Distressed Sovereign Debt Exchanges: Examples From The Past And Lessons For The Future

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(Editor's Note: This article is adapted from a speech delivered by John Chambers, chairman of Standard & Poor's Ratings Services' sovereign rating committee, at the World Bank’s DMF Stakeholders’ Forum, held in Berne, Switzerland, on June 8, 2011.)

I’d like to speak to you today about distressed exchanges. The subject is timely given all of the discussion concerning reprofiling Greek government debt.

Standard & Poor’s Ratings Services’ ratings address a narrow subject: the capacity and willingness of an issuer—in the case of my group, a central government—to pay interest and principal on debt on the due date or within the specified grace period specified in the original terms. Rated sovereigns that have missed interest or principal payments in the last 12 years include:

- Pakistan on bank loans in January 1999.
- Russia on its MinFin Series III bonds in May 1999.
- Paraguay on a missed bond put in February 2003.
- Grenada on bonds in December 2004.
- Venezuela on missed oil warrants in 2005.
- Seychelles on a private placement in July 2008.
- Ecuador on a bond it considered odious in December 2008.

These are clear-cut cases of default. But under our published ratings criteria, there is another type of default besides missing a payment. This one takes a bit of explaining. It concerns exchange offers of new debt with less-favorable terms than those of the original issue without adequate offsetting compensation. Under our criteria, such "less-favorable terms" could include a reduced principal amount, extended maturities, a lower coupon, a different currency of payment, or effective subordination. When such exchanges occur, we revise the rating on the obligation to 'D' (default), even if only a portion of the rated bonds is subject to the exchange offer. In addition, we revise the sovereign credit rating to 'SD' (selective default), indicating that the sovereign is proposing to pay less than what it had originally undertaken.

These exchanges are of a different character than the regular, voluntary, and market-based exchanges or buybacks that sovereign debt offices frequently conduct. Rather, these opportunistic transactions usually involve relatively small portions of the outstanding debt obligations. Assuming that the government honors the terms of the exchanged obligations, these voluntary exchanges do not constitute defaults under our criteria.

By contrast, we would look differently on an exchange offer that we view as having the objective of materially changing the size or profile of the debt burden of a sovereign in financial distress. When investors consider a default to be possible and when the rating has fallen, it becomes more difficult to conclude that investors are exchanging securities voluntarily. For example, while an exchange offer for longer-dated bonds might appear to be voluntary, we could conclude that investors feel pressured into accepting the exchange offer because they fear more adverse consequences if they were to decline it. In such a distressed exchange, holders accept less than the original promise because of the risk that the issuer will otherwise fail to meet its original obligations.
Trading prices of the securities under offer and the offering prices can also provide insight about the nature of the exchange offer. For example, prior to the exchange offer, an investor could have sold the to-be-exchanged, soon-maturing security in the secondary market and purchased a longer-maturity obligation similar to the new security offered in the context of the exchange offer. Had the investor been able, relatively close to the exchange date, to purchase more long-dated paper in the market-based transaction than he or she would receive in the exchange offer, we would, other things being equal, likely consider the exchange to be distressed.

One could apply a net present value calculation to assess whether an investor is likely to be better or worse off financially than before the exchange. However, this analysis is highly sensitive to the discount rate chosen. Accordingly, our criteria do not utilize the concept of net present value. Instead, on a case-by-case basis, we consider whether the modifications amount to what we view as a de facto default. Under our criteria, ratings also serve as a guide in our assessment as to whether a sovereign is entering the exchange from a position of distress, with the dividing line being the ‘B’ category.

A few examples of exchanges might help to clarify. As a consequence of the Paris Club repeatedly imposing "comparability of treatment," Indonesia defaulted in March 1999, April 2000, and April 2002. Although the government's Eurobond and FRN were spared, the Paris Club required the government to extend the maturities of its syndicated loans. The amounts and coupons, however, remained intact. All three times we lowered the sovereign credit rating on Indonesia to 'SD'.

Argentina had two mega exchanges in 2001. We didn't consider the first one, which was in May, to be distressed because we viewed the new securities as at market value, and the exchange was voluntary. However, we did lower the rating to 'B' from 'B+' because of the rising implementation risks we saw on the faltering IMF program and the interest rate risks to domestic bank securities portfolios from accepting longer-dated government securities. By contrast, we considered the second exchange, which was in November 2001, to be distressed. Maturities were extended by three years, and the coupons were 7% or less, below market value. About seven weeks later, on Dec. 24, Argentina declared a debt moratorium.

The most frequently discussed debt exchange lately was that of Uruguay. It tendered for both local law and international law U.S. dollar debt. We considered it distressed and revised the rating on the government to 'SD' in April 2003. Although interest rates on the debt were similar to those in existing bond agreements, they were well below market rates.

The Dominican Republic rescheduled debt through an exchange in February 2005, and Belize did the same in December 2006.

The most recent distressed debt exchange was that of Jamaica. It did not tender for its international law debt. It only tendered for local law U.S. dollar and Jamaican dollar debt in January 2010. The new debt was on average 6% less than the old debt and exchange extended the debt by two years.

The time a rating on a sovereign remains at 'SD' varies. Historically, for distressed exchanges, it has varied between one day and six months. Typically, when the exchange is announced and a sovereign rating committee has deemed it distressed and has formed the view that there is a good likelihood that the exchange will go through, we revise the sovereign rating to 'SD'. Then, when the exchange is completed, we assign a new rating that is based on our forward-looking opinion of default likelihood. Historically, sovereigns have emerged from default with ratings between 'CCC+' and 'B'. Afterwards, the ratings on these sovereigns continue to rise and fall with our opinion on
their underlying creditworthiness.

And here, we believe, is a common misconception: There can be life after default. Most of the sovereigns that have defaulted in the last two decades have regained access to the capital markets. Of course, their credit-standing varies, but that credit-standing is a function of the policies governments have pursued since the default and the credibility of their policies going forward. In our observations, good policies, persistently pursued over time generally lead to stronger credit fundamentals, broader market access at lower interest rates, and rising ratings. That might be something to keep in mind as reprofiling of euroarea government debt is being contemplated.

Related Research

- Argentina Long-Term Ratings Lowered to Selective Default, Nov. 6, 2001.
- Long-Term Sovereign Credit Ratings On Republic Of Argentina Raised To 'B-' From 'SD', June 1, 2005.
- Indonesia’s FC Rating Lowered to SD; CCC+ Ratings on Specific FC Obligations Affirmed, March 29, 1999.
- Republic of Indonesia’s Foreign Currency Issuer Ratings Downgraded to ‘SD’, April 17, 2000.
- Indonesia’s FC Issuer Rtgs Cut to ‘SD’ Following Paris Club Talks, Yankee Bond Remains ‘CCC’, April 22, 2002.
- Pakistan's Long-Term and Short-Term Foreign Currency Ratings Changed to 'SD', Jan. 29, 1999.
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