

Chapter 2

Protecting Against Sovereign Defaults

Abstract Chapter 2 analyzes the various means used by creditors to mitigate sovereign risk well in advance – that is, when countries issue bonds, sign loan agreements, or are at an early stage of their borrowing cycle. Section 2.1 looks at sovereign bond and loan covenants: it presents the clauses that enable creditors to enforce contracts, secure repayment flows, avoid subordination, neutralize the risk of repayment on unfavorable terms, obtain specific guarantees, and make debt renegotiations easier once a default has occurred. The main provisions studied here are the choice of law, arbitration, currency, *pari passu*, and collective action clauses (CACs) as well as pledges, negative pledges, and “inflation-proof” clauses. Section 2.2 addresses the various insurance and insurance-like instruments that investors can rely upon to hedge against default risk; these include sovereign risk insurance covenants, contracts of guarantee offered by multilateral agencies, and credit default swaps (CDSs).

Keywords Sovereign immunity • Collective action clauses • *Pari passu* • Hedging • Insurance contracts

This chapter examines the various means used by creditors to mitigate sovereign risk well beforehand – that is, when countries issue bonds, sign loan agreements, or are at an early stage of their borrowing cycle.¹ Section 2.1 looks at sovereign bond and loan covenants: it investigates the clauses that enable creditors to enforce contracts, secure repayment flows, avoid subordination, neutralize risk of repayment at unfavorable monetary conditions, obtain specific guarantees, and make debt renegotiations easier once a default has occurred. The provisions studied here include primarily choice of law, arbitration, currency, *pari passu*, and collective action clauses (CACs) as well as pledges, negative pledges, and “inflation-proof” clauses. Section 2.2 addresses the various insurance and insurance-like instruments that investors can rely upon to hedge against default risk; these include sovereign

¹ This chapter intentionally disregards three basic aspects of sovereign lending: the interest rate, the maturity, and the amount loaned (the riskier the country, the higher its interest rate, the shorter its debt maturity, and the smaller the amount issued). These features are analyzed in Chap. 4.

risk insurance covenants, contracts of guarantee offered by multilateral agencies, and credit default swaps (CDSs).

2.1 Protection Clauses in Bond and Loan Covenants

2.1.1 *The Long Road to Enforcement of Sovereign Debt Contracts*

State sovereign immunity has long been a barrier for creditors that wanted to recover unpaid amounts. In the nineteenth century, sovereign borrowers were not liable to being sued in any foreign court unless they had expressly submitted to this forum. Furthermore, the position of borrowers even in their own tribunals was contingent upon constitutional rules. In *Twycross v. Dreyfus* (1877), George Jessel – then Master of the Rolls – stated that:

[Sovereign bonds] amount to nothing more than engagements of honour, binding, so far as engagements of honour can bind, the government which issues them, but are not contracts enforceable before the ordinary tribunal of the country which issued them without the consent of the government of that country.

As a result, bondholders essentially had only two avenues for retrieving their money: convincing their government to employ gunboat diplomacy or seeking some arrangement with the defaulting country.² This explains why arbitration clauses were often added to foreign government debt contracts (Waibel 2011, pp. 158–160; Weidemaier 2010, pp. 342–344). In fact, arbitration became a conventional means of settling debt disputes at the turn of the twentieth century. The Permanent Court of Arbitration (PCA) was established in 1899 at the first Hague Peace Conference to provide services for the arbitration and resolution of debt disputes. The PCA’s decisions, although morally reinforced after the Drago–Porter Convention of 1907, did not yet have any binding force. This shortcoming was overcome in 1922 when the Permanent Court of International Justice (PCIJ) was established under the auspices of the League of Nations.³ In the famous *Serbian loans* and *Brazilian loans* cases (1929), the PCIJ provided details about the law that presumably was to govern sovereign debt contracts. It stated that “any contract which is not a contract between states in their capacity as subjects of international law is based on the municipal law of some country” (i.e., the domestic law of a sovereign state; Schmitthoff 1937, p. 185).

² These two approaches were not entirely exclusive. Prior to their military intervention in Venezuela in 1902, Great Britain, Germany, and Italy had proposed to submit their dispute to a neutral tribunal (Fischer Williams 1925, pp. 311–312).

³ Article 59 of the statute for the PCIJ was provided for by article 14 of the covenant of the League of Nations.

The absence of international law to resolve disputes between private creditors and sovereign debtors seemingly foreshadowed the decline of arbitration clauses, which increasingly became regarded as a lack of commitment from borrowers (Waibel 2011, p. 167). Instead, from the 1940s onward, investors sought legal enforcement by pushing for governing law clauses, provisions that subjected sovereign issuers to being sued in foreign courts, and/or covenants that included a waiver of immunity from suit or execution (Choi et al. 2012, pp. 138–140).

Along these lines private creditors obtained support from US authorities. In 1952, the US Department of State issued the Tate Letter; this document allowed for sovereign immunity for public acts only, thus excluding commercial acts.⁴ Although the policy prescribed thereby could not prevent a sovereign bond issuer from asserting its immunity *ex ante* or from obtaining the withdrawal of its waiver (if any) from the US Department or a court, it was a milestone in the restrictive theory of sovereign immunity (Weidemaier 2014, pp. 77–79). That policy became codified with the enactment in 1976 of the Foreign Sovereign Immunities Act (FSIA), which established that immunity determinations were contingent upon courts and not on the US Department of State. Perhaps more importantly, the statute affirmed that waivers of sovereign immunity from suit and execution were henceforth binding and irrevocable. Even if a foreign government had not waived its immunity, its property was not immune from execution provided it was “used for the commercial activity upon which the claim [was] based.” The enactment of the FSIA led to a complete re-drafting of sovereign bond covenants. Despite being almost nonexistent until then, waivers of immunity from suit were frequently included clauses starting in the late 1970s (Weidemaier 2014, p. 88).⁵ A further step was taken with the US Supreme Court’s explicit statement that the issuance of debt was a commercial act (*Republic of Argentina v. Weltover*, 1992). Thereafter, waivers of immunity were retained in foreign government debt contracts – probably because such contracts contained provisions for adjudication in both American and foreign courts and provided details regarding service of process (Delaume 1994, pp. 267–268).

While the restrictive theory of sovereign immunity gained ground in Western countries, creditors endeavored to impose new enforcement terms that sometimes were complementary to waivers of immunity. For instance, “consent to jurisdiction” clauses and governing law clauses – which stipulate that sovereign borrowers subject themselves to the jurisdiction of a foreign country and to a foreign law, respectively – were systematically included in sovereign bond contracts after the outbreak of the Latin American debt crisis in 1982 (Choi et al. 2012, pp. 154–158).

⁴ That distinction accorded with Grotius’ analysis, which opposed acts of the state *qua* sovereign and acts of the state *qua* private person.

⁵ During the years that followed, other countries passed similar laws – for example, United Kingdom and Canada in 1978 and 1982, respectively (Brownlie 2003, p. 326). France, Germany, and Switzerland had revised the principle of absolute immunity as early as the nineteenth century (Delaume 1957, pp. 203–204). These shifts support the view that *creditor* nations have long promoted a restrictive theory of sovereign immunity.

Scrutinizing governing law clauses, Das et al. (2012, p. 41) find that, as of March 2009, 69 % and 22 % of outstanding emerging market bonds issued in international markets were governed by (respectively) New York law and London law. Because the chosen law matches the selected jurisdiction, it reveals that the American and British legal systems have become central to resolving sovereign debt disputes.⁶

Since the 1970s, restriction of sovereign immunity for debt covenants has been of considerable help to creditors seeking to enforce their contract terms. However, creditors may be deprived of their rights if they attempt to seize a defaulted borrower's assets, particularly when those assets are located in a territory over which the foreign court has no jurisdiction or when the decision rendered by the foreign court is less favorable to bondholders than expected.⁷ In the nineteenth century and the interwar years, the prospect of such impediments to their claims convinced some creditors to demand security interests from borrowers.

2.1.2 *Securing Debt*

In terms of security clauses, two broad categories of debt must be distinguished: general obligation bonds and secured bonds.

General obligation bonds are backed by the full faith, credit, and taxing powers of the issuer. This means that the sovereign borrower is obliged to raise all revenues available to honor its financial commitments. For Borchard (1951, pp. 82–83), such clauses are redundant because “they merely confirm in emphatic terms a fact resulting by implication from the obligation.”

In contrast, the repayment of *secured bonds* depends on specific collateral: revenue streams or assets. Secured bonds are generally issued to protect against the discontinuity of debt reimbursement. It is therefore not surprising that the revenues or the assets earmarked are contingent upon the economic profile of the debtor country. In 1922, for example, Brazil issued a 7.5 % external bond worth £9 million that was secured by a mortgage on about 4,535,000 bags of coffee, which represented the government's entire stock and was valued at more than £13 million (*Moody's Manual* 1922, p. 32). More frequently, low- and middle-income countries were constrained to pledge customs duties in order to borrow (e.g., Ecuador, Uruguay, and Nicaragua; CFB 1895, pp. 109–110, 347; *Moody's Manual* 1929, p. 791); however, various revenues and taxes could be used to reach this objective (revenues from railway, water works, port facilities, tobacco, etc.).⁸ In some cases,

⁶ The hegemony of New York was driven in part by the enactment in 1984 of “Section 5-1401 of New York's General Obligations Law, which validates stipulations of New York law without a requirement of a reasonable connection between the transaction and New York” (Committee on Foreign and Comparative Law 2013, pp. 5–6).

⁷ In the *NML v. Argentina* decisions (28 March 2013), the French Supreme Court tightened the conditions applied to waivers of sovereign immunity from execution.

⁸ Borchard (1951, pp. 83–91) provides many examples of security clauses.

bondholders exercised direct administration of pledged revenues through agents, ad hoc organizations, or monopolies received from the debtor country. Such methods of enforcement were sometimes implemented by creditor nations (e.g., France, Germany, Great Britain, and the United States) on behalf of bondholders (Borchard 1951, pp. 91–93; Waibel 2011, pp. 42–57).

It is worth emphasizing that lenders claimed inordinate levels of securitization for countries that had recently defaulted. The Mexican and Venezuelan debt issuances of 1888 and 1905, respectively, reflect this uncompromising approach. The Mexican government had to offer as security “20 % of the net export and import duties and the total net proceeds of the direct taxes on land, houses, industries, etc.” The security required of Venezuela was “60 % of the ordinary customs duties of [its] ports, with the exception of La Guayra and Puerto Cabello.” These customs duties had to be paid “separately by the merchants, and placed at the Banco de Venezuela to a separate account” (CFB 1904, p. 261; CFB 1907, pp. 431–432).

Yet unless the debtor country was under the political and administrative supervision of a great power, collateral security turned out to be of little help to foreign investors when the borrower was unwilling to repay its debt or faced a collapse of its economy. So ever since the second part of the twentieth century, other types of clauses have been preferred by creditors (see Appendix 2 for some specific clauses added to a sovereign bond contract).

2.1.3 *Avoiding Subordination*

Instead of securing their bonds or loans, lenders have sought to prevent sovereign borrowers from creating liens over their assets or revenues in favor of other creditors – that is, without securing the current debt on an equal basis. Such “negative pledge” clauses were part of the World Bank’s and multilateral development banks’ loan contracts in the late 1940s. For policy reasons, these institutions were reluctant to demand collateral security but could not accept that future lenders would benefit from doing so (Buchheit and Pam 2004, pp. 899–900). Private bankers followed suit in the 1970s after Citigroup, a creditor of Zaire, managed to prevent two competitor firms from granting a secured loan to Zaire by successfully arguing that Citigroup’s contract included provisions comparable to a negative pledge (Buchheit and Pam 2004, pp. 902, 909; *Wall Street Journal*, “Citibank Sues over Repayment of Debt by Zaire,” 10 August 1976). Subsequently, negative pledge became a boilerplate clause in unsecured bonds and notes prospectuses issued by speculative-grade (i.e., risky) countries (e.g., Arab Republic of Egypt 2007, p. 73; Republic of El Salvador 2011, p. 64; Republic of Ghana 2007, p. 68; Republic of Paraguay 2013, p. 110; Republic of the Philippines 2003, p. 111; Ukraine 2012, p. 20).

Pari passu clauses are another type of provision included in bonds and loans to preclude discrimination among creditors. In the nineteenth century, such clauses

were often used in secured debt instruments because different lenders had frequently been offered the same collateral. In the aftermath of World War II, the decline of secured debt issuances was accompanied by the insertion of negative pledge clauses conjoined with *pari passu* provisions (Buchheit and Pam 2004, pp. 894–906). The use of freestanding *pari passu* clauses spread in the 1980s to protect creditors against involuntary subordination resulting from local law procedures. Today, however, there are two interpretations of these provisions. Buchheit and Pam (2004, pp. 917–918) state the narrow interpretation: *pari passu* clauses mean only that a debt ranks equally in right of payment with all other unsubordinated debts. Cohen (2011, pp. 14–17) presents a broader interpretation. Endorsing the decision of the Brussels Court of Appeal in *Elliott Associates, L.P. v. Banco de la Nacion* (2000), Cohen affirms that *pari passu* clauses oblige a defaulted sovereign to “pay similarly situated creditors equally, at the same time and to the same extent, in all payment situations.” This controversy bears watching because it could have a significant impact on sovereign debt restructuring processes.

2.1.4 Avoiding Monetary Erosion

Ensuring the legal enforcement and the securing of their claims (while avoiding subordination) are necessary but not sufficient conditions for creditors to derive their expected returns. Among other parameters, creditors must therefore carefully examine the currency in which their bonds are denominated. This explains why creditors have traditionally preferred to lend in their own currency – or in an international currency – to protect against monetary erosion. This preference is the contrapuntal aspect of the “international original sin” problem highlighted by Eichengreen et al. (2005a, pp. 13–14).⁹

Even though it prevents monetary erosion, lending funds to a sovereign in other than its domestic currency is not a panacea: countries that suffer from original sin are also vulnerable to exchange rate volatility; this is likely to exacerbate the currency mismatch and lead to reversals in capital inflows, thus jeopardizing the debtor’s creditworthiness.¹⁰ In their study of foreign currency borrowing during the nineteenth and twentieth centuries, Bordo et al. (2010, pp. 648–649) find that higher ratios of foreign currency debt to total debt are related to increased risks of currency crises and defaults. Creditors are therefore on the horns of a dilemma when

⁹ Recall that “international original sin” refers to the inability to borrow abroad in domestic currency. This problem affects not only developing and emerging countries with a poor track record and high inflation but also small economies that, despite their fiscal and monetary credibility, have only an embryonic financial system (Eichengreen et al. 2005b, pp. 234–238).

¹⁰ This reasoning applies also to foreign currency-indexed debt and to bonds or loans that incorporate gold clauses (in the nineteenth century and during the interwar years) or foreign exchange clauses.

choosing the currency denomination of a foreign government bond. A possible compromise is to opt for inflation-indexed bonds. Finland is reported to have introduced this type of debt instruments as early as 1945. Israel, Iceland, Brazil, Chile, Colombia, Argentina, Great Britain, Australia, Mexico, Canada, Sweden, and New Zealand did likewise during the following decades (Campbell and Shiller 1996, pp. 156–158; Henry Gemmill, “Fancy Finance: ‘Inflation-Proof’ Bonds Are the Rage in Israel, Finland, France, Austria,” *Wall Street Journal*, 9 February 1956).

2.1.5 Arranging for Guaranteed Debt

Investors naturally favor guaranteed debt, especially when the guarantee is issued by another sovereign or a pool of sovereigns whose creditworthiness is considered substantially stronger (i.e., creditor nations that themselves borrow at lower interest rates or have higher credit ratings). Such clauses provide that the “guarantor undertakes to be answerable for the payment of the debt in case the principal debtor should fail to perform his engagement” (Borchard 1951, p. 105). A guarantee clause may be added to loan or bond covenants for economic or diplomatic reasons.

In 1855, in the midst of the Crimean War, the Ottoman Empire issued a 4 % note whose interest payments were guaranteed by its two allies: Great Britain and France. In 1923, Austria managed to re-access capital markets thanks to a League of Nations loan whose interest and principal were guaranteed by Belgium, Czechoslovakia, Denmark, France, Great Britain, Italy, the Netherlands, and Sweden (Decorzant and Flores 2012, p. 13). The repayment of these two loans was not subsequently discontinued, in contrast to the fate of other contemporaneous Ottoman and Austrian securities.

More recently, Egypt issued in 2005 a 10-year, US dollar-denominated note fully guaranteed – with respect to both principal and interest – by the US government acting through the United States Agency for International Development (Arab Republic of Egypt 2007, pp. 18, 67). Similarly, in 2012, the United States affirmed its strong commitment to the democratic transition in Tunisia by signing a sovereign loan guarantee agreement with the Tunisian government.¹¹

The World Bank has also implemented credit guarantee schemes available to all countries eligible for borrowing from the International Bank for Reconstruction and Development (IBRD) or the International Development Association (IDA) (Independent Evaluation Group 2009, pp. 10–13). For example, policy-based guarantees (PBGs) and partial credit guarantees (PCGs) support government borrowing from commercial lenders or government bond issues; PBGs are offered for general balance of payments support, and PCGs are offered for projects approved by the World Bank.

¹¹ <http://www.state.gov/s/d/met/releases/198355.htm>

2.1.6 *Facilitating Debt Restructurings*

Debt renegotiation clauses have three idiosyncratic features. First, they are not designed to enforce contract terms but rather to minimize creditors' losses – in the event of default – by making debt restructurings easier. Indeed, the 1930s showed that stubborn opposition to any sovereign debt restructuring scheme could be counterproductive and costly to lenders (Adamson 2002, pp. 498–499).

Second, they illustrate the prioritization of bondholders' collective rights over individual rights when a loan is restructured. The resulting collective action clauses may take various forms.¹² The most prominent CACs are collective *modification* clauses, which enable a qualified majority of bondholders to make decisions that become binding on all holders (typically a debt restructuring), and collective *acceleration* clauses, which limit the ability of holdout bondholders to prevent a restructuring.

The third distinguishing feature of renegotiation clauses is that, although sovereign debt contracts included CACs as far back as the early 1900s (Weidemaier and Gulati 2012, pp. 16–22), they were seldom used before 2003.¹³ Collective action clauses were praised by the US Treasury Department as a means of addressing the moral hazard problem (Gelpern and Gulati 2006, pp. 1653–1654). However, the IMF (2002, pp. 27–28) expressed a more skeptical view; as its then First Deputy Managing Director, Anne Krueger, advocated instead a quasi-statutory approach via implementation of a sovereign debt restructuring mechanism.

2.2 Hedging and Insurance Contracts

When purchasing sovereign debt, creditors may individually sign distinct contracts to protect against default. Two types of instruments merit further discussion.

2.2.1 *Hedging Instruments*

Bondholders have long sought to hedge against adverse price movements and defaults. In 1824, Rothschild had lent funds to Naples and then sold part of the underwritten bonds to the public. However, the financial difficulties experienced by Latin American countries at the time¹⁴ were a widespread concern among investors,

¹² See Choi et al. 2012 (pp. 159–166) for an overview of the different CACs.

¹³ The issuance by Mexico of bonds with both types of CACs in February 2003 served as a catalyst for the inclusion of collective modification and collective acceleration clauses in most debt covenants.

¹⁴ Chile and Colombia defaulted in 1826 and Mexico in 1827 (CFB 1878, pp. 52–53).

who feared that Naples might become insolvent. Rothschild therefore proposed in 1827 the purchase of future coupons of Neapolitan bonds in order to support prices (Gille 1965, p. 168). Although primarily intended to preserve Rothschild's own reputation, this proposal was a seminal opportunity for bondholders to insure against sovereign default. Yet it remained an exceptional form of hedging because creditors generally preferred inserting provisions into debt covenants (see Sect. 2.1).

It was not until 1991 that similar instruments – namely, the credit default swaps (CDSs) – were introduced on a much larger scale in the corporate debt market and later in the sovereign debt market (Rancière 2002, p. 15; Smithson and Mengle 2006, p. 54).¹⁵ The International Swaps and Derivatives Association (ISDA), a global trade association representing participants in the Over-the-Counter (OTC) derivatives industry, provides the following definition of the CDS: it is “a contract designed to transfer the credit exposure of debt obligation between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the creditworthiness of the underlying security. In a CDS the risk of default is transferred from the holder of the security to the seller of the swap.” The CDS *spread* is the annual amount the CDS buyer must pay the seller over the length of the contract. Expressed in basis points, it is a percentage of the notional amount (1 basis point = 0.01 %).

The CDS is triggered when the reference entity (i.e., the debt issuer) experiences a credit event on an obligation. A credit event is “an event linked to the deteriorating creditworthiness of an underlying reference entity in a credit derivative. The occurrence of a credit event usually triggers full or partial termination of the transaction and a payment from protection seller to protection buyer.” For a sovereign CDS (SCDS), credit events include failure to pay, restructuring, obligation acceleration, obligation default, and debt moratorium or repudiation.

Outstanding SCDS notional amounts reached USD2.941 trillion by the end of 2012 (BIS 2013, p. 20). The top-ten CDS reference entities were Italy, Spain, France, Brazil, Germany, Turkey, Mexico, Russia, South Korea, and Japan; together these countries accounted for 55 % of all SCDSs (IMF 2013a, p. 60).

2.2.2 *Guarantee Insurance Contracts*

Export credit agencies (e.g., the US Export-Import Bank, Coface, and Euler-Hermes) have traditionally secured foreign direct investment flows to emerging and developing countries by mitigating certain types of risk. These risks include

¹⁵ Credit default swaps are not equivalent to insurance contracts for two main reasons. First, the “buyer does not have to own the underlying security, or otherwise have any insurable interest in that security”; second, “the buyer does not in fact have to suffer any loss in order to recover on the CDS” (Garbowski 2008, p. 4). An examination of the use of CDS instruments for speculating or basis trading purposes is beyond the scope of this book.

currency inconvertibility and transfer restrictions; expropriation without due compensation; war, terrorism, and civil disturbance; breach of contract; and failure to honor financial obligations. In particular, the Export-Import Bank provides guarantees that cover loans granted by US investors to sovereign governments.

In response to the development of sovereign bond markets since the 1990s, insurance companies have entered this market. Established in 1997, Sovereign Risk Insurance Ltd. offers loan guarantees to cover financial losses due to nonpayment of amounts owed by governments. This firm paid several claims to European banks following defaults by the Dominican Republic and the Seychelles in 2005 and 2009, respectively.¹⁶ The American International Group, Inc. (AIG 2006, pp. 5–9) provides insurance against failures of a government to honor (i) its payment obligations under a promissory note, bond, sovereign loan, or sovereign guarantee; (ii) its hard currency or local currency payment obligations under a guarantee agreement issued in support of a project; or (iii) its payment obligations under a purchase contract, irrespective of whether such payment obligations are denominated in hard currency or local currency. Zurich Insurance Group (Zurich 2009, p. 1) offers insurance against a sovereign not honoring its own guarantee; this insurance covers financial institutions in the event of payment defaults by a government.

International organizations have followed suit. In 2009, the Multilateral Investment Guarantee Agency (MIGA) launched its Non-Honoring of Sovereign Financial Obligations (NHSFO) coverage to protect lenders against losses resulting from a sovereign default. This guarantee is available to investors only if the payment obligation of the debtor government is unconditional and not subject to any defenses. In 2012, MIGA provided Société Générale with a NHSFO guarantee to cover a loan to the government of Ghana (MIGA 2012, pp. 20–21).¹⁷

¹⁶ http://www.sovereignbermuda.com/claims_history/claims_history.html

¹⁷ This loan was made to finance the completion of a power plant.

When Sovereigns Go Bankrupt

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