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Renegotiation, collective action clauses and sovereign debt markets

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Abstract

Collective action clauses (CACs) are provisions specifying that a supermajority of bondholders can change the terms of a bond. We study how CACs determine governments' fiscal incentives, sovereign bond prices, and default probabilities in environments with and without contingent debt and IMF presence. We claim that CACs are likely to be an irrelevant dimension of debt contracts in current sovereign debt markets because of the variety of instruments utilized by sovereigns and the implicit IMF guarantee. Nonetheless, under a new international bankruptcy regime like that recently proposed by the IMF, CACs can increase significantly the cost of borrowing for sovereigns, contrary to what is suggested in previous empirical literature.

Keywords: Sovereign debt; Collective action clauses; Renegotiation; Moral hazard; International bankruptcy court

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1. Introduction

Collective action clauses (CACs) are provisions in debt contracts specifying that the terms of the contract regarding principal, interest, and maturity can change if there is

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consent of a predetermined supermajority of bondholders. This paper studies how CACs determine governments' fiscal incentives, bond yields, and default probabilities. Understanding these interactions is essential for the design of the so-called "Sovereign Debt Restructuring Mechanism" (SDRM) proposed by the IMF and currently under discussion.[1]

CACs introduce flexibility in situations of financial distress by facilitating renegotiation.[2] In their absence, bondholders have no incentives to enter into the renegotiation process since, individually, they are unable to affect the probability of repayment (as long as the debt is not held by a large lender). CACs solve the problem of free riding among creditors within a legal jurisdiction because a supermajority of bondholders can make the outcome of the renegotiation mandatory for all. But the existence of CACs does not always imply a friendly restructuring process. Sovereigns tend to issue debt in different jurisdictions, and while CACs coordinate creditors within each one, the free riding problem between jurisdictions remains. This is a feature of the 1990s not present in the 1980s, when few banks concentrated most of the sovereign bonds. To attend to this problem, the idea of an international bankruptcy procedure (or an SDRM), to coordinate creditors in different jurisdictions, has been put forward.[3]

It has been argued that facilitating renegotiation can have both positive and negative consequences. Because renegotiation relieves countries from debt overhang, governments might run reckless fiscal policies that increase the likelihood of financial crisis. Since lenders anticipate this behavior, the cost of the lack of commitment to run responsible fiscal policies is borne by the country itself. In the end, the severity of the moral hazard problem determines whether facilitating renegotiation, by creating an SDRM, make countries worse or better off. The debate about the value of an SDRM lies precisely on this trade off.[4]

We setup up a model to understand the determinants of this tension. We focus on environments where countries can strategically issue debt with and without CACs, and in different legal jurisdictions, both in the presence and absence of the IMF. We show that an SDRM is never a good idea when debt contracts are state contingent. Under uncontingent debt payments, we derive a series of implications that we believe are both new and relevant for the discussion of an international bankruptcy procedure. Furthermore, we point at some empirical evidence to question conclusions from previous empirical results.

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[1] The discussion about policies regarding sovereign debt dates back at least to Adam Smith. See the evolution of these ideas in Rogoff and Zettelmeyer (2002).

[2] See Dixon and Wall (2000) and Sturzenegger (2002) for descriptions of commonly used CACs.

[3] Ghosal and Miller (2003) evaluate CACs against a SDRM with an international bankruptcy court. They favor the latter given that this court is assumed to have verifiability, commitment, and enforceability power (all of which are assumed away in our discussion). Eaton (2002) also assumes that an international bankruptcy court can distinguish why things went bad (verifiability).

[4] This trade off is in the spirit of Bolton and Scharfstein (1996). See Morris and Shin (2003) and Corsetti et al. (2003) for an interesting catalytic finance approach alternative to our (ex post) incentive imperfection. See Haldane et al. (2003) for an asymmetric informational approach and Jeanne (2003) for a model where debt maturity works as a commitment device.