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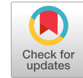
Foreign-law bonds: Can they reduce sovereign borrowing costs?☆



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ABSTRACT

Governments often issue bonds in foreign jurisdictions, which can provide additional legal protection vis-à-vis domestic bonds. This paper studies the effect of this jurisdiction choice on bond prices. We test whether foreign-law bonds trade at a premium compared to domestic-law bonds. We use the euro area 2006–2013 as a unique testing ground, controlling for currency risk, liquidity risk, and term structure. Foreign-law bonds indeed carry significantly lower yields in distress periods, and this effect rises as the risk of a sovereign default increases. These results indicate that, in times of crisis, governments can borrow at lower rates under foreign law.

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1. Introduction

When governments borrow from capital markets, many decide to issue their bonds under a foreign jurisdiction. This paper explores the pricing effects of this choice. Specifically, we test whether sovereign bonds that are governed by foreign law, e.g. English or New York law, trade at a premium compared to bonds issued under domestic law. The intuition behind this question is simple. Domestic-law bonds can have weaker legal protection since the contract terms can be altered retroactively by changes in the law of debtor countries. Through an act of parliament, governments can, in principle, change the currency denomination of domestic-law bonds, their payment terms, or the voting rules for a potential restructuring. Such a retroactive change of contracts is not possible for foreign-law bonds, because legislation by national parliaments has no authority beyond domestic borders. Foreign-law bonds are also increasingly prone to litigation and enforcement in foreign courts, possibly making them better shielded against unilateral default and restructuring.[1] This paper explores if there is a "legal safety premium" priced into sovereign bond yields: how do markets value bonds that are protected by the rule of law abroad?

Our study is motivated by events in the run-up to the Greek debt restructuring of 2012, which showed that governing law can play a crucial role in sovereign bond markets. On February 23, 2012, the Greek parliament passed the "Greek Bondholder Act", which retroactively introduced collective action clauses (CACs) with aggregation features into its outstanding *domestic-law* sovereign bonds.[2] After the exchange offer was launched shortly later, more than 66% of domestic-law bonds were tendered. This forced minority holders to also exchange their bonds and accept the associated haircut, even if they voted against the offer. In

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[1] See IMF (2013); Frankel (2014); Hébert and Schreger (2017); Schumacher et al. (2018)

[2] Greek law no. 4050/2012 "Rules of amendment of titles issued or guaranteed by the Hellenic Republic with the Bondholder's agreement", see Hellenic Parliament, online available at http://www.hellenicparliament.gr/Nomothetiko-Ergo/Anazitisi-Nomothetikou-Ergou?law_id=3b426740-db7b-471a-9829-80a89a6518b5, accessed6March2018.

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contrast, the Greek legislation could not change the terms of the *foreign-law* bonds, allowing investors in those bonds to reject the exchange offer and hold out.[3] The foreign-law clause thus protected these investors from deep losses: the nominal principal on domestic-law bonds was reduced by 53.5%, amounting to a 65% haircut in net present value terms (for a detailed assessment of the case see Choi et al., 2011; Gulati and Zettelmeyer, 2012; IMF, 2013; Zettelmeyer et al., 2013). More recently, the Austrian government retroactively inserted CACs into the bonds of an Austrian wind-down entity. Randl and Zechner (2016) estimate that following this legislative action, the spread between domestic and foreign-law bonds issued by the Austrian government increased.

After the Greek experience of 2012, many observers argued that bonds with foreign governing laws are preferable from a creditor perspective.[4] Gulati and Zettelmeyer (2012) even suggest to use differences in governing law as a policy tool to address the debt overhang problem in crisis countries. Specifically, they propose voluntary debt restructurings in which holders of local-law bonds swap these against foreign-law bonds with longer maturities, i.e. with a present value haircut. Such voluntary swaps could be mutually beneficial since investors receive a safer asset while countries achieve debt relief. A first application of this idea was the Greek debt exchange proposal itself, since all Greek-law bonds were exchanged into new English-law bonds – a carrot to induce investors' participation in the exchange.

The potential advantages of foreign-law bonds have also come to the attention of debt managers. Cyprus, Greece and Portugal all returned to the international bond market by issuing English-law instruments in 2014, and other small non-core euro area countries, such as Latvia or Slovenia also shifted their sovereign bond issuance patterns from domestic to foreign law, according to primary market data by Dealogic. We generally find foreign-law bonds to account for a substantial share of public sector borrowing in the last decade, both in Europe and in emerging markets (see Figs. 1 and 2).

Despite the widespread use of foreign-law bonds, there is still limited evidence on the effect of legal clauses and governing law on pricing in sovereign debt markets.[5] Few rigorous empirical studies exist and theory is ambiguous on whether and how sovereign bond contract design matters. On the one hand, Roubini (2000) and Weinschelbaum and Wynne (2005) argue that contractual bond clauses such as CACs or governing law are likely to be irrelevant, both ex-ante and once the country enters financial distress.[6] On the other hand, the work by Bolton and Jeanne (2007, 2009) suggests that debt which is harder to restructure, in legal terms, will effectively be senior and therefore have lower yields ex-ante (a similar argument is made by Pitchford and Wright, 2007).[7] Our paper informs this debate empirically by applying standard fixed income valuation techniques to a large sample of bonds to understand whether foreign-law debt is indeed priced at a premium, and how large this premium is across countries and time.[8]

Ideally, we would estimate the premium on foreign-law bonds by comparing two otherwise identical bonds that were issued in different jurisdictions - that is, “twin bonds” that share the same currency, maturity, coupon and other features except that one was issued under domestic law while the other was issued under a foreign jurisdiction. Unfortunately, such “twin bonds” are very rare (we could only identify one pair for Argentina and construct another for Russia by interpolating two bonds). As an alternative, we therefore rely on standard fixed income valuation approaches to compare bonds with different currencies, maturity and coupon structure to infer the premium associated with foreign-law bonds. We use the euro area sovereign debt crisis as a laboratory since it provides the cleanest setting for such an exercise by allowing us to deal with currency risk in a straightforward way. In emerging markets, it is very difficult to find local-law and foreign-law bonds denominated in the same currency. Disentangling the currency risk premium from a jurisdiction premium is further complicated because there is no domestic currency risk-free yield curve (see Du and Schreger, 2016). This is not a problem in the euro area because Germany issues credit risk-free bonds in EUR which can be used to separate currency from credit risk. The identification of a foreign-law premium in our paper thus comes from comparing bonds by the same sovereign issued under different jurisdiction, e.g. an Italian local law bond and one under New York law, and using risk-free benchmark yield curves to correct for currency risk. More generally, our approach accounts for term structure effects, bond liquidity, currency risk, and country-level default risk. We also include bond fixed effects to account for time-invariant bond characteristics such as coupon size, maturity, or legal bond features such as CACs or negative pledge clauses. Our time window is 2006–2013 and we cover the near-universe of actively traded foreign-law bonds in the euro area.

As an add-on to our main analysis, we also show two simpler case studies from emerging market countries based on the Argentina and Russia “twin bonds” mentioned above (identical domestic-law and foreign-law bonds by the same government issued in USD) to proxy the jurisdiction premium, although in a more simplistic way than for the euro area.

Our main result is that a foreign-law premium exists, but it only becomes sizable and relevant in periods of debt distress. We document a large increase in that premium during the crisis, particularly for Greece where the premium reached over 1000 basis points as default became imminent. Portugal also experienced a large spike in the premium, which at times reached levels well above 500 basis points. During non-crisis times and in less vulnerable countries, however, the premium can be slightly negative, implying that governments incur a small cost when issuing foreign-law bonds outside of distress episodes. We document that the premium rises with credit risk. A rise in the credit default swaps (CDS)-implied risk-neutral default probability of 10 percentage points is associated with a 0.2 percentage point increase in the premium. However, this effect is stronger in countries experiencing deeper financial crises: for Greek bonds, the effect is more than twice as large. Furthermore, our estimates point to a non-linear relationship, with a non-negligible foreign-law premium emerging only for elevated levels of CDS spreads. These effects are economically meaningful, at least in

[3] The result was that more than 50% of Greek bonds under English, Swiss and Japanese law were not restructured and have been serviced in full and on time ever since. (Zettelmeyer et al., 2013). Holdouts amounted to EUR 6.4bn in face value or 3.1% of total debt exchanged.

[4] For example, an article in the New York Times reported that “investors might think twice before investing in those local law bonds, no matter how high the yield” (Thomas, 2012). Similarly, the Wall Street Journal reported analyst recommendations to sell domestic-law Portuguese government bonds and buy foreign-law ones instead (Stevis, 2012).

[5] A larger literature exists on the distinction between domestic and external debt by residency of creditors, see for instance Reinhart and Rogoff (2011). For a discussion about the different dimensions along which domestic and foreign debt can be distinguished, see Panizza (2008)

[6] Roubini (2000) argues that initial contractual terms are likely to be irrelevant since creditors and sovereigns can find ways to work around them ex-post, as shown by a number of actual cases. Weinschelbaum and Wynne (2005) emphasise that governments have a variety of different debt contracts outstanding and that the relevance of contract design in individual portions of the debt will decrease the more diversified the debt stock is. Moreover, they argue that the implicit guarantee of official sector bailouts in case of distress makes investors ignore contractual clauses.

[7] There is a large related theory literature studying the ex-ante and ex-post effects of easy versus hard to restructure debt and the economic consequences of sovereign bond contracts and creditor behavior during debt crises, see Miller and Zhang (2000), Ghosal and Miller (2003), Gai et al. (2004), Haldane et al. (2005), Engelen and Lambsdorff (2009), Bi et al. (2011), Pitchford and Wright (2012) and Ghosal and Thampanishvong (2013).

[8] Note that our focus is on debt issued under foreign law, and not debt issued to foreigners. The resulting premium is likely to be the result of differences in a restructuring technology associated with foreign law, but may also be affected by differences in the willingness to impose different losses on creditors situated in different jurisdictions. There have been cases in which governments discriminated against foreign investors in favor of domestic creditors. But this is not a general pattern, and there have been numerous cases in which the opposite was true (Erce, 2012). A number of papers have investigated the strategic discrimination of foreign versus domestic investors (e.g. Guembel and Sussman, 2009; Broner et al., 2010, 2014). The European debt restructurings in Cyprus and Greece both discriminated against domestic-law bonds. The market assessment of the risk of discrimination is therefore ex-ante unclear, and this paper attempts to estimate investors' valuation of this risk empirically.

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