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Waiting for Superbond

Sovereign bond contracts should be enforceable. Is that really too much to ask?

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In the documentary film *Waiting for Superman,* educator Geoffrey Canada describes his heartbreak when, as a fourth grader living in a New York ghetto, he realised that Superman wasn't real — that no one was coming to save him. He'd have to save himself.

Investors in sovereign debt need to take a lesson from Canada's epiphany. If — as is being widely predicted — Sri Lanka's recent default presages a wave of emerging market debt distress and restructurings, creditors are in for some rude shocks.

Unlike past debt crises, this one will involve two major new challenges.

First, the terms of most sovereign bond contracts have been so dramatically degraded over the last 20 years that the bonds have become functionally unenforceable. Among other challenges, creditors will face the prospect of working through a thicket of onerous collective action clauses that enable debtors to manipulate the restructuring negotiations.

But even more threatening to recovery values is the fact that this will be the first debt crisis in which China holds the whip hand. Since 2014, Chinese institutions have become a major lenders and investors in over 130 countries through the mercantilist One Belt One Road (OBOR) initiative. Those bills are now coming due.

Notwithstanding the recent, breath-less announcement that China will co-operate with the G-20 and IMF to restructure Zambian debt, there's no objective indication of China's true intentions toward Zambia, much less elsewhere. Historically, China has been secretive about the scope and terms of its dealings with countries that owe it money. It is imperative that OBOR transactions be fully and transparently made part of restructurings — and Chinese interests be explicitly bailed in — to protect the interests of everyone else.

Predictably, debtors will seek very high levels of forgiveness to reduce their debt service obligations to sustainable levels. It's one thing to agree to forgive principal, reduce coupons and extend maturities in the name of debt sustainability. But it's quite another to remain fatalistic about contractual terms that don't ensure that restructured debt is actually paid in accordance with its terms.

The case in point is Argentina. In 2020, creditors of Argentina were asked to — and did — accept feckless contractual terms even as they provided substantial debt forgiveness. Now, less than two years later, Argentina, hasn't undertaken the structural economic reforms identified as necessary to manage even this newly reduced debt — much less $40bn it owes to the IMF. As Argentina cycles through its third Economy Minister in a single month, bond prices imply that another default on international debt — Argentina's ninth — is on the horizon.

What can be done?

If creditors become serious about negotiating durable restructurings that will avoid the economic and social trauma of endless cycles of default and litigation, it's time to insist on contractual terms that are meaningfully different from what we've got now. It's time to insist on instruments that are enforceable: a Superbond.

A strong bond contract — one that affords creditors a wide range of legal protections and obviates many of the vagaries of current enforcement efforts — would make future restructurings significantly less likely and would structurally lower the cost of capital to sovereign borrowers. Borrowers — recognising that the playing field has been levelled to give lenders effective legal remedies — might think long and hard about incurring more debt than they can comfortably repay and might make the tough political choices to ensure that their debts are timely repaid and sustainable. And, precisely because a Superbond would be more likely to be repaid than inferior contracts, a Superbond would trade better in the secondary market.

So, what are the critical elements of a Superbond? In many instances, restoring the contracts to a status quo ante.

In the days of syndicated bank lending to sovereigns, banks insisted on full fiscal transparency and conventional lending covenants — like debt-service ratios and limits on overall debt. Today's bondholders should require nothing less. Two other covenants are vitally important as OBOR loans threaten to involuntarily subordinate other lenders.

A strong pari passu clause — providing that payment obligations under restructured bonds will not be legally or practically subordinated to other debt obligations — is essential to ensure that the restructured bonds are not treated less favourably than debts owed to Chinese lenders and investors. The other is a robust negative pledge clause that prohibits debtor nations and their instrumentalities from pledging sovereign assets as collateral or a source of repayment to certain favoured lenders. This is what happened in 2017 when Sri Lanka was compelled to cede the port of Hambantota to Chinese interests. And it might just be happening on a larger scale if Pakistan cedes Gilgit-Baltistan to China to offset its debts. If private creditors are going to be asked to restructure claims against Sri Lanka, Pakistan, Lebanon, Zambia, or other nations, they're going to need a Superbond to avoid being involuntarily

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subordinated to Chinese interests.

Enforcement of these covenants will require transparency and information rights. But, as will soon be demonstrated in the Zambian case, the IMF and the G-20 are intent on dictating terms to private lenders: presenting them with a fait accompli, rather than giving them a seat at the table. This kind of backroom dealmaking echoes one of the most troubling aspects of OBOR. China has insisted on strict confidentiality of its lending terms, leaving other creditors in the dark as to the debtor's true financial condition. Even now the Sri Lankan government can't say for sure how much of its $51bn debt is owed to China.

In contrast, a Superbond would require debtors to account fully for all their debt obligations and involve the private sector in the entire process — no exceptions. This is the only way to get any country's fiscal house in order.

Finally, there must be means to enforce these enhanced covenants and the underlying payment obligations in court. The rights of bondholders to enforce their contracts have been steadily eroded in recent sovereign bond contracts. No more. The right of bondholders to bring lawsuits directly must be restored; bondholders should not be limited to proceeding through an indenture trustee.

Indeed, under a Superbond, violation of key covenants would be independently actionable, even before a payment default. The Superbond would have a comprehensive waiver of sovereign immunity as to the sovereign and all its instrumentalities. The sovereign would further agree never to assert such immunity with respect to its debts and, perhaps, bolster that promise with a surety bond equal to, let's say, 10 per cent of the principal amount. A bond could support the payment of liquidated damages if the sovereign in bad faith violates its "will not assert" obligations. And because a sovereign's assets can be seized generally only if they are used for commercial activities, the Superbond will require sovereigns to stipulate that property located outside the state is, by definition, commercial, unless used exclusively for diplomatic or military purposes. Not least, a debtor's central bank should guarantee the sovereign debt and waive immunity as to both jurisdiction and its assets, anywhere in the world — including funds in the hands of the Bank for International Settlements and the New York Federal Reserve.

Denizens of the sovereign debt ecosystem — lawyers, G7 bureaucrats, pundits, IFIs — will find these ideas anathema. But here's the rub: either you intend a contract to be enforceable, or you don't. If the former, default should lead to accountability — not to easy exits, fraudulent use of proceeds, or optional compliance with covenants.

Of course, there is one enormous practical impediment to the creation of a Superbond: the inability of the creditor class to coalesce around these ideas — and to exert the only undeniable power they have left: collective action.

Investors in sovereign debt have the power to convert a vicious circle of borrowing, default, and restructuring into a virtuous one. The 50-year experiment in private sector hard currency lending to low-income countries has been a bust. As defaults proliferate, Churchill's admonition comes to mind: a good crisis should never go to waste. In the coming crisis, creditors can fundamentally change the relationship between the private sector, sovereign borrowers, the official sector, the IFIs — and even to help unwitting borrowers to find a way out of the OBOR mercantilist debt trap. If only creditors can find the collective will.

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