



LET'S TALK ABOUT...

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

Default

(Part One) Debt restructuring, as discussed in the past articles, is a form of default in every respect, being the result of insolvency and failing to comply with the contractual obligations towards creditors-investors. In most cases it means not repaying principal at its due expiration date. It may be useful, after considering debt restructuring, to turn to the concept of default in more general terms, because some more features are of interest for both operators and investors. Firstly the debtor, that is the issuer of the instrument, may not repay it because is unable to do so, due to troubled financial conditions and poor cash flows, but it may also decide not to comply with its obligations still having the means – though such cases are much more uncommon in the financial markets – up to the most odd cases of “strategic” defaults, in which the missed payments may be motivated (in the issuer’s view) by legal, political or commercial reasons. If the event of a default is mostly associated with the fixed income market, that is bonds and notes, it also applies to other financial instruments, such as mortgage-related products, commercial paper and other similar investment vehicles, of old and new creation. In formal terms the case of default must not be confused with bankruptcy, first of all because not all debt issuers are subject to bankruptcy (as in the case of sovereign, supranational and public institutions and agencies), and secondly because the latter refers to a legal procedure which also imply a sort of protection and judicial supervision for the defaulted subject, normally a corporation. Within the financial markets typical defaults concern the missed payments of periodical interests (coupons) or the failed reimbursement do principal at the date of expiration. In such case the debt’s terms become relevant, as they are mentioned in the issue prospectus: for instance the debt class, primary or subordinate, the future recovery of unpaid coupons together with the next ones, the presence of specific collateral (corporate assets) or the explicit mention of private or public institution which guarantee payments should the issuer default. We remind that issuers’ financial reliabilities may be assessed by considering the debtors’ ratings – although such tool is no longer so valid indeed and pretty controversial – and the level of CDS’s, credit default swaps, that are the percent premiums investors should pay in order to assure due repayments. If a private (corporate) issuer’s default almost usually end up in an ordinary bankruptcy or other judicial procedure, in different terms according to different jurisdictions, if the case of a sovereign (or supranational institutional) default, no bankruptcy path is obviously applicable (states do not go bankrupt by definition), so that legal and practical consequences and outcomes are usually lighter for them. That is a pretty interesting point, which will be considered next. *(to be continued)- GLT*

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(Part Two) Sovereign borrowers, such as states, governments, their related public agencies (the latter often enjoying "guarantees" by the former), are not subject to bankruptcy by definition, so that in case they default in paying interests or principals, investors are not able to take legal steps towards them and benefit from judicial procedures which can take to refunds. In legal terms the consequences of defaults for states and sovereign entities are paradoxically slighter than for private institutions, e.g. corporations. That is also true if states do have funds for repayments, however opting for "strategic" defaults and/or long and complex restructuring projects, with delays, unfair terms imposed to investors, long lasting negotiations, and so on, just as has been the case for Argentine debt. Among the major events in the area of sovereign insolvencies, we remind the partial default on some North Korean loans in 1987, the Russian domestic issues in 1998, which did not affect the Eurobonds, up to the case of Argentina since 2002. If in most cases there are no legal outcomes for defaulting sovereign borrowers, other consequences come in terms of negative image and exclusion from international capital markets. However both for straight defaults and debt restructurings, harmful effects are not so heavy indeed as one may think, according to many researches, and do not last too long, just a handful of years. Moreover negative outcomes connected to defaults and the higher costs of restructurings may be balanced by likely currency devaluations, depreciations in the currency's external value of the sovereign borrower, so that the debt itself becomes actually cheaper, with an advantage for the defaulter and damage for the creditor-investor, not to say of the devaluation's commercial benefits for the insolvent state. Of course devaluation is only possible if the exchange system is free of floating and the currency is not strictly pegged or part of a rigid supranational monetary system, as in the case of the euro. On the other side currency devaluations often fuel domestic and import-related inflations, together with other problems, which we will consider further down. *(to be continued)- GLT*

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(Part Three) When a sovereign state defaults in reimbursing principal at maturity or paying coupons, the consequences it faces are generally milder than for a similar corporate event. That is particularly true in legal terms, as a sovereign entity is not subject to bankruptcy, so escaping those judicial procedures which usually also include a sort of protection for creditors.

The “punishment” for an insolvent state is rather heavier in terms of image and access to the international capital markets, should it have to raise new funds. However such consequences usually last much less than one may think, just several years on average, and are often balanced by some sort of currency devaluation which promote exports and relaxes the financial cost of defaulted debt, should it be somehow “restructured” (see previous articles). Historical analysis show that after a default, the major outcome for the insolvent issuer is an increase in the financial cost of borrowing of about 400 basis points, that is a 4% spread over the yield paid by “reliable” similar issuers assumed as market benchmarks. Such situation tends to last for about 3-5 years. The same is valid for the image damages. The domestic “real” economy of the defaulted state may be affected too and the GDP may initially fall, but in that case the trend does not last too long. Such arguments may lead to believe that – at least for sovereign states – not repaying debts is all in all extremely profitable (and many politicians think so indeed), or at least not so damaging, but one more variable in play is the political one, in that such events negatively affect the destiny of the leading class at the moment of the default, although citizens and foreign investors actually bear the most of the practical negative outcomes. One may also wonder why when financial conditions deteriorate and insolvencies become evident and inevitable, certain governments delay and postpone decisions and restructuring plans (as was the typical case for Argentina). The reasons may be mainly political and psycho-sociological, and the next article will consider them. *(to be continued)- GLT*

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