A Credible Solution to Europe's Debt Crisis: A "Trichet Plan" for the Eurozone

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Executive Summary

In April 1989, Mexico's external debt negotiator, Angel Gurria, asked his country's commercial bank creditors for a 55 percent haircut. This was the opening pitch of the newly created Brady Plan, which finally addressed both the debt overhang of developing countries and the weak balance sheets of their commercial bank creditors, ultimately resolving the LDC Debt Crisis.

More than twenty years later, Europe is in the midst of a similar sovereign debt and banking crisis. The EU is in a destabilizing feedback loop that it cannot control. Sovereign credit is deteriorating and this is reducing confidence in national banking systems, causing or increasing the likelihood that sovereigns will have to assume bank liabilities. This further impairs the sovereign credit and increases the lack of confidence in the banks.

We review the basic tenets of the Brady Plan in the context of our personal experience working on many of these sovereign restructurings and how they could apply in a comprehensive solution for the European debt crisis. The markets and the Eurozone desperately need a positive confidence shock in the form a comprehensive plan that simultaneously addresses the sovereign debt overhang and the balance sheets of European commercial banks.

Introduction

It will be twenty-two years ago this month when Mexico's external debt negotiator, Angel Gurria, now Secretary-General of the OECD, fired the first pitch of the Brady Plan, named after the Treasury Secretary of new administration of President Bush #41. President Carlos Salinas of Mexico had taken office just four months earlier and stated his administration's debt policy while campaigning: "If we don't grow, we don't pay." He believed that only after addressing the debt overhang could Mexico return to stable economic growth.

The LDC debt crisis (Less Developed Counties) erupted seven years earlier in August 1982 when Mexico declared a 90-day moratorium on external debt payments. Tight monetary policy in the U.S. had driven up interest rates and, coupled with falling commodity prices, impaired the capacity of these countries to refinance their external debt. Most of the debt was medium term loans at floating rates of interest (three or six-LIBOR plus a spread) to commercial banks in France, Germany, Japan, Italy, Switzerland, the UK and the US.

Twenty or so sovereigns in the developing world lost access to new bank loans at this time. Some of them, like Mexico, had relatively low debt ratios when the crisis started, but had to assume large stocks of private debt, including interbank lines, that increased their debt to the neighborhood of 100 percent of GDP. After the Mexico shock, these sovereigns got new foreign loans in amounts equal only to their interest payments due and had to accept austerity policies that brought economic growth to a halt. This situation was unsustainable and was not resolved until they secured debt relief under the Brady Plan framework beginning in 1990. Soon after completing their Brady Plans, capital began flowing back to these countries in a big way.

Economic and Political Crisis

Similar to the current situation in the Eurozone, the LDC debt crisis was really two major problems, which, in its early stage created an unstable feedback loop. It was first an economic problem which morphed into a political crisis for many highly indebted sovereigns. Second, it was a banking crisis.

The collapse of external credit and investment spending was a "brutal turning point" for economic growth in the developing world. This complicated the countries' fiscal imbalances, as large deficits became larger even with deep cuts in spending. Deficits had to be financed by central banks, causing a cycle of inflation, capital flight, exchange rate weakness and recession, in short, a "Lost Decade."

Years of austerity sparked political unrest in some countries, such as Brazil, Argentina and Peru and some of these stopped external debt payments all together after 1984. Mexico continued to work with the international financial community to remain current on interest payments. The banks rewarded the government of Mexico for its effort-by allowing it to be the first in line for debt reduction under the Brady Plan.

Commercial Banking Crisis

Second, the LDC Debt Crisis was a commercial banking crisis. Many of the large global banks were heavily exposed to LDCs and some faced losses that approached their equity capital. Faced with this threat, the international financial community fashioned a coordinated response that managed to stabilize things for about six years. They negotiated agreements almost every year for each country rolling over (or rescheduling) loan principal payments and extending new loans to keep interest payments flowing.

The banks used this time to build up reserves. But seven years later, the sovereigns were no closer to being able to borrow again and some banks were starting to cut their exposure. The equity prices of banks with large LDC portfolios were being punished by the markets and banks that could afford it began to sell their loans into a fledging secondary market at very steep discounts. The price discovery, or lack thereof, of a new secondary market for steeply discounted LDC loans put even more pressure on the banks.

The Brady Plan of March 1989 therefore had two objectives: 1) to address the debt overhang of the countries; 2) and to strengthen the still weak balance sheets of the banks.

"This menu is not edible…"

In April 1989, Mr. Gurria brought his young team of Mexico's "best and brightest" to New York, several of whom would go on to become presidents, cabinet ministers, and central bank presidents, to open negotiations with the country's Bank Advisory Committee (BAC). This committee represented the global banking community which held essentially all of Mexico's $50 billion debt to foreign private creditors.

Mr. Gurria opened negotiations by asking the BAC for a 55 percent haircut, which coincided with the secondary market discount at the time. The remaining 45 percent of the face amount of the loans would be converted into a 30-year bond with a floating coupon rate of LIBOR + 13/16% and enhanced with principal and interest collateral. These bonds would later become known as "Discount Bonds." He also offered a second option under which a bank, rather than taking a haircut, could choose to make new loans to Mexico in an amount close to half their eligible exposure. The "new money option" completed a narrow, two-option "menu of options."

After listening to the proposal, one BAC member from a major Japanese bank turned to Mr. Gurria and said in his heavily accented English, "This menu is not edible!" It would take months of intense negotiations, which included a breakdown over the oil-linked value recovery rights and some arm twisting by President Bush and Fed Chairman, Alan Greenspan, for the two parties to come to an agreement.

We were part of the debt negotiating team from Bank of America (BofA), which was Mexico's largest creditor at the time. We were well aware that the outcome of the Mexico deal would determine the future health of our bank. We understood the Mexico Brady deal would become the "cookie cutter" for the fifteen or so sovereign restructuring deals that were coming, many of which, we later worked on and helped shape.

Trichet and the Paris Club

One of our highlights during that era was making a presentation on the Brady Plan to the Paris Club, the group of government creditors from the world's largest countries' that negotiate restructurings of official bilateral loans. The chairman of the Paris Club at the time was European Central Bank President, Jean Claude Trichet. From this experience, we believe that Mr. Trichet is familiar with how to construct a successful restructuring and very astute on how to deal with free riders, which was a big problem during the LDC Debt Crisis.

Shortly after our presentation, the Paris Club in April 1991 granted the Republic of Poland a 50 percent haircut on debt to foreign governments, which was implemented in two stages. The first consisted of 80 percent interest forgiveness and a rescheduling of principal payments in the first three years of the agreement, which, on a present value basis, amounted to a 30 percent haircut. The second stage allowed for an additional 20 percent haircut in later years provided Poland remained in compliance with its IMF program.

The restructuring included a controversial clause that allowed Poland to receive the second stage of debt forgiveness only after it negotiated comparable debt or debt service relief from the commercial banks. We later helped the Polish government negotiate these terms when we became the government's financial advisors for their Brady Plan restructuring. This was considered one of the most successful Brady restructurings because of its decisive resolution of Poland's debt overhang. Poland's post-restructuring economic performance speaks for itself.

The Bank of America Problem

After returning in 1986 from a five year sabbatical as President of the World Bank, Bank of America CEO, Tom Clausen, made the bank's LDC loan portfolio a top priority. BofA was under pressure as sovereign loans were beginning to trade in a illiquid secondary market, some at 70-80 percent discounts.

In mid-1989, these secondary markets had $380 billion or so of supply (some banks desperately wanted to sell their portfolios) and very little demand. Large banks knew that if they sold only a small portion of their loans there, it would drive the price down several points.

BofA had been slowly building reserves but not enough to cover the secondary market discounts and a forced mark-to-market would have driven the bank to the brink of insolvency. The bank had great cash flow generation from its consumer businesses but needed more time to "grow" out of the LDC debt problem.

Though the markets were becoming impatient, the bank was increasing reserves and slowly selling down portions of its LDC portfolio. A mandatory mark-to-market would have been disaster. We spent many hours in those days on talking points to counter the Congressional pressure for mandatory write downs.

Mexico's Menu of Options

The Bank Advisory Committee countered Mr. Gurria's opening offer with a 22 percent discount and it was game on. The final deal had three options, which were roughly equivalent in market value: 1) a 6.25 percent Par Bond; 2) a 35 percent Discount Bond (similar in structure to the one Gurria had proposed); and 3) New Money option in which banks could choose to make new loans equivalent to 25 percent of exposure.

Banks on the BAC carefully negotiated the terms of each option to ensure that the international banking community could live with the haircut and could choose the form in which the haircuts would be granted. They structured options to optimize capital under the different accounting, tax, and regulatory regimes of the international banking community. The goal of many banks, including BofA, who understood the new Brady bonds would continue to trade at large price discounts in the secondary market for some time, was to structure a deal that would prevent a mandatory mark-to-market of their LDC portfolio. By protecting equity capital and allowing the losses to be spread over a longer time horizon a significant reduction in bank balance sheets was averted.

Just about half of Mexico's banks chose the Par Bond option. This bond had a semi-annual coupon, of 6.25 percent (at the time six-month LIBOR was close to 10 percent) and allowed the original loans to be converted a "par" with no reduction in principal. A bullet principal payment was due in December 2019 and was collateralized in full by U.S. Treasury zero coupon bonds. The bond included a mechanism, which would collateralize three semi-annual coupon payments and roll forward every time Mexico made a payment.

U.S. banks used the FASB 15 accounting rule to avoid a write-down when they swapped their loans for Brady bonds. The rule allowed for restructured loans kept as long-term investments to be booked at original face value if the sum of nominal income and principal payments exceeded the original loan extended.

Some banks were able to further bolster capital by utilizing special tax treatment, which allowed for tax losses in the bond exchange without a corresponding accounting loss. The strategy worked well as Mexico and the Brady Plan countries recovered and the banks had more time to grow and diversify their assets.

Conversely, some European banking regulatory and tax agencies made the Discount Bond relatively more attractive, as their policy was to incentivize banks to reduce their LDC exposure. The Discount Bond was exchanged at 65 percent of the original loan amount for a floating rate 30-year bond. The bond had a semi-annual coupon of Libor plus 13/16 percent and bullet principal payment in December 2019, collateralized in full by U.S. Treasury zero coupon bonds. It also included the same interest collateral as the Par Bond.

Value Recovery Rights

The Mexico Par and Discount bonds included a value recovery mechanism linked to Mexico's oil revenues. The mechanism required Mexico to pay up to an annual 300 basis points in extra coupon payments in the event the Pemex oil price and export volumes exceeded a certain negotiated threshold beginning six years after issuance. We helped design and negotiate the value recovery mechanism and recall many bankers predicting that they "would never see a dime of recovery value." To their surprise, Mexico made payments under the value recovery in the first year of eligibility in 1996.

This helped to motivate Mexico to buy back and retire its Brady Bonds almost twenty years before they matured. If Mexico's 6.25 percent Par Brady Bond were still outstanding and trading today, the oil-linked value recovery rights would be deep in the money and paying at the maximum 300 bps per annum. The Par Bond would be trading close to a price of 150% of face value, providing a 16 percent plus hypothetical annual return if the bond was purchased at market value at the date of issuance. This compares to a 6 percent annual return on the S&P 500 over the same time period.

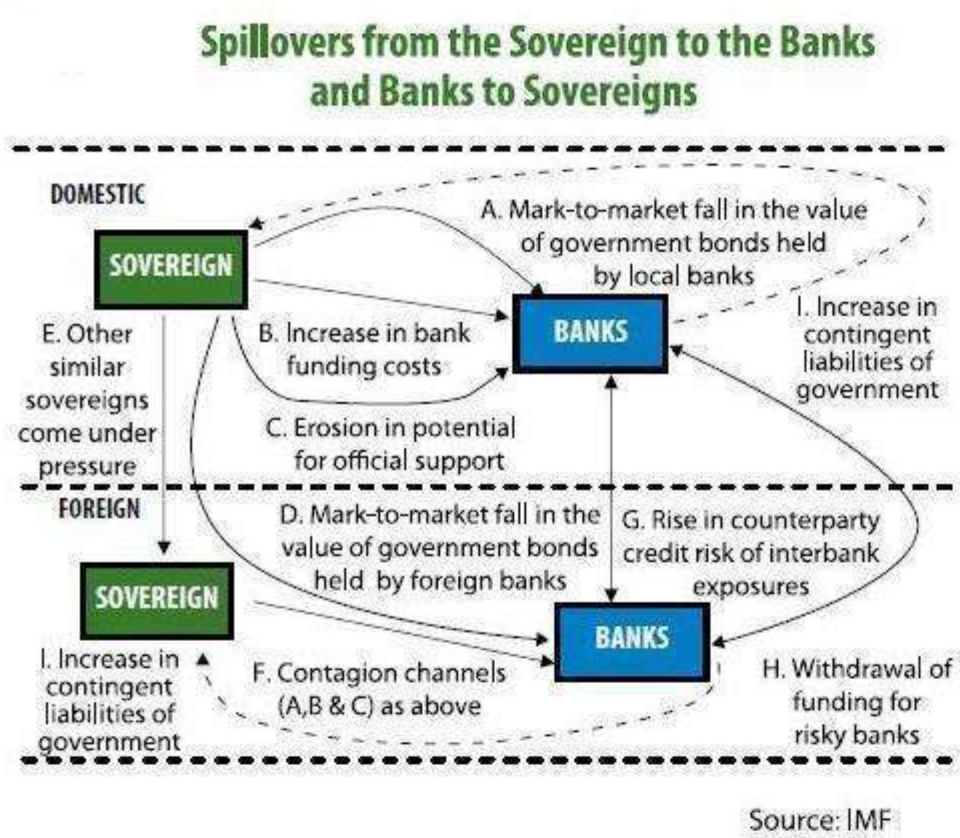
Mr. Gurria insisted that the agreement allow for early retirement of the bonds through buybacks or market exchanges. Many bankers on the BAC did not take Mr. Gurria seriously on this point as they believed the country would be back at the negotiating table sooner rather seeking more debt relief. Many bankers, jaded by seven years of annual rescheduling negotiations *ad infinitim*, simply could not imagine that the Mexico's debt crisis was about to be resolved with a single transaction.

European Sovereign Debt Crisis

Since the sovereign debt crisis erupted in Europe last year, we have noted the frequent references to Brady bonds in the media and research reports. We agree with those who say that European policymakers need a comprehensive plan to resolve the crisis. Like some observers, we believe that many heavily-exposed EU banks probably have large implied losses on their books and inadequate capital. We understand the impulse to provide the sovereigns with liquidity, but our experience with the LDC debt crisis suggests to us that heavily indebted sovereigns will not be able to recover market access this way. Should the European Union lose control of this crisis it could have catastrophic consequences for many heavily indebted sovereigns around the globe.

Cases of insolvency need to be met head on with debt reduction. Reliance solely on such policies as fiscal austerity to limit borrowing needs and deflation to adjust relative wage rates may be reaching the limit. Risk-free interest rates are at historic lows, and will only go up from here. The markets know that several of the sovereigns in the Eurozone periphery will have to restructure their debt. We are not sure that this can wait until the European Union rolls out the new European Stability Mechanism in July 2013.

The Eurozone is in a destabilizing feedback loop that it cannot control. Sovereign credit in the periphery is deteriorating fast and this is reducing confidence in the region's banking systems, causing or increasing the likelihood that sovereigns will have to assume bank liabilities. This further impairs the sovereign credit and increases the lack of confidence in the banks



Europe needs a plan with the same two objectives as the Brady Plan: 1) reduce the debt overhang of the periphery sovereigns; and 2) bolster the balance sheets of the banks and preserve their capital by controlling the form and magnitude of losses that they will have to realize.

As with the LDC debt crisis, it is not advisable, and may not be necessary, to rescue banks from these losses by, for example, transferring portfolios of sovereign bonds at par or a subsidized price to some type of Eurozone trust or the EFSF. Given today's market structure and the instrumentation of the debt -- bonds with relatively liquid secondary markets and price discovery -- the European banking system probably does not have the benefit of time. This is further complicated by fluid political dynamics in both the periphery and the core Eurozone countries.

The"Trichet Plan"

The negotiation and implementation of, say, a "Trichet Plan" should be less contentious and complicated than the Brady Plan given that the problem is more local and a supranational framework could provide regulatory, accounting, and tax guidance for Eurozone banks. It could be implemented in two phases.

The first phase would take the form of an exchange offer, or series of offers, negotiated in private between the banks (represented by a Eurozone Bank Committee) and the sovereign debtor and treating a certain stock of bonds issued prior to a certain date. These offers would be market transactions involving the principals, debtor and bondholder, but would be highly orchestrated in advance.

The indebted sovereign would offer medium to long term, enhanced debt or debt service reduction (replacement) bonds or credit agreements for the existing bonds. For this, the EU, perhaps the new European Banking Authority, could create special accounting, tax and regulatory treatment specifically for the restructured Eurozone debt aimed at getting the largest creditor banks behind a menu of options, which meets the needs of both debtor countries and banks.

Credit enhancements for these instruments could take many forms, including collateralization of all or part of principal or interest payments funded or underwritten by the EFSF/ESM, contingent guarantees from the EFSF or ESM, or some form of explicit or implicit seniority. The cost of these enhancements, which would be minimal, and should, like in the Brady Plan, be borne by the sovereign debtor and not European taxpayers.

World Bank/IMF Special Facility

The credit enhancements could also be purchased from a triple-A rated third party, such as the World Bank, if an appropriate official European issuer is not feasible. Rather than waiting for political agreement on a "Eurobond" type issuing authority, for example, the Trichet Plan could move forward if the World Bank or IMF were set-up a special facility to guarantee, say, a 25-year bullet principal payment on the periphery Trichet Bonds. The debtor country and the World Bank/IMF would negotiate the appropriate pricing and payment mechanism for such as a unique contingent credit guarantee. The European Bank for Reconstruction and Development (EBRD) may even take part in such a facility.

Haircut Realized Over Several Year Time Horizon

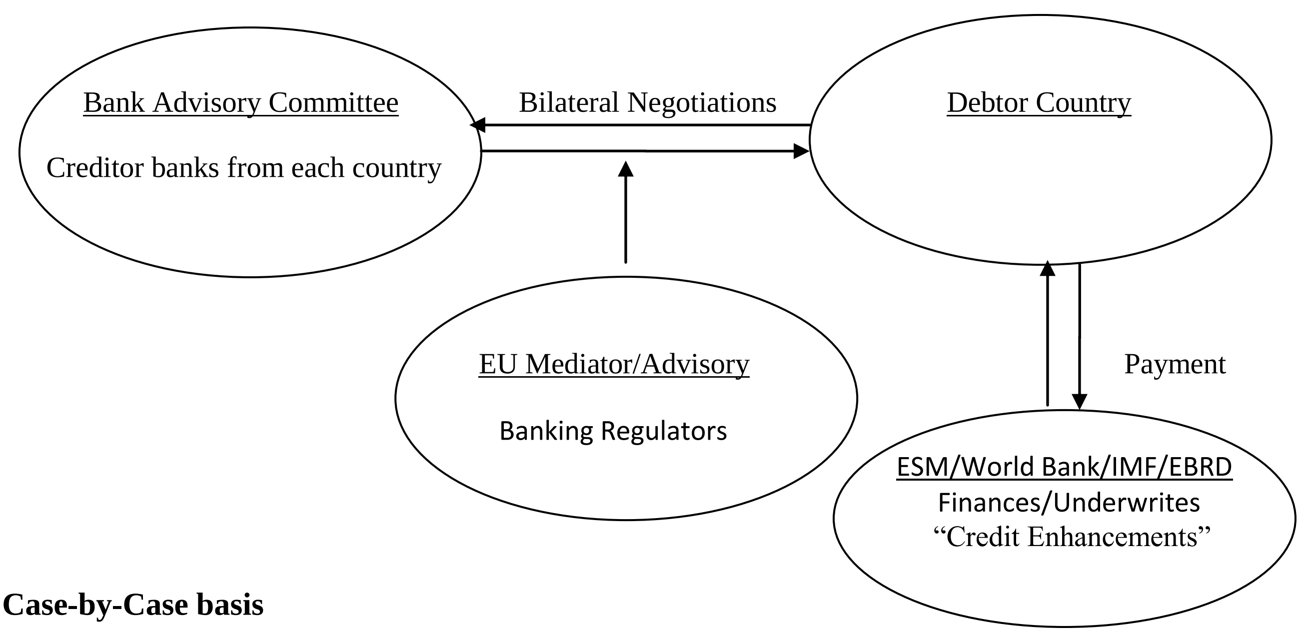
This treatment could allow EU banks (a) to limit the size of the losses that they must realize; (b) to spread the losses over the life of the new instruments; and (c) bolster their balance sheets with a new credit partially guaranteed by the EESF/ESM.

If not already on the books, the Financial Stability Board may need to write specialized accounting and tax regulations for the "Trichet Plan." This would be similar to the benefit of U.S. FASB 15 accounting for US banks in the Brady plan. How best to do this, though, would hinge on an analysis of the banks' balance sheets, especially their holdings of this debt, the availability, if any, of dedicated capital, and the strength of income from other assets.

This could also facilitate bringing the different constituencies together to negotiate a European "cookie cutter" that grants the appropriate reduction with the appropriate conditionality. This would restore confidence and give the banks more time to diversify their balance sheets.

The second phase would launch an offer with comparable terms to all non-bank bond holders and non-EU banks. This phase could also be negotiated, but this may not be necessary if the first phase establishes a new benchmark bond or two, with liquidity by virtue of having been chosen by the largest bank creditors. Phase one will determine all of the major terms of the secondary exchange offer, though some terms might be tailored to non-bank creditors.

Phase I - Solving the EU Banking System/ Sovereign Balance Sheet Problem



Case-by-Case basis

A "Trichet Plan" must also be flexible and deal with each country on a case-by-case basis. For example, during its Brady negotiations, Brazil said that it had up front access to only $2 billion of collateral, far short of the amount needed to cover the choices banks were expected to make from Brazil's Brady bond menu. Brazil's commercial bank debt was $50 billion. The banks wanted full collateralization at the close of the deal and the Brazilians refused, arguing it couldn't afford it. This caused negotiations to stall.

Because Brazil said it could access more funds from the IMF and World Bank to purchase the collateral over time, we designed temporary Phase-in Bonds, which gave Brazil no debt relief and relatively onerous terms, which Brazil would call and exchange for Brady Bonds when the cash collateral was obtained. This satisfied both banks and the Brazilian government and worked very well allowing the restructuring to close probably years before than would have been the case.

Another example of case-by-case flexibility of the Brady Plan was the size of haircut. The haircut was a central element of negotiations and varied depending on the needs of the case at hand. Early Brady countries, such as Mexico (1990), Venezuela (1990) and Uruguay (1991) had smaller debt overhangs and received debt reduction in the neighborhood of 30-35 percent. Later Brady countries, such as Poland (1994), Panama (1996) and Peru (1996) had bigger debt overhangs in part because of a need to capitalize larger past-due interest claims. These countries negotiated haircuts in the neighborhood of 45 to 50 percent.

Yet another example of case-by-case flexibility is Uruguay's value recovery warrants. Unlike the oil-linked value recovery mechanisms in Mexico and Venezuela (both of which paid), Uruguay's value recovery was a modified terms-of–trade index. We included in the numerator the price of the country's main exports, wool, beef, and rice, and because the country imported oil, the denominator was simply the price of crude oil.

Value Recovery

The ideal value recovery facility for the European periphery countries would, like the cases of Brady-era value recovery facilities for Mexico (1990, oil), Venezuela (1990, oil), Bulgaria (1994, GDP), Uruguay (1991, terms of trade) and Costa Rica (1990, GDP) vary by the specifics of each case. The idea is to add value to the replacement bonds by offering the possibility to claw-back portions of the forgiveness granted should the sovereign substantially recover its debt service capacity.

One alternative that has been suggested is GDP warrants. This type of facility would require the sovereign to make extra coupon payments in the event an index of its real GDP were to surpass a certain threshold after a period of grace of ten years or so. Value recovery of this sort has been used successfully in a number of cases, including Costa Rica in 1990 and Argentina in 2001. Other alternatives might include an index linked to an international price such as a commodity price or market or industrial index which directly impacts and provides the debtor country with windfall revenues or expenditure reductions.

One of the lessons of the Brady era was that value recovery mechanisms like these added option value to the new bonds because they were thought to have better price discovery. Whatever the form, the final structure of the value recovery mechanism must ultimately reflect and be contingent upon a significant and sustained upgrade in the borrowers' debt servicing capacity. Designing and negotiating the "correct" mechanism is really a secondary issue to achieving this objective.

Special Accounting and Tax Treatment for Restructured Debt

A "Trichet Plan" needs first to address the balance sheets of the banks. An exchange offer with a menu of options could easily be crafted in which enhanced "replacement bonds or credits" can resolve debt overhangs and be tailored to the needs of the banks. These instruments could spread the haircut over several years.

This could be achieved in different ways. One possibility, for example, is a FASB 15-style conversion of old bonds for new Par Bonds with losses realized quarter by quarter as coupon payments received fall below banks' funding costs. Another possibility is enhanced step-up fixed or floating rate Par Bonds or front-loaded interest reduction bonds.

Alternatively, a discount instrument could phase in the discount (reduce the face amount of the bonds) over time, say 5-10 percent per annum over a seven year period, a "Phase-in Discount Bond," for example. Similar to Poland's Paris Club deal, the discounting of the principal and interest reduction in each year would be linked to the country remaining current in an IMF program. This would have the benefit of ensuring a reduction of the debt stock, while incentivizing fiscal and economic discipline.

Unlike other European debt proposals, we believe that the stakeholders, both borrower and lender, with some guidance from EU regulators, should take the losses. They should set the terms of the restructuring, and design the instruments in a menu of options, which fits their best interests.

The "Trichet Plan" deals first with overexposed Eurozone banks and will alleviate the fear of banking collapse and Lehman-like systemic contagion, which has made even the talk of restructuring a "taboo" topic. Furthermore, the pragmatic and more realistic structure will relieve political pressures in the European core as the bailouts will stop and insolvency issues will finally be addressed. The principles we have outlined here are proven and pragmatic; they were the core of the successful resolution of the last major sovereign debt crisis, and have been accepted by global capital markets and the international financial community.

EFSF/ESM Funds for Banking Recapitalization

The EFSF/ESM funds, currently being used and earmarked for the sovereign bailouts, could then be used more effectively to recapitalize and further strengthen the Eurozone banking system, for example. If designed and executed correctly, the political friction within the Eurozone could fade as taxpayers in the core countries, rather than assuming the debt of the periphery, could actually profit from such a recapitalization plan.

Debt-for-equity, education, environment and poverty swaps

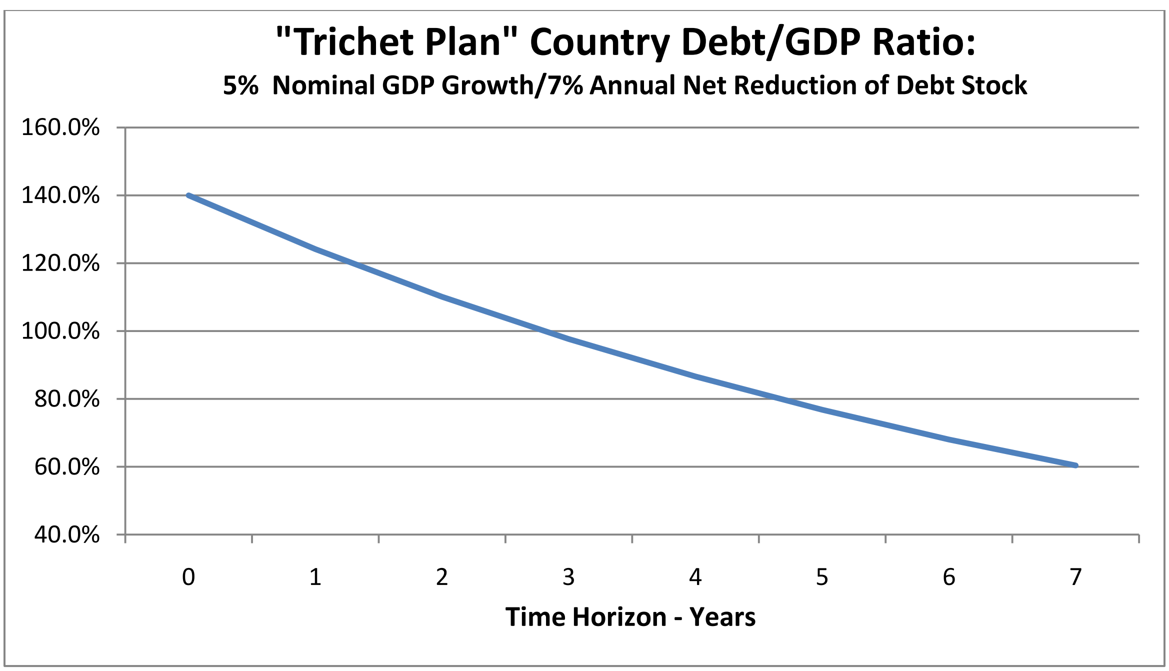
Menus of options could also include language which allow for debt-for-equity, debt-for-environment, debt-for-education, or debt-for poverty swaps. The new “Trichet bonds” or credit agreements would be purchased in the secondary market and used as currency in privatizations or to partially pay tuition in specially designed educational programs at local public universities like Portugal where more investment in education is an urgent priority, for example.

Debt could also be extinguished through the purchase of the “Trichet Bonds” by environmental organizations to finance public sector land at home or even cross-country public land for conservation projects or even used in carbon offset mechanisms. We were involved in debt-for-nature swaps at BofA, where the bank donated a certain portion of its Costa Rican loans to finance the purchase of a conservatory in the country’s rain forest.

Debt-for-poverty swaps could allow charitable organizations to purchase the bonds to pay for government services, public lands for food production, or public buildings for low income housing. These swap mechanisms could be carefully designed to be additive on a fiscal basis as not to substitute for current revenues. The subsidy of the swap, the difference of the secondary price and redemption value, would incentivize the private sector to create public goods. In addition, the debtor country would retire debt by capturing most of the secondary market discount.

Long-term Perspective: “Seven-year 5 and 7 Plan”

European policymakers must take a long-term perspective and focus on both debt reduction and returning the debtor countries to growth as there are no easy fixes for the current crisis. There is hope, however.



In a hypothetical example, if a "Trichet Plan" country with an initial 140 percent debt to GDP ratio can grow by 5 percent per annum (in nominal terms) over a seven years, while, at the same time, reducing its net debt stock by 7 percent every year, the Debt/GDP ratio would decline to 60 percent of GDP.

Conclusion

We think that the EU has a range of good options for structuring enhanced replacement bonds, which would have an implicit seniority, contingent guarantees, value recovery mechanisms and debt swap provisions. This structure would be a much more efficient, less costly and more politically acceptable and sustainable use of EFSF and IMF funds than what we have seen so far.

The special EFSF programs could be redirected to make contingent financing available to sovereigns in the form of stand-by letters of credit for partial guarantees on the issue of replacement bonds. These enhancements could take many forms, such as guarantees on all or portions of principal due at maturity or according to an amortization schedule, or guarantees on portions of coupon interest.

By first focusing on bolstering European bank balance sheets and dealing with their sovereign exposure to the periphery, the fear of systemic contagion of a European sovereign restructuring would be greatly reduced. Furthermore, a bold and comprehensive "Trichet Plan" seems to be the only way to break the vicious feedback loop Europe finds itself in.

Our proposal, unlike other European debt proposals, is predicated on the notion that the borrowers and lenders and not outside parties should take the losses, set terms of the restructuring, and design the instruments in a menu of options which best fits their needs. The consenting adults who created Europe's crisis are the ones who should resolve it – albeit with assistance from EU regulators and officials

There is much at stake, not just for Europe, but the rest of the highly-indebted West. Forbearance by piling debt upon debt to deal with what is ultimately an insolvency issue is no longer an option in the Eurozone and further stumbles could increase global systemic risk. Policymakers should not entirely discount the risk that the crisis in the periphery could spread to the core of Europe and even skip across continents and oceans.

The authors wish to thank Barry Eichengreen for his valuable comments on this article.

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