A Mature Approach:

Using a Unilateral or Voluntary Extension of Maturities to Restructure Italian Debt

Recommendations by:

Andrew Edelen
Paige Gentry
Jessalee Landfried
Theresa Monteleone

May 9, 2012

INTRODUCTION

Italy's sovereign debt problem is primarily a liquidity problem. In late 2011, interest rates on ten-year Italian bonds soared, peaking at above 7 percent. With a debt-to-GDP ratio over 120 percent, interest rates that high would quickly prove unsustainable. Commentators began predicting default, and certain economists called for an immediate restructuring of Italy's debt.[1]

Italy is not Greece. In normal times, Italy should be able to service its debt out of its budget surplus and gradually reduce its overall debt burden through responsible budgeting. But these are not normal times. The markets remain skittish about debt in the European periphery, the positive effects of the ECB's lending programs cannot last indefinitely, and Italian investors can hardly expect a lender of last resort to backstop Italian obligations should the specter of default become a reality.

This paper argues that any restructuring of Italy's debt should focus on shielding Italy from future liquidity crises before they happen, a measure of protection that can be achieved by means of a "soft" reprofiling of Italian bonds in the near term. We recommend that Italy use the threat of a unilateral reprofiling to make a voluntary exchange offer more attractive to creditors. In Part I, we analyze Italy's current debt stock and the characteristics of its current bondholders to demonstrate why a reprofiling of the debt is the best option for Italy.In Part II, we consider the authority for extending bond maturities under existing Italian law.Part III discusses the market and legal risks inherent in a unilateral reprofiling. Finally, Part IV argues that notwithstanding those risks, Italy can use the feasibility of a unilateral reprofiling as a credible threat to encourage in a voluntary restructuring of its outstanding debt.

---

[1] *See, e.g.*, Nouriel Roubini, Op-Ed., *Time to Act—Italy Must Restructure Its Debt*,FIN.TIMES, (Nov. 29, 2011) http://www.ft.com/intl/cms/s/0/459f80e0-19b8-11e1-ba5d-00144feabdc0.html.

I. THE CONTEXT: ITALIAN DEBT STORY

In the wake of the Greek restructuring, private sector investors turned their attention to Italy, its disappointing growth levels, and its 120 percent debt-to-GDP ratio. In a matter of months, the interest rate spreads above German bonds for 10-year Italian bonds rose from 200 basis points in to over 400 basis points by December 2011.

Prior to the crisis, however, few would have seriously doubted Italy's solvency. While its debt load is large, it has maintained and serviced a public sector debt in excess of 100 percent debt-to-GDP since 1992.[2]Moreover, Italy has consistently run a primary budget surplus over the past decade. It was only during the financial crisis in 2009 that it reported a deficit, but it subsequently balanced its budget in 2010.[3] In this respect, Italy's economy is structurally sounder than most European countries'. Italy also benefits from a relatively healthy private sector. Italian households are the wealthiest of the European economies, and their finances have remained relatively stable even through the financial crisis.[4] This private sector strength provides Italy with a cushion as it rebalances its public finances.

In response to the European debt crisis and to its own debt load, the Italian government has made a concerted effort to constrain its budget.[5] Those measures involve a 20 billion euro package of tax increases, pension changes, and spending cuts, as well as measures to liberalize

---

[2] With the exception of one year, 2003, when it dipped to 99.3 percent. See Carmen Reinhart and Kenneth Rogoff "Debt-to-GDP ratios," available at http://www.reinhartandrogoff.com/data/browse-by-topic/topics/9/

[3]http://cib.bnpparibas.com/01/MyDocuments/C1201_A1.pdf

[4]http://cib.bnpparibas.com/01/MyDocuments/C1201_A1.pdf

[5] "Monti Cabinet Agrees Itality Austerity Plans," Financial Times, December 5, 2011, available at http://www.ft.com/intl/cms/s/0/ef821ec4-1dc8-11e1-9fd4-00144feabdc0.html#axzz1u1bHtNt7

the labor market and encourage growth. These reforms as well as Italy's primary surplus should enable Italy to continue paying interest on its outstanding debt.

As promising as these reforms may be, the markets, recognizing that political will is often weak, remain skeptical of plans to reign in Italy's debt. With markets as sensitive as these, there is a substantial risk that as Italy's debts come due interest rates could once again soar. Inflated rates could quickly prove unsustainable, and the threat of default could become a self-fulfilling prophecy.

Italy needs time to demonstrate the effectiveness of its budgetary reforms and to allow its economy to start growing again. A restructuring plan should focus on buying that time. We recommend that Italy reprofile its debt by extending the maturities on the medium to long-term debt governed by Italian law. By extending the maturities, Italy can lock in lower interest rates, which will give it the stability it needs to weather shocks to the market and demonstrate its fiscal responsibility. Italy's debt stock is ideal for a reprofiling as a majority of its debt consists of instruments that can easily be changed and because Italian banks own a large percentage of the debt.

A.The Debt Stock

Italy's debt stock is ideal for a reprofiling—a majority of its bonds have low coupon rates, are governed by Italian law, and have no contract terms.This debt, therefore, provides a crucial opportunity for Italy: it is flexible because it easy to change and any change to the debt will reduce the Italian debt burden significantly.

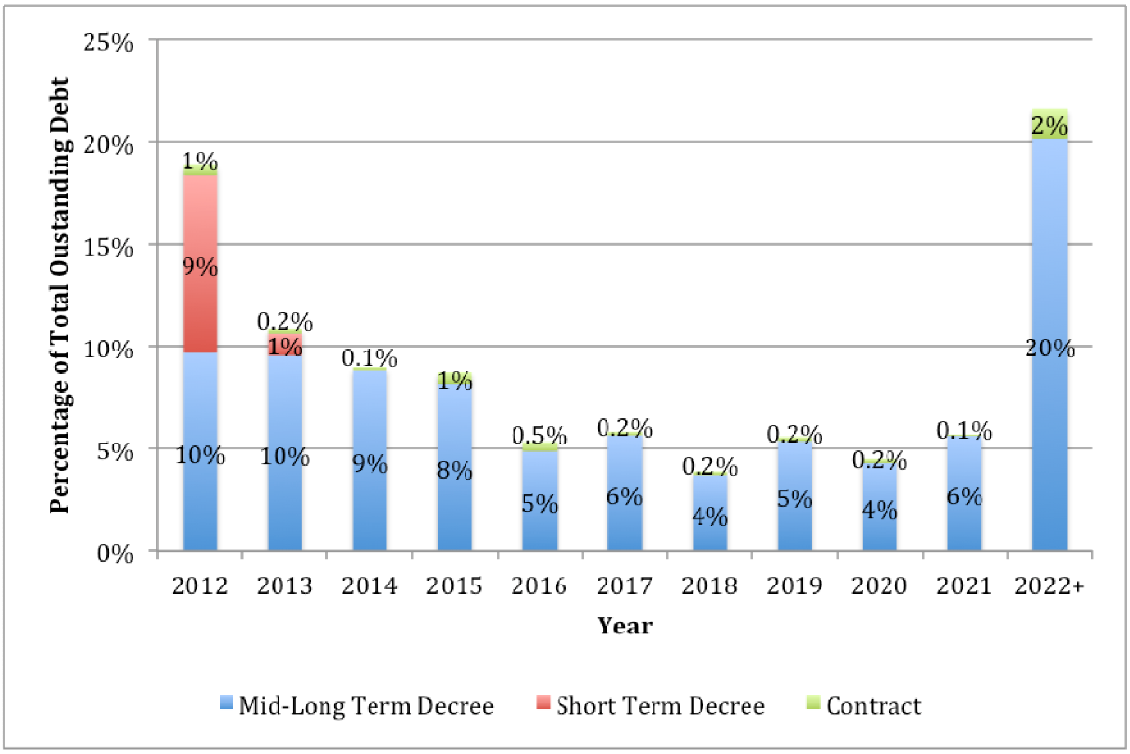
Italy has over €1.619 trillion in outstanding bonds.[6] The average maturity of the debt is 6.84 years.[7]Over 96 percent of the total debt is governed by Italian decree (hereinafter "decree bonds") and has no contract terms.[8]The remaining 4 percent of the debt has contract terms (hereinafter "contract bonds").[9]U.S. and English law govern 2 percent of the contract bonds.Italian law likely governs the remaining 2 percent of contract bonds.[10]

Approximately €1.3 trillion or 81 percent of Italy's outstanding bonds will mature after 2012.[11]Of this debt, €1.2 trillion or 76 percent are mid- to long-term decree bonds (see Chart 1).[12]

Chart 1: Percentage of Total Outstanding Debt Due by Bond Type and Year (as of February 29th, 2012)[13]

---

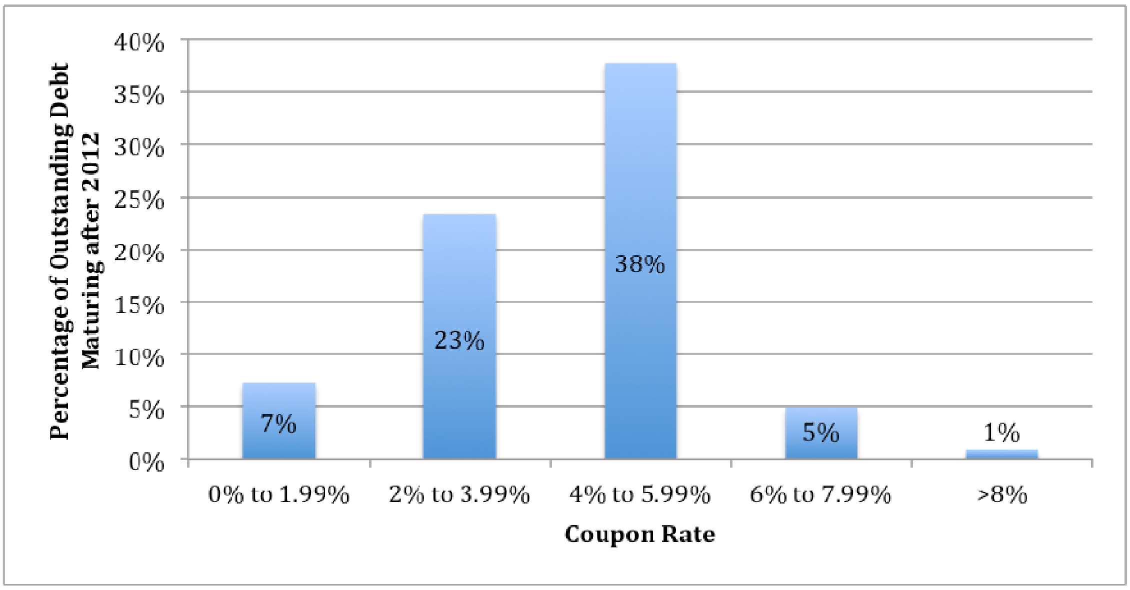
[6] Ministry of the Economy and Finance, *Public Debt:Outstanding [sic] Public Securities, Breakdown by Maturity*, Italian Department of the Treasury (February 29, 2012).Calculations are based only on bonds due after February 29th, 2012.
[7] *Id.* and authors' calculations.
[8] *Id.*
[9] *Id.*
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] *Id.*



Italy has been able to service its debts at a rate of 6 percent.[14] As we propose, Italy should extend the maturities on its mid- to long- term decree bonds that have coupon rates of less than 6 percent and mature after 2012. These bonds comprise€1.1 trillion, or 68 percent, of the total outstanding debt, creating a huge opportunity for Italy to lock in lower interest rates and extend maturities of existing debt (see Chart 2).

Chart 2:Decree Bonds Maturing after 2012—Coupon Rates as a Percentage of Outstanding Debt[15]

[14] *SeeItaly Govt Bonds 10 Year Gross Yield*, BLOOMBERG (May 4, 2012), http://www.bloomberg.com/quote/GBTPGR10:IND.
[15] The remaining 26 percent of the outstanding bonds are in either short-term decree bonds or contract bonds.*See* Ministry of the Economy and Finance Calculations, *supra* note 6; calculations by authors.



To put this into perspective, over 83 percent of the bonds that will come due from 2013 to2015 are mid- to long-term decree bonds with coupon rates of less than 6 percent.This comprises 24 percent of the total outstanding debt.This distribution of maturities and the prevalence of low coupon bonds give Italy a great opportunity to lock in lower rates by extending the maturities on its existing debt.

B. The Bondholders

Italian investors currently hold over 50 percent of Italy's sovereign debt and this number only appears to be growing.As of June 2011, Italians owned over 53.8 percent of the outstanding debt. Of this figure, 14.3 percent was owned by Italian households, 12.6 percent by Italian banks, 9.7 percent by Italian insurance companies, 8.2 percent by other Italian holders, which include the Bank of Italy, pension funds, and other investors, 5.2 percent by foreign funds that are attributed to Italian savers, and 3.8 percentby Italian funds.[16] Foreign holders own the remaining 46.2 percent.

[16]BANK OF ITALY, FINANCIAL STABILITY REPORT 57 (Nov. 2011).

There are indications that the percentage of debt owned by Italian residents has increased significantly since these figures were reported. From 2010 to 2011, Italian financial institutions' holdings of Italian government securities increased from 30.7 percent to 32.2 percent of total government debt.[17] And the Italian government has not issued any foreign law bonds since 2010, likely due to a diminished international appetite for Italian debt.A restructuring plan should seek to minimize the negative impact on Italian investors because a severe restructuring will directly impact the liquidity of Italy's banks and residents.

C. Accounting for Debt

Extending the maturities of Italian debt, as opposed to inflicting a haircut on the outstanding bonds, will minimize the negative impact of a restructuring on Italian and European banks.According to the 2011 EU stress tests, approximately 34 percent of the Italian debt held by domestic banks was accounted for on their banking books, whereas 66 percent was held in the banks' trading accounts.[18] In the months since that report, however, those numbers have probably changed dramatically. As the sovereign debt crises accelerated over the course of 2011, financial institutions began moving large amounts of their sovereign debt holdings out of their trading accounts and onto the banking books. This was in large part driven by the ECB's lending programs, which allowed banks to post sovereign bonds as collateral for loans.

Bonds held on banking books are classified as "hold-to-maturity" and are not marked to market.Therefore, while extending maturities would cause a drop in the bonds' market value, that reduction would not necessarily be reflected on banks' hold-to-maturity books.In the event

---

[17] BANK OF ITALY, *General Government Debt: By Holding Sector* 10 in SUPPLEMENTS TO THE STATISTICAL BULLETIN(Mar. 2012).
[18] Tracy Alloway, *Mark to Market*, FT ALPHAVILLE BLOG (July 26, 2011, 9:16 AM), http://ftalphaville.ft.com/blog/tag/mark-to-market/

of a unilateral restructuring, however, accounting rules would require banks holding the bonds to record an impairment charge, and banks' balance sheets would take a hit.That hit, however, would not necessarily be large. According to analysts at JPMorgan, bonds originally marked as hold-to-maturity need not suffer a loss in such a scenario because impairment charges are calculated by reference to the effective interest rate of the original bond, not the prevailing interest rate at the time of the restructuring:

> If the coupon is maintained, but the maturity is extended, and the probability of receipt remains unchanged (or is improved), this calculation can result in a present value that is identical (or very similar) to the last reported amortized cost. In such a case the impairment charge would be zero (or very small).[19]

It is important to note, however, that reclassified bonds may not benefit from the same calculation.

This is not to say that the banking sector would be entirely unaffected by a reprofiling of Italian bonds. Rather, it suggests that, because banks classify many Italian bonds as hold-to-maturity assets, Italy may be more likely to win widespread support for a voluntary reprofiling of bonds if the outstanding principal remained intact. While explicit threats to reprofile outstanding bonds would likely have an immediate, negative impact on the spreads of Italian bonds and, therefore, the value of those bonds as accounted for on banks' trading books, a restructuring targeting banking-book bonds could avoid having that effect.

II. EXTENDING MATURITIES UNDER EXISTING AUTHORITY

[19] See Tracy Alloway, *To Avoid Greek Restructuring Losses – An Accounting Loophole*, FT ALPHAVILLE BLOG (May 10, 2011, 10:52 AM)http://ftalphaville.ft.com/blog/2011/05/10/564496/to-avoid-greek-restructuring-losses-an-accounting-loophole-for-banks/

Approximately 96 percent of Italy's total debt is in decree bonds.These bonds are governed by local law and contain few, if any, contract provisions, which gives the Italian government flexibility in the event of a restructuring. The flexibility offered by Italy's decree bonds is demonstrated by the example of Greece's recent debt restructuring. In Greece, a large percentage of the debt was similarly governed by local law and contained few provisions. The combination of these two factors allowed the Greek government to restructure the bonds by passing a law that retroactively added Collective Action Clauses (CACs) to all of its outstanding local-law debt.[20]The insertion of CACs allowed the Greek government to coerce most bondholders into voluntarilytaking a deep haircut and force holdouts to participate in the deal. If Greece's bonds had not been issued under local law or had contained now-standard bondholder protections, this retroactive insertion would not have been possible.

Even if Italy does need to restructure its debt, it may not be wise to follow the Greek example of forcing creditors to take large haircuts. In Italy more of the more of the debt is in domestic hands, particularly in the banking sector. And the percentage owned domestically is only increasing. Any haircut, therefore, would counterproductively harm the local economy and potentially necessitate a bailout of the Italian banks.

Given that Italy's current challenge is one of liquidity rather than a fundamental inability to pay its debt, and that a very large percentage of low-interest debt is maturing in the next few years, reprofiling existing debt by extending the maturities would benefit Italy in two ways.First, an extension of maturities would prevent a liquidity crisis by locking in lower interest

[20]NeelabhChaturvedi& Katy Burne, *The Mechanics of the Big Greek Debt Swap*, WALL ST. J. THE EURO CRISIS BLOG (Feb. 28, 2012, 11:37 AM),http://blogs.wsj.com/eurocrisis/2012/02/28/the-mechanics-of-the-big-greek-debt-swap/.

rates.Second, the maturity extension would prevent a banking crisis by protecting the domestic banks' balance sheets.

Under the highly flexible decree bonds, Italy could simply follow Greece's example and pass a new law specifically mandating the extension of maturities. But Greece's move to change the bonds through legislation produced political problems because many parties viewed it as illegitimate. Moreover, Italy is not yet in the dire straits that Greece was in, which makes any legislative change to the bonds appear even less justifiable. Italy, however, does not need to pass a new law to reprofile its debt because existing law governing theItalian decree bonds seems to give the Ministry of Economy and Finance the authority to restructure the bonds as is necessary, including the ability to extend maturities.

A Consolidated Act regulating public debt governs Italy's decree bonds.[21]To demonstrate that this Act gives the Italian government the authority to restructure the bonds, we will lay out the relevant provisions of the Act and then describe how they should be read in concert.

Article 3, the provision of the Act that appears to delegate authority to the Ministry of Economy and Finance in order to do what it must in order to effect a restructuring, says,

> In each financial year, the Ministry has the authority, within the annual limits established by the budgetary law, to issue framework decrees that allow the Treasury to . . . proceed, in order to restructure the national and external public debt, to the reimbursement before maturity of bonds, *to the transformation of maturities* . . . .[22]

Article 8 adds, "The payments of public debt are not reduced, *paid late* or subject to any special levy, not even in case of public necessity."[23]When read together, these provisions seem to allow Italy to extend the decree bonds' maturities without passing new legislation or regulations that

---

[21] Decree of the President of the Republic of December 30, 2003, no. 398 (published in the Official Gazette of 9/3/2004, Supplementoordinario no. 37).
[22] *Id.* at Art.3(1)(c) (emphasis added).
[23] *Id.* at Art.8(2)(emphasis added).

would apply to the bonds retroactively.

Article 3(1)(c) gives the Ministry the authority to reimburse bonds before maturity, and to transform the maturities of its debt. By listing early payment and "transformation of maturities" as separate options, Article 3 indicates that an acceptable "transformation of maturities" would include an extension.If a court were to read Italy's laws governing these bonds as "contract terms," Italy has a strong argument that extending maturities is within the terms of its contract with investors.It can defend against a takings claim by arguing that extending the maturity date on the bonds simply does not constitute a taking because the government had always preserved its authority to take this action in the case a restructuring became necessary.

Given that Article 3 sanctions a maturity extension, the prohibition in Article 8 against late payment only makes sense if it excludes maturity extensions. If the Ministry extended the maturity of a bond as permitted by Article 3, it would not make sense for the sovereign to be considered as a chronically late payer based on the previous payment schedule. Rather, the maturity extension changes the payment schedule, and the sovereign's payments are deemed on time when they are paid according to this new payment schedule.

This interpretation of Articles 3 and 8 is certainly not immune from challenge. But Article 81 of the Consolidated Act places the exclusive jurisdiction for claims regarding these bonds in Italian administrative courts:

> Regarding controversies between the State and its creditors concerning the interpretation of contracts pertaining to Government bonds or the laws relative to them, or in any case, regarding public debt, it is the lower-Court of the regional administrative tribunal that *provides exclusive jurisdiction*, and the Council of State on appeal.[24]

Italy is likely to succeed in claims of breach of contract or expropriation in its own courts.And, because Italy has not waived sovereignty, as is customary in many sovereign debt contracts,

[24] *Id.* at Art.81 (emphasis added).

international courts,where foreign investors may be able to bring claims, are likely to respect this jurisdictional choice.

III.RISKS OF A UNILATERAL REPROFILING

As discussed above, Italy could pursue this reprofiling unilaterally, or it could use the possibility of maturity extensions as a credible threat to induce participation in a voluntary exchange. This section outlines the significant risks that a unilateral reprofiling carries.

A.Legal Challenges

Although Italian law gives Italian administrative courts exclusive jurisdiction over disputes arising from the decree bonds, Italy may still face legal challenges if it pursued a unilateral extension of maturities.First, as a member of the European Union, Italy is also subject to the laws of the European Union.Italy may be forced to defend against a claim of invalid expropriation either in the Court of Justice of the European Union or the European Court of Human Rights.Second, Italy is a party to a number of bilateral investment treaties, which may subject it to arbitration before the International Centre for Settlement of Investment Disputes.

B. Cross-Default Provisions

Another risk of a unilateral reprofiling is the possibility that the cross-default provisions contained in Italy's outstanding contract bonds would be triggered. If these provisions were triggered, Italy would likely need to borrow money—at higher rates, after the reprofiling—in order to pay the interest and principal that would be due immediately on these bonds.

The risk of cross-default for the bonds governed by New York law seems slim. Although extension of maturities may be considered an “event of default” under the terms of these bonds, the cross-default provision is only triggered if the bondholders in the relevant series (in this case, the holders of the decree bonds) accelerate the payment of principal and interest. The decree bonds, which do not contain any provisions, do not have a process for acceleration. Therefore, it is unlikely that the cross-default provisions on the New York law bonds would be triggered, unless a court were willing to hold that decree bondholders have an implicit right to accelerate their bonds or that acceleration is only required for cross-default when the relevant series of bonds contains provisions allowing for acceleration.

However, the cross-default provision contained in the bonds governed by Italian law appears to present a greater risk of being triggered if Italy were to unilaterally extend the maturities of the decree bonds. Failure to make principal or interest payments on any “external indebtedness” defined as “moneys borrowed by the Issuer on the international market,” is considered an “event of default.”And, unlike the bonds governed by New York law, there is no requirement that holders of the defaulted bonds accelerate in order for holders of these contract bonds to be accelerate their bonds.Italy would have to argue that once the maturities were extended failure to pay the principal on the original maturity date does not constitute a late payment.This argument may work in an Italian court, but it is not clear that it would hold up were the issue brought before the European Court of Justice or the European Court of Human Rights.

Italy could avoid potential problems with cross-default provisions on the contract bonds by repurchasing the contract bonds on the open market.It would likely need to issue more short-term decree debt to do so.

C.Credit Default Swaps

Extending maturities on outstanding debt will likely trigger Credit Default Swaps (CDSs), which are essentially forms of insurance sold against the sovereign's potential default. As of this writing, there are approximately €342.6 billion in CDSs written on Italian bonds in gross, and about €20 billion net.[25]

It is not entirely clear, however, that triggering the CDS contracts should be among Italy's primary concerns.European parties involved in protracted Greek restructuring deal were very concerned with avoiding triggering the CDS contracts.[26]Italy, however, should not be so worried about whether or not its actions constitute a triggering event.Although it is near impossible to determine whom the net purchasers and sellers of CDS protection on Italian debt were, it is likely that Italian banks were net *purchasers*. For a party concerned about hedging against the risk of sovereign default, it would not make sense to purchase protection from the institutions most likely to be in trouble if the Italian government could not pay its debts. And if Italian banks are net purchasers, Italy might actually prefer a plan that triggers the CDS contracts so that its banks need not suffer a net present value loss without compensation.

Even if it made sense for the Italian government to seek to avoid triggering the CDS contracts, it would still be very difficult to do so in any restructuring with elements of coercion in it. The CDS contracts terms dictate that they will be triggered by credit events, which include both repudiation and—more likely in Italy's case—restructuring. "Restructuring" is defined to

---

[25]TOP TEN CDS POSITIONS, ISDA CDS MARKETPLACE,http://www.isdacdsmarketplace.com/exposures_and_activity/top_10_cds_positions (last visited May 7, 2012).
[26]David Oakley & Tracy Alloway, *Bankers Fear Political Moves Will Kill Off CDS*, FIN.TIMES (Oct. 25, 2011), http://www.ft.com/intl/cms/s/0/dccc8d98-ff03-11e0-9b2f-00144feabdc0.html#axzz1tk6XlfWC.

include reductions in interest or principal, postponement of due dates, preferential treatment, and using an unpermitted currency for payment.[27] After the International Swaps and Derivatives Association (ISDA) determined that Greece's use of CACs to bind holdouts in its debt exchange did constitute a restructuring and therefore triggered CDSs,[28] it is likely that any attempt by Italy to alter bond terms in any forceful manner will also be considered a triggering credit event for the purpose of the CDSs.

Italy can avoid triggering the CDS contracts through a truly voluntary exchange.To be truly voluntary, Italy must be careful to avoid the appearance of coercion in its exchange. Exchanges that are 'voluntary' in name but that essentially leave bondholders no other option but to participate can still trigger CDSs.

D.Ratings Downgrade and ECB Collateral

The ECB temporarily suspended its acceptance of Greek bonds as collateral for loans when Greece's debt was downgraded as a result of the initiation of its private sector exchange offer.[29] Italy would likely face a similar downgrade and potentially a similar suspension following a unilateral extension of maturities, and such a suspension could create serious liquidity problems for Italian banks holding a lot of Italian debt.But the ECB may be hesitant to create this type of problem for the Italian financial system, considering the size of the Italian economy.

---

[27]ISDA, 2003 ISDA CREDIT DEFINITIONS, Art.IV, § 4.7.

[28] News Release, ISDA, ISDA EMEA Determinations Committee: Restructuring Credit Event Has Occurred with Respect to The Hellenic Republic (Mar. 9, 2012), http://www2.isda.org/news/isda-emea-determinations-committee-restructuring-credit-event-has-occurred-with-respect-to-the-hellenic-republic.

[29] Press Release, European Central Bank, Eligibility of Greek Bonds Used as Collateral in Eurosystem Monetary Policy Operations (Feb. 28, 2012), http://www.ecb.int/press/pr/date/2012/html/pr120228.en.html.

IV. A LESS RISKY ALTERNATIVE: A VOLUNTARY EXCHANGE IN THE SHADOW OF A UNILATERAL REPROFILING

Because a unilateral extension of maturities on existing debt carries significant risks, Italy should consider a voluntary exchange offer to protect itself from the liquidity crisis that would result from a drastic change in interest rates. Current investors might be loath to accept a voluntary exchange involving any haircut now when Italy's borrowing rates are still perceived as manageable. Nevertheless, with the Eurozone sliding into recession,[30] Italy may be able to persuade creditors that an extension of maturities, which would shelter Italy from sharp changes in interest rates, would be in creditors' best interest.

A voluntary exchange may be successful for two main reasons.First, the concentration of Italian debt in the hands of Italian banks may facilitate greater acceptance of the terms of a voluntary exchange offer that involves only an extension of maturities.Second, Italy can provide negative and positive incentives to persuade its creditors to take a voluntary exchange offer because the bonds creditors currently own are extremely vulnerable to an involuntary restructuring.

Although the large amount of Italian debt held by domestic banks would be problematic if Italy sought a reduction in the principle of its outstanding debt, this concentration may be beneficial if Italy pursues a voluntary extension of maturities. Not only does concentration of bondholders result in easier creditor coordination, but the Italian banks may also be more subject to moral suasion in a voluntary exchange. Italian banks have a special stake in the continued viability of the Italian economy. Moreover, these many of these banks benefit from their close relationship with the Italian government through their role as specialists in the issuance of

[30] Alex Brittain, *Euro-Zone Data Cement Recession Fears*, WALL ST. J. (Apr. 4, 2012), http://online.wsj.com/article/SB10001424052702303299604577323033542536646.html.

government debt.

Italian banks' concerns about their own capital requirements would likely be outweighed by the incentives for accepting a voluntary exchange.A voluntary extension of maturities would not hurt their balance sheets to the same extent as a haircut to principal would.And if the exchange is completed while interest rates are manageable, it doesn't represent as much of a sacrifice.Moreover, because so many of the banks have shifted the bonds onto their banking books, where only the face value of the bonds are reported, more banks are likely to prefer a maturity extension to a haircut.

Italy can credibly suggest that failure of a voluntary exchange offer may force it to take unilateral action later. As discussed above, current Italian law may permit the Ministry to unilaterally extend the maturities on its outstanding debt. Although there are significant risks to this strategy, Italy could use it if it became absolutely necessary.Creditors could be persuaded, therefore, that it would be better for them to participate in an earlier, less painful voluntary extension rather than being involuntarily subjected to something more drastic later on.

Italy can also sweeten the deal by offering creditors better bonds than they currently own. As discussed above, the majority of the outstanding Italian bonds are issued by decree, governed by local law, and contain no contract terms. As such, they are vulnerable to the sort of involuntary restructuring that could be accomplished by a change of law. In light of the recent restructuring in Greece, investors should perceive a plausible threat that Italy would use similar means to achieve a harsh haircut. Investors might be willing to accept an extension of maturities as protection from an involuntary restructuring. Therefore, those who participate in a voluntary exchange should receive bonds governed by foreign law. Receiving new bonds governed by New York or English law would essentially act as a guarantee that those who participate in the voluntary exchange will not be subject to a harsher, Greek-style restructuring in the future.

Investors may also respond positively to the inclusion of *pari passu* and negative pledge clauses, which are intended to protect investors from being treated worse than other creditors in the event of an involuntary restructuring. The potential downside of including those clauses, namely potential holdout litigation in subsequent restructurings, would be offset by the inclusion of collective action clauses following the model adopted by the European Union's Economic and Financial Committee. As CACs are increasingly considered common market practice, their inclusion should not increase the cost of Italy's borrowing much if at all.

Of course, a voluntary exchange that provides investors with the protection of foreign law and new contract terms will come at a cost for Italy, which will be relinquishing the possibility of a future Greek-style restructuring. For this reason, it is critical that Italy design avoluntary reprofiling so that it is unlikely to need a significant debt reduction later. Despite the obstacles, Italy will benefit in the long term by restructuring its debt early, rather than by fits and starts.[31]

CONCLUSION

Italy has a liquidity problem, but it also has the tools to address the problem.A majority of the Italy's debt is held in medium- to long-term securities that are governed under Italian law, contain no contract terms, and have low interest rates.Extending the maturities on these bonds will enable Italy to ride out shocks to the economy and prove to the world that its fiscal reforms will work.While Italian law already seems to allow Italy to unilaterally extend the maturities on its debt, this is likely a riskier strategy than necessary.Italy should use the threat of a unilateral restructuring to encourage a voluntary exchange for bonds foreign-law bonds with longer

[31] *See generally,* CARMEN M. REINHART & KENNETH ROGOFF, THIS TIME IS DIFFERENT (2009).

maturitiesand additional contract provisions.This exchange would allow Italy to address its liquidity problem while minimizing the impact of the reprofiling on its banks,which own a large percentage of the outstanding debt—a mature strategy, if there is any.