Merits of single-limb CACs

Quelling euro debate on 'automatic' restructuring

by Mark Sobel in Washington

Tue 10 Jul 2018

Like the international community, the euro area has a legitimate interest in promoting more orderly and predictable sovereign debt restructurings, in which the private sector bears its fair share of the burden of unsustainable debt. That is easier said than done.

Foreign-law bonds issued in London and New York typically included a collective action clause allowing for a bond-by-bond vote. But what would happen in cases of 'variable restructuring', where some bonds were restructured and others were not? The country would not be able to predict its amortisation needs, under which the value of assets is reduced to reflect their decreasing worth over time, and costly litigation could ensue. The country concerned might end up paying hold-outs more than those accepting the restructurings, and those taking the deal might be less so inclined in future. Of the 36 Greek bond issuances governed by English law that included CACs and could partake in a debt exchange in 2012, only 17 were successfully restructured, accounting for 30% of the total value of Greek debt governed by foreign law.

The euro area advanced the idea of a two-limb test, now included in all its domestic bonds, to restructure a series of bonds at the same time. Such a dual restructuring vote requires an aggregate vote of the bondholders of the relevant debt, as well as an individual bond-by-bond vote. This approach however would hardly have dealt with the problems of variable restructuring outlined above.

In 2014, the US Treasury successfully led a public-private sector expert group, which I chaired, in developing a 'single-limb' clause, allowing one vote to be taken on all of the relevant debt. If a high threshold is surpassed, all the relevant bonds are to be restructured. In essence, the single-limb clause allows a bankruptcy process to be mimicked through contracts. It deals with the variable restructuring problems. Contractual language allowing single-limb CACs is now the global norm for foreign-law sovereign bonds.

The single-limb methodology is far preferable to the two-limb approach. It says nothing about 'automaticity' and the terms and conditions under which a restructuring should be triggered or take place. Decisions about restructuring are not going to be taken more lightly because of the presence of single-limb CACs. The two issues – single-limb CACs and automaticity – should not be conflated, even if it is difficult for euro area governments to divorce the two, given the broader debate.

Single-limb CACs are a positive innovation that will make sovereign debt restructurings more orderly and predictable. They will help tackle the hold-out creditor problem and limit ensuing litigation, which have often bedevilled restructurings. Euro area governments would be well advised to modernise the CACs in their sovereign bonds by including the single-limb feature.

Rigid and automatic rules about private sector involvement are a recipe for disaster. When policy-makers assess the debt sustainability of a stressed country, they need to retain appropriate flexibility and a case-by-case approach. Of course, in doing so, they should also guard against denying reality by fudging assumptions about debt sustainability or excessively interjecting politics into methods of handling unsustainable debt.

The debate over private sector involvement will go on. Germany, the Netherlands and some other northern European countries, as a matter of principle, have long sought more automaticity in private sector involvement, and they are unlikely to change their views anytime soon.

Italy, a country with high debt that could fall afoul of another 'Deauville moment', understandably is fiercely resistant to automaticity, and squarely sees the single-limb CAC debate in that context. France, too, rightly worries about market runs, higher spreads and sees automaticity as crossing a red line.

Euro area reform is multifaceted, with many topics that will occupy officialdom for years to come. For the time being, working to incorporate single-limb CACs into euro area sovereign bonds is a modest yet useful compromise.
Given the implacable views of the two camps, carrying out that task could quell the euro area automaticity debate at least for a few years. If that happens, then single-limb CACs will have served once again a noble purpose.

Mark Sobel is a former Deputy Assistant Secretary for International Monetary and Financial Policy at the US Treasury. Until earlier this year he was US representative at the International Monetary Fund. He chaired the international public-private group that developed the single-limb clauses. The clauses were developed by the London-based International Capital Market Association. See Mark Sobel, Oxford Capital Law Market Journal, January 2016, ‘Strengthening collective action clauses: catalysing change—the backstory.’ See also IMF, ‘Strengthening the Contractual Approach to Address Collective Action Problems in Sovereign Debt Restructurings’, September 2014; or Anna Gelpern, Ben Heller, and Brad Setser in ‘Count the Limbs: Designing Robust Aggregation Clauses in Sovereign Bonds’, November 2015.

This is the second of two articles on euro-collective action clauses. The first was published on 9 July.