The Big Read Sovereign bonds

Why the coming emerging markets debt crisis will be messy

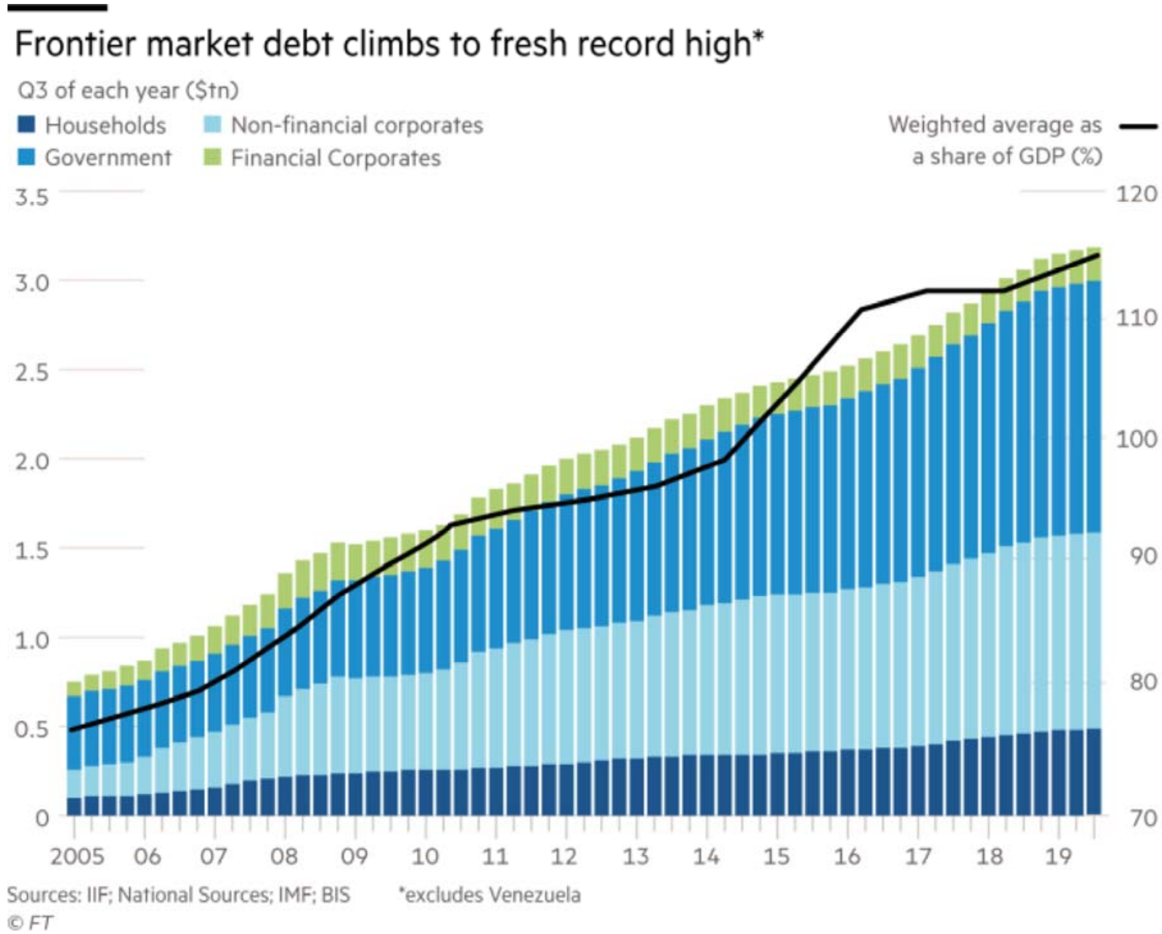
Large investment funds could play hardball with developing countries that default

Colby Smith in New York and **Robin Wigglesworth** in Oslo 10 HOURS AGO

The Maldives' coral-encrusted islands have long been irresistible to tourists. But today its secluded luxury resorts are deserted, except those converted into makeshift quarantine facilities for stranded coronavirus patients.

The virus has shattered global tourism and devastated the Maldivian economy. The IMF has gone from projecting a 6 per cent expansion in gross domestic product this year to an 8 per cent contraction. The risk is that this brutal, abrupt recession could translate into the Maldives becoming the latest country to sink into sovereign bankruptcy.

Zambia, Ecuador and Rwanda have all announced in recent weeks that they are struggling to repay their debts. Lebanon has already kicked off its restructuring process, while Argentina, which was battling its creditors even before the pandemic struck, appears to be heading for its ninth sovereign default since independence in 1816. Investors believe many other developing countries are not too far behind.



The Maldives is hardly the biggest country likely to succumb, but given its debt burden to creditors such as China and the severity of its recession, it is the "poster child of how easily the dominoes will fall", warns Mitu Gulati, a sovereign debt expert at Duke University.

The IMF has already lent the country $29m to tide it over, but warned that the loss of tourism has "severely weakened" the economy and that additional financial support would be needed. The country's $250m bond due in 2022 has tumbled to trade at just 81 cents on the dollar, indicating that investors are increasingly concerned about the Maldives' capacity to make good on its obligations.

The kindling for another big emerging markets debt crisis has been accumulating for years. Investor demand for higher returns has allowed smaller, lesser-developed and more vulnerable "frontier" countries to tap bond markets at a record pace in the past decade. Their debt burden has climbed from less than $1tn in 2005 to $3.2tn, according to the Institute of International Finance, equal to 114 per cent of GDP for frontier markets. Emerging markets as a whole owe a total of $71tn.

A boy crosses a street in a slum in northern Tripoli. Ashmore has built up a huge stake in Lebanon's debt that in practice gives it a veto over how the country will restructure some of its bonds © Hassan Ammar/AP

"The challenge is enormous," says Ramin Toloui, a former head of emerging market debt at bond manager Pimco and assistant secretary for international finance at the US Treasury, who now teaches at Stanford University. "The withdrawal of money [from EM funds] is greater and more sudden than in 2008, the economic shock is huge and the path to recovery more uncertain than it was after the last crisis."

The G20 has agreed to temporarily freeze about $20bn worth of bilateral loan repayments for 76 poorer countries. It has urged private sector creditors to do the same, but few analysts believe that is feasible, and predict the result will probably instead be a series of ad hoc debt standstills and restructurings for swaths of the developing world.

Resolving the coming debt crises may be even tougher than in the past, however. Rather than the banks and governments — the primary creditors in the mammoth debt crisis that racked the developing world in the 1980s and 1990s — creditors are nowadays largely a multitude of bond funds. They are trickier to co-ordinate and corral into restructuring agreements.

Covid-19 slams emerging market bonds

Rebased (May 9, 2019 = 100)

Sources: Bloomberg; VanEck Vectors; JPMorgan EM Local Currency Bond ETF; iShares; JPMorgan USD Emerging Markets Bond ETF

Although the need for financial relief is stark in many cases, there are indications that some investment groups may break with the custom of reluctantly accepting financially painful compromises to achieve a restructuring, and instead fight for a better deal.

“Normally these guys would get out of Dodge City at the first sign of trouble in the debtor country. They're not set up to deal with prolonged debt restructurings and don't like the reputational risk that would result from an aggressive campaign against a country in deep economic and social distress,” says Lee Buchheit, a prominent lawyer in the field. “But having watched some holdout creditors extract rich payouts, even some of the traditional institutional investors appear to be reconsidering the virtues of passivity.”

Medical staff interview residents of Guayaquil, Ecuador, during the Covid-19 pandemic. Ecuador, Rwanda and Zambia have all announced in recent weeks that they are struggling to repay their debts © Jose Sanchez/AFP/Getty

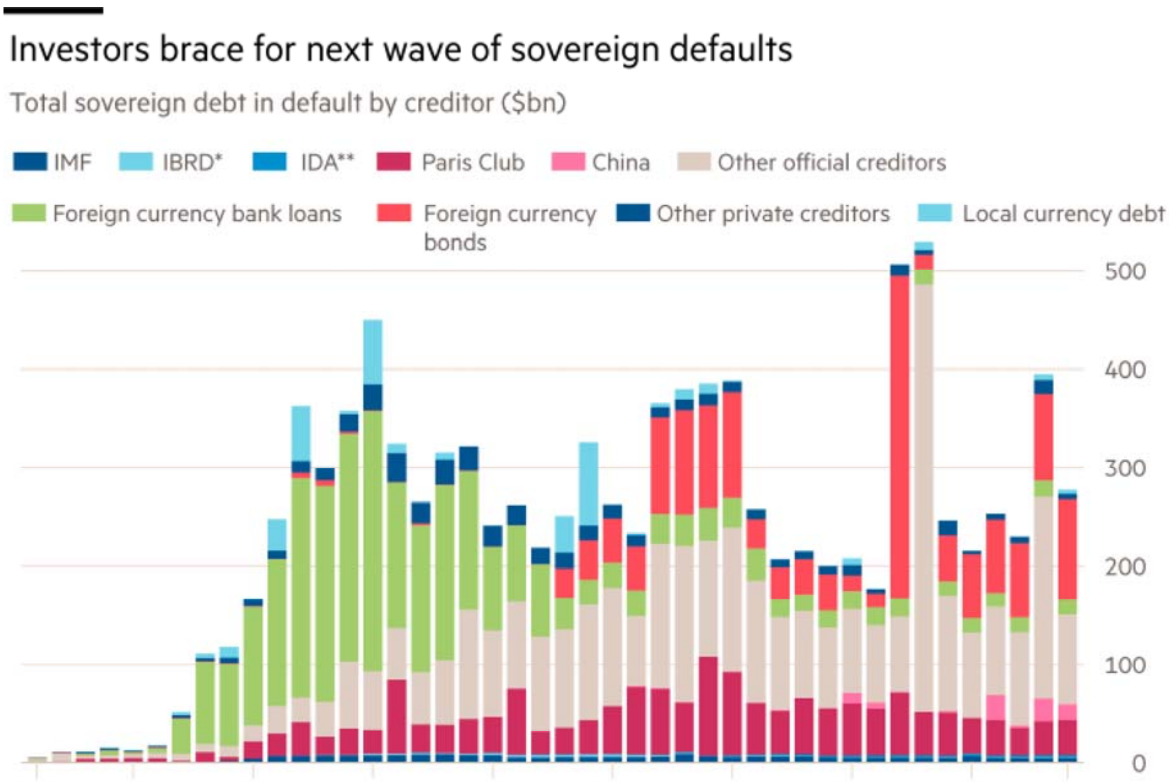
Holdout strategy

In the past, such aggression has been the preserve of what critics call "vulture funds" — investors who seek to profit from government debt crises through obstinacy and legal threats.

Their basic strategy is to act as a "holdout". Sovereign debt restructurings amount to exchanging a country's old bonds for new ones, often worth less, with a lower interest rate or longer repayment times. Holdouts refuse to join in, and instead threaten to sue for the full amount. As long as the number of holdouts is tiny, countries have often elected to simply pay them off rather than deal with the nuisance of a potentially lengthy courtroom battle.

For example, when Greece restructured most of its debts in 2012, it grudgingly chose to repay in full a smattering of overseas bonds where hedge funds had congregated. Others, like Argentina, have chosen to fight. The uncertainty of the outcome — and how hard it can be to compel a country to pay through legal means — long ensured a delicate but functional balance to the sovereign debt restructuring process.

However, in 2016 Elliott Management's Jay Newman etched his name in the annals of big hedge fund hauls by extracting $2.4bn from Argentina for the firm after a decade-long legal battle.



Source: BoC-BoE sovereign default database (available in a forthcoming paper) *IBRD: International Bank for Reconstruction and Development **IDA: International Development Association

"[Holding out] long seemed like a cat-and-mouse game that was costly and uncertain, but now it has shifted to a more promising strategy," says Christoph Trebesch, an academic at the Kiel Institute for the World Economy in Germany. Although still daunting, Elliott's success could inspire more copycats and complicate the looming spate of EM debt crises, some experts fear.

Moreover, there are signs that traditional investment groups are also toughening up, which could turn a difficult process into a more protracted nightmare for government lenders and borrowers alike.

One lawyer who has worked with creditors points out that many investment funds have piled into EM bonds in recent years, and the prospect of deep and broad losses could be ruinous to some heavily-exposed funds. "Before, the holdouts were the main problem, but now it could be the traditional funds," he says. "If your back is against the wall, you're going to fight."

Tourists sail kayaks in the Maldives. The IMF has gone from projecting a 6% expansion for the nation's economy this year to an 8% contraction © Carl Court/Getty

After the IMF's failed attempt to set up a quasi-sovereign bankruptcy court in the early 2000s, the main response by governments has been to introduce "collective action clauses" into their bonds. These dictate that if a large majority of bondholders vote for a restructuring, typically 75 per cent, the agreement is imposed on all holders.

But investors have wised up, buying bigger chunks of specific bonds in an attempt to amass such a large position that they enjoy a de facto veto over the restructuring terms of the instruments. And some older bonds have no such clauses.

So far there are only a few examples of larger investment firms taking a tougher stance, but they are notable for how successful they have been. The first was Franklin Templeton, which managed to extract what some analysts say were surprisingly favourable terms in Ukraine's 2015 debt restructuring, having snapped up enough bonds to become the country's largest private creditor.

More recently, Ashmore has built up a huge stake in Lebanon's debt that in practice gives it a veto over how the country will restructure some of its bonds. And this year, Fidelity successfully played hardball with Buenos Aires, calling the Argentine province's bluff that it was unable to make a $250m payment due in January. Buenos Aires ended up paying in full.

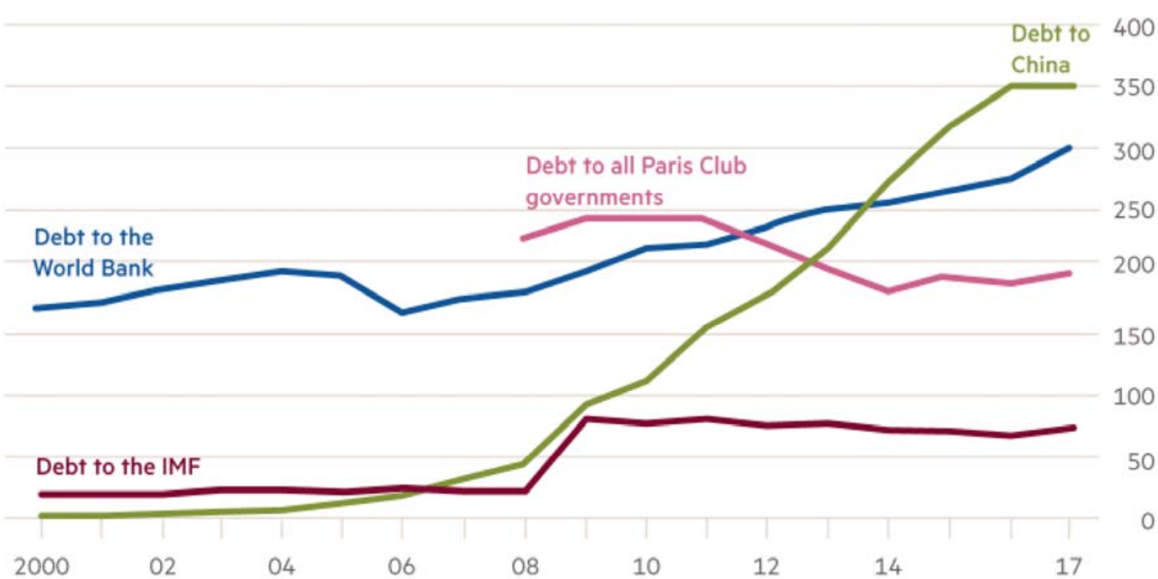
Fidelity is also part of a larger creditor group that has pushed back on Argentina's plans to restructure its $65bn foreign debt burden. The group includes some of the world's largest institutional investors, including BlackRock and T Rowe Price, and together with the two other main bondholder groups, wields enough power to make or break any deal.

Franklin Templeton and Ashmore declined to comment. Fidelity declined to comment on its Argentine bust-up, but said in a statement that its policies on sovereign restructurings had not changed.

"When it becomes necessary to negotiate with those who have borrowed our investors' money, we do so in good faith and in a reasonable, professional manner," the investment group said. "The interests we represent are those of the millions of individuals, and thousands of financial advisers and institutions who have entrusted their money to us to invest on their behalf."

China is now the largest official creditor to the developing world

Aggregate external public debt owed to different official creditors ($bn)



Sources: Horn, Reinhart and Trebesch (2019); World Bank; International Development Association; Paris Club
© FT

Debtor advantage

Fidelity's nod to the fiduciary duty money managers owe clients is telling. Traditional asset managers are unlikely to be quite as stubborn or litigious as Elliott. But with a spate of examples that a tougher approach can be successful, more may feel compelled to follow suit — no matter how severe the coronavirus crisis proves for many countries.

"They don't want to be Elliott, but they have a fiduciary duty and for some of them it will be existential, so they might as well fight to the death," says the creditor lawyer. "It doesn't take many of them to change their attitudes and this will become very difficult."

Clinching a victory, however, is another story, says one holdout investor. Amassing a blocking stake "gets you a seat at the table, but it doesn't tell you when you will be eating", the person adds.

People buy groceries in Buenos Aires. Argentina, which was already battling its creditors even before coronavirus struck, appears to be heading for its ninth sovereign default since independence in 1816 © Marcelo Endelli/Getty

These dynamics are why many investors believe the G20's call for private-sector creditors to copy their blanket debt "standstill" will probably prove futile. Absent some kind of extraordinary legal mechanism — such as the UN Security Council resolution that shielded Iraq's assets from seizure from creditors after the US invasion in 2003 — investors warn that it will be challenging to come to a collective and voluntary agreement. Instead, they say the coming wave of debt crises will have to be handled on a case-by-case basis.

For the investment funds looking to take an aggressive stance in any default talks, the obstacle might not be the potentially bad PR but the perception among some governments that the pandemic gives them more leverage. Given that bond prices have plummeted to distressed levels, countries will probably harden their stance and seek more favourable terms in forthcoming restructurings.

Bill Rhodes, a former top Citi executive who was one of the key figures in the Latin American debt crisis of the 1980s, argues that the threat of fresh outbreaks of coronavirus will strengthen the hand of debtor countries when negotiating repayment terms.

"We are looking at just the first wave of Covid-19, so some of these finance ministers are going to feel like they really have to drive a tough bargain," he says. "The IMF will be very firm on pushing for the countries to get discounts."

Ramin Toloui says 'the withdrawal of money [from EM funds] is greater and more sudden than in 2008, while Mitu Gulati says the Maldives is the 'poster child of how easily the [EM] dominoes will fall' © Reuters/Duke

Institutional deal

A group of sovereign debt experts, including Mr Gulati and Mr Buchheit, has come up with a pandemic debt relief proposal. Countries should strike an agreement with creditors to funnel debt payments into credit facilities set up by the World Bank or a regional development bank, which would then be lent back to the countries to pay for essential spending.

Its backers hope this would avoid a technical default and impose a de facto debt standstill. The carrot of the legal protection enjoyed by organisations such as the World Bank — which are considered "super-senior" in debt restructurings — might help sweeten the deal. Once the crisis has faded a decision can then be taken on whether a full but orderly debt restructuring is needed, and any money deposited in the facility would be protected.

Bill Rhodes: 'We are looking at just the first wave of Covid-19 ... finance ministers are going to feel like they really have to drive a tough bargain [in forthcoming restructurings]' © Pete Marovich/Bloomberg

It is unclear whether the World Bank, which has not publicly commented on the idea, would go for this proposal, and some heavy-handed coercion from the likes of the US would probably be needed to get many creditors to agree. But Mr Trebesch says the proposal may be acceptable to China, which has edged out the IMF and the World Bank as the largest official creditor to developing economies via its Belt and Road Initiative, according to data he compiled with Harvard's Carmen Reinhart and economist Sebastian Horn. "If things really blow up, China might prefer this option to an outright default," he says.

Whatever avenue is eventually taken, it is essential that policymakers start grappling more forcefully with emerging market travails, given the danger that their severity is likely to reverberate across the international financial system, according to Scott Minerd, chief investment officer at investment firm Guggenheim Partners.

"This pandemic will quickly escalate from a health crisis to a humanitarian crisis, and ultimately to a solvency crisis," Mr Minerd wrote in a recent note to clients. "Political stability will be the last domino to fall. But my biggest concern is that this crisis will be much deeper and more prolonged than people anticipate, which leaves a lot of space for another shoe to drop in the global financial crisis."