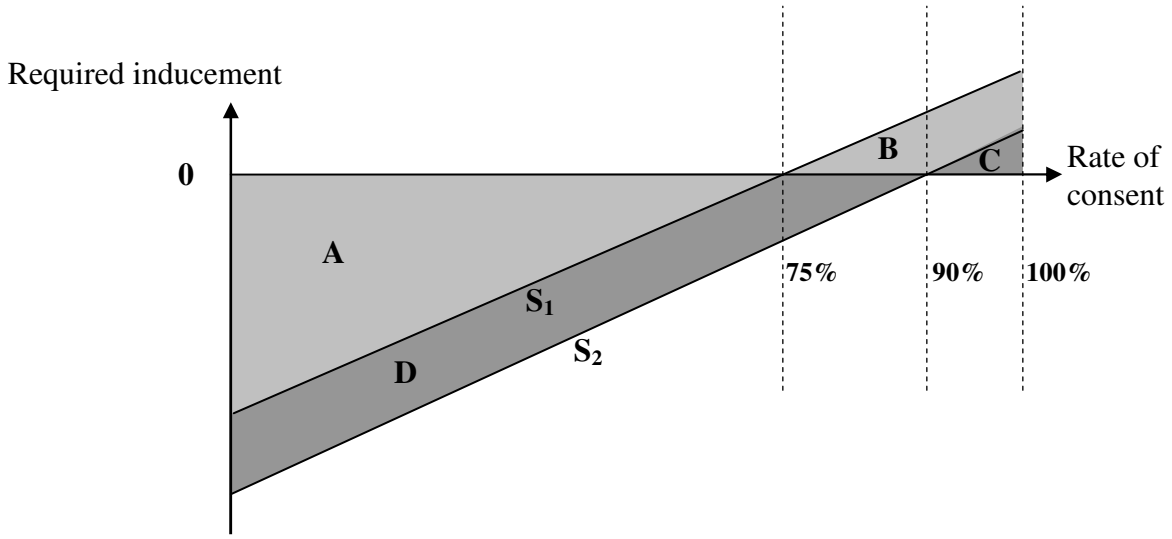

Figure 2 – Voting thresholds and investor surplus

Imagine a troubled sovereign debtor who decides to make use of the CACs in its bonds by proposing an amendment to the financial terms. In our graphical model, the horizontal axis measures the proportion of bondholders who will support the restructuring. The vertical axis measures the inducement required to persuade bondholders to vote for the restructuring. This setup gives rise to a supply schedule for votes such as S_1: At the bottom of S_1 we find those bondholders who are most enthusiastic about the restructuring. They expect a large surplus or, in other words, require a negative inducement. Towards the top we find those who are most sceptical; they would require a side payment to tender their votes. Of course no inducements can be paid in a restructuring, i.e. we are at the point where the supply schedule intersects the horizontal axis. The debtor must design the restructuring offer such that S shifts to the point where the required threshold is achieved. To illustrate, we have picked supply schedules that achieve 75% and 90% consent rates, respectively. Under S_1, the net gain that investors would receive from a restructuring, let us call it 'investor surplus', is equal to the areas A less (B+C). Under S_2, that area increases to (A+D) less C. Increasing the voting threshold thus increases investor surplus by B+D. This is why it was no surprise to see investor representatives lobbying for high voting thresholds.

Borrowers' Perspective

Borrowing costs

The fear that New York law bonds with collective action clauses could be less attractive to investors and thus imply higher borrowing costs is by far the most widely-cited explanation for the sovereign borrowers' hesitation to incorporate the clauses in new bond issues, and was thus identified as the biggest obstacle to reform early on in the debate. As Jack Boorman (2003) of the IMF dramatically put it: "[T]he private sector seems to be going around to emerging market countries and trying to scare the hell out of them about the fact that [CACs] will lead to an increase in spreads...".

Accordingly, much research has been devoted to investigating empirically the existence of any spread premia on sovereign bonds with CACs. Häseler (2009) summarises the five major studies in the period 1999 to 2004 and concludes that higher borrowing costs are a myth. Although the empirical methodology improved over time in terms of sample sizes, accuracy of coding, and econometric sophistication, no study achieved stable results that stood the test of the next paper down the line. The same lack of spread premia for CACs emerges from two more recent studies, Bradley et al (2008) and Häseler (2010).

Signalling

The IMF (2002) discussed the possibility that borrowers might be afraid that the financial markets will view the use of CACs as a signal of deteriorating credit quality. After all, CACs only have value in a restructuring situation. A borrower who will never default has no reason to use the clauses. The concern here is that the issuer may unwittingly reveal information about its *type*, in addition to the apprehensions that investors may have about its *behaviour* (moral hazard).

In practice, however, it is most questionable whether the act of issuing with CACs can possibly contain information that sophisticated investors and rating agencies do not already possess. Moreover, the contractual details of a new debt issue are rarely the result of the debtor's conscious choice but are instead typically left for legal advisors to negotiate. Investors would thus be interpreting a signal that was likely never sent in the first place. An interesting empirical test by Gugiatti and Richards (2003) accordingly yields no measurable signalling effect.

First mover problem

It was commonly thought at the time that the first country to issue bonds with CACs under New York law would incur substantial costs. Subsequent movers would benefit by being able to copy the contract terms from the first mover. Presumably the risk of investor hostility would also have declined. The tragedy of this constellation is, of course, that no one wants to be the first mover since the benefits provided to others cannot be internalised. The completeness of the shift in 2003 may be regarded as evidence of the first mover problem at work.

From an ex post perspective, however, it is not easy to make sense of the concerns about large upfront costs for the first mover. The lack of evidence on higher borrowing costs was already common knowledge and indeed Mexico suffered no noticeable spread premium on its celebrated bond issue. Furthermore, insiders must have known that market practice was much more varied at the time than was commonly thought, so that the 'introduction' of CACs to the US market was not really that daunting a task. Finally, the costs of drafting the 'new' type of

bonds can hardly have required a major effort, given that it had often happened before by accident (Gugiatti and Richards 2004).

Myopia

This is the intra-country, inter-generational version of the first mover problem. While the assumed costs of introducing CACs accrue at the time of borrowing, the benefits materialise only in the event of default, which is unlikely to happen during the borrowing Finance Minister's term in office. The decision makers would thus be providing a service to their successors, which is something politicians do not typically rush to do.

The catch with the myopia theory is the same as above: It is not clear why there should have been any substantial upfront costs. In fact, the opposite could be argued. The markets might even view the first mover as proactive, innovative, and thus worth investing in.

Conclusions

In search of an explanation for the delayed adoption of collective action clauses in sovereign bonds under New York law we have scrutinised every major potential reason for opposition by investors or borrowers that has been suggested in the literature. None are convincing.

By way of conclusion, we offer two additional explanations. First: Much of the benefits of CACs accrue neither to borrowers nor to bondholders. By enabling smoother restructurings and reducing the risk of financial contagion, CACs may yield large positive externalities to the international financial institutions, to other countries, and to other markets. The universal adoption of CACs is in all likelihood a welfare improving reform, but only a small fraction of the welfare gains falls on the parties that must implement the reform.

Second: CACs imply costs that accrue to both borrowers and bondholders but which are invisible to the naïve observer. So far we have characterised the clauses as an option for collective action that as such precludes none of the crisis resolution strategies that was previously available. Market participants may have disagreed with this view. After all, the primary motivation for the stronger use of CACs was to obviate bailouts – which are by far the most convenient way out of a debt crisis for both borrowers and lenders. By potentially reducing the chances of a bailout, CACs thus impose a large indirect cost on the primary actors.

Where does this leave us? A credible commitment to no more bailouts would have sped up the adoption of collective action clauses and may yet be needed to complete the reform in the sphere of CACs and elsewhere. The recent case of Greece has demonstrated once more how third party assistance relieves the market of any pressure to adopt more efficient structures. Furthermore, regulation is an option that should have been and perhaps should still be considered more seriously. When a welfare improving reform fails to be implemented due to an unfortunate allocation of costs and benefits, an outside impetus may be needed. CACs could be made a listing requirement on the major stock exchanges, as has long been the practice in London with respect to the appointment of a trustee.

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