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IN THE QUEST OF A FRAMEWORK FOR SOVEREIGN DEBT RESTRUCTURING*

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RESUMEN

El reciente fallo del juez Griesa en la reestructuración de la deuda argentina ha dado lugar a preguntas de gran relevancia para los mercados de deuda internacionales. El caso es un síntoma de un sistema de resolución de crisis de deuda que no funciona –sistema en el que se confía demasiado en la capacidad de los mercados para resolver las crisis. El fallo pone en el centro de la escena un conjunto de problemas fundamentales que la comunidad global está intentando resolver.

Este artículo provee un marco para el debate actual sobre como resolver las deficiencias en las reestructuraciones de deuda soberana. En particular, se enfoca en tres conjuntos de preguntas:

1) ¿Hay soluciones sencillas y rápidas, como restaurar la inmunidad soberana, o cambios dentro del enfoque contractual privado?

2) ¿Qué cambios se pueden implementar dentro del enfoque contractual? ¿En qué medida resuelven los problemas existentes? ¿Son políticamente alcanzables?

3) En la medida en que esas propuestas no resuelvan los problemas, hay una necesidad obvia de un enfoque colectivo. ¿Cómo sería una solución ideal? ¿Hay soluciones intermedias políticamente alcanzables?.

ABSTRACT

Judge Thomas Griesa's recent ruling in Argentina's case has raised enormous questions in sovereign debt markets. The case is a symptom of the current flawed market-based system for resolving sovereign debt crises. It raises fundamental issues that the global community is addressing.

This article provides background for the ongoing debate on how to fix the frameworks for sovereign debt restructuring. It focuses on three sets of questions:

1) Are there quick fixes, e.g. restoring concepts such as sovereign immunity, or improvements in the private contractual approach?

2) What are the most important improvements in the private contractual approach? To what extent will these solve the problem? Are they politically achievable?

3) To the extent that quick fixes and private contractual approaches do not do the tricks, there is an obvious need for a more collective approach. What would an ideal solution look like? Are there halfway houses, politically achievable?.

Keywords: Sovereign Debt, Restructuring, Contractual Approach, Statutory Approach

JEL Codes: F34, H63, K12

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1. Introduction

The debate on the necessity of a Framework for Sovereign Debt Restructuring (FSDR) has been revived by the outgoing process of Argentina's debt restructuring. The complexities of this case unveil the fallibilities of the private contractual.

Sovereign debt crises are recurrent phenomena in the era of financial globalization. Capacity of repayment is uncertain, especially for the most volatile economies. There are states of the world in which countries are unable to service their debts –the reason why most countries pay interest rates on their debt that include a compensation for risk. Sometimes these risks are miscalculated, both by the debtors and the lenders. History provides several examples of countries that engage in economic reforms that lead to higher levels of lending and borrowing –only to realize later on that there were no commensurate increases in the capacity of debt repayment. This is, for example, the story of Argentina that led to the last sovereign default and subsequent restructuring. In the 1990s, the country implemented a set of economic reforms pushed by the *Washington Consensus*, but the associated promises of higher wealth were not delivered. The experiment ended with a catastrophic economic and social crisis in 2001 (see Galiani, Heymann, and Tommasi, 2003).

Debt restructurings are an essential feature of the functioning of the market system. There are important economic analogies between debt restructurings of corporations and sovereigns. Firstly, the possibility of bankruptcy guarantees limited liability of firms. Without limited liability, markets could not work efficiently. Equivalently, the possibility of a sovereign default imposes limits to the cost of downside states for countries.

Secondly, when a corporation goes bankrupt, its assets are still valuable, and should be put to work. It would be a waste of resources for the society to have equipment that is not being utilized because the firm that owns it is bankrupt. Corporate bankruptcy laws ensure that such a waste of resources does not occur. Similarly, when a sovereign cannot repay its debt, there are still valuable projects in the country –projects that could put the labor force back to work, and whose execution may require external credit. A restructuring would allow the sovereign to recover the access to international credit markets for exploiting those economic opportunities. Lenders would also benefit from having access to good investment opportunities. It is then in the best interest of both the borrower and the potential lenders to resume the flow of credit.

This basic principle of modern capitalism –that distressed debtors need a fresh start— has recently been defied by the ruling (described in section 2) of judge Thomas Griesa of the Court for the Southern District of New York regarding litigation of vulture funds against Argentina. The ruling, by encouraging holdout behavior in restructuring processes, threatens the normal functioning of international debt markets. It creates global inefficiencies and inequities, and makes restructurings *de facto* impossible.

The global community is showing its preoccupation for the issue and its willingness to fix the deficiencies in the existing frameworks for sovereign debt restructuring (SDR). The proposal of the business community consists in a modification of the terms of debt contracts that would presumably rule out vulture funds' behavior. Although these new terms constitute an improvement over the existing terms, they leave important problems unaddressed.

On the other hand, the majority of governments supports the creation of an international framework for the resolution of sovereign defaults, as manifested in the recent Resolution 68/304 adopted by the General Assembly of the United Nations (September 9, 2014).

This paper provides an overview of the outgoing debate on the necessity of a FSDR, and analyzes the advantages and disadvantages of the different approaches on the fore. Section 2 describes key recent events. Section 3 analyzes the limitations of the private contractual approach. Section 4 proposes a set of principles that should guide the design of a FSDR. Section 5 concludes.

2. Background

The current approach for sovereign debt restructuring features a decentralized process where the country in distress negotiates with many different creditors. These negotiations can be difficult and lengthy.

The resolution of Argentina's 2001 sovereign debt default brought back to the fore the problems with the existing framework (Guzman and Stiglitz, 2014a; 2014b). There were two rounds of negotiations, in 2005 and 2010. By the end of the second round, 92.4 percent of the debt had been restructured.

A group of investors (popularly known as vulture funds) bought a small part of the debt in default in secondary markets at a small fraction of the face value, and litigated against the country in the courts of New York, demanding full payment on the principal plus full interest (interest that included a compensation for the risk of no repayment).[1]

In 2012, judge Thomas Griesa from the New York Southern District came up with a peculiar interpretation of *pari passu*, a standard contractual clause that is supposed to ensure equal treatment among equals. His interpretation was that equal treatment meant that while the holders of exchange bonds would get paid for what they accepted in the restructuring, vultures would get paid in full –full principal and interest.[2] To enforce the ruling, in 2014 he ordered an injunction that prohibited Argentina from repaying the 92.4 percent of bondholders who had reached an agreement with the country unless it simultaneously paid the vultures in full on a ratable basis.[3]

The ruling creates a moral hazard problem. It negatively alters the incentives of holders of bonds in default for entering into a negotiation, as it increases the payoffs of being a holdout. Under this interpretation of *pari passu*, defaults become de facto impossible. Countries, understanding this possibility, would be more reluctant to borrow in the first place. The more affected countries would be the more volatile ones, which are the ones more likely to need a restructuring down the road. Therefore, the ruling creates both inefficiencies and inequities in the functioning of international financial markets.

A healthy environment for international debt markets is a public good. Individual countries, when dealing with vultures, do not internalize the positive externalities that fighting them implies to the rest of the global economy. That explains in part the success of the vultures' business over the last two decades. Therefore, a solution needs a global approach.

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[1] The leading vulture was NML Capital, a subsidiary of the hedge fund Elliot Management.
[2] It had already been reasonably argued that the ratable payment theory of the *pari passu* clause is a fallacy (Buchheit and Pam, 2004).
[3] Vultures constituted only 1 percent of the holders of the total debt in default.

There is consensus on the need to fix the frameworks for sovereign debt restructuring, but there are different views on how to move forward. The approach supported by the business community and the IMF differs from the one supported by the large majority of countries. The business community has recently made a proposal that consists in modifying the terms of the contracts (as defined in ICMA's Standard CACs and Standard Pari Passu Provision Notes of August 29, 2014).[4] Although the new terms are an improvement over the old ones, they will not suffice to solve the variety of problems faced in SDRs. On the other hand, most countries advocate for the establishment of a multinational legal framework, through the United Nations. We will next discuss both approaches.

3. Limitations of the Private Contractual Approach

Collective action clauses (CACs) allow a majority of bondholders to agree to changes in bond terms (for example to reduce the value of the principal) that are legally binding to all the bondholders, including those who vote against the restructuring. Bond contracts may or may not contain them. If they don't, the restructuring is not finished until all the creditors agree with a proposal. Under a unanimity rule of this nature, holdouts –and particularly vulture funds—can emerge, delaying the restructuring even when there is no disagreement on the capacity and willingness for debt repayment. In the interim, the country has no access to international debt markets.

This coordination problem has been present in several sovereign debt crises. The introduction of CACs in the bond contracts has been a response to it.[5] CACs implemented at the level of each bond ameliorate the problem, but do not fully solve it when a country has multiple debt obligations, as it is generally the case. If a CAC establishes that the negotiation over of a series of bonds will be terminated when, say, 75 percent of the bondholders agree with the restructuring (binding all the other bondholders of that series to accept the deal), there would still remain the possibility that one investor buys an epsilon more than 25 percent of just one series of bonds, and refuses to accept a deal, impeding the termination of the whole restructuring.

[4] Available at http://www.icmagroup.org/resources/Sovereign-Debt-Information/

[5] In the 1990s, bonds issued in the London market under the English law contained CACs, while bonds issued in the New York market under the law of the state of New York did not (Eichengreen and Mody, 2003). Mexico was the first country to do so under the jurisdiction of the state of New York in 2003.

To solve this problem, what is needed is a formula for the aggregation of the different instruments over which CACs are applied. But this is not the only problem that may arise in a restructuring. It is simply an important one.

3.1. ICMA's response to the vultures' problem

The International Capital Market Association (ICMA) has recently proposed new terms for the bond contracts. The new terms clarify the meaning of *pari passu* and provide a formula for the aggregation of different classes of securities over which collective action clauses are applied.

The clarification of *pari passu* suggested by ICMA contradicts the peculiar interpretation provided by judge Griesa in Argentina's case[6]: The debtor should have no obligation to pay the creditors who accepted the proposal and the holdout creditors on an equal or ratable basis.

Under the new terms, CACs could also be applied if a supermajority agrees with the restructuring proposal. The supermajority would be defined by acceptance of the aggregate principal amount of outstanding debt securities of all of the affected series, and its decisions would be binding to all the other investors.

These terms mainly attack the vulture funds' business and constitute an improvement over the previous terms, but leave some important issues unaddressed. CACs are no panacea. If they were, there would be no need for domestic bankruptcy laws that spell out issues like precedence and fair treatment.

A comprehensive solution requires more than simply tweaking the terms of contracts. The rest of the section describes the limitations of the contractual approach even if the suggested improvements are implemented.

3.2. The problem of sovereign immunity

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[6] ICMA's pari passu provision establishes that "*The Notes are the direct, unconditional and unsecured obligations of the Issuer and rank and will rank pari passu, without preference among themselves, with all other unsecured External Indebtedness of the Issuer, from time to time outstanding, provided, however, that the Issuer shall have no obligation to effect equal or rateable payment(s) at any time with respect to any such other External Indebtedness and, in particular, shall have no obligation to pay other External Indebtedness at the same time or as a condition of paying sums due on the Notes and vice versa.*"

Sovereign immunity has been eroding since the 1970s. First, as a result of the sanction of the Sovereign Immunity Act in 1976 in the US and State Immunity Act in 1978 in England, that permitted to hold public entities legally accountable for breach of commercial contracts.[7]

More recently, sovereign immunity has been challenged by litigation over the so-called champerty defense –an English common-law doctrine, later adopted by US state legislatures, that prohibited the purchase of debt with the intent of bringing a lawsuit. In 1999, in *Elliot Associates, LP v. Banco de la Nación and the Republic of Peru*, the Second Circuit of Appeals of New York determined that the plaintiff's intent in purchasing the Peruvian debt in default was to be paid in full or *otherwise* to sue.[8] Such an interpretation was absurd, as it was not reasonable to expect to be paid in full over a promise that had already been broken. Nevertheless, the court ruled that Elliot's intent did not meet the champerty requirement because litigation was contingent.

In 2004 the New York state legislature effectively eliminated the defense of champerty concerning any debt purchase above 500,000 US dollars. That decision, besides contradicting the understanding over which hundreds of billions of dollars of debt had been issued, guaranteed the good health of the vultures' business.

3.3. Debtors coordination and signaling equilibrium

In the presence of imperfect information, debtors try to show that they are of a "good type" by using costly signals.

In the context of sovereign debt, debtors may choose excessively tough jurisdictions to signal they are unlikely to default. Then, even if the judiciary of a jurisdiction like the state of New York creates severe inefficiencies for debt restructuring, debtors could still resort to it. Other debtors, by acting differently, would signal that they are more likely to restructure. Hence, the payoff of deviating to a more reasonable jurisdiction would be lower. This is an inefficient global equilibrium –a signaling equilibrium.

[7] Schumacher, Trebesch, and Enderlein (2014) show that there has been an enormous increase in litigation against governments since 1976.
[8] The issue is more extensively treated in Blackman and Mukhi (2010).

Escaping from the bad equilibrium requires a global solution –a solution that cannot be provided by the decentralized contractual approach.

3.4. The unresolved problem of existing contracts

The new terms do not solve the problem for the hundreds of billions of dollars of debt issued under the old terms (approximately USD900 according to IMF (2014)).

This problem is especially important in an anemic global economy. The recent European crisis shows that not even relatively advanced economies are exempt of debt problems (and it also shows that judgments on capacity of debt repayment can be very difficult, even close to the date a country ends up facing a sovereign debt crisis[9]). More countries could face difficulties for debt repayment in the near future. Without the establishment of a framework that comprehends all the existing debt contracts, sovereign debt restructurings will continue being problematic.

3.5. Coordination among creditors

There are complicated bargaining problems among classes of creditors. A supermajority voting does not solve those problems. A simple supermajority rule could lead to a situation where junior creditors vote to have themselves treated equally with more senior creditors –and succeed. Issues of determination of seniority are especially important in the context of sovereign debt restructurings, as the set of claimants of the country's resources include not only formal creditors, but also others like the workers and pensioners. Chapter 9 of the US Bankruptcy Code recognizes these rights. The private contractual approach, instead, does not contemplate them.

When countries issue debt under different jurisdictions, establishing priority of claims could be a daunting task, with multiple contradictions. For example, a bond issued under the jurisdiction *X* could establish that the holder of that bond has priority over all the other claims. But at the same time another bond issued under the jurisdiction *Y* could establish the same. Who would then have priority if in times of crisis it were not

[9] Reinhart and Rogoff (2009, p. 287) provide an illustrative example of these difficulties, when they classify Greece in 2009 as a country that is a candidate for "graduation", i.e. as a country "*that managed to emerge from centuries of serial default on sovereign debt and eventually stopped defaulting*" (p. 283).

possible to satisfy both claims at the same time? Under a decentralized private contractual approach, solving these issues would require an intricate and lengthy negotiation, with complex legal questions. The outcome would be determined on the basis of bargaining power, not on the basis of efficiency or equity considerations.

The same issues could arise for determining valuation of debts issued in different currencies (Guzman and Stiglitz, 2015).

3.6. Credit Default Swaps and misalignment of incentives

Sovereign debt restructuring problems may be aggravated by the non-transparent use of CDSs. CDSs separate ownership from economic consequences: the seeming owner of a bond could even be better off in the event of a default, as the payments over the CDS would be activated in such event.

The opacity of this market makes unclear the real interests of those with a seat at the bargaining table. This is another reason for delaying restructurings and creating inefficiencies.

Efficiency in restructuring requires transparency of the interests of the interests of the actors involved in the negotiations. Courts should demand full disclosure of CDSs positions to the holders of bonds in default (or to its subsidiaries).

3.7. Macroeconomic issues

Empirical research shows that sovereign debt crises occur almost exclusively in bad economic times (Tomz and Wright (2007), Levy Yeyati and Panizza (2011), Panizza, Sturzenegger and Zettelmeyer (2009)). This is consistent with the predictions of economic theory (Aguiar and Gopinath (2006), Guzman (2014)). Those are the times when expansionary macroeconomic policies are mostly needed.

The solution implied by the private contractual approach does not internalize the positive macroeconomic externalities associated with timely restructurings.

3.8. Final remarks on the private contractual approach

The problems we have described impose costly delays for the debtor and good-faith creditors. Delays affect the capacity of governments to run countercyclical macroeconomic policies. They also create tensions between governments and the IMF, as pressures for intervention may be larger when access to credit is difficult. These costs could be reduced if debt restructurings were resolved more quickly.

The business community is advocating for easy fixes in the contracts to solve the current deficiencies in the system. But easy fixes are not really fixes.[10] They are insufficient amendments that leave a legacy of problems for the next debt crisis.

If the private contractual approach was viable, why has no government relied upon it? Why doesn't the private sector rely on it either, and instead relies on bankruptcy laws? Why don't contracts specify what will happen in the event of a breach of a credit contract? Specifying every possible contingency would lead to a problem of combinatorial explosion. That is why all contracts are incomplete. There are some elements of contingency that can be incorporated in contracts (like the GDP indexed bonds), but not every contingency can be contemplated ex-ante. And this incompleteness of contracts implies that there may be ambiguity concerning the treatment of different claims.

The market-based approach cannot provide an efficient and equitable solution to the problems that arise in sovereign debt restructurings. The existence of CACs is a demonstration of the inability of markets to produce an efficient solution ex-ante. But their existence does not ensure an efficient solution ex-post.

The good health of international financial markets requires a comprehensive approach that solves the inefficiencies and inequities noted above.

4. Principles for a Framework for Sovereign Debt Restructuring

This section outlines a set of principles that should be taken into account for the design of a multinational FSDR (see also Stiglitz (2002), Guzman and Stiglitz (2015)).

[10] And even more could be done within the contractual approach. For a set of recommendations, see Brooks, Guzman, Lombardi, and Stiglitz (2015), and Stiglitz, Guzman, Lombardi, Ocampo, and Svejnar (2015).

The framework should contain elements from Chapters 9 and 11 of the US Bankruptcy code. The final goal is to achieve efficiency in restructuring, what includes driving the economy to a state of full utilization of its resources.

In the first place, the framework should incentivize debtor countries in distress to avoid delays in the initiation of a restructuring. Delays are costly, as they put impediments to wealth creation –and governments tend to delay restructurings to avoid the political costs that they entail. Larger costs of restructuring incentivize delays. The framework should also prevent delays for termination by setting precise deadlines for each stage of the process.

It should acknowledge that the capacity of debt repayment is endogenous, facilitating the conditions for the restoration of economic growth. As a consequence, it should establish provisions of lending into arrears, such that those creditors that lend to a country after it initiated a restructuring are treated as senior creditors. It should also include stays for litigation while the restructuring is underway, to protect sovereigns from disruptive legal actions that create delays.

Some time after the initiation of the process, the sovereign would propose a restructuring plan that could include the reprogramming of payments and haircuts. The proposal should delineate the economic plan that determines its economic consistency. The other parties involved in the negotiation could suggest alternative proposals. If those advocate for policies of fiscal austerity as the mean to achieve a larger sustainable capacity of repayment, they should provide economic models and empirical evidence that sustain the validity of that proposition.[11]

It must contemplate what is the minimum set of principles over which the different parties involved would agree on. A hard law approach (as the creation of an International Bankruptcy Court) that entails sacrificing sovereign immunity may not be acceptable. Instead, the creation of an International Shadow Bankruptcy Court or Commission that produces non-enforceable statements on the reasonability of restructurings could be a viable alternative that would legitimate SDRs, and that would ensure orderly and timely processes.

[11] The existing empirical evidence shows that fiscal austerity in recessions has almost always been associated with larger economic contractions rather than expansions; see Jayadev and Konczal (2010).

5. Conclusions

Restructuring is not a zero sum game. Rules can have large effects on the overall economic performance. The current state that features a decentralized market-based process for sovereign debt restructuring makes that sum too negative –more negative than what could be achieved under a more reasonable approach.

The world needs to move to a different equilibrium. This requires the implementation of a framework for sovereign debt restructuring at the multinational level. The framework should be balanced. A system that is too creditor-friendly would discourage borrowing. It would also diminish the incentives of creditors to assess the creditworthiness of the debtor. On the other hand, a system that is too debtor-friendly could also discourage lending.

An approach that entails a more active role for the judiciary can resolve some of the inefficiencies and inequities noted above. The standardization of contracts and their interpretation through a unique international legal framework would solve complex coordination problems.

Efforts must be made for attaining such a legal structure. Its credibility will depend on its openness, transparency, and representativeness. The global community should be able to provide such a service to the citizens of the world.

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