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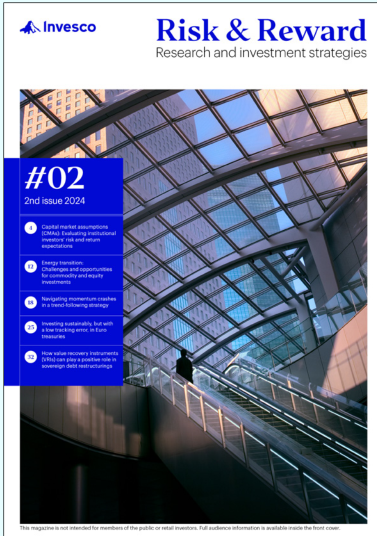
How value recovery instruments (VRIs) can play a positive role in sovereign debt restructurings

By H. Daniel Phillips



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In the context of sovereign debt restructurings, VRIs have become increasingly prevalent. We view them as a potentially valuable tool for Eurobond investors to recoup some losses in the event of a sovereign debt default. However, there is still room for improvement in several elements of their design and implementation.

When Suriname completed its Eurobond restructuring in late-2023, bondholders exchanged two traditional bonds for two new bonds. One of them looked much like the original two, while the other offered a range of potential cash flows based on the timing and size of the country's future oil production.

The second bond was a so-called value recovery instrument (VRI),[1] which is not an entirely new idea. Similar instruments have long been issued to help bondholders preserve their original capital. In recent sovereign debt restructurings, however, they have been used more often, and they will probably also play a role in the upcoming restructurings in Ghana, Sri Lanka, and Zambia. If investor demand for Suriname's VRIs is any indication, appetite for them is strong, and we welcome the continued refining and reintroduction of these innovative instruments.

When a sovereign debt restructuring takes place, bondholders traditionally receive new bonds, with fixed cash flows even when the economic and political situation is in flux. But in the case of VRIs, investors' cash flow depends at least in part on the evolving facts on the ground. This makes them an effective way to capture financial upside if economic conditions turn out better than expected at the time of restructuring.

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Aligning incentives between bondholders and issuers

Suriname has been producing oil for decades. However, it was not until massive deposits were found offshore in neighboring Guyana that the current oil bonanza began. Suriname borrowed on the Eurobond market in 2016, partly to recapitalize its state-owned oil company and make it more capable of managing the expected boom. At the same time, the country borrowed from development banks, the International Monetary Fund (IMF), the Chinese government, and local banks – ultimately bringing public debt to unsustainable levels. Not all of this money was well spent, and when Suriname eventually defaulted in late 2020, it set about restructuring some USD 675 million in Eurobonds.[2] These bonds made up a substantial portion of the country's debt load, which totaled 148% of GDP.[3]

The country insisted that its debt stock was too large and, after years of difficult negotiations, it agreed with bondholders on a haircut on the original principal owed. In exchange, the bondholders received a new bond that looked much like the old ones – along with a VRI.[4]

The cash payout of the VRI depends on multinational oil companies' successful exploitation of Suriname's immense, newly discovered oil reserves. The bondholders argued – successfully – that giving the country a steep discount on its original debt to make its new debt sustainable under prevailing economic forecasts was fair. However, in the high likelihood that this transformational amount of oil production dramatically improved economic outcomes, bondholders believed that a VRI should help compensate them for their earlier haircut with part of this newly materialized wealth.

In our view, this arrangement better aligns Suriname's incentives with those of its bondholders. Suriname wants the massive amount of financial gain that comes with being a substantial oil exporter, while bondholders want to recover their initial loan. If Suriname achieves its target oil production, bondholders will be paid more. If it doesn't, bondholders will receive no additional compensation. A final investment decision by the international oil companies is due later this year, and the first cash that Suriname would see from oil sales would not be available until 2028. Any number of things could delay or halt the production of oil and reduce the likelihood or timing of VRI payments, but bondholders seem happy to hold them nonetheless.

Figure 1 shows the price of each instrument since debt restructuring. The price of the VRI is up 89% since the restructuring, while the more traditional bond is worth only 8% more, suggesting that investors see potential value in Suriname's future oil revenues.

The increasing popularity of capturing potential future gains

The IMF has played a dominant role in almost all sovereign Eurobond restructurings. In a typical scenario, a country runs into balance of payment problems and finds itself without the hard currency needed to service its debts. With no available market financing, the IMF typically steps in to provide an emergency loan with conditions attached. Usually, the conditions involve a host of reforms designed to prevent future crises and the restructuring of existing debts to free up cash in the near term. The newly restructured debt must conform to the IMF's economic and financial projections for the country or the IMF will stop disbursing its emergency support. This has long been problematic for bondholders, as it leaves potential debt repayment on the table by locking in future cash flows.

But the IMF's projections often prove pessimistic. If, for instance, the IMF limits external debt service to a certain percentage of projected GDP, and a new bond is negotiated and issued based on those projections, this locks in a fixed payment based on an uncertain economic indicator – sometimes 10-15 years into the future. If the country's growth recovers faster than

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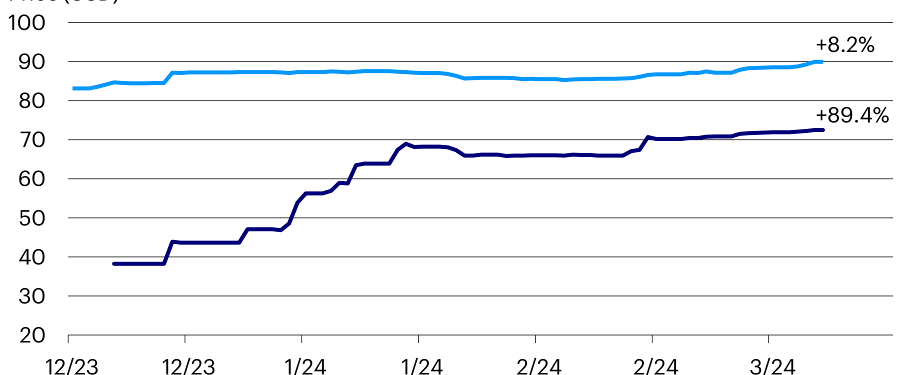
Figure 1
Suriname sovereign bond prices since restructuring



Source: Bloomberg L.P. Data from December 8, 2023 to March 7, 2024.

Since 2000, Argentina, Ukraine, and Greece have issued VRIs.

anticipated, it could end up with a larger discount on its original debt than it legitimately needed.

Like Suriname, Zambia is currently considering a VRI to restructure its debt. The proposal, not yet sanctioned by Zambia's bilateral creditors (China, France, etc.), includes two bonds as well. One is fairly commonplace and the other is a VRI. The VRI would feature both substantially higher interest rates and earlier maturities if either (i) the IMF increases Zambia's Composite Indicator[5] past a certain threshold or (ii) the following two conditions hold: the three-year rolling average of Zambia's US dollar exports (largely copper) and the US dollar-equivalent of government revenues exceed the IMF's July 2023 projections.

Two other countries currently negotiating Eurobond restructurings, Sri Lanka and Ghana, are also discussing VRIs as a way to compensate bondholders for possible principal haircuts.

Old idea, new design?

Markets tend to shun instruments like VRIs when offered outside of a restructuring scenario because of the complexities involved in price discovery and the novel nature of the underlying contract language. Some older, local currency-denominated versions called 'state-contingent instruments', such as France's infamous Le Giscard bonds,[6] or external bonds issued by small island states that reduce or extend cash flows in the event of a natural disaster,[7] can in some ways be seen as a predecessor.

We focus here on upside VRIs that have emerged from recent Eurobond restructurings – including their potential benefits and risks. Since 2000, Argentina, Ukraine, and Greece have issued VRIs alongside more traditional bonds when exiting restructurings of their Eurobond debt. In each case, bondholders saw VRIs as the "least bad" option for recovering their initial investments. Each country's VRI differed regarding its payment triggers and legal language, and each presented its own unique problems.

During the Greek debt crisis of 2011-12, bondholders were vulnerable given the broader political questions at play surrounding the unity and future of the eurozone. The enormous debt load Greece had accumulated – coupled with the broad implications for the stability of the eurozone and thus the involvement of powerful institutions such as the European Central Bank, the IMF, and the European Commission (the so-called 'troika') – resulted in a harsh restructuring for bondholders. In exchange for deep haircuts, they received VRIs in the form of GDP warrants designed to pay only if the country ended up growing faster than anticipated at the time of the restructuring.

However, high hurdles for growth meant that the complex pay-out formula[8] seemed unlikely to trigger, leaving the warrants for years with little value in the secondary market and thus offering minimal value to the original bondholders.

Almost the opposite happened in Ukraine in 2015, when a densely concentrated creditor group – many of whom were spooked by the Greek restructuring only a few years prior – pushed for warrant targets that were easier to meet and had uncapped payouts. Once the triggering of these payments seemed like a real possibility, worries mounted that the payments would become a substantial drag on Ukraine's debt sustainability. The war in 2022 made the issue moot by making a restructuring all but inevitable, but the criticisms of those warrants began well before Russian tanks rolled over Ukraine's border.

In Argentina in 2005, GDP warrants emerged as a component of that country's sovereign restructuring package. However, the country's government eventually unilaterally changed the way it calculated certain official statistics that the bond contract relied upon to determine the payment size and timing. Litigation over this methodological change and its warrant payment implications continues to this day.

Each of these previous warrants presented different problems and attracted different criticisms, but the new class of warrants in Suriname and elsewhere have sought to address these issues.

Potential issues ahead

We believe VRIs have the potential to be useful elements in future debt restructurings. But there are several impediments that could delay the design improvements needed to help establish them as accepted elements of a restructuring.

First, the IMF seems to want a greater say in their design and implementation, which could add a third party to debt negotiations in addition to the debtor country and bondholders. While the IMF's stewardship of the restructuring process is welcomed by everyone, their processes can be opaque, lengthy, and seemingly arbitrary to bondholders.

Second, despite advances in how these instruments are currently structured (such as enhanced data verification by independent third parties, increased clarity on the relevant triggering formulas, caps to prevent payouts perceived as egregious, etc.), there will likely still be concerns about data and definitions. Unfortunately, until a standard set of practices emerges, it seems that potential mistakes and disagreements are likely unavoidable and can only be addressed by clarifying language in each subsequent VRIs.

Third, difficulty pricing these option-like instruments and the inability of certain fixed income funds to hold them mean that they will likely enjoy less liquidity in the secondary market than traditional bonds.

The successful cases will establish a precedent for fairer and more universally accepted instruments.

Conclusion: The future of VRIs

The potential for VRIs to make investors whole after a haircut to their principal is clearly positive, but we believe investors should be very aware of some of the risks involved. For instance, these instruments are not eligible for inclusion in indices and can be difficult to price, causing liquidity to be low and risk premia high. Moreover, we emphasize the importance of being thoroughly informed about the specific triggering and payment characteristics of each bond and recognizing their potential risks. As time goes by, we believe the successful cases will establish a precedent for fairer and more universally accepted instruments, substantially reducing these two risks. The broader adoption and standardization of VRIs is thus valuable, as they provide another tool that can allow investors to help distressed countries restructure in a sustainable way while retaining potential upside for bondholders in a more positive scenario.

Notes

1 VRIs are also referred to as state-contingent debt instruments (SCDIs), as the cash flows are contingent on certain future developments, or 'states'.
2 Source: IMF (2021).
3 Ibid
4 At the time of default, Suriname had issued 2023 bonds at 9.875% and 2026 bonds at 9.25%. For each bond investors held, the final restructuring terms in November 2023 offered bondholders one new 2033 bond (a 7.95% cash coupon with 14 equal amortizations starting in 2027) and one VRI bond. The VRI stipulates that, once Suriname has earned USD 100 million from oil proceeds, the VRI bonds receive 30% of royalties thereafter, or 6.25% of overall revenues from a specified oil concession. To encourage repayment, the VRI grows at 9% annually until it is paid off, but its size is capped at 2.5 times the size of the initial VRI.
5 The Composite Indicator incorporates a decade of macroeconomic indicators and assessments of a country's institutional strength and capacity. The score determines a country's debt-carrying capacity as judged by the IMF. The higher the score, the more debt a country is deemed capable of carrying.
6 In 1973, French Finance Minister Valery Giscard d'Estaing devised and sold 'Le Giscard' bonds that carried a 7% coupon but included safeguard clauses stating that, if the French franc ever dropped its peg against a basket of gold and other currencies, the coupon and principal would then be linked to the price of gold. Eventually, the franc was floated and the price of gold rallied. By 1980, the government was paying 40% interest on the original principal, and the principal due at maturity was more than six times the amount initially raised.
7 In 2004, Hurricane Ivan inflicted damage on the small island nation of Grenada equivalent to 200% of GDP and even rendered the Prime Minister homeless for a brief period. Eventually the restructured Eurobond debt included a catastrophe clause that would lead to a moratorium on payments in the event of another major hurricane. Barbados followed suit in 2019.
8 The IMF summary of payment triggers: "These warrants are again characterized by three rules: (i) a level condition: nominal GDP must exceed a base case nominal GDP specified to be a certain value from 2014 to 2020, then equal to the 2020 value; (ii) a growth condition: the real GDP growth rate must exceed the baseline growth rate; (iii) a cap: 1% of the nominal value of the original instrument. Payout then equals a notional amount that decreases each year multiplied by 1.5 times the difference between the real growth rate in that year and a baseline growth rate."

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