FDL Finance for Development Lab

Lessons From The Ecuador 2020 Debt Restructuring Case

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About Finance for Development Lab

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Introduction

Ecuador, like several other frontier economies with high levels of external debt, is currently facing severe liquidity constraints. In recent years, Ecuador has made significant efforts to avoid such challenges, including successfully completing an ambitious program with the International Monetary Fund, restructuring its external commercial debt in 2020 (which amounted to over US$ 17 bn), and addressing its debt to the Chinese lending institutions in 2022 (approx. US$4bn).

Such developments require thoughtful consideration of the best funding strategy, especially given the current capital market shutdown and the need for socially and politically acceptable fiscal reforms. In this context, looking back at the 2020 debt restructuring episode can offer valuable insights and guidance on the best approach to handle liquidity vulnerabilities while engaging in a constructive dialogue with key creditors.

In March 2020, Ecuador faced a double blow with the plummeting oil prices and the Covid-19 health crisis. It became the worst-hit country in Latin America by the pandemic. Disturbing images of deceased individuals on the streets of Guayaquil made headlines for several weeks. As a result of this dual crisis, Ecuador experienced a loss of over US$10 bn in fiscal revenues in 2020 compared to the original budget. This represented a nearly 25% revenue shortfall, equivalent to 10% of the GDP.

On March 24th, Ecuador publicly announced that it was facing severe liquidity shortages and was no longer able to fully meet its debt obligations. While the authorities decided to make the principal payment due on March 24th, 2020, they missed the coupon payments on the remaining bonds and subsequently launched a consent solicitation for a standstill. This was rapidly followed by comprehensive debt restructuring negotiations and discussions on a successor IMF program.

Embarking on the 9th episode of debt restructuring was not easy for Ecuador. In 2008, the country defaulted on 2 of its 3 outstanding international bonds on the back of an audit, considered highly biased, that had declared this debt to be illegitimate. Market players considered this event as the first default based on "willingness to pay grounds" in modern history. Until today, the default track record remains in investors' minds and has resulted in a higher premium in the cost of financing ever since the country returned to the market in 2014.

This paper aims to provide insights into a unique debt restructuring process. Several interesting takeaways emerge, which could be relevant for future debt restructuring episodes, including:

- **Securing a six-month standstill was key in putting the debt negotiations on the right track and avoiding default.** In fact, raising early pre-default negotiation was critical for a fast and beneficial outcome down the road. It represented a sign of good faith, beneficial to maintaining discussions on track even in tougher moments later on.
- **The third generation of Collective Action Clauses,** based on an offer designed to maximize incentives to participate, **turned out to be very effective in avoiding holdout issues**.
- **Restructuring discussions are more effective when reputable creditors, who have high stakes and concerns about the soundness of the asset class, take the lead**.

- **The support from the national authorities is crucial for success.** In this case, the Ecuadorian authorities taking the lead on proposing fiscal measures helped start the discussions. On the other hand, **having the IMF onboard, with tangible program discussions, has been a catalyst** for efficient debt restructuring talks.

1. A fragile position with limited instruments to cushion the shock

Ecuador started 2020 in a vulnerable position with very limited policy tools to cushion the shock. Contrary to many Latin American countries, Ecuador had not taken advantage of the 2007-2014 super commodity boom to build up fiscal reserves. Pre-existing oil stabilization funds and fiscal prudential rules were removed in 2008-2010 through new constitutional and legal provisions. At the same time, the significant increase in fiscal revenues as a percentage of GDP driven by oil prices from 2005 to 2014 was accompanied by almost double the expenditure-to-GDP ratio. With a significant share of rigid expenditure outlays, the fall in fiscal revenues from 2015 onwards was accompanied by a much slower and smaller expenditure adjustment, resulting in substantial and growing fiscal deficits in the years before the pandemic.

Ecuador's economy has been structurally affected by a lack of diversification, with a significant reliance on oil. In 2019, the country's oil exports represented 40% of total exports, serving as the primary source of foreign currency. The country missed the opportunity to take advantage of the oil price bonanza to unleash the potential of the private sector.

Besides, Ecuador's economic activity was already slowing at the onset of the COVID-19 crisis. The real GDP slowdown started in 2015 once the commodity supercycle ended with the collapse in oil prices. The economy further contracted in the fourth quarter of 2019 by 1 percent (y-o-y)[1] due to social unrest in October and the impact of fiscal consolidation. Growth in 2019 was 0.1 percent, well below the expected levels for emerging countries. A contraction in domestic demand was offset by export performance.

As a dollarized economy, the country lacked an independent monetary cushion to address the COVID-19 shock. Back in the year 2000, the authorities decided to substitute their domestic currency with the U.S. dollar to halt capital outflows and put an end to the implosion of the financial system. While dollarization helped to control inflation (which stayed in the low single-digit levels for a couple of years), extend the time horizon of economic agents, stabilize the financial market, and help resolve the 2000 economic crisis, it also meant that Ecuador could not have an independent monetary policy, making it harder for the government to intervene during times of recession. Although Ecuador gained competitiveness when the dollar depreciated from 2000-2014, it started to lose competitiveness in 2015, when its neighbors devalued their currencies. Ecuador could not do the same and instead kept on raising the minimum wage. This, coupled with the protracted fiscal fragility and depleting liquid reserves, increased vulnerabilities of the dollarization system, especially during the pandemic.

In addition, the country's external reserves only provided a limited buffer. When the dual (Covid and oil prices) crisis hit the country, the level of international reserves represented US$ 2bn, equivalent to 1.4 months of imports. This fell well below the reserve adequacy level of 3 months of imports recommended by the IMF.[2] When considering an alternative assessment of reserve adequacy, which is more relevant for a dollarized economy, Ecuador's central bank did not have sufficient "freely disposable liquidity". This meant that its international reserves were insufficient to cover its sight ("demandable") deposit liabilities,

[1] International Monetary Fund, IMF Country Report No. 22/225, "Fourth and fifth reviews under the extended arrangement under the Extended Fund Facility, request for a waiver of non-observance of performance criterion, rephasing of access, and financing assurances review—Press Release; Staff Report; Staff Statement; and Statement by the Executive Director for Ecuador", July 2022.
[2] International Monetary Fund, IMF Survey, "Assessing the Need for Foreign Currency Reserves", April 2011.

mainly with the financial system and public sector entities. The low coverage largely reflected legal changes allowing the Central Bank to purchase public debt, weakening its position in liquid assets.

On the fiscal side, given recurrent budget deficits, an increasing public debt stock, and a high-interest bill, the country's fiscal space was very limited. Its level of public debt had risen from 33% of GDP in 2015 to 50% of GDP at end-2019.[3] While this level of debt stock is in line with peer countries, the high cost of Ecuador's debt resulted in an interest charge above 15% of revenues, well above the 9.8% median level of developing countries rated single B (between B+ and C).[4] These imbalances made the country's dollarization system even more susceptible to economic shocks.

Ecuador also had limited access to sources of financing. China, the country's largest bilateral lender, quickly reached its exposure limits. As a result, Ecuador secured an IMF program in 2018. However, this program did not fully cover its funding needs, so it increasingly relied on market financing.

[3] International Monetary Fund, IMF Country Report No. 22/225, "Fourth and fifth reviews under the extended arrangement under the Extended Fund Facility, request for a waiver of non-observance of performance criterion, rephasing of access, and financing assurances review—Press Release; Staff Report; Staff Statement; and Statement by the Executive Director for Ecuador", July 2022.
[4] Moody's, General Government Interest Payment/General Government Revenue, Moody's Statistical Handbook, May 2019.

2. March 2020: A dual shock of unprecedented magnitude

In March 2020, two major external shocks caused Ecuador's economic prospects to deteriorate severely: (i) the COVID-19 outbreak and (ii) the collapse of oil prices.

Ecuador made headlines for being one of the first countries in Latin America hit hard by the coronavirus pandemic. As a result, the COVID-19 health crisis exerted significant pressure on Ecuador's economy and public finances, leading to a sharp decline in both domestic and global demand. To address this, the authorities rolled out a US$3.9 bn emergency package in the second quarter of the year. This package aimed to purchase medical equipment and provide economic and social assistance to workers and companies.

In parallel, the sudden fall in oil prices – mainly due to the drop in oil demand as lockdowns were being announced all over the world – **particularly affected Ecuador, given the country's reliance on oil revenues**: in 2019, gross oil revenues represented c. 37% of budget revenues and c. 39% of exports. As a result, Ecuador's forecasted net oil revenues for 2020 were reduced by half, from US$ 8.2 bn to US$ 4.1 bn.

This dual shock significantly reduced Ecuador's export revenues, putting a considerable strain on the budget, curtailing external financing flows, and exacerbating the pre-existing lack of market access. It also dampened economic activity and created substantial risks to debt sustainability. As of April 2020, export revenues were expected to decrease by almost US$ 10bn, more than doubling the government's gross financing needs: from US$ 5.6bn estimated in December 2019 to over US$ 13bn as of April 2020 estimates. Real GDP growth was expected to fall to -6.3% that year, and the significant reduction in exports was expected to move the primary balance into negative territory, from an expected surplus of 3.7% of GDP for the year 2020 to a deficit of 3.9% of GDP. If not addressed promptly, the immediate balance of payments could cause significant socio-economic disruptions.

The magnitude of the shocks increased the country's risk premia well above 2,000 basis points, indicating a loss of market access for Ecuador. This situation was not unique to Ecuador but was a common feature of the crisis for many high-yield issuers, who experienced a spectacular capital outflow during the first months of the pandemic.

3. Characteristics of Ecuador's debt stock

Figure 1. Breakdown of Ecuador's Non-Financial Public Sector Debt at end-2019

	Amount (US$ bn)	Amount (% of total debt)	Avg. remaining tenor	Avg. interest rate	Debt service over 2020-2021	Debt service over 2022-2030
Multilateral	US$ 12.3 bn	23%	8.2 yrs	3.8%	US$ 2.7 bn	US$ 10.2 bn
Bilateral	US$ 6.5 bn	12%	4.7 yrs	4.2%	US$ 2.7 bn	US$ 4.5 bn
Treasury certificates (CETES)	US$ 2.0 bn	4%	1.0 yrs	1.1%	US$ 2.0 bn	US$ 0.0 bn
Domestic debt	US$ 11.3 bn[2]	21%	4.8 yrs	3.8%	US$ 1.6 bn	US$ 4.4 bn
Other external debt (banks, Brady bonds, PAM)[1]	US$ 3.5 bn	7%	3.9 yrs	4.8%	US$ 2.0 bn	US$ 2.0 bn
International Bonds	US$ 17.7 bn	33%	7.2 yrs	8.7%	US$ 3.5 bn	US$ 25.3 bn
TOTAL	**US$ 53.3 bn**	**100%**	**6.2 yrs**	**5.4%**	**US$ 14.5 bn**	**US$ 46.4 bn**

Source: *Ministry of Economy and Finance of Ecuador, Update on macro outlook and debt restructuring strategy Republic of Ecuador, 3 June 2020.*
Notes: *(1) PAM stands for Petroamazonas; (2) US$11.3bn debt stock composed of US$ 5bn of medium-term bonds and US$ 6.2bn of other liabilities (domestic arrears). The financial terms in the table correspond to the US$5 bn of domestic bonds.*

The public debt structure of Ecuador prior to the crisis was quite diversified, with official sector creditors (multilateral and bilateral) representing slightly more than one-third of the total debt stock (35%), international bonds accounting for another third (33%), domestic debt and other financing sources representing the remaining 32%. As may be expected, the longest tenor financing came from the multilaterals (with much shorter terms for bilateral obligations), while borrowing on international capital markets had the highest cost – with an 8.7% weighted average coupon, compared to a weighted average interest rate of 5.4% for the total debt stock. The highest debt service payments were scheduled for official sector creditors (with similar amounts for multilaterals and bilateral obligations) and international bonds in the next 2 years, with international bonds representing more than 50% of debt service payments if a 10-year horizon was considered.

The severe recession in 2020 resulted in an increase in the debt-to-GDP ratio from c. 50% of GDP in 2019 to c. 69%[5] expected for the end of 2020, putting further pressure on the already weakened public

[5] International Monetary Fund, IMF Country Report No. 20/286, "Request for an extended arrangement under the Extended Fund Facility—Press Release; Staff Report; Staff Supplement; and Statement by the Executive Director for Ecuador", October 2020.

finances of Ecuador. This is the result of a greater amount of debt contracted but, most importantly, a lower nominal GDP because of the oil price effect on the deflator.

The weighted average life of the debt stood at approximately 6 years at the outbreak of the crisis, implying that c. 15% of the debt stock had to be repaid or refinanced during the coming year. Total debt service numbers for the two upcoming years (2020-21) were even higher – at US$ 14.5bn, or c. 16% of 2020E GDP. The refinancing of such large amounts was a daunting challenge. The already challenging situation in pre-COVID times became impossible once the health crisis broke out. Ecuador's sovereign bond yields skyrocketed, and the country's risk premia surpassed 2,000 basis points.

In such an adverse context, Ecuador had no choice but to adopt a comprehensive debt management strategy addressing the various debt categories. This strategy took into account several parameters, such as creditor type (multilateral debt, bilateral debt with China representing a significant part of this debt, domestic debt, international bonds, and other private sector debt), remaining average tenor, average cost of the debt outstanding and upcoming debt service payments. A customized approach was developed for each category of creditors.

Negotiations with multilateral creditors mainly focused on seeking new financing at concessional terms. This approach allowed to quickly attract significant financial support, including a US$ 6.5bn (661% of Ecuador´s quota with the Fund) arrangement under an Extended Fund Facility (EFF) with exceptional access with the IMF (signed at the end of August 2020), a US$ 643m IMF Rapid Financing Instrument, US$ 795m in World Bank budget support, US$ 575m of CAF funding, US$ 899m from IADB for contingency and COVID-related expenditures.

Discussions with bilateral creditors focused on renewing sizeable credit lines on favorable financial terms. These discussions mainly centered on negotiations with Chinese lenders representing c. 92% of the total debt held by bilateral creditors. Liquidity relief in the form of a one-year postponement of US$ 0.9bn loans (much lower than the initially expected US$ 2.4 bn of fresh financing at IMF program approval) was obtained as part of this workstream, while discussions for a debt reprofiling eventually concluded in 2021-22.

Treatment of domestic debt (US$ 2.0bn of Treasury certificates and US$ 5.0bn of domestic bonds) **mainly consisted of the roll-over of the maturing tranches** under existing terms and conditions. The central government's historically larger fiscal deficit compared to the overall Non-Financial Public Sector led to increased pressure, particularly due to intra-public sector debt. This included growing obligations to Social Security for pensions and health-related liabilities, as well as larger arrears with local governments, state-owned enterprises, and the Central Bank's holding of substantial Treasury bills and bonds. These challenges needed to be addressed separately and gradually.

Finally, **the restructuring of the international bonds was crucial to put public finance back on a sustainable path.** It was also one of the main pre-conditions for the signature and future disbursements under the potential (at that time) IMF EFF arrangement.

4. Debt Sustainability Analysis ("DSA") of Ecuador

On 1 May 2020, the IMF approved Ecuador's request for emergency financial assistance under the Rapid Financing Instrument (RFI) of c. US$ 643m[6]. While this did not meet all of Ecuador's official financing needs, it provided much-needed liquidity support in the midst of the health crisis and established the framework necessary for the restoration of Ecuador's public debt sustainability. This framework laid the basis for the new IMF program approved later in August 2020, as well as the restructuring negotiations of international bonds.

Long-term debt sustainability of the country's debt under standard macroeconomic assumptions is one of the key pre-conditions for any new IMF program. In the context of Ecuador, the IMF cannot approve a new EFF arrangement without first evaluating the "sustainability with high probability" of Ecuador's debt. Given the dual macroeconomic crisis, the IMF stressed the importance of ensuring the sustainability of Ecuador's debt from both the debt stock and cash flow perspectives. The significant increase in the public debt stock to an expected approximately 69% in 2020 has raised concerns about the risks of further rapid growth, emphasizing the need to control the debt stock over the medium and long term. Additionally, imposing constraints on the maximum level of annual gross financing needs as a share of GDP appeared necessary to reduce the refinancing pressure on the government in the long run.

In its Staff Guidance on Public Debt Sustainability Analysis in Market-Access countries[7], the IMF considers that "public debt is sustainable when the primary balance needed to at least stabilize debt under both the baseline and realistic shock scenarios is economically and politically feasible, such that the level of debt is consistent with an acceptably low rollover risk and with preserving potential growth at a satisfactory level".

In the case of Ecuador, the analysis relied on a relatively ambitious non-oil primary balance trajectory (NOPBS), which includes oil derivative subsidies but excludes other oil-related revenues or expenditures. This trajectory suggested an adjustment from a deficit of 5.8% of GDP in 2020 to a surplus of 4.5% of GDP in 2025, followed by a steady state primary surplus of 3.1% thereafter. As a reference point, the primary surplus stood at 4.1% on average between 2001 and 2008. This level compares to 1.7% retained in the Argentina DSA and reflects the need for a dollarized economy to maintain significant primary surpluses considering the limited sources of financing, but also to gradually reduce the Ecuadorian economy's reliance on oil.

The analysis also accounts for the higher vulnerability of Ecuador to external shocks compared with peer countries, as reflected in its history of "booms and busts" and its nine preceding episodes of sovereign debt restructuring.

As a result, **the IMF has set two main debt sustainability targets for Ecuador:**

- **A Gross Financing Needs (GFN) target of 6% of GDP on average for the period 2025-2030**
- **A Public Debt-to-GDP target of 55% of GDP by 2025 and 45% of GDP in 2030**

[6] International Monetary Fund, IMF Country Report No. 20/178, "Request for purchase under the rapid financing instrument and cancellation of arrangement under the Extended Fund Facility—Press Release; Staff Report; and Statement by the Executive Director for Ecuador", May 2020.
[7] International Monetary Fund, "Staff Guidance Note for Public Debt Sustainability Analysis In Market-Access Countries", May 2013.

The first binding constraint in the IMF analysis is the medium-to-long-term GFN target that is suitable for the country's debt structure and the depth of domestic financial markets. This target defines what the IMF considers as a minimum cash-flow debt relief for the period 2020-30 and reflects the fact that the targeted level of GFNs in restructuring cases tends to be lower than what would be considered "safe" outside of a restructuring, given a shallow domestic banking system and the need to avoid reliance on rapid external market re-access. It is important to note that in other economies of similar size, such as Ukraine, the IMF tolerated higher levels of GFNs up to 12% but the idiosyncrasies of Ecuador pushed the IMF to consider much lower manageable levels. This is due to (i) the high dependence of Ecuador's fiscal revenues on international oil prices, making the country highly exposed to abrupt external oil price shocks, (ii) the dollarization of Ecuador's economy, which limits the array of available tools to tackle crisis situations, and (iii) the shallow domestic debt market, increasing the reliance on official financing and external market access. Similarly, low levels have also been adopted for Argentina, which was considered equally vulnerable.

In the next step, the IMF established debt-to-GDP ratio targets using a similar approach. It was believed that a sustainable ratio would be well below 50% to address the country's vulnerabilities. In order to achieve this goal within the program's timeframe, given the ambitious non-oil primary balance trajectory and assuming aggressive debt restructuring scenarios, the IMF set the initial target at 55% for 2025 and a long-term target at 45% starting from 2030. These targets were in line with the objectives and timeline outlined in the 2020 Public Finances Bill *(Código Orgánico de Planificación de las Finanzas Públicas, COPLAFIP*, adopted before the restructuring) and were more ambitious than those set under a standard IMF Debt Sustainability Analysis framework.

The debt sustainability objectives provided a framework for negotiations with international bondholders, but the IMF program did not predetermine the outcome of the negotiations, nor did it set a minimum threshold of debt relief to be secured. The negotiation process focused on both (i) providing the country with short-term relief measures and (ii) ensuring the long-term debt sustainability of Ecuador's debt. The fact that the COPLAFIP targets were enshrined by the IMF gave creditors assurance on the successor EFF arrangement and resulting authorities' commitment to fiscal consolidation path and necessary reforms.

5. The sovereign debt restructuring process

Ecuador undertook one of the fastest sovereign debt restructuring processes in modern history.

The consideration of debt restructuring began in early March 2020. Prior to that, authorities had conducted a significant liability management exercise in September 2019, which postponed almost all international bond redemptions beyond 2022. They did not anticipate the severity of the health crisis or the drastic decline in oil prices that would coincide with it.

By mid-March, the country reached an agreement with the IMF to apply for the Rapid Financing Instrument (RFI), which was designed for unexpected external shocks. However, the authorities had to give assurances about the prospects of debt sustainability in order to receive this support from the Fund. While negotiating an extension of debt payments with Chinese partners, it became evident by the second week of March that a more comprehensive debt relief plan, including actions on bonds, was necessary due to the magnitude of the shock.

A dedicated team was set up at the Finance Ministry to deal with the debt issue. It included the Ministry's key departments but also a group of advisors, such as former senior policymakers, an international financial advisor, an international legal advisor, and a dealer manager. Strategic considerations related to the debt restructuring, detailed below, included: (i) honoring or not the debt payments due on the week after which included US$ 342m of debt service payments coming due on March 24th, as well as US$ 198m of three bond interest payments due on March 27th, (ii) dealing with the repo and asset-backed transactions, (iii) securing a standstill from the two outstanding syndicated loan facilities providers, (iv) restructuring the short-dated SOE's facility, which was held in majority by two of the country's largest bondholders, and (v) effectively securing debt relief from Chinese counterparts.

Fully defaulting on the upcoming bond payments would have been extremely costly as principal payments did not include any grace period in Ecuador's bond contracts. Therefore, defaulting on such payments would have immediately triggered cross-default clauses and resulted in substantial patrimonial losses. However, a 30-day grace period came with interest payments, leaving some room for the government to initiate discussions with the various stakeholders involved.

Despite mounting and heavy pressures from local constituencies who called for a specific containment strategy, the authorities took the decision, with the support from international players and MDBs, to proceed with the principal payment of US$ 325m while missing the interest payment due on March 27th, thus taking advantage of the grace period. As they communicated this to the market, they also announced the launch of a consent solicitation for payment deferral until August 15th in order to minimize the risks of cross defaults and acceleration and to focus on designing, negotiating, and implementing a full-fledged and adapted restructuring strategy.

While small in size (US$ 175m outstanding), the 3-year bond issued by Petroamazonas, a national oil company then dedicated to exploration and production activities, required special attention due to two major bondholders holding more than 50% of the total amount. The biggest one took the leadership of a creditors' group made up of the largest institutional investors interested in Emerging Markets which

total holdings in Ecuador exceeded 53% by the end of the process. Building trust with them was key. In this regard, it required to recognize the special and short-term nature of the Petroamazonas facility and agree very rapidly on restructuring terms that would (i) push repayment resumption to September 2020, (ii) limit monthly payments thereafter to US$ 20m, while (iii) ensuring to the noteholders that most of the reimbursements would be made before the next administration comes to power in May 2021. Those two market creditors, in turn, advocated for a vote in favor of the interest deferral within the majority creditor group.

The successful consent solicitation for an interest deferral until August was a turning point in establishing an orderly restructuring process. It gave a strong signal to the broader financial community that the process was making progress. It raised awareness among the country's other creditors that most bondholders supported Ecuador's initiative and provided reassurance to the IMF about the seriousness of the country's initiative and the good faith discussions. It also severely limited the scope for adversarial action by holdouts. The main remaining challenge at that time was a significant distance between the two officially announced bondholder groups. Whilst the group led by the largest bondholder showed unity, uniformity, and proactiveness, the second group, led by a Steering Committee composed of bondholders with smaller holdings and represented by two financial advisors, encountered difficulties in putting things in motion. These coordination difficulties hindered the process down the road.

By the third week of April, the board of the International Monetary Fund voted in favor of a Rapid Financing Instrument for Ecuador amounting to US$ 643m. The authorities also committed to re-engaging with the Fund in view of a successor program following the cancellation in May 2020 of the previous EFF arrangement approved by the IMF Executive Board in March 2019. The RFI allocation was also an opportunity for the publication by the IMF of an updated macroeconomic and fiscal outlook that served as an independent basis for discussions with creditors on debt sustainability.

By the time the government decided to sit at the table and negotiate the terms of the bond restructuring, it had already managed to build a track record of engaging with bondholders, signalling proactive involvement and control over the restructuring process. Throughout the preparatory phases, the authorities kept the bondholders' representatives informed of each step, thus involving them in the process.

6. The creditors' perspective

Ecuador's bondholders were divided into two groups. The first group consisted of institutional investors, who also happened to be the largest holders of Argentine debt. This group had already organized itself as a creditor committee in Argentina when the new administration came to power in December 2019. This group was quickly geared up to enter into the Ecuador discussions as they started. The second group, comprising a more diverse set of players also appeared in the discussion, but it took them longer to get organized.

Throughout the process, the main group expressed its willingness to act fast and to make concessions provided that the government sets the right precedent and shows the right commitment and proactiveness. The main explanation for such behavior is that bondholders who were expecting a wave of defaults wanted to set precedents that could be useful down the road.

On the other hand, Ecuador has benefited from its market-friendly image and has demonstrated a positive attitude and role throughout the process. Assurances of good faith and transparency were provided early on in the process with bondholders. The country and its creditors agreed constructively on some general principles, with a commitment to anchor the discussions on long-term sustainability.

The case of the group of holders of the 2024 instrument

One unique aspect of Ecuador's bonded debt is the 2024 instrument.[8] This series did not include the latest generation of collective action clauses, which were embedded in the contracts of subsequent bond issues. As such, to activate the aggregation clauses under the dual limb aggregation method that enables cram-down holdouts, higher thresholds were required for the 2024 bonds than for the rest of the bonded debt, and the single-limb aggregation method was not possible[9].

Some bondholders attempted to exploit these legal differences in the bond terms to extract additional premia by trying to reach a blocking position exceeding 25% of the total holdings of this specific bond series. The existence of this group was a source of concern to the authorities as the level of nuisance generated on a standalone series could pollute the whole process. This situation was similar to the one in Argentina, where the so-called "Exchange bondholders"[10] designed the same strategy. However, the Argentina Exchange bonds group had a stronger argument as the bonds they were representing were the result of a previous restructuring.

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[8] Which was the first to be issued when Ecuador came back to the market in 2014.

[9] Under the last generation collective action clauses (also called Enhanced Collective Action Clauses), the proposed amendments of key features ("reserved matters") of bonds is possible either (i) when the voting thresholds of 66 - 2/3% for the pool of eligible holders is reached and at least a 50% participation in each individual series of bonds (the so-called *dual limb* aggregation method) or (ii) when the voting threshold of 75% of the eligible holders is reached without series by series constraints (the so-called *single limb* aggregation method). This is a change to the second-generation collective action clauses which brought in a mechanism to aggregate across different bond series, allowing bondholders of one or more series to force bondholders in other series into new terms if voting thresholds are met in each series if the affected series are governed by the same indenture.

[10] The Argentina Exchange bondholders Group gathered the holders of the bonds issued in 2005 and 2010 as a result of the restructuring of pre-2005 defaulted bonds.

7. Sealing a sustainable debt restructuring deal

As stated above, **by the time Ecuador was ready to start discussions about broad restructuring terms, it had already formed strong alliances with key members of the group led by the largest bondholder.** Additionally, it had taken significant steps to demonstrate its commitment and determination to reach a deal that would be both fair to the creditors and sustainable for the Republic.

A few weeks prior to the negotiation sessions, the parties agreed to hold restricted discussions during which confidential content could be exchanged and prepared Non-Disclosure Agreements to this end. The difference in the pace of interactions to get to these confidential discussions is what created the lag between the two creditors groups. The "largest bondholder" group was in a position to react rapidly and to be on time for the discussions, whereas the second one spent a significant amount of time on internal coordination issues and only got things done by the time a deal was reached with the first group.

The Republic's initial offer was structured as an opening gambit. This means that it incorporated all the features that would provide the Republic with the necessary relief, but it left room for significant adjustments while still meeting the Republic's objectives. These features included a coupon relief over the next two years, incremental coupons thereafter with a cap at 5% over the long run, a significant grace period on principal payments up until 2026 and thereafter principal repayments not exceeding US$ 2bn a year, and maturity extension up until 2050 from an initial curve ending in 2030. Creditors' reaction to this first offer was a symmetrical move, putting on the table a counteroffer that reflected a significantly higher recovery value while embedding some significant room for adjustment.

The discussion tipping point was right after this first round of offers when both parties committed to converging towards an acceptable middle point. At this stage, however, the Ecuadorian authorities decided to adjust their position to match the effort that their constituencies could absorb. This move disappointed the creditors' committee and required significant effort to restore the level of trust that had been established.

By the time the two second-round offers were exchanged, both parties were within a 'deal space', namely a range of recovery value that made a deal feasible, acceptable to the local constituents in Ecuador, to the IMF in the framework of the successor program discussions and to the creditors. Parties responsibly cut the apple in half, resulting in the offer published in the framework of the agreement in principle on July 7th, 2020. Interestingly enough, the bond exchange was also contingent on having secured a Staff-Level agreement with the IMF by the agreed exchange date. Such a condition provided comfort to bondholders' concerns on commitments to fiscal adjustments.

Figure 2. Terms of the final restructuring offer of Ecuador's international bonds

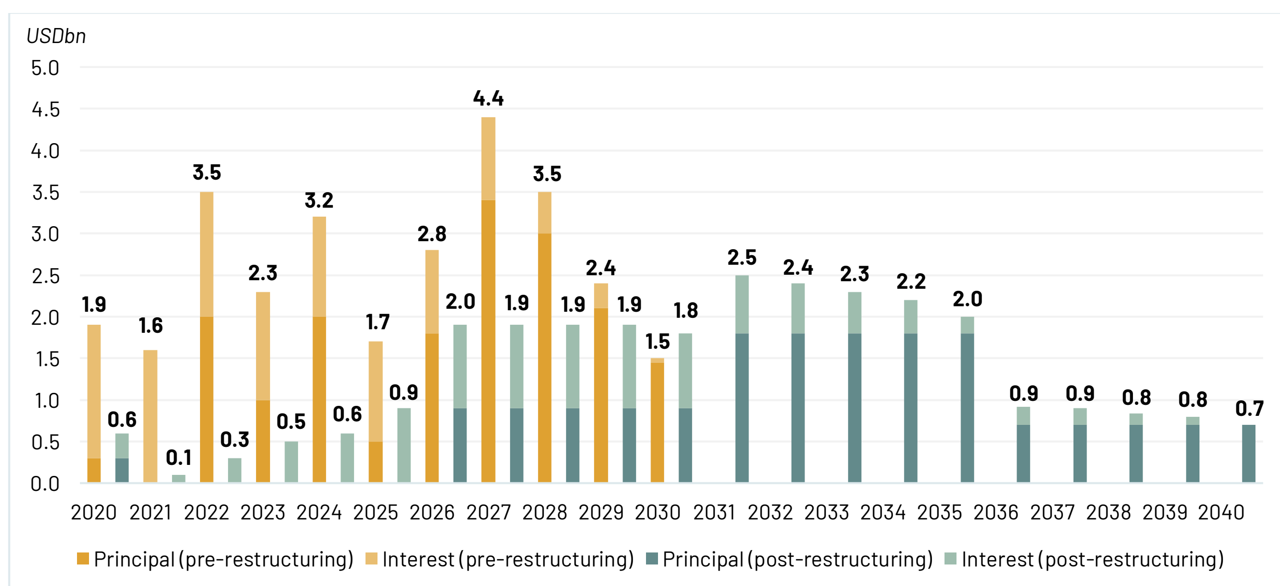
	Existing bonds' characteristics										New bonds' characteristics		
	Bond 1	Bond 2	Bond 3	Bond 4	Bond 5	Bond 6	Bond 7	Bond 8	Bond 9	Bond 10	New Bond 1	New Bond 2	New Bond 3
Maturity	2022	2023	2024	2025	2026	2027	2027	2028	2029	2030	2030	2035	2040
Capital repayment	2022	2023	2024	2025	2026	2027	2027	2028	2029	2030	(2026-2030)	(2031-2035)	(2036-2040)
Nominal amount (US$m)	2,000	1,000	2,000	600	1,750	1,000	2,500	3,000	2,125	1,400	3,768[2]	8,606[2]	3,460[2]
Interest rate[1]	10.750%	8.750%	7.950%	7.875%	9.650%	9.625%	8.875%	7.875%	10.750%	9.500%	2021: 0.50% 2022:5.00% 2023: 5.50% 2024: 6.00% 2025: 6.90% 2026-30: 6.90%	2021: 0.50% 2022:1.00% 2023: 2.50% 2024: 3.50% 2025: 5.50% 2026-30: 6.90%	2021-22: 0.50% 2023: 1.50% 2024: 2.50% 2025-26: 5.00% 2027: 5.50% 2028: 6.0% 2029: 6.50% 2030-40: 6.90%
Weighted average interest rate	10.750%	8.750%	7.950%	7.875%	9.650%	9.625%	8.875%	7.875%	10.750%	9.500%	5.53%	5.21%	5.26%

Source: Ministry of Economy and Finance of Ecuador

Notes: (1) No coupon payments in 2020, however coupons on the new bonds accrue at 0.5% starting from settlement date; (2) Maximum nominal amounts depending on exchange offer participation.

The final offer put Ecuador's debt on a sustainable trajectory and granted the Republic substantial debt service relief. It also provided the country with a 5-year timeframe to engage in fiscal consolidation efforts and structural reforms to boost higher growth prospects.

Figure 3. Ecuador debt service 2020-2040, before and after the restructuring



Source: Ministry of Economy and Finance of Ecuador

The terms of the final offer provided for a US$ 10.4bn debt service relief during the next 5 years with an additional US$ 5.9bn saved over 2025-30. The average interest rate was almost halved from 9.2% to 5.3%, while the weighted average tenor of bonded debt doubled from 6.1 years to 12.7 years. The new repayment profile allowed the limit of the yearly debt service of newly issued bonds to US$ 2.5bn over the next 20 years. These new terms put the debt on a sustainable trajectory under the framework agreed with the IMF, with the debt-to-GDP ratio expected to go down from c. 69% in 2020 to 55% in 2025 and 45% in 2030.

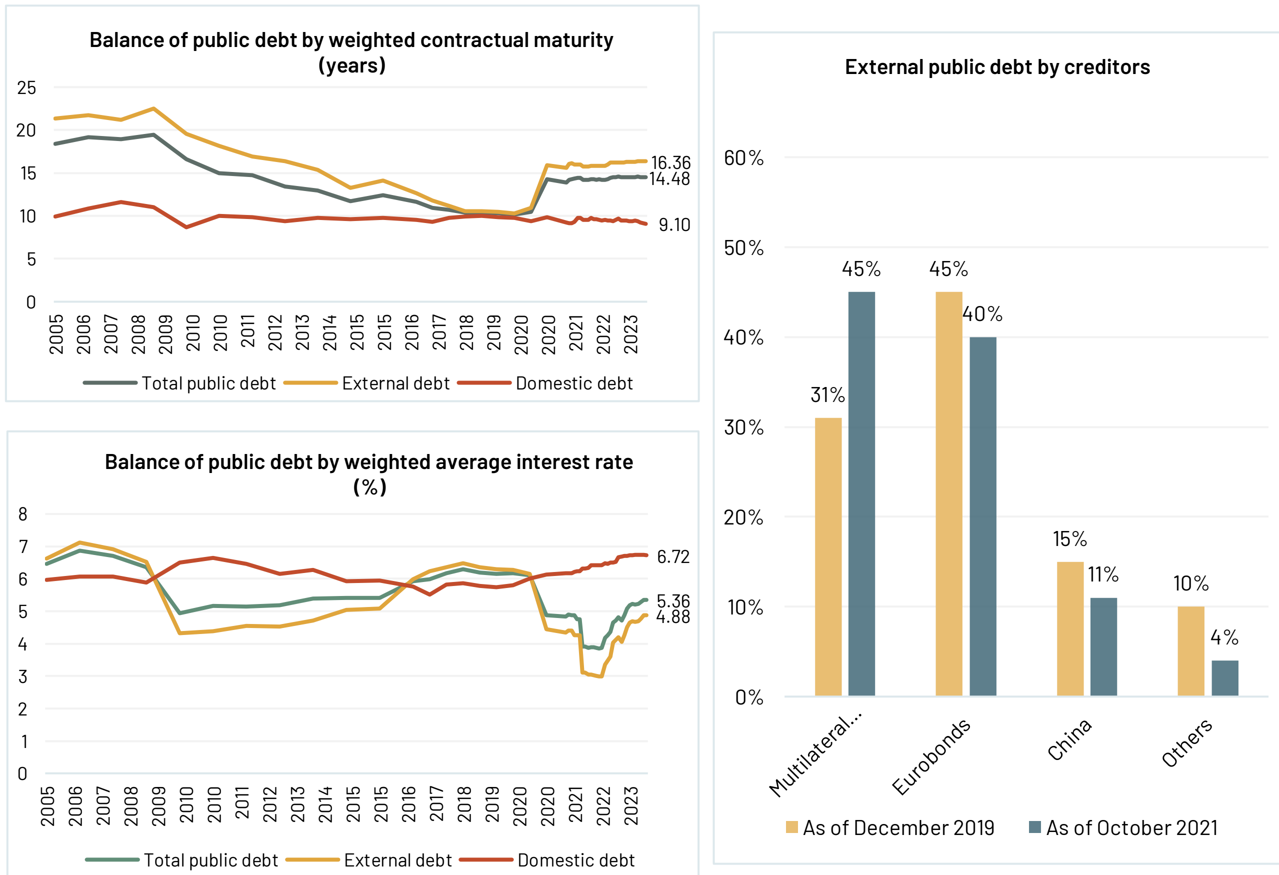
Figure 4. Summary of the main benefits of the final restructuring offer of international bonds of Ecuador

		Existing debt stock	New debt stock	
Bond duration		**6.1-years average** (amortizations between 2022 and 2030)	**12.7-years average** (amortizations between 2026 and 2040)	More sustainable debt profile
Nominal amount		US$ 17,375m	US$ 15,835m (8.9% nominal haircut)	
Interest rate		9.2% weighted average (with 10.75% as max. interest rate)	5.2% weighted average (with 6.90% as max. interest rate)	
Payment of US$ 1,087m of accrued interest between March 2020 and Settlement date[1]		Scheduled to have been paid between March and July 2020	Zero-Coupon PDI Bond payable between 2026 and 2030, applying a 14% nominal haircut	
Debt service over	2020-2024	US$ 12.0bn	US$ 1.5bn	Significant liquidity relief
	2025-2030	US$ 16.2bn	US$ 10.3bn	
	2031-2040	US$ 0.0bn	US$ 15.6bn	

Source: *Ministry of Economy and Finance of Ecuador, (1) 7 August 2020 as Settlement date, payment of accrued interest to consenting holders only.*

As a result of the debt renegotiation process, combined with domestic efforts, the composition of Ecuador's public debt evolved towards a larger share of debt with multilaterals, longer terms, and lower average interest rates.

Figure 5. An improved public debt composition and average costs



Source: *Ministry of Economy and Finance of Ecuador*

The strength of new generation CACs in enforcing a deal

Once the agreement in principle was reached with the majority of bondholders, **the Republic, along with its advisors, structured the official offer to exchange the old bonds into new ones in a way that maximized the incentive to participate in the offer.** Bondholders who were initially resistant to the deal and were brought in through the collective action clauses were only given the option of the longest maturity bond, with a recovery value approximately 20% lower than the average package for willing bondholders.

The exchange offer was launched under the second limb aggregation method, meaning that, as long as bondholders with more than 66 2/3% in aggregate holdings and 50% of each series accepted the deal, the deal would apply to all bondholders. Considering that the supportive group made it public that they held more than 50% or close to 50% of each outstanding series, the required take-up to reach the thresholds was relatively limited. This significantly increased the likelihood of success of the deal and hence triggered a snowball effect among creditors. As a result, the participation rate exceeding 93% and made this transaction the first overwhelmingly successful restructuring in the post COVID-19 era. In some series, votes even exceeded 98% to 98.5%, supporting the view of a good negotiation strategy and the effectiveness of the CACs.

Note that, while Ecuador would have been a relevant case for the use of value recovery instruments considering the economy's high reliance on oil, neither the main creditors nor the debtor expressed any interest in them. On the one hand, Real Money Players had a clear preference for pure fixed income instruments and had a clearly higher discount rate for such contingent instruments, hence making them less attractive. On the other hand, the government, who had been very much criticized on past oil pre-financing transactions, was reluctant to engage in any form of oil-attached instruments.

8. Reprofiling debt with Chinese banks

China's involvement in the 2020 debt deal was supposed to include a 3-year maturity extension along with financing assurances of US$2.4bn of new loans from China under the program years. While some smaller debt reprofiling operations were conducted over August and September 2020 to provide Ecuador with some liquidity relief prior to the start of the program, these financing assurances never materialized. **This is why, following the 2021 elections, Ecuador set the reprofiling of Chinese loans at the top of the economic agenda.** Discussions were opened regarding a further rescheduling of US$3.5bn worth of China Development Bank (CDB) and China Exim Bank liabilities which featured very short maturities.

The negotiations made progress because Ecuador had already completed the restructuring of its Eurobonds and had started a new IMF program with ambitious fiscal and monetary reforms. Additionally, there were improved political relations, reflecting increasing trade and foreign investment interests. Furthermore, there was a significant supply of Chinese COVID-19 vaccines during the height of the pandemic, which were secured during a high-level Presidential visit to China during the 2022 Beijing Winter Olympic Games.

The final agreement with China was announced in September 2022, and successfully reduced near-term refinancing needs by doubling maturities, reducing interest rates, and enhancing the oil sale conditions for prices and sales spot availability under parallel commercial agreements. Another important feature of the restructuring is that it was entirely publicly disclosed, addressing the growing demand for more transparency.

9. A successful debt restructuring must be followed by a comprehensive growth strategy

Overall, Ecuador's sovereign debt restructuring process was concluded at a relatively high speed and was successful in avoiding an open crisis, which would have been painful for both the country and market participants. Notably, financing from the IMF EFF was necessary to help Ecuador avoid a dire situation that could have challenged the dollarization regime or the country's financial stability.

In hindsight, it may be said that the unprecedented COVID-19 context influenced Ecuador's treatment. Indeed, the health crisis allowed for unusually frontloaded IMF support, which helped protect vulnerable groups, while the requested fiscal and structural reforms were backloaded. Despite some delays in implementation, such reforms were successful in strengthening the country.

In the years ahead, the country will continue to experience some liquidity tensions, which will have to be addressed by structurally enhancing economic growth, strengthening the government's financial buffers, and diversifying the sources of funding.

The international financial community needs to help the country strike the right balance between opening up the economy, implementing structural reforms, providing greater protection for the most vulnerable segments of the population through well-calibrated social programs and redistribution mechanisms, and equipping the government with tools to enhance its financial buffers. The government is taking the right steps in this direction with the recent adoption of a 3% VAT increase, which sent a strong signal to development partners and gave hope regarding the country's ability to preserve financial stability through political deals.

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