

Core Matters

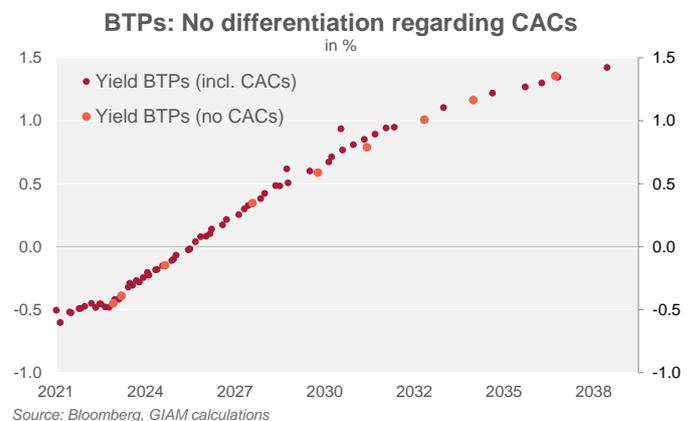
Collective Action Clauses in a rising debt world

Florian Späte, Guillaume Tresca

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Our Core Matters series provides thematic research on macro, investment and insurance topics

- Amid increasing government debt burdens, the handling of sovereign defaults may become more pressing in the future. As there is no statutory approach in place to handle a necessary debt restructuring, Collective Action Clauses (CACs) have come to the fore to facilitate such procedure.
- CACs aim to coordinate the bondholders' actions. Essentially, they allow a majority of bondholders to agree to a debt restructuring that is binding for all creditors. This accelerates the process and reduces costs.
- Starting from the first drafts at the beginning of the century, CACs have evolved over the last years and are now common for most government bonds. In this report, we highlight the scope, limitations and boundaries of current CACs.
- We then explore the effects of CACs in both the euro area and emerging bond markets (EMs). It turns out that in the euro area, market participants barely differentiate between bonds with and without CACs: there is no significant yield difference.
- In EMs, CACs are a more widely diffused tool, given the recurrence of restructurings and the recent rise of public debt. They have allowed shorter, more efficient, and orderly restructurings. In the long run, the inclusion of CACs for EM sovereign bonds has led to lower borrowing costs, both for IG and HY sovereign issuers. During periods of market stress, some bond arbitrages arise depending on the inclusion of CACs. However, it is hard to precisely separate the CAC premium from pure payment terms of a specific bond.
- The Covid pandemic has highlighted that the current framework for resolving sovereign debt crisis may be pushed to its limits. Holdouts are still possible. The new, but untested, G20 Common framework may ease some of the shortcomings.



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1. Introduction

In the aftermath of Argentina's messy 2001 debt crisis, calls for establishing a way to deal more efficiently with sovereign debt defaults became louder. Countries are sovereign entities, that cannot be liquidated: hence a mechanism to restructure debt is necessary. The most well-known statutory approach is the so-called sovereign debt restructuring mechanism (SDRM), proposed by the IMF.¹ It includes an international convention that binds debtors and creditors to a process that facilitates debt restructuring. An essential part of the SDRM is a quasi-court for sovereign bankruptcy. However, due to the lack of support among IMF members, the SDRM has not yet been put into force, and none of the restructurings in recent years have used this approach.

Under a market-based option, sovereign debtors and creditors negotiate a debt restructuring. The introduction of Collective Action Clauses (CACs) is key for this alternative approach. Several restructurings have been completed in recent years and CACs have become the preferred way to ensure a smooth process. This is especially relevant today. As sovereign debt burdens have increased in recent years (not least due to the Covid-19 pandemic) the issues of sovereign debt sustainability and potentially effective debt restructuring are more topical than ever.

The outline of the paper is as follows. First, we explain the need to use a restructuring mechanism and the basic nature and structure of CACs. Second, we describe related problems and the developments that have emerged since the introduction of CACs. We then analyse how the use of CACs has evolved in recent years. We also examine the extent to which CACs influence the yield level, with a focus on euro area and EM bonds. Finally, we discuss CACs' limitations,

¹ See Krueger (2002), A New Approach to Sovereign Debt Restructuring, IMF

challenges, and possible further developments.

2. The holdout problem and the functioning of CACs

Whenever countries face an unsustainable sovereign debt burden, default becomes a highly likely option. As there is no bankruptcy procedure for sovereigns, restructuring becomes necessary to restore sustainability. Restructuring can only be prevented if other countries or international organizations (e.g. the IMF) bail out the creditors (e.g. Mexican Peso Crisis in 1994).

However, to shift at least some of the costs to the private sector, a default usually triggers a complex restructuring procedure. As long as no appropriate processes are in place the debtor has to negotiate with each bondholder as each of them can ultimately decide whether to **accept or refuse** the debtor's offer.

This creates the so-called holdout problem. Bondholders who do not agree to the debtor's proposal keep their original bonds, hoping then issuer will stick to the original obligation. Usually, these creditors pursue legal actions and sue the debtor for complete payment.² This is problematic for the restructuring process as bondholders would be treated unequally. Moreover, the possibility to holdout (and to receive full compensation eventually) gives every bondholder the incentive to refuse any relief proposal. This reflects the creditors' *collective interest* dilemma to reach an overall satisfactory agreement with equal terms and with a common share of loss. However, each creditor has an *individual incentive* to hold out and freeride on other bondholders' debt relief. Hence, exploiting the right to opt-out of a restructuring implies delaying (or even preventing) a consensus-based solution that would benefit the group. This makes the success of the restructuring attempt uncertain and in any case, prolongs and increases the cost of the restructuring (e.g. Argentina 2001, where litigations are still ongoing).

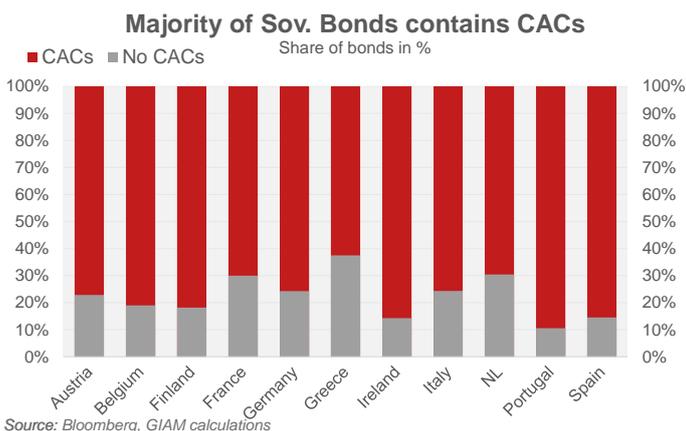
CACs facilitate coordination of bondholders

Financial market participants called for a procedure to enforce collective action upon the bondholders to avoid such lengthy restructuring processes. As the SDRM was generally not accepted, a more decentralized and contractual approach came to the fore. Following an initiative by the US Treasury in 2003, the use of CACs as a way to adjust the terms of bond contracts has gained broader acceptance. A CAC allows a supermajority (details below) to agree to a debt restructuring

² As many countries have enacted laws that do not allow to initiate such court proceedings within the country, creditors sue the sovereign abroad. Frequently this occurs in New York as often the New York law is the governing law.

that becomes mandatory for all bondholders. The modification of payment terms applies also to the minority that has not agreed. Hence, CACs aim to safeguard creditors' equality.

Predecessors of CACs have been in use for more than 100 years (mainly for debt contract issued under the English law), but it took several financial crises to generate the political will to help CACs make a global breakthrough. Since 2003, when Mexico issued a bond governed by New York law, they have become more common, and have since emerged as the norm for bonds governed by New York and English law.³



CACs are included in the contractual terms of a bond. They take effect once a sovereign debtor defaults. They do not interfere with the terms of the contract but initiate a procedure to ease collective action between the creditors. In contrast to the more coercive SDRM, they allow for party autonomy (in contrast to the need to settle the issue in court). The restructuring may provide for various measures. Among others, the amount payable may be reduced (haircut); it can also include a reduction of the coupon and/or postponing the date of payment.

The key idea of CACs is that the restructuring may proceed even if not all bondholders agree. This means that individual creditors can no longer delay or postpone the restructuring; CACs tend to reduce the time to deal with defaults. This way the need for bailouts is reduced, as the inclusion of CACs makes it more likely that in case of an unsustainable debt situation the private sector will be involved and will have to bear part of the losses. **CACs therefore encourage market discipline and support the regular functioning of bond markets.**

A *supermajority* that is specified in the bond contract is a requirement to gain a specified level of support. The level is

³ Prior to 2003 a formal meeting to vote was required. Meanwhile, CACs usually do not mandate that a meeting takes place which simplifies the process.

⁴ Bonds held by a private bank, however, are usually not excluded. The distinction is not always clear-cut and often the share of ownership or control of the board of directors are considered.

higher than the usual 50%. This hurdle ensures that the majority does not erode the rights of a minority. Several thresholds for a supermajority are possible. The most common barriers are 66.7% and 75% but higher levels are also possible.

CACs also differ in that they may contain a *disenfranchisement clause*. This removes certain creditors the right to vote if they do not act autonomously or if they are controlled by other agents. This clause is introduced to reduce the influence of the debtor itself. It implies that the issuer, possibly acting through the national central bank or a state-owned bank, might be excluded from voting.⁴ The importance of a disenfranchisement clause became obvious when the Ecuadorian government arranged the purchase of Ecuadorian sovereign bonds in 2008. A default was already looming at that time, and prices were very low. The effect was that Ecuador stepped up its ownership of bonds such that the other bondholders were unable to exercise collective rights.

The Greek debt restructuring in 2012

The Greek debt restructuring was the biggest in history, with an outstanding debt of more than € 350bn. As most bonds were issued under domestic law and did not include CACs the Greek government introduced them retroactively in 2012. This way participation of creditors was ensured even in case they had voted against the restructuring. Eventually, a volume of almost € 200bn was restructured (out of € 206bn eligible).

Around € 6bn of debt was not restructured as these bonds were governed by foreign law and included series-by-series CACs. Creditors rejected the restructuring of 19 out of 36 bond series and were holding out. In the end these bonds were repaid in full while creditors participating in the restructuring lost around 75% of the net value of their bonds. Given the rather small share of foreign law bonds Greece was able to manage the holdouts. However, it shows that a restructuring including a high proportion of non-CAC bonds governed under foreign law can be more difficult. Holdouts can even prevent a debt restructuring and ultimately undermine the functioning of bond markets.

Concerning the voting modality, various mechanisms are possible. The simplest approach is to vote on an *issue-by-issue basis* (as in the Greek restructuring in 2012, see box⁵), where each bond is voted on and counted separately (to be

⁵ <https://www.chathamhouse.org/2018/08/greek-bailout-imf-and-europeans-diverge-lessons-learned>
<https://voxeu.org/article/greek-debt-restructuring-lessons-learned>

distinguished from the single-limb or two-limb CACs explained below). Hence, there is a separate vote for each instrument. In case the required supermajority is achieved this binds all bondholders of that series (but not holders of other series). If this is the case for all bonds the debt restructuring can proceed smoothly. In fact, most bonds in the early years of CACs had this kind of series-by series CACs. An alternative approach is the so-called **two-limb CACs**. They include a second threshold. There is a (lower) supermajority for *each* bond series and a (higher) one for the *aggregated* total outstanding volume across all series. However, both voting modalities allow for an opportunistic behaviour by creditors and can complicate the execution of a restructuring. The resulting problems and the further development of CACs are discussed in the next chapter.

3. Problems and further evolution of CACs

Voting on an issue-by-issue basis or two-limb CACs can trigger the re-emergence of the holdout problem. Creditors can establish blocking majorities in one or more issues. This applies in particular to rather small issues where this can be done at low costs. If creditors succeed in achieving a supermajority for the total volume (in case of the two-limb CAC) or the debtor still proceeds (in case of the series-by-series CAC although some series have not reached the necessary majority), holdouts' benefit and cheat the other bondholders as the non-restructured bonds will be repaid in full.

Aggregation clauses bound bondholders of all issues

Accordingly, two-limb CACs were complemented with *aggregation clauses*. To make holdouts more difficult and to prevent additional complications they **bind an aggregate number of different series by one vote**. If the overall cross-series vote is approved with a (higher) supermajority (e.g. 80%) it overrules every single vote on a specific series. Thereby individual opportunistic decision-making is hampered, and cooperative, economically superior results can be generated. To protect bondholders of specific issues there must be at least a simple majority for each bond series. Otherwise, the aggregation fails.⁶

In another variant, the **single-limb aggregated CACs** provide for *only one vote* and allow a majority of bondholders

across all series to bind the minority.⁷ Hence, in contrast to two-limb CACs, they allow the majority vote to take place *at the level of all bond series combined*, without the need for a majority at the level of the holders of each individual series. Accordingly, contrary to series-by-series CACs the concept of single-limb aggregated CACs is to vote by creditor class (rather than by instrument). It is mandatory for the use of single-limb aggregated CACs that all bondholders receive the same (new and restructured) bond or menu of bonds as a replacement for their legacy holdings. The application of single-limb CACs is especially useful in case creditors are rather homogeneous. However, at this point, the concept of equal treatment of all bondholders reaches its limit. If all bondholders receive the same new bond for a bond with a certain nominal amount it leads to different outcomes in terms of net present value. Depending on the remaining maturity and the coupon level of the original bonds (being restructured) some bondholders are hit harder than others. But the idea of identical net present value reduction has been ruled out so far to avoid complicated discussions about appropriate discount rates. In case more currencies are involved it becomes even harder to agree on an appropriate curve.

Because of this uniformly applicable offer to all bondholders and to prevent the abuse of single-limb CACs, the requirement for the voting result is particularly demanding. Hence, a high supermajority (at least 75%) is necessary for a single-limb aggregated CAC to come into effect.

In 2014 the IMF endorsed so-called **enhanced CACs**. These combine the different designs of CACs and offer a menu of voting procedures. In this way the flexibility is increased as enhanced CACs provide for the consideration of both series-by-series and (single- and two-limbs) aggregated voting procedures. Since 2014 more than 90% of all newly issued sovereign bonds include enhanced CACs.⁸ Moreover, against the backdrop of the ongoing litigation regarding the restructuring of Argentina, the IMF recommended the use of *modified pari passu clauses*. They explicitly exclude the obligation to pay creditors on a rateable basis.⁹

Hence, the aim of single-limb aggregated CACs is to raise the costs and the risks of holdouts. However, in recent years the investor base has become more fragmented and less homogeneous. It shows a higher degree of diversity with respect to instrument holdings, engagement strategies, and interests. This raises the challenges for the use of single-limb CACs and is certainly one reason why single-limb CACs have hardly been used in recent years. Nonetheless, the stringency of the structure and the material increase in the cost of

⁶ Currently, around 45% of outstanding bonds have two-limb aggregated of series-by-series CACs.

⁷ In 2014 the International Capital Market Association (ICMA) recommended such CACs for bonds governed by English law.

⁸ However, only a little more than 50% of all *outstanding* bonds include enhanced CACs.

⁹ Generally, a *pari passu* clause means all creditors will be paid pro-rata, in equal rank, and at the same time. This obligation is softened to aggravate legal disputes.

holding out is remarkable. This has induced euro area finance ministers in 2018 to make single-limb CACs mandatory for new sovereign bonds as of 2022.¹⁰

Another, more fundamental problem of CACs refers to the changing incentive structure. For example, the smoother handling of restructurings can lead to excessive borrowing by debtors. Knowing this **moral hazard problem**, creditors may demand a premium.¹¹ Additionally, CACs (and the lower restructuring costs associated with them) can also **reduce the incentive for international organisations** (e.g. the IMF) to extend assistance to highly indebted countries.¹²

CACs, however, also have more practical limitations. As sovereign bonds are usually issued in different jurisdictions (and even currencies), the existing CACs are very heterogeneous.¹³ Some (older) bonds may not yet include CACs and other debt instruments (e.g. syndicated bank loans) generally do not have CACs. What is more, secured bonds offer different rights and respective creditors may enforce the collateral and receive proceeds from it. The same applies to bonds embedding options in contrast to plain vanilla bonds. These factors can also prevent a uniform application of the clause and therefore a quick and smooth restructuring. Finally, even if holdouts cannot stop the restructuring and have to participate in the restructuring their legal claims continue to remain valid and there is a risk that the sovereign will eventually be obliged to honour them.

To overcome these shortcomings and further limit holdout risks, targeted statutory tools (like anti-vulture fund legislation) have been introduced in some countries (e.g. France and Belgium).¹⁴ These complement the contractual CAC approach as they help limit legal risks in case contractual restructuring tools fall short.¹⁵

4. CACs: a powerful tool for EM sovereign bonds and restructurings

CACs have gathered most of the attention in the EM sovereign fixed-income space. Except for Greece in 2012, all sovereign restructurings have taken place in emerging countries since 2007. The protracted 2005 and 2012's Argentina restructurings perfectly illustrated the holdout problem and its long-term consequences.

Almost all EM international sovereign bonds¹⁶ now include basic CACs¹⁷, and it is usually only off-the-run and illiquid bonds in EM HY countries that do not include basic CACs. Since the 2014 IMF [recommendation](#), **enhanced CACs**¹⁸ have been included in most of the new issuances¹⁹. Following the Argentina restructurings, most of them also include a new *pari passu* clause. Their incorporation is similar for English and New York law bonds, but they are absent in other jurisdictions that use the older form of CAC.

It is estimated that 50% of outstanding EM sovereign bonds do not include enhanced CACs – a ratio set to fall as old issues expire, though 30% of those bonds will mature in more than ten years. Only a very few small issuers continue to stand out against the market trend.

The role of CACs is gaining more importance in the EM space. Indeed, since the onset of the Covid crisis, discussions on a new international framework to resolve EM sovereign debt crisis have gathered speed. The IMF is forecasting EM sovereign debt to reach 73.2% of GDP in 2026 from 54.7% in 2019. According to the joint IMF-World Bank Debt Sustainability Framework, over half of low-income countries are at high risk of, or already face, debt distress. CACs have been a welcome support in the latest EM sovereign

BTPs: Increasing Share of CACs



Source: Bloomberg, GIAM calculations

¹⁰ https://europa.eu/efc/efc-sub-committee-eu-sovereign-debt-markets/collective-action-clauses-euro-area_en

Another reason for the introduction of single-limb CACs is to tackle so-called vulture funds (see below).

¹¹ But, as stated above, CACs also tend to reduce the legal uncertainty and speed up a restructuring. Which effect predominates is ultimately an empirical question (see next chapters).

¹² Knowing about this effect can in turn help to increase market discipline.

¹³ This applies even more as sovereign bonds also differ according to the year of issue and, hence, the design of the included CACs.

¹⁴ Vulture funds are specialised hedge funds that invest in distressed debt. Later, they refuse to participate in the restructuring process and aim for complete payment assuming other creditors restore the solvency of the country. The respective legislation essentially limits the amount of money that vulture funds can get through litigation to the amount paid

when they bought the bond for a discount price. This makes speculation economically unattractive.

¹⁵ Although the effectiveness of this kind of legislation is not known yet the European Parliament called on European member states to adopt similar laws.

https://www.europarl.europa.eu/doceo/document/TA-8-2018-0104_EN.html

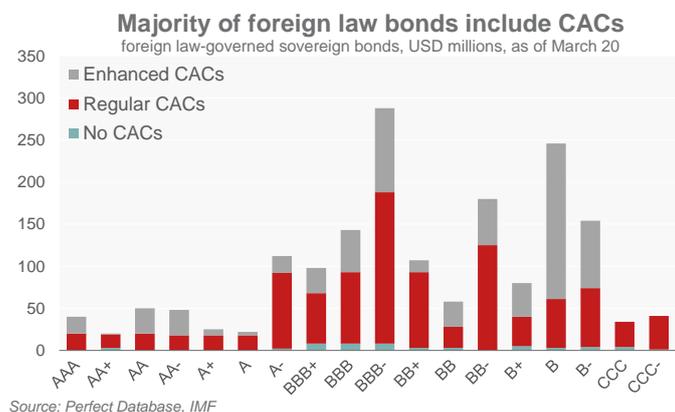
¹⁶ International sovereign bond is a sovereign bond governed by a law other than the law of the issuer. It is usually English or New York law. It essentially covers EM countries.

¹⁷ English law -governed bond include CACs for the past century. New York law bonds usually include CAC since 2003. [4% of bonds includes no CACs as of March 2020](#)

¹⁸ [IMF, Strengthening the contractual framework to address collective action problems in sovereign debt restructuring, 2014](#)

¹⁹ 91% of EM bonds and 96% of frontier market issues

restructurings. According to the IMF²⁰, EM restructurings have been smoother and have been largely pre-emptive since 2014 thanks to the CACs. In addition, CACs have reduced the duration of restructurings and increased the participation rate compared to earlier periods. Since 2014, the duration of restructurings using enhanced CACs was 1.2 year on average vs. 3.5 years over 1978-2010. In half of the EM restructurings, CACs were used to achieve full participation, and there has been no ex-post litigation with private creditors.



contain so-called **uniform Euro CACs** as part of the bond terms and conditions. These CACs refer not only to plain vanilla bonds but to a wide range of securities, including floating rate bonds, unsecured and collateralised bonds, and zero-coupon obligations.²¹ Technically, the Euro CAC is a two-limb aggregated one. The lower threshold is set at 66.7% of the outstanding principal in each bond series and the supermajority of the aggregated principal to overrule single votes is specified at 75%.

The Argentina restructuring and the holdouts saga

2001's Argentina default and the subsequent 2005 restructuring make the most striking example of the holdout problem. It took almost 15 years to close the restructuring. Indeed, the 2005 restructuring allowed the repayment of 76% of \$82bn of bonds with a significant level of holdouts. A second restructuring in 2010 led to a final 7% of holdouts on the initial 2001 defaulted bonds. However, the remaining holdouts continued to seek full repayment in courts, trying to seize Argentina assets abroad. An unusual interpretation of the *pari passu* clause in Argentina bonds by the New York state court in 2012 forced Argentina to choose between paying all its bondholders (including holdouts) or none of them. They could not pay only those who cooperated with the 2005 and 2010 restructurings and ignore the rest. Bonds also included a *right upon future offers* (RUFO) clause. According to this clause, the settlement of a better offer with the holdouts would cause the remaining 93% to be entitled to receive their payment in full as well. This led Argentina to default again in July 2014 and limited Argentina 'access to markets. Eventually new elected President Macri found a deal with the remaining holders in 2016.

The design of Euro CACs has immediate consequences for the ECB's extraordinary policy measures. The ECB's issue share limit within the framework of the Asset Purchase Programme (APP) was initially set at 25%. This way, the functioning of financial markets should be safeguarded, and it aims to prevent the ECB from becoming a dominant creditor of euro area governments. Even stretching the APP to its limit, a supermajority against the ECB would remain possible.²²

by the Eurosystem. If bond terms already provide for a blocking minority at 25%, the (lower) limit remained in place and the ECB purchased only up to 25% of that series. However, a supermajority in bonds with Euro CACs against the ECB is no longer possible if the aggregate ECB holdings of an issuer exceed 25%.

CACs have reduced duration and costs of EM restructurings

A good example is the Ecuador and Argentina restructurings in 2020 which saw the first use of the enhanced CACs. Both confirmed the CAC's role in reducing the risk of holdouts and the length of the process. Restructuring went rapidly and smoothly. The two-limb mechanism was used in both cases, while the single-limb mechanism has not yet been tested in any restructurings. The participation rate was close to 98% in Ecuador and 99% in Argentina.

5. CACs lower EM bonds yields but have minimal impact on euro area bonds

Following the Great Financial Crisis, it was decided to make CACs mandatory for all euro area government bonds with a maturity above one year in 2011 (Art. 12 ESM Treaty). Hence, the decision to amend the ESM Treaty was already agreed on before the Greek debt crisis.

Since 2013 all newly issued euro area government bonds

²⁰ [The International architecture for resolving debt involving private-sector creditors, IMF, 2020.](#)

²¹ However, regional and municipal bonds are excluded and may be issued without CACs.

²² Later, the issue share limit was increased to 33%. However, the higher ceiling was subject to a bond-by-bond check to avoid a blocking minority

The fact that CACs have become mandatory in the euro area is noteworthy as more than 90% of bonds are issued under local law. Hence, the sovereign can change the law anyway and introduce them retroactively (like in Greece 2012). This 'local law advantage' makes restructuring for euro area countries comparatively easy in any case.²³

Latest EM restructurings and the use of CACs

Country	Debt exchanged	Duration (years)	CACs		Participation rate % (post CAC)
			included in bond	Used in exchange	
Grenada	Domestic, internat. bonds	2.7	yes	yes	100
Ukraine	International bonds	0.9	yes	yes	100
Mozambique	EMATUM bond	0.9	n.a	n.a	85
Belize	Superbond	0.4	yes	yes	100
Mongolia	International bonds	0.05	no	n.a	n.a
Barbados	Domestic debt	0.3	no	yes	100
Mozambique	International bonds	2.9	yes	yes	99.5
Barbados	International bonds	1.5	yes	yes	93
Ecuador	International bonds	0.4	yes	yes	100
Argentina	International bonds	0.7	yes	yes	99
Argentina	Domestic debt	0.8	no	n.a	n.a

Source: IMF, Anthony, Impavido and van Selm (2020)

But the interaction of the local law advantage and the existence of Euro CACs creates legal uncertainty. Weidemaier (2019) stresses that it cannot be taken for granted that euro area governments are obliged to use Euro CACs in case of a restructuring. Hence, euro area governments may still be able to revert to the local law advantage. Accordingly, as most bonds are issued under local law, they would alter their law to facilitate the restructuring and to achieve a sizeable debt relief.²⁴ While this path is riskier, they can still look for alternatives to the Euro CACs without violating the ESM Treaty.

Importantly, the fact that CACs have become mandatory constitutes an acknowledgment that restructuring in the euro area will be feasible, rendering the statement that the Greece restructuring was exceptional and unique less credible. This somewhat ambiguous political attitude pursues two goals at the same time. On the one hand, it aims to reassure financial markets that another restructuring is unlikely. On the other hand, euro area governments promise euro area taxpayers that there will be no further bailout and private investors will contribute in case of restructuring.

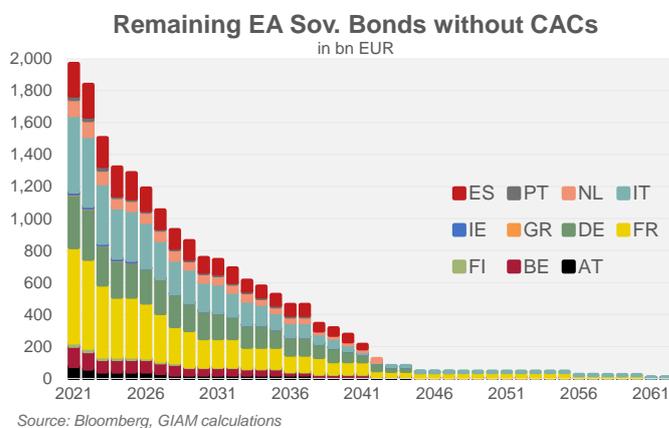
Several empirical studies have been conducted to determine how CACs affect the euro area government yield level in recent years.²⁵ Broadly speaking, the results are inconclusive and the effect on bond prices is rather small. If at all, they seem to slightly lower yields for low rated countries and very

long dated bonds. This tentatively shows that the reduction in restructuring costs has a stronger effect than that of moral hazard. Hence, the fear that CACs would increase the funding cost of euro area governments has not materialised.

Only in the case of low-rated European countries and very long-dated bonds, there are some indications of a small yield lowering effect.²⁶ This indicates that the benefit of an orderly debt resolution is seen as more valuable for countries that have a higher probability of default.

Market participants do not differentiate between European bonds with or without CACs

This also complies largely with our own observations. The example of Italy shows that there is no significant yield difference between bonds with or without CACs (see chart on the cover page). This does not change in times of market stress. In any case, the differentiation will become less important in the future as the share of outstanding bonds without CACs has come down significantly in recent years. Currently, about three-quarters of all euro area government bonds have CACs. The total volume of non-CAC bonds has already fallen below € 2000bn and will continue to decrease.



Source: Bloomberg, GIAM calculations

In EMs, given the growing inclusion of enhanced CACs and their role in swift restructurings, one would expect an impact on the pricing of EM sovereign bonds. In a recent novel approach based on a 23-year history²⁷, results show there is no visible obvious pricing impact between regular CACs bonds and the other bonds on the primary market. Recently issued bonds with enhanced CACs align with their respective

²³ https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3159665

²⁴ Weidemaier, Mark C. (2019), Restructuring Italian (or other euro area) debt: Do Euro CACs constrain or expand the options?, UNC Legal Studies Research Paper

²⁵ Among others, see e.g. here:

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3318570

²⁶ <https://www.imf.org/en/Publications/WP/Issues/2020/08/07/Do-Enhanced-Collective-Action-Clauses-Affect-Sovereign-Borrowing-Costs-48960>

²⁷ <https://www.imf.org/en/Publications/WP/Issues/2020/08/07/Do-Enhanced-Collective-Action-Clauses-Affect-Sovereign-Borrowing-Costs-48960>

sovereign yield curve, whether investment grade or high-yield.

On the secondary market, the result is different and conclusive. On a global basis, the inclusion of regular CACs has usually led to lower secondary EM bond yields. The impact is even greater for high-yield countries as the value of the CAC rises along with the default probability. Likewise, the introduction of enhanced CACs since 2014 has been associated with lower spreads. The benefit of an expected orderly and rapid restructuring is prevalent over the moral hazard impact.

Arbitrage arises between EM bonds during market stress periods

That being said, we note that in a market stress period, on a case-by-case study, some bond arbitrage may temporarily arise on the secondary EM market as CACs matter when the risk of default is high. The arbitrage can be complex and not straightforward depending on the inclusion of CACs, the previous behaviour of the debtor, and the specific bond payments.

Ecuador 2020 restructuring. Bond without enhanced CACs outperformed
price in % of face value



Source: Bloomberg, Generali

For instance, in the latest Argentina and Ecuador restructurings in 2020, enhanced CACs traded cheaper versus other bonds:

- The 2024 bond in Ecuador without enhanced CACs outperformed as investors were expecting a better outcome.
- Old 2005 indenture bonds in Argentina with higher voting thresholds traded higher. After the restructurings, the 2038 and 2041 bonds did not go through a legal language update, offering better creditor protection and they are now

trading a few points higher. That said, they are also offering different pure payment terms and so it is hard to entirely isolate the CAC premium.

In Sri Lanka, where at some point a credit event is likely, the bonds are split in terms of CAC terms, and yet we have not seen a clear differentiation in pricing. In El Salvador, some bonds were issued under an old Fiscal Agency agreement and had no CACs. Other bonds in the structure do have ordinary, modern CAC language. However, there is no obvious price differential between these bonds in the curve as the market is not pricing restructuring anytime soon (cash prices are close to par).²⁸

6. Challenges in the post-Covid world: a new restructuring framework and the extension of CACs

CACs are a significant step forward in mitigating collective actions but have some limitations.

Firstly, **holdout** is still possible, even under enhanced CACs, especially in countries with low total outstanding debt. Thirteen low-income countries have a minimum bond purchase for holdouts below USD400m.

Secondly, other instruments than bonds, like **syndicated bank loans or multilateral country loans** do not embed any sort of CACs. It can represent a significant part of the debt in low-income countries. Moreover, CACs only tackle debt held by the private sector, and leave aside official sector involvement²⁹. Likewise, sub-sovereign and state-owned entities (SOEs) can create challenges. As their bonds do not necessarily include CACs and we know that they can be a weight to the sovereign debt profile in some countries.

Thirdly, **asymmetry of information** between the debtor and creditor on the perimeter of the debt, be it public or private, can complicate the debt restructuring.

To face these limitations, technical options may be considered. The main idea is to extend further the coverage of enhanced CACs. Sovereigns could run exchange operations by buying former bonds without enhanced CACs and replacing them with new bonds, including enhanced CACs. To resolve the impact of holdouts further, the issuance of bonds under a trust structure³⁰ (that limits individual creditor's enforcement actions) will provide an additional barrier to holdouts. So far, issuances under English law are almost exclusively using a fiscal agency agreement (FAAs), while New York law bonds use trust structures most of the

²⁸ Lebanon is another case. Bonds do not have enhanced CACs but given the macro-backdrop and subdued recovery expectations, holdout is unlikely.

²⁹ The surprising use of the G20 Common framework by Ethiopia has raised questions on the size of the undisclosed debt held by public creditors.

³⁰ Bonds can be issued under fiscal agency agreements (FAAs) or trust structures. According to the IMF, under an FAA, the fiscal agent just makes principal and bond payments to bond holders. Under a trust structure, a trustee act on behalf of all bondholders as a group. It puts limitations on individual creditor enforcement. Only the trustee can start litigation.

time.

Beyond these technical adjustments, reforming CACs is part of an ongoing discussion, and an important component of the international financial architecture. New instruments are needed in addition to the usual CACs. Systemic changes have been considered. In New York, some lawmakers are trying to modify article 7 of the New York banking law to pass over bond documents and allow sovereign and subnational debt to be restructured by the courts, therefore reducing the importance of CACs. Discussions are slow and have a low chance of success.

In our view, the most promising change is the **new G20 Common Framework** introduced in April 2021³¹ for low-income countries only. This new framework will bring together G20 and Paris club directors to cooperate on debt treatments, initiated by the debtor country. Debt eligible to the treatment will include all public and publicly guaranteed debts. In addition, all official bilateral creditors with claims on a debtor country will participate and comparability of treatment between public and private creditors will be sought. It is a significant change for official creditors as for instance China is not a member of the Paris club and public and private creditors will be treated in the same way.

This new framework has been untested, and Ethiopia is the

first country with Eurobonds which has called for it. The Ethiopia restructuring in the next months will be worth monitoring, being a case study for a new form of restructuring in a post-Covid environment.

7. Conclusions

CACs have now been widely used in euro area government bonds and EM sovereign space. Thanks to the CACs, EM restructurings have been smoother and largely pre-emptive since 2014. Indeed, they have helped to reduce the duration of restructurings and to increase the participation rate. Their impact on sovereign yields is less straight forward. In Europe, the results are inconclusive and the effect on bond prices is rather small. The example of Italy shows that there is no significant yield difference between bonds with or without CACs. In EM, CACs have globally led to lower bond yields on the secondary market, especially for non-investment grade countries. That said, during market stress periods, some arbitrage can arise between CAC and non-CAC bonds, though it is hard to distinguish the real impact of the CAC premium from other idiosyncratic factors and the bond payment structure.

Issued by:	Generali Insurance Asset Management S.p.A. Società di gestione del risparmio, Research Department
Head of Research:	Vincent Chaigneau
Head of Macro & Market Research:	Dr. Thomas Hempell, CFA
Team:	Elisabeth Assmuth Research Operations Elisa Belgacem Senior Credit Strategist Radomír Jáč GI CEE Chief Economist Jakub Krátký GI CEE Financial Analyst Michele Morganti Head of Insurance & AM Research, Senior Equity Strategist Vladimir Oleinikov, CFA Senior Quantitative Analyst Dr. Martin Pohl GI CEE Economist Dr. Thorsten Runde Senior Quantitative Analyst Dr. Christoph Siepmann Senior Economist Dr. Florian Späte, CIIA Senior Bond Strategist Guillaume Tresca Senior Emerging Market Strategist Dr. Martin Wolburg, CIIA Senior Economist
Head of Insurance and AM Research:	Michele Morganti
Team:	Raffaella Bagata Research Operations Alberto Cybo-Ottone, PhD Senior Economist Mattia Mammarella Research Analyst Roberto Menegato Senior Insurance Research Analyst Giovanni Millo, PhD Senior Economist, Econometrician Antonio Salera, PhD Economist, Pension Expert Federica Tartara, CFA Senior Economist
Head of Credit Research:	Vivek Tawadey

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