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Ukraine's Creditors Fear Moratorium as Debt Deadline Looms

By The Moscow Times

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International Monetary Fund (IMF) Managing Director Christine Lagarde

LONDON — Ukraine is likely to pay all bond coupons falling due over the summer but a $500 million maturity in September could mark a halt to debt repayments if a restructuring deal has not been reached by then.

War-ravaged and on International Monetary Fund life support, Ukraine has threatened to suspend payments if bondholders fail to accept demands for a 40 percent write-down, or "haircut," in the face value of its sovereign bonds.

Kiev has so far honored all debts, recently paying $500,000 and $75 million in coupons, the latter on a eurobond held entirely by Russia. But the moment of reckoning is approaching: September's $500 million payout will be a major challenge for a country with less than $10 billion of hard currency reserves.

"It's not usually a comfortable position to call a moratorium because it then becomes a hard default," said Gabriel Sterne, head of global macro at Oxford Economics.

Like most analysts he expects Kiev to honor coupons due over the summer, including a $120 million payment on July 25.

"[A moratorium] wouldn't be worth doing, for example, for the sake of $70 million. There has to be a pain threshold, a hard constraint ... and for Ukraine that will be the September $500 million bond," Sterne added.

Not making that payment would tip Ukraine into full-fledged default, with associated reputational and financial damage. It would also allow bondholders to demand immediate repayment on the country's entire stock of bonds.

The bondholders have rejected haircuts, saying that their restructuring proposal, based on extending debt maturities, will provide the needed savings. They also argue, not unreasonably, that Ukraine's other creditors including the IMF are owed far more money, yet are not taking any write-downs.

But because Ukraine's crisis was partly triggered by Russian interference, it enjoys the backing of Western lenders and governments — the IMF has said it will lend to Ukraine even if it halts debt payments.

That leaves creditors with relatively few cards.

"The government and the IMF are likely to continue pushing for a reduction of coupons and face value, potentially creating risks of a hard default in September," said Bank of America/Merrill Lynch, predicting a fall of up to 20 cents in bond prices from current levels near 50 cents per dollar.

A default might even work to Kiev's advantage.

Debt restructurings conducted after a default typically led to an average 48 percent haircut in net present value terms (NPV), Sterne said, citing a 2007 IMF analysis of emerging market workouts conducted between 1998 and 2005. NPV refers to the worth of future bond interest payments in current terms.

But the study showed that NPV haircuts after voluntary restructurings averaged 8 percent.

Creditors

The bondholders are led by Franklin Templeton's Michael Hasenstab, who after a string of successful bets on troubled credits such as Ireland and Hungary, bought up over a third of Ukraine's outstanding sovereign bonds.

The group, which includes T. Rowe Price, BTG Pactual and TCW holds $8.9 billion, or almost half the bonds targeted for a haircut.

They are calling on Ukraine to restructure debt in such a way that it stays in investors' good books, noting that a key plank of the IMF's plan is a return by Kiev to capital markets to raise

$7 billion between 2017 and 2020.

"Imposition of a haircut, not to mention a debt default, would further reduce an already narrow universe of Ukrainian debt investors and make such financing impossible not only in 2017 but well beyond," the committee said in a statement.

Research shows an investor-friendly restructuring does tend to ensure a speedier return to bond markets.

According to a 2013 paper by economists Juan Cruces and Christoph Trebesch, sovereign bond yield spreads were still about 127 basis points (bps) above pre-default levels four to five years after the imposition of a 40 percent haircut.

"Higher creditor losses are associated with significantly higher post-restructuring spreads and longer periods of market exclusion," the paper said.

But an IMF paper from 2007 concluded that lower debt ratios and economic policies that improve creditworthiness are probably more important considerations when a country returns to markets after default.

That study also noted that "if creditors concluded that the default reflected exogenous factors, the sovereign's reputation as a trustworthy borrower would remain untarnished."

Duke University law professor Mitu Gulati, who has closely followed Ukraine's debt saga, rates bondholders' chances of escaping haircuts at "zero" and says Kiev should not worry about future bond market access at the moment.

"I think Ukraine is in a bad enough financial condition that it is not going to be able to borrow any time soon," Gulati said. "Plus, we know that the sovereign debt markets are quite forgiving — particularly if Ukraine is making the right financial decision, given its economic realities."

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