Think 20 Turkey

Keys For the Adoption of an Effective Regime on Sovereign Debt Restructurings[1]

Sovereign debt restructuring mechanisms are critical elements in the international financial system and contribute to the prevention and management of sovereign debt crisis (before and after the default events). These processes constitute an essential tool to ensure the sustainability of debts, a necessary condition –at the same time- to safeguard and sustain economic growth.

However, the lack of an appropriate multilateral legal framework, allowing the utilization of a predictable and rapid mechanism to guide the restructuring of sovereign debt generates the proliferation of incentives that dramatically increase costs both for debtors and "good faith" creditors. Among them, Krueger (2002) lists the following [2] :

- A sovereign state could be pushed to delay seeking a restructuring, draining its reserves, and leaving the debtor and the majority of its creditors worse off.
- The absence of a mechanism for majority voting could complicate the process of working out an equitable debt restructuring that returns the country to sustainability.
- The risk that some creditors will be able to hold out for a lower cut, or full payment, may prolong the negotiations, and eventually inhibit an agreement.
- The absence of a predictable process creates additional uncertainty about recovery value, negatively impacting on balance sheets.

[1] This policy paper stems from the joint work of the Think 20 Turkey Sovereign Debt Restructuring Working Group that includes Manuel Montes (The South Centre) and Guillermo Wierzba (CEFID-AR), and represents the views of these authors. Think 20 (T20) Turkey is chaired by the Economic Policy Research Foundation of Turkey (TEPAV). For more information about T20 Turkey and its work, please see http://www.t20turkey.org.

[2] Krueger, Anne (2002) "A New Approach to SovereignDebtRestructuring". IMF.

The recent experience of Argentina demonstrates that it is possible for "vulture funds" to get rulings in excess of the legal and contractual framework, encroaching on the rights to collect of third party "good faith" creditors. These developments were not foreseen by the international financial system actors and have identified the urgency of establishing a stable and definitive framework for sovereign debt restructurings.[3]

It must be highlighted that Heavily Indebted Poor Countries (HIPCs) and Multilateral Debt Relief Initiative (MDRI) countries have been victims of the kind of litigation Argentina has endured. The IMF (2014) reports on 18 cases in which damages have been awarded [4]. It is not clear how other cases were settled in lieu of court resolution. The litigation provoked on HIPC and MDRI is the best proof that the market-based approach is not adequate. The UK government when compelled to amend its laws, responded in a statutory way, to the series of debt restructuring stimulated legal actions by commercial creditors.

Over the past three decades, the changes that took place in global finance, combined with the political, institutional and legal reforms that have accompanied this process, consolidated a set of new challenges for sovereign debt restructuring processes.

In the debt crises of the early 80s, the eventual introduction of the Brady Plan led to a fragmentation of lenders. From that moment, renegotiations became more complex, going beyond a group of syndicated banks, and with bond holders characterized by their anonymity and scattered across the globe.

In turn, this process was accompanied with legal changes which eliminated the doctrine of law which endowed the states of full immunity, and replaced it with the restrictive doctrine that distinguishes state activities between those sovereign acts subject to the immunity right, and those of private character deprived from that right. Under this new regime, the core countries adopted increasingly restrictive rules that involved deliberately vague definitions and led to the proliferation of legal disputes. The reformulation of the Champerty principle (which previously specifically prohibited the acquisition of bonds with the mere purpose of litigating) in the State of New York (NY), facilitated the "vulture funds" strategy in that jurisdiction [5] [6].

[3] South Centre (2015) "The battle to curb vulture funds" South Bulletin. February 2015

[4] IMF (2014) "Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI) – Statistical Update", International Monetary Fund (IMF), Washington DC, December 2014

[5] Kupelian, R. y Rivas, S. (2014) "Vulture Funds. The trial against Argentina and the difficulty they represent in the global economy, "Working Paper No. 49 of CEFID-AR.

[6] When the vulture fund, Elliott Associates L.P., litigated against Peru in 1999, the second circuit of NY, in a sentence that created jurisprudence, arbitrarily determined the non-pertinence of the Champerty doctrine. Later, the legislation was modified in 2004 limiting its scope only to minor debts.

At the same time, reforms occurred in the debtor countries, which all owed to legally cede sovereignty to foreign courts. In consequence, waiver clauses in relation to sovereign immunity were included in bond contracts, establishing the primacy of foreign jurisdictions.

The other novel element has to do with the development of sovereign credit default swaps (SCDS). These new instruments create a hedge against the risk of sovereign default and do not require that holders own the insured bonds to acquire them (except in the European Union). This creates incentives for a group of the debt holders to block the restructuring processes, in order to force a default event [7].

Even though there is a general consensus about the negative effects caused by the delay in the restructuring of sovereign debt, marked differences are observed, regarding proposals to moderate its impact on the global economy. There are two main paradigms. On one side, there is one school with the position that the improvement in the elaboration of issuing prospectuses is sufficient to overcome the problem and; on the other, the position recognizing the need for a statutory change allowing the adoption of a set of rules that must be applicable to all involved jurisdictions and parties. In the context of this second paradigm, The United Nations General Assembly (UNGA), in its September 2014 resolution decided to advance towards the creation of a multilateral legal system. Such would be a sphere where the forms in which decisions are taken assume a democratic representation of sovereign nations, which contrasts with the strong bias in favour of the interests of developed countries observed in multilateral financial institutions. In this context, this paper seeks to identify some issues that we consider relevant for the elaboration of a specific proposal for regulation and operation [8].

Statutory modification. As pointed out by many economists of diverse schools of thought (Krueger, Akyuz, Stiglitz, Guzman, Lombardi, Ocampo, Montes, Ugarteche, Li and others) [9] [10], the improvement in debt contracts provisions (Collective action clauses -CACs-, more precisely in the *pari passu* approach and others) does not fully resolve the problem,. The experience of Argentina in US courts is *prima facie* the most recent evidence of this reality and of the fact that the existence of a statutory mechanism is necessary to make the voluntary, market-based mechanisms effective and immune from self-interested behavior of parties with profitable opportunities from the failure of debt restructuring. Among the problems identified, are the enormous amount of overhanging sovereign bonds without the improved clauses,

[7] Stiglitz, J.; Guzman, M.; Lombardi, D.; Ocampo, J. y Svejnar, J. (2014) "Frameworks for sovereign debt restructuring" Conference Report, Columbia University, New York, November 17, 2014.

[8] UN, 2014, "Towards the establishment of a multilateral judicial framework for the sovereign debt restructuring processes". September, 2014.

[9] Brooks, S.; Guzman, M.; Lombardi, D. y Stiglitz, J. (2015) "Identifying and resolving inter -creditor and debtor -creditor equity issues in sovereign debt restructuring" CIGI Policy brief N°53.

[10] Ugarteche, O. y Acosta, A. (2012) "Los problemas de la economía global y el tribunal internacional de arbitraje de deuda soberana" at http://polis.revues.org/5393

competition for attracting capital in situations of external constraint, the problems of "interpretation" in different jurisdictions and the adoption of a blocking position through the acquisition of a of small amount of bonds by specialized litigators [11]. Therefore, the establishment of a statutory mechanism that ensures a set of conditions that should be respected by all countries subscribing the agreement (and, therefore, their national jurisdictions), would be necessary even for such clauses to be effective and to protect the interests of good faith creditors. Such agreement should guarantee the impossibility of a minority of bondholders blocking the restructuring process. At the same time, it would be appropriate to have liquidity protecting mechanisms, as in the case of domestic bankruptcies, and the suspension of court filings to facilitate such process. Finally, the entire stock of debt issued should be considered as eligible for restructuring [12].

Regulation of SCDSs. In recent years, the utilization of this hedging instrument for speculation purposes (hiring an insurance contract without holding the principal) has been growing. This has enabled, as indicated by Stiglitz et al (2015), the emergence of divergent interests among creditors since some of them could expect to obstruct the restructuring with the aim of inducing the default which triggers the payment of the insurances. Moreover, as they are over-the-counter (OTC) transactions, they are not recorded, adding opacity to the restructuring process. Speculative (naked) positions should be banned worldwide, as they have been in the Eurozone and the sellers and buyers SCDS positions should be known by the regulatory agencies.

The restructuring mechanism should be set up at the request of sovereign states. Krueger (2002) proposed that the IMF be the institution determining the debt sustainability status of each country. This calculation would trigger the restructuring process. This proposal has been criticized, noting the existence of two conflicts of interest, first from the fact that the IMF directors represent both creditor and debtor countries (and also, due to its power structure and governance, developed countries have more capabilities to impose their will) [13]; and second, for assigning the IMF a privileged creditor status over all other creditors, including those in the private sector. Moreover, the credit policies of the organization, aimed at dealing with situations of balance of payments problem, have proven ineffective. Mainly because austerity goals accompanying financing can make debt repayment even more unfeasible and

[11] As Yuefen Li (2015) notes this affects the poorest countries in particular since investment funds with large resources could end up acquiring a percentage higher than 25% of the issue, and thus block the restructuring agreements.

[12] Proposal by Argentina (2015) "Towards a multilateral legal framework for sovereign debt restructuring processes". January 23, 2015. Available at http://www.unctad.info/upload/Debt%20Portal/GA%20Ad%20hoc%20committee%20statements/Permanent%20Mission%20of%20Argentina.pdf

[13] Currently, the need to review the functions and governance of this organism is part of the G20 agenda for discussion.

because rescues create a "moral hazard" that encourages reckless financing [14]. Historical experience reveals that the "moral hazard" associated with "strategic" default by sovereign States has been a much less relevant problem than "too little and too late" debt restructurings in which rescues are granted, socializing private losses, without guaranteeing a return to the sustainability of debtor countries [15].

[14] Akyuz (2015) "Presentation to the Committee on Sovereign Debt Restructuring Processes" held at the United Nations in New York.

[15] Li, Yuefen (2015) “Debt Restructuring Mechanism: Options formoving forward” Southnews N°84 February 2015.