Argentina

STRATEGY FOR THE REGULARIZATION OF THE EXTERNAL DEBT

Inter-American Development Bank

Recommendations

The analysis of this memo supports the following recommendations:

General Principles

State that Argentina will adhere to the principles approved by the G-20 and the United Nations General Assembly for sovereign debt restructuring, and insist on the holdouts' reciprocity.

Beyond these general principles, to propose detailed norms regarding the confidentiality of data and discussions and regarding the nature of all public statements.

Organization and Coordination

To initiate negotiations with the organized groups of creditors: the New York (NY) plaintiffs and the Italian retail bondholders organized under the committee known as Task Force Argentina (TFA).

The negotiations could take place separately or jointly, depending on logistical factors and the preferences of the creditors. There would be just one exchange offer, that would be open to all the holders of defaulted bonds, and it should consist of a menu of options, designed with the different preferences of the various groups in mind.

To accept the role of the Special Master, appointed by Judge Griesa, who does not fulfill any special function as mediator or arbiter, but acceptance of whom would be a demonstration of good will to the judge.

To hire, immediately, a well-qualified accounting and auditing firm, to carry out a verification of the existing claims.

Negotiating Issues

To take as a basis, the value of the claims that have been approved by the court, without trying to differentiate between the nominal value and the interest arrears or to take any other approach that would defy the court's decisions or the terms of the contract.

To negotiate a haircut over such claims making use of two arguments: the fiscal needs of the Argentine government (taking into consideration the probable devaluation of the peso and an economically correct measurement of fiscal deficit), and the need to arrive at an agreement that will achieve legitimacy and Congressional approval.

It is probable that the final agreement will consist of several options: cash, bonds, and even "fresh funds" provided by some holdouts. This would satisfy different groups of creditors and be useful to Argentina, by avoiding liquidity pressures in the context of reduced international reserves.

To hire a financial advisor to act as an intermediary in the negotiation, and to provide impartial advice. An independent advisor, compensated through a fixed salary and not able to subscribe to, or participate in the Argentine bonds market, would be free of the conflicts of interest that could affect large investment banks in their financial advice.

Introduction

With the election of a new President in Argentina, the time has come to start negotiations with the creditors in order to restructure the bonds that did not participate in the 2005 and 2010 exchanges, and in this way to take a critical step towards full normalization of relations between Argentina and the international financial community.

The economic and financial goals of Argentina entering negotiations as soon as possible, leaving behind the prolonged default, are very clear:

- To move toward reestablishing normal access to the markets so that the national government can complement existing financing options and contribute to non-monetary financing of the fiscal deficit;
- To lower financing costs, given that the sovereign spread would be reduced significantly, and would be aligned with other countries with similar fundamentals, with positive feedback to the Argentine private sector's cost of financing;
- To obtain a lifting of the injunction that has prevented the servicing of new bonds or of bonds issued in the 2005 and 2010 exchanges.
- To open the door to significant improvement in Argentina's credit rating; to avoid acceleration of any exchange bond.
- To contribute to the recovery of the current depressed levels of foreign direct investment through lower financing costs for investors and an improvement in the perception of the investment climate.
- To conclude an exchange under the most favorable terms possible, deferring payments for many years.

Bondholders also have strong incentives for good faith negotiation of the terms of restructuring:

- Their claims have not been paid for almost 14 years, and without exception, the creditors – whether they are the *pari passu* plaintiffs, the group of close to 50 thousand Italian retail bondholders litigating at ICSID, the bondholders with court judgments, or many who simple have been waiting for a better offer than those of 2005 or 2010 – surely want

to convert these claims into productive assets.

- The litigating bondholders – whether their claims are being considered in US or European courts or at ICSID – have on several occasions over the years requested negotiations without conditions, with the Argentine authorities. If they do not negotiate in good faith – including with regard to recovery value vis-à-vis nominal claim – they would undermine their credibility and reputation before the courts.

- With regard to the injunction issued by the New York court, and affirmed on appeal, if the plaintiffs do not negotiate in good faith they risk the measure being lifted. As the appeals court pointed out, the injunction is not an automatic consequence of having violated the *pari passu* clause in the old bonds, but rather it is an "equitable" remedy, given that Argentina has been "recalcitrant" up to now in the negotiation with the plaintiffs. The balance of equities could change if there is a change in perception of which of the parties is acting in a recalcitrant manner.

With regard to the restructuring of the old bonds: How will this impact on the interests and goals of the holders of the exchange bonds?

- First, the chief priority of the exchange bondholders is to receive their interest arrears, payment of which has been blocked by the New York court order, and to hold "productive" exchange bonds from now on.

- Equally important, the exchange bondholders would like to see an increase in the price of their bonds (a reduction of spreads). The market has clearly demonstrated in recent years that the prices of these bonds improve when negotiations with holders of the old bonds appear more probable, and vice-versa.

- To sum up, it can be argued, as Argentina has done, that to settle with the defaulted debt creditors (the old bonds) on better conditions than those given to the exchange bondholders is "unfair." But in practice, the exchange bondholders have not taken that position. Their fundamental interest, frequently articulated, is to see the injunction lifted, and to see the prices of their bonds rise sooner rather than later, and this overrides any concern with regard to the unfairness of an agreement. On the other hand, in other recent cases of sovereign debt restructuring, the holdouts have obtained better conditions than the bondholders who accepted the terms of the restructuring.

Clearly, the initiative to start negotiations lies with the new administration. However, before proceeding publicly, a series of important issues should be carefully considered in order to improve the likelihood of a reasonably rapid and advantageous conclusion of the negotiations.

Issues to Consider

1. General Principles and Code of Conduct

The form as well as the substance of the negotiating posture will be important, especially when contact is initiated. It would be a very positive step for Argentina if, as part of its first official statement proposing the beginning of negotiations, it explicitly declared that it would adhere to the generally accepted principles for sovereign debt negotiations, and insisted on a reciprocal commitment by the creditors. During the last decade, all sovereign countries have agreed to adhere to the Principles for Stable Capital Flows and Fair Debt Restructuring, approved by the G-20. Moreover, the General Assembly of the United Nations recently approved a resolution – given strong support by Argentina – entitled Basic Principles on Procedures for Sovereign Debt Restructuring. With respect to the restructuring negotiations, both statements of principles are focused on the following four key elements:

- Good faith from both parties to the negotiation
- Open dialogue and cooperation
- Transparency of data and policies in the discussions
- Fair play (avoid discrimination) for all the creditors

In all cases where these four basic principles have been observed, the negotiations have been concluded quickly and successfully.

It would make sense, given the long history of default, litigation and controversy, to go further than these basic principles and to propose additional elements, as part of a Code of Conduct for the negotiations. Such points would include:

- Signing of a confidentiality agreement by all of the participants to the negotiation, with respect to any data provided that is not in the public domain;
- Agreement that the discussions themselves and the concrete proposals formulated by both parties should be confidential, unless public disclosure is mutually agreed.
- Periodic public communications on the negotiations would be defined and scheduled by mutual agreement.
- All parties agree to avoid attacks on their counterparty, through the press or public statements, including using pejorative expressions to refer to counterparties, such as "rogue debtor" or "vultures", etc.

Argentina could take other measures to indicate its flexibility and willingness to negotiate in good faith. For example, getting Congress to repeal the "Lock Law" or at least to approve a resolution authorizing the commencement of negotiations with the holdouts, would send a very powerful and positive signal to the courts as well as to the creditors. Also, as will be mentioned below, Argentina would do well to accept the role of the Special Master appointed by Judge Griesa to facilitate the progress of the negotiation. Steps such as these would not diminish Argentina's capacity to negotiate an advantageous settlement, and would send all the right signals to Judge Griesa, so that he might lift the injunction at some point.

2. Issues of Organization and Coordination

Generally, there are three groups of holders of non-restructured bonds: (1) bondholders who have brought suit in New York, (2) Italian retail bondholders who have begun an arbitral procedure at the ICSID, and (3) a diffuse group of small holders, some of whom have brought litigation in various jurisdictions, while others have stood aside. The claims of each creditor include not only the nominal amount of the bonds in their possession, but also all the accrued interest, where this amount is calculated based on the norms stipulated in the original bond plus the outstanding statutory interest on judgments. The total nominal value of all restructured[1] obligations is about USD 6.2 billion and the total quantity of accrued interest is approximately estimated by market participants to be two to three times this amount. Currently, claims by the New York creditors (the original *pari passu* plaintiffs, in addition to the "me too's" that are now covered by Judge Griesa's court order, or anticipate being covered shortly) add up to approximately USD 10 billion. The Italian group (organized in a committee called Task Force Argentina, or TFA) have claims for approximately USD 2 billion. The total claims of the bondholders who are not organized are estimated with less precision, but it is believed that they make up about USD 6 to 12 billion. It is thought that few in this group hold large positions individually.

Since the holders of defaulted debt are very diverse as to their domicile, size of their holdings, legal status, and goals, it is not a simple question to decide whether to initiate formal negotiations with representatives of all, or only some creditors. If the authorities wish to begin negotiations with more than one group, a closely related question is whether the negotiations ought to be carried out jointly with all, at the same negotiating table, or if they ought to take place in tandem but separately.

Key considerations include:

- The logistics of organizing any negotiation that includes the third group (diffuse, and still lacking homogeneous organization) should not be underestimated since it could cause a long delay in beginning the negotiations.
- Moreover, experience in other cases – more recently, Ukraine's successful restructuring that was brought to a conclusion by a committee consisting of only four large holders – suggests that the small bondholders are ready to follow the leadership of the largest holders as long as they feel that they will not be discriminated against in the agreed upon restructuring options.
- Given the well-known "toughness" of the NY litigants, it is more likely that this third dispersed group would be satisfied to allow them to take the leadership in the negotiation, as long as they receive the same exchange offer. Also, in practice, it would be very difficult for any holdout from among this third group to carry out a successful legal battle to block a future international issuance, and likely to be prohibitively expensive, as well.
- In any case, it is of fundamental importance to reach an agreement with the NY

[1] Note the text says "obligaciones reestructuradas", "restructured obligations", although clearly reference is being made to "unrestructured obligations".

group, so as to lift the injunction and put an end to the prohibition against paying accrued interest on the exchange bonds. However, the court order could be lifted even before an agreement, if Judge Griesa were persuaded that Argentina is negotiating in good faith and in a manner consistent with the country's capacity to pay, while the plaintiffs fail to do so.

Therefore, it appears reasonable for Argentina to initially focus on starting negotiations with the NY groups and with Task Force Argentina. Both groups are well organized and have experience in negotiation, which will minimize logistical risks. At the same time, the authorities should facilitate some type of dialogue with any other significant group of creditors. If a significant number of members of this diverse group of creditors (for example, with claims in excess of USD 2 billion) wanted to take part in the negotiation, it would be counter-productive to refuse them. However, they should be advised that, to be adequately represented, they should organize a defined group (committee) that is broadly representative of this class.

The question remains whether there ought to be one negotiation that includes Argentina and the NY and TFA creditors, or two negotiations that are separate but in tandem. Arguments can be made, for the most part speculative, in favor of one or the other approach. Both options could, probably, turn out to be adequate from the perspective of Argentina. Under these circumstances, it would be reasonable for the authorities to respect the will of the creditors.

If both parties prefer an individual negotiation, Argentina should agree. However, if they prefer separate negotiations, this would necessitate special arrangements for sharing essential information on the progress of the other negotiations in order to insure equity among creditors.

Whether the negotiations are held jointly or in tandem, it is important to keep in mind that there could be different preferences among creditors, which Argentina ought to handle carefully. The retail bondholders have shown a preference for payment in cash, for example, while the institutional investors could be indifferent as to whether they receive cash or bonds, because their focus is on the net present value. Therefore, an exchange offer could include a menu of options adapted to the preferences of different groups. It is possible that, in spite of this non-discriminatory approach, some bondholders accept a settlement, while others continue to refuse one. Depending on the circumstances, it may be reasonable to close an agreement with some bondholders and continue negotiating different terms with the rest. But, of course, it is essential to continue the negotiation until agreement is reached with all the holdouts, because the injunction, or the risk of a new order, will remain until all claims have been settled.

There is another organizational issue involving the NY creditors. Judge Griesa has appointed a Special Master to facilitate negotiations. In spite of the fact that this court figure has no formal role in the mediation, and much less a role in dictating a settlement, Argentina has long been opposed to the presence of a Special Master and, in particular, has accused the current Special Master of being biased. There is a good reason for the new Administration to reconsider this objection. Like it or not, in the event of a rupture in the negotiations, Judge Griesa may, at his discretion, reexamine the "balance of equities" that underlay his injunction. If he decides that the rupture is due to Argentina's

position, the ruling will doubtless continue in effect, but if he comes to the conclusion that it is owing to the lack of good faith on the part of the creditors, he will feel free to lift the injunction. It is clear that, in taking any of these future decisions, the judge will rely to a significant degree on the information provided by the Special Master. Therefore, on this point, it would be convenient for Argentina if negotiations move forward under the auspices of the Special Master. This would not in any significant way reduce Argentina's negotiating power, but would do much to indicate to Judge Griesa that Argentina is making concessions and showing good faith in the negotiating process.

One final organizational issue is the quantification of the claims. It is, of course, important for all parties to have a good estimation of the total quantity of the claims, since it will be a significant data point in agreeing on an exchange offer that adequately addresses the issue of payment capacity. Moreover, the execution of any settlement requires that the claims of each creditor be independently verified. It would be more convenient for Argentina to begin this process as soon as possible by hiring a highly qualified auditing firm to lead the verification process and inform the creditors how to proceed to validate their claims. If the verification process began only after concluding the negotiations, this would result in significant delays in the implementation of any exchange. The verification agent would periodically issue reports on the conciliated amounts and the aggregate volume associated with the claim, but would not reveal to any of the parties the amounts claimed by individual creditors.

3. Negotiation Issues

It is premature to formulate or predict exactly the outcome of the negotiations, in particular with respect to economic terms – that is, to what degree Argentina will improve on its prior offer to reopen the exchange in 2010, and how ready the creditors will be to adjust downward their demand for the total repayment of their debt. However, there are various general decisions on what directions should be considered prior to beginning negotiations. Specifically:

- Argentina must be in the position to oppose any proposal from the creditors that it believes is unaffordable. In order to do so an explicit fiscal model will be necessary, that it shares with the creditors. Judge Griesa has been sensitive to arguments on capacity to pay, but he did not find them sufficiently persuasive during the *pari passu* case. It is important that the authorities prepare a fiscal model of this sort as soon as possible.

- As for the economic terms, the negotiations ought to focus exclusively on reaching a mutual agreement on a menu of options – which in addition to new, long term bonds could include some limited component of cash payment and fresh funds – so that the creditors may choose at the time of the exchange of their claims. Haircuts – nominal and NPV – for each option on the menu shall be applied equally on all claims, without distinguishing between original nominal value and accrued interest. It would be a strategic error for Argentina to try to negotiate different haircuts for original nominal value and accrued interest. It is almost certain to be a futile effort that would only consume time, given that all the claims have equal legal status. Moreover, such an effort would be seen as interference in the equality between the various creditors. Of course, all the claims

must be validated independently as part of the offering procedure, either before or after the exchange.

- Some of the NY creditors have indicated that, as part of a settlement, they would agree to purchase new bonds ("fresh funds"). Clearly this is an aspect that can be considered in the elaboration of the menu of options for the exchange. Other creditors might not be interested in offering fresh funds, but might be ready to accept an offer worth less on a present value basis, with fewer bonds, and more cash (or only cash, in the case of small investors).

- The option of fresh funds must be coordinated with broader plans to return to the international markets. This suggests that it would be convenient if the authorities began discussing with investment banks, possible alternatives for bond issuance, once the NY court injunction is lifted.

- All sovereigns that have successfully restructured have hired financial advisors to assist them. Financial advisors fulfill various useful functions. They can be intermediaries between the country and the creditors, which would allow for preliminary exchanges before direct negotiation between the counterparties, facilitating the exploration of various hypotheticals before direct discussion of them. In general, advisers can be very useful in giving authorities objective opinions on what is and is not feasible, such as reading the other side, etc. However, the best financial advisers have been those who have demonstrated their independence – that is, those without connections to the large investment banks and who do not compete for the "management" of the exchange or for a new bond issuance. This approach – the hiring of independent financial advisers who are paid a fixed salary – was used successfully by Greece and Ukraine.

- Contrary to what is typical in debt restructuring cases, it is difficult for Argentina to argue about the haircut on the basis of capacity to pay, or solvency. The total value of the claims amount to approximately 4% of GDP (at the current exchange rate) and it is difficult to argue that such an amount could make a substantive difference in a debt sustainability analysis. However, there is a very credible argument in relation to the practical incapacity of the government to implement an agreement that does not imply a haircut, due to the need to obtain Congressional approval and to create political legitimacy for the settlement. The exercise in the following section, which should be considered merely illustrative, tries to argue the case for a haircut taking into account the following elements:

    - The current exchange rate is clearly over-valued and the real depreciation that will be necessary will substantially reduce Argentina's GDP in US dollar terms.

    - The fiscal deficit has arisen to dangerous levels and this, together with the point above, cause the sustainability of the sovereign debt to be supported with only narrow margins.

    - The political situation requires that the fiscal adjustment go hand in hand with a haircut on settled claims.

- The exercise is an example of the justification that Argentina can use to support its offers at the negotiating table (which should probably be communicated via the financial adviser). It is worth mentioning that the financial engineering of the offer will be extremely important. The offer will consist in large part of long term bonds, and the holdouts will be concerned only with the market value of the bonds, which will depend on the spread that Argentine debt will have in a post-settlement scenario. Thus, these spreads are a key parameter that Argentina must consider carefully in the design of a negotiation strategy. It is also of fundamental importance that the financial package or menu that is agreed upon, be designed in such a manner that it can be presented in a favorable light domestically.

4. Example of a Debt Sustainability Analysis

- It is important to state that this is only a first pass at this difficult question, and that it should be seen as only an illustration of how Argentina might present its case within the framework of a negotiation. The main hypotheses are detailed in the following tables. They describe a scenario of relatively gradual fiscal adjustment and an adjustment of the real exchange rate concentrated on the short term (immediately reaching a level that can be considered equilibrium). The figures for projected growth and interest rates can perhaps be viewed as somewhat conservative. The base case assumes the total payment to holdouts with bonds, and the full recognition of the debt, along with the pensioners litigating in Argentina over the inflation adjustment of their pensions (estimated at USD 10 billion), which must be included as a basic point of equity.

Sovereign Debt Dynamic with Payment to Holdouts, No Discount							
	2015	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Real GDP Growth	**0.2%**	**1.0%**	**1.5%**	**2.0%**	**2.5%**	**3.0%**	**3.0%**
Nominal Interest Rate - Domestic	**20.4%**	**36.0%**	**27.4%**	**25.1%**	**21.7%**	**14.7%**	**14.7%**
Primary Surplus	**-1.5%**	**-2.5%**	**-2.0%**	**-1.5%**	**-1.0%**	**-0.5%**	**0.0%**
Nominal Interest Rate – External	**3.5%**	**6.5%**	**6.5%**	**6.5%**	**6.5%**	**6.5%**	**6.5%**
Real Depreciation	**-12.0%**	**50.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**
Total Government Debt (in Billions of USD)	**262.6**	**254.1**	**280.4**	**309.9**	**343.4**	**370.2**	**396.6**
GDP in USD	**591.3**	**402.8**	**416.4**	**434.0**	**453.7**	**476.7**	**500.8**
Debt/GDP	**44.4%**	**63.1%**	**67.3%**	**71.3%**	**75.7%**	**77.7%**	**79.2%**
Source: own calculation							

- The alternative scenario presented below assumes a 50% haircut in the settlement with the holdouts.

Sovereign Debt Dynamic with Payment to Holdouts, with 50% Haircut							
	2015	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Real GDP Growth	**0.2%**	**1.0%**	**1.5%**	**2.0%**	**2.5%**	**3.0%**	**3.0%**
Nominal Interest Rate - Domestic	**20.4%**	**36.0%**	**27.4%**	**25.1%**	**21.7%**	**14.7%**	**14.7%**
Primary Surplus	**-4.5%**	**-2.5%**	**-2.0%**	**-1.5%**	**-1.0%**	**-0.5%**	**0.0%**
Nominal Interest Rate – External	**3.5%**	**6.5%**	**6.5%**	**6.5%**	**6.5%**	**6.5%**	**6.5%**
Real Depreciation	**-12.0%**	**50.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**
Total Government Debt (in Billions of USD)	**252.5**	**244.8**	**270.4**	**298.8**	**331.5**	**357.5**	**383.0**
GDP in USD	**591.3**	**402.8**	**416.4**	**434.0**	**453.7**	**476.7**	**500.8**
Debt/GDP	**42.7%**	**60.8%**	**64.9%**	**68.9%**	**73.1%**	**75.0%**	**76.5%**
Source: own calculation							

- Two facts are apparent from the above exercise. In the first case, under somewhat pessimistic but reasonable assumptions, the sovereign debt of Argentina could take the path of explosive unsustainability. The second case, which includes a large haircut on holdout claims, does not modify the debt trajectory sufficiently to return to sustainability. Thus, a strong fiscal effort will be necessary. The problem is whether it is possible to obtain the needed political legitimacy and Congress' approval for a complicated fiscal adjustment if the holdouts do not compromise as well, given this topic's political sensitivity in Argentina today.

- The following scenario considers, in addition to a haircut on the holdout debt, a primary fiscal adjustment that is more substantial and concentrated in the short term, which would allow a level of debt that appears more manageable and less risky.

Sovereign Debt Dynamic with Payment to Holdouts, 50% Discount and Greater Fiscal Adjustment							
	2015	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Real GDP Growth	**0.2%**	**1.0%**	**1.5%**	**2.0%**	**2.5%**	**3.0%**	**3.0%**
Nominal Interest Rate - Domestic	**20.4%**	**36.0%**	**27.4%**	**25.1%**	**21.7%**	**14.7%**	**14.7%**
Primary Surplus	**-4.5%**	**-2.0%**	**-0.5%**	**0.5%**	**1.5%**	**2.5%**	**3.5%**
Nominal Interest Rate – External	**3.5%**	**6.5%**	**6.5%**	**6.5%**	**6.5%**	**6.5%**	**6.5%**
Real Depreciation	**-12.0%**	**50.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**
Total Government Debt (in Billions of USD)	**252.5**	**242.8**	**262.0**	**281.0**	**300.8**	**310.3**	**314.8**
GDP in USD	**591.3**	**402.8**	**416.4**	**434.0**	**453.7**	**476.7**	**500.8**
Debt/GDP	**42.7%**	**60.3%**	**62.9%**	**64.8%**	**66.3%**	**65.1%**	**62.9%**
Source: own calculation							

The possibility of ending the long litigation on unpaid debt and obtaining access to the international capital markets on attractive terms presents itself immediately to the new government administration. The reward for a successful negotiation will surely be very high. But the path is mined with tactical, legal and political risks. This brief note tries to present some considerations that will enable the beginning of strategy designed to overcome these risks effectively.