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Sovereign Debt Evolution: The Natural Disaster Clause

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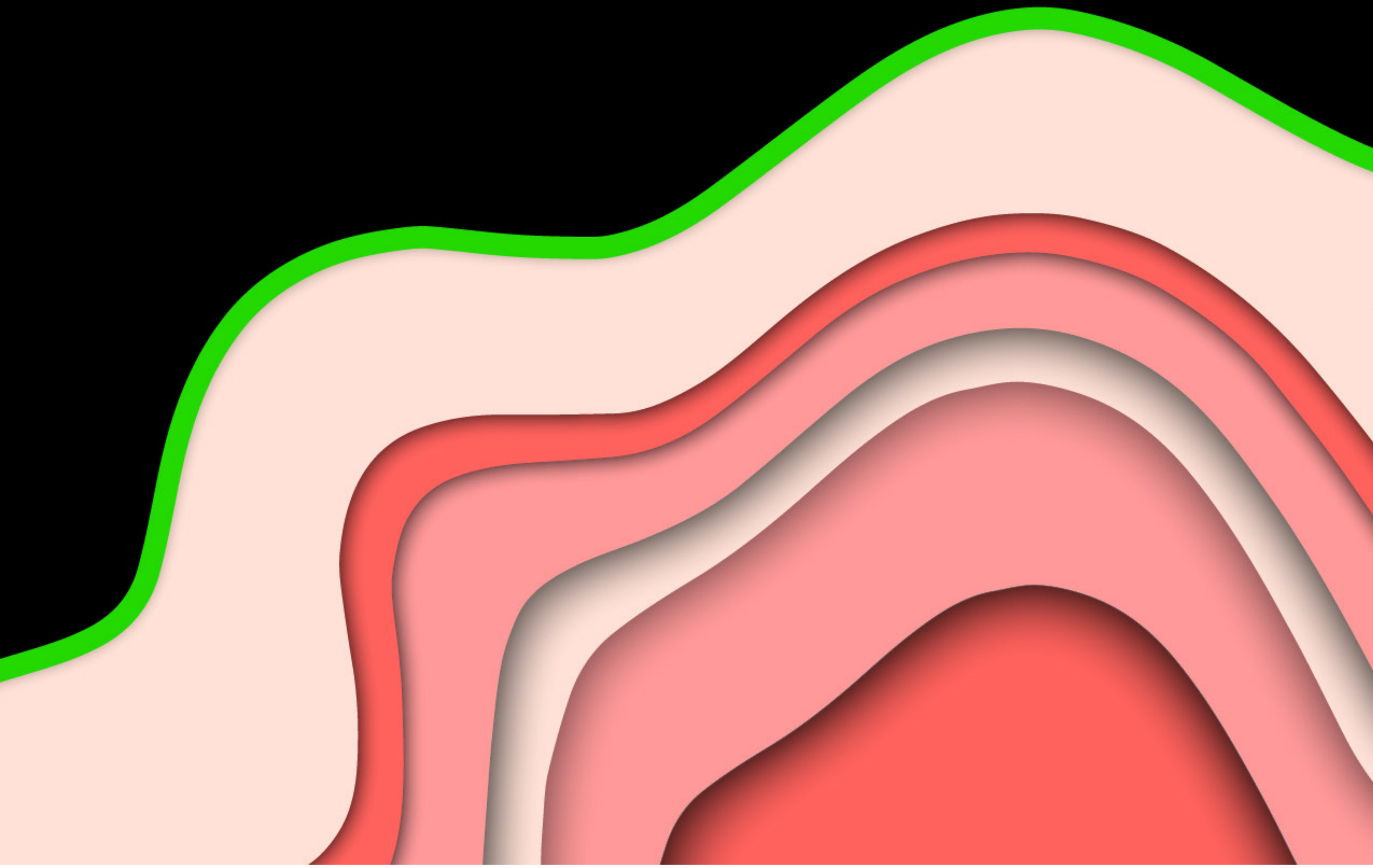

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Introduction

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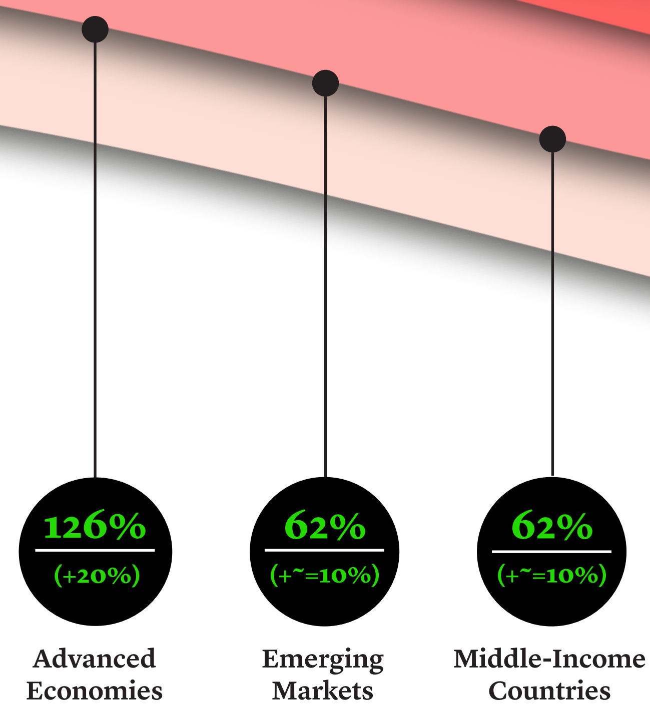


The Sovereign Debt Stage

The world of sovereign debt sits in the intersection of politics and finance, law and economics. On this stage, there are many players with competing interests. These range from politicians making difficult decisions for which they are answerable to their electorates, to fund managers who owe fiduciary duties to their investors, and from international financial institutions who may have to write the final check in a restructuring, to legal and financial advisors, as well as academics, who help sovereign debtors come up with solutions where problems initially appear intractable. Sovereign debt restructurings are unique in their power dynamics and the near complete absence of institutionalized processes. Despite the periodic efforts of policy makers, practitioners and industry groups, past proposals to adopt a legally recognized bankruptcy procedure for sovereign debt have been unsuccessful to date[2]. For now, the international community will have to continue to rely on the four corners of the debt contract to prevent and resolve sovereign debt problems.

The lack of a centralized framework for dealing with sovereign debt is becoming a more prominent issue than ever as sovereign debt levels soar. Sovereign debt levels have been steadily increasing over the last twenty years and are expected to make what the International Monetary Fund (the IMF) refers to as an "unprecedented jump" in 2020 in light of the COVID-19 pandemic, with sovereign debt levels rising 20 percentage points to a level of 123 percent of GDP for advanced economies and nearly 10 percentage points to a level of 63 percent of GDP for emerging market and middle-income countries[3].

So What is Being Done?

In the slow tango between creditors with their legal remedies on the one side and sovereigns with their tactical advantages on the other, the legal techniques used in sovereign debt restructurings have evolved slowly but considerably over the last thirty-five years. Perhaps most significantly, sovereign issuers began adopting collective action clauses (CACs) in their debt instruments. With CACs, bondholders agree upfront (i.e., when they buy the bonds) to be bound by the terms of a restructuring if a specified supermajority of bondholders approves of the terms proposed by the issuer. A sustained effort led by the United States Treasury culminated in the adoption by the International Capital Markets Association (ICMA) of model CACs in 2014 that strengthened the existing series-by-series CACs by allowing holders of different series of bonds to be aggregated for the purpose of approving a restructuring, further reducing the ability of bondholders to hold out. The enhanced CACs have been heralded as state of the art for sovereign bonds and the best tool available to sovereigns to pre-empt a restructuring or minimize the cost and economic disruption of debt restructurings. The IMF and the Group of Twenty (G20) have both supported uptake of these clauses, and based on the IMF's latest progress report on CACs, 88 percent of new international sovereign bond issuances between October 2014 and October 2018 included the enhanced CACs.
The increasing ubiquity of CACs has enhanced the contractual architecture which should help make debt restructurings more orderly and efficient. Yet, even with this tool in hand, many sovereigns are unable (or unwilling to act in time) to preempt the need to restructure. Many recent debt restructuring negotiations – including where the debt stock contained the latest CACs – have stretched over numerous months, if not years. Faced with soaring sovereign debt levels, particularly in the context of the COVID-19 pandemic, there is a renewed impetus for innovations in the sovereign debt restructuring process evidenced by, among other things, the G20 proposal for a Common Framework for Debt Treatments. As part of this broader call for reform of the infrastructure for restructurings, there is increasing support for sovereign debt clauses that automatically suspend or lower principal and/or interest payments in the event of economic shocks, including from the General Counsel and Managing Director of the IMF[4].

As currently contemplated, these "extendable debt" clauses require that the issuer and investors agree on quantifiable and externally verifiable indicators of economic shock upfront. The suspension of principal and/or interest payments will then be tied to those indicators reaching certain pre-defined thresholds. The clauses could help pre-empt the need to restructure by reducing debt service burdens at times when sovereign finances are tightest, allowing the sovereign's economy time to rebound from the shock before they need to resume debt service.

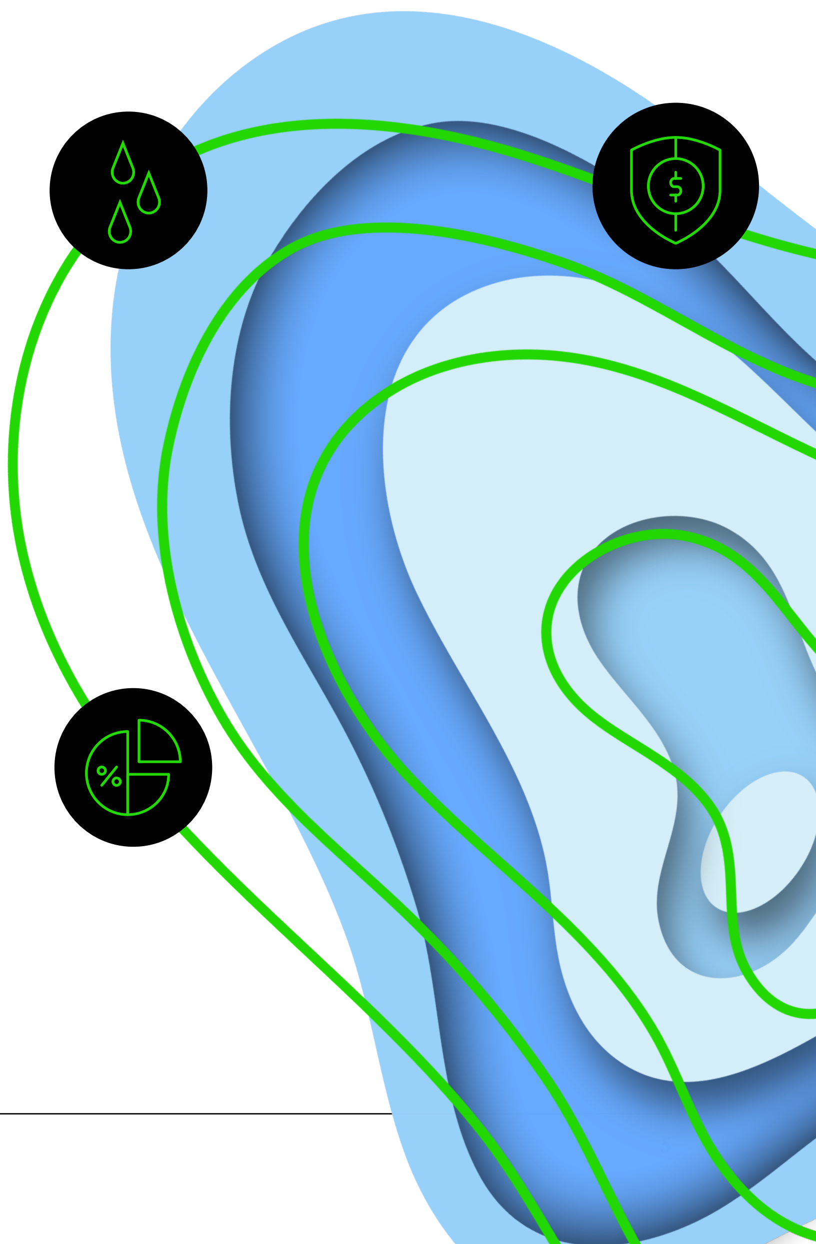
Bond clauses that permit the issuer to turn off payments in times of trouble are not new. Banks routinely issue regulatory capital instruments that do exactly that. In the context of sovereign debt, this concept has also been tested in the form of natural disaster clauses.

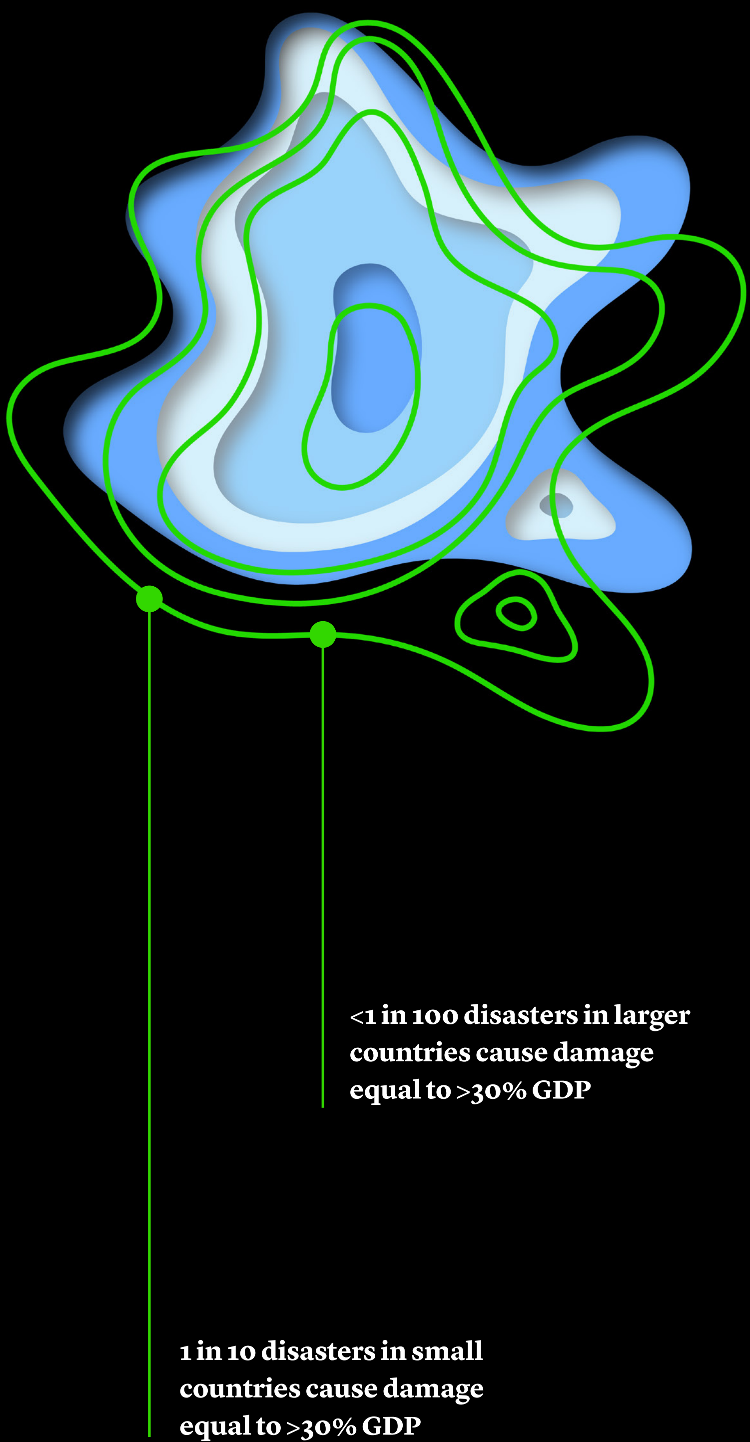
The Natural Disaster Clause: An Overview

The natural disaster clause, also sometimes referred to as a hurricane clause, embeds within the contractual terms of a debt instrument the ability of an issuer to defer payments of interest and principal in the event of a qualifying natural disaster. This deferral, which is at the option of the issuer, provides sovereigns with a degree of flexibility to suspend payments when they need it most. The built-in debt relief buffer helps a sovereign absorb some of the financial impact of a natural catastrophe, mitigating the severe financial damage that often results.

Issuers in the Caribbean have been hit hard by natural disasters over the years, and natural disasters are only increasing in their intensity and frequency in the context of global climate change[5]. Hurricanes can cause billions of dollars in damage. These costly crises have a disproportionate macroeconomic impact on small countries. In larger countries, the impact of natural disasters is often focused locally, and accordingly the disaster response, as a proportion of overall national resources, is modest. For small countries, natural disasters can have a direct impact on a much larger portion of the country geographically and economically, and often a much larger portion of national resources is needed for emergency response and recovery expenditures. The loss of life and the impact on well-being, food supply and human capital are felt across a much more significant percentage, if not the entirety, of the country. After a hurricane, tourism sectors are often forced to shut down for months, hitting small, island nations particularly hard given the share of GDP often made up by this key sector. According to the IMF's findings, one in ten disasters that hit small countries cause damage equivalent to more than 30 percent of GDP – contrasted with fewer than one in one hundred for larger countries[6].

There is a lot that is being done by vulnerable countries, often with the help of multilateral development banks, to self-insure, pool insurance, pool resources and secure access to emergency funding. Even still, two-thirds of losses caused by natural disasters in the Caribbean are uninsured. If incorporated across a sovereign's debt stock, the natural disaster clause can play a key role, in addition to other measures, in a country's fiscal resilience to deal with the economic costs and fiscal impact of natural disasters. The natural disaster clause has the benefit of providing immediate relief, in contrast to post facto relief. It also has the advantage of being at the issuer's option, allowing the sovereign greater control over its financial response to the disaster. The cash that would otherwise be used towards debt service could be used by the country towards rescue, relief and rebuilding efforts in the wake of a natural disaster.





Natural disaster clauses have obvious appeal for sovereign issuers, but creditors should embrace them as well. The deferral does not mean that the sovereign will not be paying back its debt. Rather, the clause provides breathing room, with a payment moratorium for a prescribed period of time. Where it is clear that the sovereign issuer has suffered a catastrophic loss and will not have sufficient funds to service the bond, it is not in the creditors' interests to force a formal restructuring. The ability of the issuer to make the deferral eliminates the need to seek affirmative bondholder consent and reduces the risk of a disorderly default, thereby avoiding the costs associated with a formal restructuring process[7]. In addition, the deferral reduces gross financing needs in the aftermath of a disaster, thereby maintaining the sovereign's overall debt level at a more consistent level and further reducing the likelihood of a restructuring.

This clause was born when it was first inserted into the bonds issued by Grenada in the context of its 2015 debt restructuring. Barbados followed in 2018 and 2019, inserting a variation of the clause into nearly its entire debt stock in connection with its debt restructuring. In the meantime, ICMA published a model "hurricane-linked extendible feature" for sovereign bonds and loans at the end of 2018.

A Closer Look at Natural Disaster Clauses

The Inaugural Natural Disaster Clause: Grenada

Grenada, who was the first sovereign to incorporate the natural disaster clause into its bonds, is the poster child for how and why this clause is needed to promote financial stability and reduce the need for inefficient and expensive restructurings.

Sovereign debt problems do not tend to appear overnight. Sovereign debt restructurings are usually preceded with tell-tale signs, whether they are in the form of fiscal mismanagement, a fall in bond prices, or alarm bells from analysts, credit agencies and the IMF that a restructuring would be imminent. Grenada's financial woes, however, appeared literally overnight following an external shock when, in September 2004, Grenada was struck by Hurricane Ivan.

The devastation brought by Hurricane Ivan was thorough and uncompromising. Almost 90 percent of the houses in Grenada were destroyed or severely damaged by the hurricane, so much so that even the Prime Minister was rendered homeless when his official residence was destroyed. The total damage to the island was more than 200 percent of Grenada's nominal GDP.

Investors received a relatively mild treatment in the 2005 restructuring following Hurricane Ivan. The restructuring included changes to the coupon structure and maturity dates of the old instruments but no haircut to the principal amounts. This restructuring stemmed the bleeding for a period of time, but, after a decade of economic difficulties, Grenada needed to restructure its debt again in 2015.

With this second restructuring, Grenada took a proactive step to avoid a future fiscal and economic disaster like the one it had experienced in 2004 and adopted the inaugural natural disaster clause in its U.S. dollar bonds due 2030, as well as its agreement with the Export-Import Bank of the Republic of China and the instruments held by its Paris Club creditors.

The natural disaster clause included in Grenada's bonds due 2030 allows Grenada to defer the principal and interest payment due on the next semi-annual payment date if it experiences a tropical cyclone causing between U.S.$15 million and U.S.$30 million in losses and to defer the principal and interest payments due on the next two semi-annual payment dates if it experiences a tropical cyclone causing U.S.$30 million or more in losses. The determinations of both what constitutes a qualifying tropical cyclone and the dollar amount of loss experienced are tied to Grenada's parametric insurance policy from the Caribbean Catastrophe Risk Insurance Facility (CCRIF), a risk pool that provides coverage for catastrophic hurricanes, earthquakes and excess rainfall events to Caribbean and Central American countries.

In the event Grenada receives a policy payout under its CCRIF policy for a loss greater than U.S.$15 million, it can elect to make its deferral by delivering to the trustee of the bonds a certificate describing the tropical cyclone and confirming that it meets the requirements for the deferral and a written report from CCRIF confirming that the cyclone was an insured event and the amount of loss.

Grenada must also deliver a notice to bondholders describing the cyclone and keep the trustee informed from time to time on the progress of relief, recovery and reconstruction programs.

Once Grenada has elected to make its deferral, all deferred interest amounts are capitalized into principal and the remaining principal amortizations are increased pro rata to take into account the interest capitalization and the deferred principal payments. Grenada is limited to deferring payments three times.

Innovations to the Natural Disaster Clause: Barbados

The Barbados restructuring, which followed a few years after Grenada's, was not precipitated by a hurricane. There is a common saying in Barbados that "God is a Bajan." While o ther islands in the region have been ravaged by extreme weather conditions, Barbados, luckily, has been spared the worst of the natural disasters that befall the Caribbean.

Even with geography on their side, it was hard for the decision-makers not to look back at 2017 when Hurricane Maria devastated Puerto Rico and caused a major humanitarian crisis. The Barbadians decided in the context of their 2018-2019 debt restructuring to implement the natural disaster clause across nearly their entire debt stock.

The Barbados restructuring took place in two main stages. First, Barbados dollar-denominated domestic-law governed instruments were restructured in November 2018.

Then, U.S. dollar-denominated English, New York and domestic law governed debt was restructured in the fall of 2019 and early 2020. The vast majority of instruments issued in connection with the first stage of the restructuring contained a natural disaster clause. As with Grenada's, this first iteration of Barbados's natural disaster clause allows Barbados to defer principal and interest payments when it receives a policy payout under its CCRIF policy in connection with a qualifying natural disaster. What was new for Barbados was that its natural disaster clause: (i) expanded trigger events to include earthquakes and excess rainfall events in addition to tropical cyclones; and (ii) had a lower loss threshold of U.S.$5 million, compared to a staggered threshold of U.S.$15 million and U.S.$30 million for Grenada.

If Barbados receives a CCRIF policy payment related to a tropical cyclone, earthquake or excess rainfall event with losses greater than U.S.$5 million, it can elect to defer interest and principal payments for two years. All deferred interest amounts are capitalized into principal as they would have come due and the remaining principal amortizations are increased pro rata to take into account the interest capitalization and the deferred principal payments. In connection with the deferral, Barbados must also deliver a notice to bondholders describing the cyclone, but there is no requirements to provide a certificate from Barbados, a written report from CCRIF or summary reports to the trustee, as are required for Grenada. Barbados is also limited to deferring payments three times.

In the second stage of its restructuring in the fall of 2019 and early 2020, Barbados again added the natural disaster clause to the restructured instruments. This clause largely mirrored Barbados's first iteration except for three key changes.

First, the loss threshold for the second iteration of Barbados's natural disaster clause is U.S.$5 million for earthquakes and floods and U.S.$7.5 million for hurricanes.

Second, Barbados is still limited to deferring payments three times, but it is also not allowed to make a deferral in the final two years before maturity to prevent a deferral under this clause from extending the final maturity of the bond.

Third, and most interestingly, this second iteration of Barbados's clause includes a blocking mechanism for bondholders. Upon receiving notice from Barbados that it has experienced a natural disaster and intends to defer payments, holders of 50 percent of the principal amount of the bonds have 15 days to block Barbados's deferral. This veto right was included to address bondholders' concern regarding potential opportunistic or abusive triggering of the clause on the part of the issuer.

With the natural disaster clause included across its debt stock, Barbados will be able to free up as much as U.S.$700 million, or almost 15% of its economy, in debt service payments, which could instead be spent on emergency response, rebuilding and recovery[8]. Barbados is now considered the only country in the world with a climate-resilient public debt stock.

Development of a Model Clause: ICMA

In November 2018, with Grenada's clause and the first iteration of Barbados's clause already out in the market, ICMA published a model "hurricane-linked extendible feature" for sovereign bonds and loans.
Like Grenada's natural disaster clause, the ICMA model clause allows the issuer to defer principal and interest payments if a qualifying tropical cyclone strikes, and again, the determination of what constitutes a qualifying tropical cyclone and the dollar amount of loss experienced are tied to the issuer's CCRIF insurance policy. With a nod to Barbados, the ICMA model clause opens up the possibility of including earthquakes and excess rainfall events as triggers. The ICMA model clause does not include a suggested loss threshold.

Sticking with the Grenada precedent, the ICMA clause requires the issuer to deliver to the trustee a certificate describing the tropical cyclone and confirming that it meets the requirements for the deferral and a written report from CCRIF confirming that the cyclone was an insured event and the amount of loss. The issuer must also deliver periodic reports to keep the trustee informed from time to time on the progress of relief, recovery and reconstruction programs.

The unique feature of the ICMA clause is that rather than increasing the remaining scheduled principal amounts pro rata, all payments are pushed back by three years, extending the final maturity of the bond by three years. The ICMA clause does not limit the number of deferrals made.

Putting the Natural Disaster Clause in Context: Other Applications

Bonds with a natural disaster clauses do not on their own provide fresh funds to help countries recover from natural disasters, nor are they “green” bonds or a way to prevent climate change and future natural disasters. Instead, they fall somewhere in between. They were designed as a liquidity relief mechanism in the context of the sovereign debt world with no centralized bankruptcy framework backdrop in order to help sovereigns avoid the need for a formal debt restructuring in times of a humanitarian crisis. Viewed through this lens, the development of the clause seems timely given, as mentioned above, recent calls to adopt clauses that suspend or lower payments in the event of economic shocks, which could be met by extending the applicability of the natural disaster clause. In the case of natural disaster clauses, issuers have identified, to which investors have agreed, policy payouts under catastrophe insurance policies as an externally verifiable indicator of economic shock. The challenge would be to identify what triggers would be appropriate in other circumstances.

A Comparison to Pandemic Bonds and the CCRT

One permutation of the natural disaster clause that has been discussed in the last year is unsurprisingly the pandemic clause. Pandemic clauses could provide sovereigns with a built-in buffer to absorb the financial impact in the event of a health crisis, like the COVID-19 pandemic.

The World Bank’s Pandemic Emergency Financing (PEF) bonds (also known as the pandemic bonds) provide a useful comparison point for would-be pandemic clauses. PEF bonds were developed by the World Bank’s International Bank for Reconstruction and Development (IBRD) in collaboration with the World Health Organization (WHO) after an Ebola outbreak in 2014, which killed more than 11,000 people in West Africa. The advocates for the pandemic bonds point out that the payouts under the pandemic bonds would be automatic, which would provide a more reliable source of funding than relying on the kindness and generosity of the international community in times of crisis. The goal was to be able to quickly deploy financing to International Development Association (IDA) countries – a group of the seventy-six poorest nations – when needed most for pandemic response efforts.

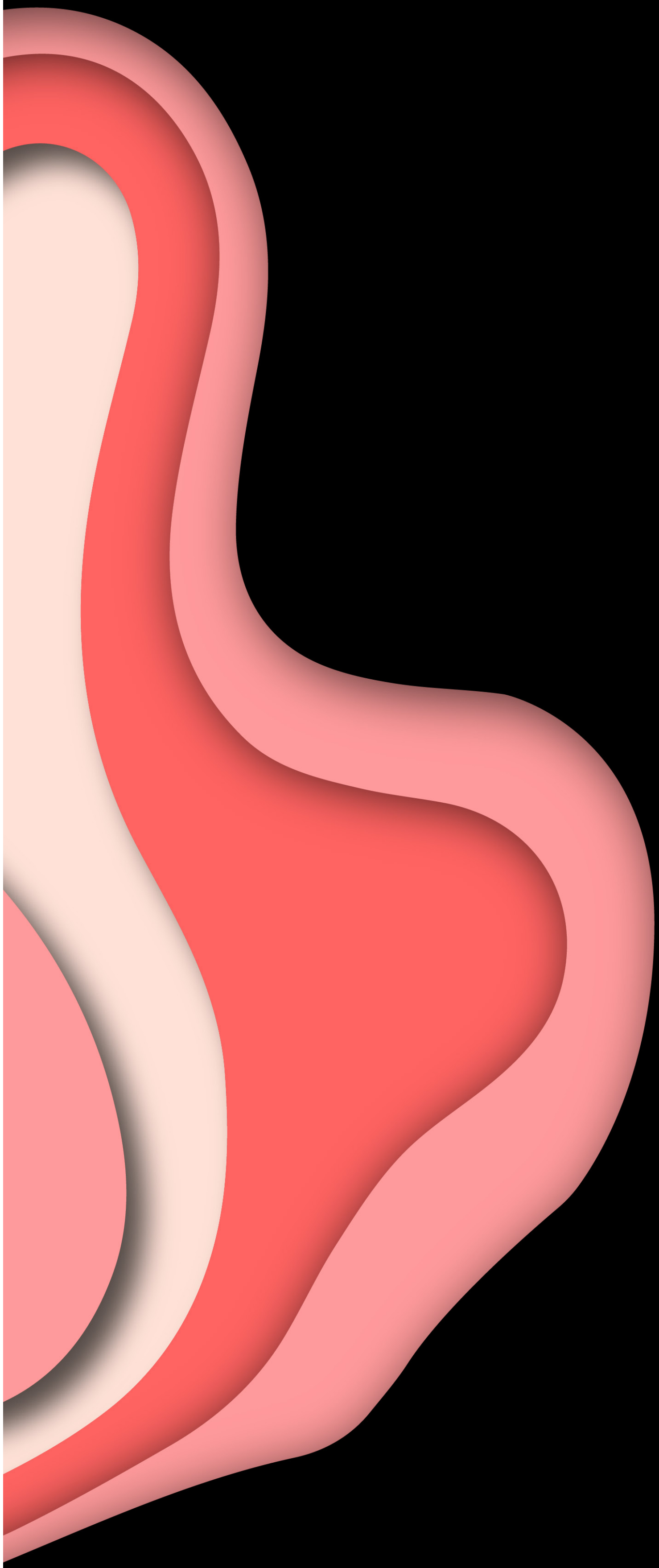
First issued by the IBRD in 2017, the PEF bonds provide for principal reductions when an outbreak of one of the six identified viruses reaches a predetermined level of contagion. The level of contagion in turn ties to number of deaths, the spread of the disease and whether the disease spreads across international borders, and is based on publicly available WHO data. When a principal reduction occurs, the IBRD transfers an equivalent amount to the PEF Trust Fund to channel the funds to countries in need of aid due to the pandemic outbreak.

In contrast to the PEF bonds, a pandemic clause would not provide fresh funding to sovereigns experiencing a health crisis. Instead, the sovereign’s own debt service obligations would be deferred for a period of time, freeing up cash to be used in response to the crisis, similar to the operations of a natural disaster clause. The inclusion of pandemic clauses in the debt instruments issued by the sovereigns themselves would take out the middle man (e.g., the IBRD). When a pandemic outbreak occurs, the investors would provide the relief, in the form of a deferral of payments, directly to the sovereign issuer. One key difference from the perspective of the investors is that the bonds with a pandemic clause would still be repaid in full after the deferral period, unlike an automatic reduction in their principal amount in the case of PEF bonds.

A related benefit of pandemic clauses is that the debt relief provided could be both higher and more targeted. During the COVID-19 pandemic, the PEF bonds paid out $196 million in 2020, but this amount was divided among the seventy-six IDA nations, so that averages $2.6 million per country. Contrast that with the $700 million that would be freed up from debt payments for just Barbados alone if the natural disaster clauses were triggered in its debt instruments.

There are several challenges here. First, a pandemic clause would need to include a suitable set of triggers. A lot has been written elsewhere on how the trigger criteria chosen for the PEF bonds are too complex and tied to indicators that only occur once a pandemic is well underway, which defeats the aim of a timely disbursement of emergency funding. These same critiques would befall pandemic clauses unless issuers and investors are able to develop and accept a more simplified set of trigger conditions.

Second, investors must be willing to invest in such financial instruments. The inclusion of a pandemic clause in a bond document would introduce an element of probability into whether the bonds would be payable and this does not fit well with the conventional methods used to price sovereign bonds. The garden variety fixed income investors looking to park their money in sovereign bonds may find such features too exotic for their tastes.



Conclusion

Scientist have found that lizards that are able to survive hurricanes evolve to grow longer limbs and stronger claws to improve their clinging capacity[9]. In the same way lizards are forced to evolve, Caribbean islands have been forced to develop new ways to deal with increasingly frequent and intense hurricanes. After more than a dozen debt restructurings in the Caribbean in the past twenty years, the two island nations of Grenada and Barbados have grown longer limbs and stronger claws, sparking a promising idea for small developing countries that are vulnerable to natural disasters. Perhaps this idea can spur more innovations in the sovereign debt space to deal with other types of crises such as a pandemic.

▼ **Sui-Jim Ho, Partner** Sui-Jim Ho's practice focuses on finance, capital markets, and restructuring. He advises on a broad range of financial products including loans, bonds, and derivatives. Jim also advises on general corporate and regulatory matters. He is particularly noted for his experience in complex emerging markets work across many geographies, ranging from Africa and Latin America to Russia/CIS.

As a noted "sovereign debt expert" (The Legal 500 UK), Jim has been involved in many high-profile sovereign debt transactions. He also advises supranationals and central banks on various institutional and regulatory matters. Notably, he advised Greece on its €206 billion bond exchange, the largest sovereign debt restructuring in history, and Barbados on its debt exchange, which resulted in Barbados becoming the only country in the world whose public debt stock is climate resilient as a result of the inclusion of the innovative "natural disaster clause" in its debt instruments.

▼ **Stephanie Fontana, Associate** Stephanie Fontana's practice focuses on international corporate and financial transactions.

She concentrates on cross-border transactions, principally in Latin America. She advises on sovereign debt offerings and restructurings, other securities offerings by issuers in Latin America, and mergers and acquisitions.

1. Sui-Jim Ho is a Partner and Stephanie Fontana an Associate at Cleary Gottlieb Steen & Hamilton LLP. The authors were part of the legal team that advised the Government of Barbados in its 2018-2019 debt restructuring. Any views expressed herein are strictly those of the authors and should not be attributed in any way to Cleary Gottlieb Steen & Hamilton LLP or the Government of Barbados.
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