

A Better Value Recovery Mechanism for Sovereign Debt Restructurings

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Abstract

The amount of debt relief that a sovereign borrower seeks from its commercial creditors in a debt workout will reflect a mountainous pile of assumptions about the likely state of the debtor country's economy in the future. If those assumptions prove to have been too optimistic (meaning that the future turns out to be bleaker than the architects of the debt restructuring predicted it would be), then another round of debt restructuring may be in the offing. But if the assumptions turn out to have been excessively pessimistic, the creditors will have given more debt relief than was actually necessary to restore the country to a sustainable footing. Clawing back some or all of that unwarranted generosity has been the province of "value recovery" features in sovereign debt restructurings.

Since they were first introduced into sovereign debt workouts 24 years ago, value recovery instruments have required sovereign borrowers to make additional cash payments if key assumptions about the country's future economic picture prove to have been overly bleak. From the sovereign's standpoint, however, those cash payments are wasted.

We argue that a more sensible way of achieving the sole objective of a value recovery feature (recompensing creditors for sacrifices that prove down the road to have been unnecessary) would be to apply the cash toward a partial prepayment of the restructured debt. For all mark-to-market holders of those restructured instruments, such prepayments will improve the market value of their holdings and benefit the creditors in several other ways. For the sovereign debtor, cash paid out in this manner will contribute to a wholly virtuous improvement in overall debt dynamics.

In the context of a sovereign debt restructuring, a value recovery instrument (**VRI**) denotes a contractual feature whose purpose is to

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reimburse creditors providing debt relief for all or a portion of the money that they forwent when they agreed to amend their old debt instruments. The logic behind VRIs is powerful. The sole objective of creditors when they join a debt restructuring is to give the debtor an amount of debt relief sufficient to allow the debtor to regain its financial footing. Creditors do that to enhance the collectibility of the residual amount of their claims. Providing debt relief *less* than that required to achieve this objective will invite another debt restructuring somewhere down the road. But granting debt relief *in excess* of that needed for the debtor to regain its financial footing is, from the creditors' standpoint, just an unwarranted gift.

The Problems

There are three problems. The first is that no one knows at the time of the debt restructuring just how much debt relief will be needed to achieve — but not exceed — this goal of returning the debtor to a sustainable debt position. In most sovereign debt workouts, the job of making this prediction falls to the International Monetary Fund (sometimes with the participation of the World Bank). As part of the preparation for an IMF economic adjustment program, the Fund staff will undertake a Debt Sustainability Analysis (**DSA**) that seeks to predict how much debt the country can reasonably be expected to carry over the near to medium term.

The second problem is that a DSA calls for a mountainous pile of assumptions: assumptions about future commodity prices, future tax receipts, future exchange rate movements, future interest rates, future trade patterns, and so forth. When the Fund staff makes predictions about the likely state of affairs a couple of years out, those predictions are educated guesses. Three to six years out, the predictions range from speculative to highly speculative. After about six years, however, the DSA is an exercise in occult divination.

Which sets up the third problem. What happens if the DSA assumptions turn out to be too conservative? In other words, what happens

if the Republic of Ruritania's economic future ends up being much healthier than the Fund staff had predicted it would be when they prepared the DSA way back when? If Ruritania's creditors provide debt relief predicated on what later turn out to have been excessively gloomy DSA assumptions, the creditors will have simply given Ruritania an unwarranted windfall.

The VRI Solution

Value recovery features are intended to address this third problem. Should Ruritania's financial future end up being rosier than some dyspeptic IMF/ World Bank staffers thought it would be when they prepared the DSA, the value recovery feature will return to the creditors some or all of the money that they (unnecessarily) left on the table at the time of the debt restructuring. Or at least that is the theory.

VRIs have gone through three phases since they were first introduced in sovereign debt restructurings in 1990. In the first phase, starting with the Brady Initiative deals for oil exporters like Mexico, Venezuela and Nigeria in the 1990s, the VRIs took the form of oil warrants: instruments that paid a stream of cash if the price of the sovereign debtor's principal commodity export (oil) in the future exceeded a specified level. The justification is that if the price of the commodity from which the debtor derives a very substantial portion of its foreign currency income exceeds the projected price level that was used for the purpose of setting the financial terms of the debt restructuring, the country's debt servicing capacity will be greater than forecast.

The second phase of the VRI evolution involved debtor countries without a dominant commodity export. Most of the VRIs issued in this phase linked payouts to the debtor country's GDP (Bulgaria 1994; Bosnia and Herzegovina 1997; Argentina 2005/10; Greece 2012; Ukraine 2015). These GDP-linked instruments have had a checkered career. Argentina is currently fighting lawsuits in both New York and London relating to the GDP-linked VRIs that it issued as part of its debt restructurings in 2005 and 2010.

The exceptionally rich GDP-linked instrument that Ukraine issued in 2015 has been a major complication in that country's recent debt management initiatives.

In the latest crop of VRIs (Suriname 2022; Zambia 2024; Sri Lanka 2024) value recovery takes the form of backing out some (or, in the case of Suriname, all) of the debt relief being provided by commercial creditors if certain conditions are satisfied in future years.

The Sovereign's Perspective

It may be difficult to quarrel with the market's logic for demanding a value recovery feature: if more debt relief was given than turned out to be necessary, the creditors should be recompensed for that unnecessary sacrifice. Sovereign debtors, however, make the following points:

1. Beware the logical fallacy of *post hoc, ergo propter hoc*. Just because some aspect of Ruritania's economy outperforms a DSA projection in a future year, it may be too facile to conclude that more debt relief was provided in the restructuring than turned out to be needed. This is particularly true for debt sustainability targets that make assumptions about when the debtor country may be able to regain market access. New investors in that future year may be willing to resume lending because they view Ruritania's legacy debt stock — on its restructured terms — to be manageable. Had the financial terms of that restructuring been harsher for Ruritania, perhaps future investors might have continued to shun the country.
2. Value recovery instruments that are triggered by future commodity prices or GDP levels will, by definition, be out of the money at the time they are issued. That is, the commodity price benchmark at the time of issuance will be lower, potentially significantly lower, than the trigger price in the VRI. VRIs are thus by their nature uncertain and contingent; they may or may not start to pay off in the future. The markets accordingly tend to misprice VRIs at the time they are issued. In practical terms, this means that the sovereign debtor will typically receive little or nothing (in the form of improved financial terms in the debt restructuring) for its willingness to include a value recovery feature in the package. That value recovery feature, however, may require the debtor to pay substantial amounts of money down the line if and when the VRI reaches its trigger threshold.

When VRIs in the form of oil warrants were issued in the Brady Initiative debt restructurings of the 1990s, for example, so little value was accorded to the warrants in the first few years after issuance that traders often neglected even to mark their books about whether a warrant was being sold together with the underlying Brady bond.

3. The emotional appeal of a VRI lies in the ability of the creditors caught up in a sovereign debt workout to claim that *they* — by providing debt relief — are at least co-authors of Ruritania’s future prosperity and accordingly *they* are entitled to some form of recompense if Ruritania’s economic performance exceeds expectations. The fallacy embedded in this emotional appeal rests in the pronoun “they”. Ever since the oil warrants of the 1990s, VRIs have typically taken the form of free-standing instruments, fully detachable from the bonds issued as part of the sovereign’s debt restructuring. And in a large percentage of cases, the creditors involved in the debt restructuring will immediately sell the VRI — often for pennies — to institutions that had never lent Ruritania any money, much less ever provided Ruritania with debt relief. If and when the VRI payments are triggered, that cash will *not* flow to the creditors that had provided debt relief and thus earned a moral entitlement to be recompensed.
4. VRIs, particularly GDP-linked VRIs, can be complicated and opaque. This invites legal risk (witness the litigious adventures of Argentina’s GDP warrants) and can trigger future debt restructuring nosebleeds (see Ukraine today).
5. When a VRI is triggered, the cash that the debtor must pay out is utterly wasted in the sense that the debtor will receive no benefit of any kind for making those payments apart from preserving a reputation for honoring its contracts. The payments do not buy anything; they do not reduce any liability of the sovereign; they do not service the sovereign’s debt; they often do not even reward the institutions that supported the sovereign in its time of need.

A Better Design: Mandatory Prepayment VRIs

A better VRI mousetrap would be one that (i) rewards Ruritania’s creditors for the sacrifices they made at the time of Ruritania’s debt restructuring, (ii) provides a positive benefit to Ruritania in return for making VRI payments, and (iii) reduces legal and operational risk through simplicity of design and drafting.

Most modern investors in sovereign debt instruments are mark-to-market institutional holders. As a result, while investors care deeply *that* their securities go up in value, they are less concerned with *how* they go up in value. There are two ways to enhance the market value of a debt instrument: increase its cash flows or decrease the time period over which that cash is paid.

Traditional value recovery features take the first approach: they call for additional cash payments if the debtor country outperforms the IMF's DSA assumptions. We argue for the second approach. If the country outperforms the assumptions on which the debt restructuring was based, the consequence should be an acceleration of the timing of already-scheduled cash flows. Such an acceleration will improve the market value of the bonds without forcing the country to increase the overall amount of its cash expenditures.

A value recovery feature can be designed that would require the sovereign — if and when the trigger for making the VRI payments is reached — to apply those monies to a mandatory *prepayment* of the debt instruments issued as part of the country's debt restructuring (let's call them the **New Bonds**). In accordance with standard market practice, such prepayments would be applied in inverse order of maturities, meaning that they would be applied first to retire the final amortizations of the New Bonds. The determination of whether such a prepayment is required in any given year, and the amount of that prepayment, can be made separately for each year during the life of the value recovery feature.

A mandatory prepayment of this kind would convey five immediate financial benefits to mark-to-market holders of the New Bonds:

- i. In the most likely situation, the New Bonds issued in Ruritania's debt restructuring will trade for a long time at a discount, typically a heavy discount, because the sovereign will be recovering from a bout of severe financial distress. This happens whenever the discount factor applied by the market to value a sovereign debt instrument is higher than the cash coupon on that instrument. A prepayment of a portion

of the principal of such an instrument immediately repays — at par — a claim that the mark-to-market holder has been holding on its books at a discounted value. Simple example: if the New Bonds are trading in the market at 60¢ on the dollar (a 40% discount) and Ruritania makes a partial prepayment of principal as a result of the VRI feature embedded in the New Bonds, the holder will realize an immediate 40 point gain on that prepaid amount.

- ii. The prepayments would be applied in inverse order of maturities, which would reduce the average weighted life of the New Bonds. In a normal yield curve environment, this should improve the New Bonds' market value.
- iii. The holder of the New Bond will, to the extent of the partial prepayment, be receiving its money back earlier than expected. This permits a holder to reinvest those funds. In any situation in which the coupon rate on the New Bond is less than the market rate for an investment in a debt instrument of a similarly rated issuer, the holder will realize a pick up in the cash flow on the amount of the reinvested prepayment.
- iv. A prepayment of the New Bonds reduces the aggregate size of the sovereign's stock of external debt. This improves the sovereign's overall debt dynamics and, all other things being equal, should improve the market value of the New Bonds.
- v. An additional benefit is that the contingent value feature will be embedded in the New Bond itself, not in a separate VRI security (which some mutual fund investors cannot own). Moreover, the market has readily available tools to evaluate bonds with maturity uncertainty, such as the callable bonds that have long formed a part of fixed income markets. Bloomberg terminals provide tools to evaluate bonds with maturity uncertainty resulting from a scenario-dependent shortening of maturity ("yield-to-worst").

Market Considerations

Some creditors may argue that in the case of a conventional free-standing VRI issued in a sovereign debt restructuring, they can sell that instrument immediately in the market for cash once the restructuring closes. It may not sell for much, but it will sell for something. A mandatory prepayment value recovery feature, they may complain, denies them the ability to realize this immediate cash improvement in their overall recovery in the restructuring.

There is an easy response to this complaint. The amount of cash that the market will pay for a free-standing VRI issued in a debt restructuring will reflect the market's assessment of two things: (i) the likelihood that the circumstances triggering cash payments on the VRI will be satisfied and (ii) the point in the future when this might occur. The more likely the payment trigger being met, the richer the resale value of the VRI at the time of its issuance. The market will make precisely the same assessment in the case of a mandatory prepayment value recovery feature embedded in a New Bond. How likely is it, the market will ask itself, that Ruritania will wind up making par prepayments of principal on the New Bond? The more optimistic the market's assessment that such prepayments will be made, the richer should be the resale value of the New Bonds at the time of their issuance. In other words, while the creditor participating in the restructuring won't be able to liquidate for cash a free-standing VRI when the restructuring closes, it will be able to liquidate the New Bonds it receives in that restructuring at a higher price than it would have realized absent the mandatory prepayment value recovery feature.

Benefits for Sovereign Debtors

From the standpoint of the sovereign debtor, a mandatory prepayment value recovery feature is significantly preferable to a traditional free-standing VRI, even if the amounts paid under both are the same. The cash paid on a free standing VRI is wasted; it reduces the sovereign issuer's international reserves without conveying a benefit of any kind to the sovereign. In contrast, each dollar paid under a mandatory prepayment value recovery mechanism reduces the sovereign's debt, decreases the amount of future interest payments the sovereign must make on that debt instrument and improves the sovereign's general debt dynamics leading to lower borrowing costs in the future.

While creditors may not care how the market value of their bonds is improved through a value recover feature, this will not be a matter of indifference to the sovereign debtor. A mandatory prepayment value recovery feature will significantly benefit the sovereign borrower in comparison to a traditional VRI. If the country outperforms its IMF DSA, the country's debt is paid off faster than the anticipated schedule, leading to a wholly virtuous cycle of better debt dynamics, improved market access and increased fiscal space. Finally, a mandatory prepayment feature is simpler and easier to justify to voters. It should thus escape the legal risks and commercial complexities that have historically plagued stand-alone VRIs.
