FRAMEWORKS FOR SOVEREIGN DEBT RESTRUCTURING

NOVEMBER 17, 2014
COLUMBIA UNIVERSITY, NEW YORK

CONFERENCE REPORT

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Conference Report

Center on Global Economic Governance

Initiative for Policy Dialogue

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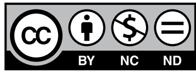

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CONFERENCE REPORT

Joseph E. Stiglitz, Martin Guzman, Domenico Lombardi, José Antonio Ocampo and Jan Svejnar

The conference Frameworks for Sovereign Debt Restructuring was held at Columbia University on November 17, 2014 with the sponsorship of the Initiative for Policy Dialogue (IPD), the Center on Global Economic Governance (CGEG), the Centre for International Governance Innovation (CIGI) and the United Nations Department of Economic and Social Affairs (UNDESA). The following points emerged from the discussion.

1. There is a new world in sovereign debt restructuring. There are three critical factors: the move from bank to market finance makes debt restructuring more difficult; the increased use of credit default swaps (CDSs) creates perverse incentives that hurt efficiency in restructurings; and the recent US court decision on Argentina's case makes debt restructuring difficult — or impossible.

2. Although there are "quick fixes" that would ameliorate problems (such as restoring sovereign immunity), these do not address the underlying problems in sovereign debt restructuring (discussed below). The view that Argentina is the exception, and therefore recent court decisions are of little relevance for the functioning of the market, is at best unsettled, and probably wrong. (What was unusual about Argentina was that it bargained hard; because it would not give in to creditor demands, markets interpreted that it bargained in bad faith.)

3. Poorly designed arrangements for resolving sovereign debt problems can lead to inefficiencies and inequities — and to Pareto inferior outcomes. Delays in restructuring can be very costly. Insufficiently deep restructuring can force the economy through multiple crises and restructurings — at a high cost. An inadequate restructuring framework increases the costs of borrowing and the benefits of lending, leading to sub-optimal levels of credit flows. Restructurings that impose excessive burdens on the borrower may lead to insufficient due diligence on the part of lenders.

4. Any framework for sovereign debt restructuring has to take account of the primacy of the functions of the state, its obligations to its citizens and the "social contract" the state has with its citizens. Claimants on the state include not only the formal creditors, but also informal claimants, such as old age pensioners. Poorly designed arrangements will simply encourage governments to convert informal claimants into less flexible formal contracts.

5. There seems to be considerable scope for improving private debt contracts, by including better designed collective action clauses (CACs) (the failure of the last round of CACs is a warning that it may not be that easy to do so), clearer statements concerning the meaning of the *pari passu* clause (although the "novel" interpretation of Judge Griesa is a warning that this may not be as easy as one hoped), the incorporation of champerty defence clauses and other provisions relating to lending in arrears and stays. The recent International Capital Market Association's proposals (also supported by the International Monetary Fund [IMF]) for aggregation of CACs and for clarifying the meaning of *pari passu* are improvements over the old terms, but are not sufficient to solve a variety of problems faced in sovereign debt restructurings (described below).

   It was not clear the extent to which it was possible to include provisions analogous to US Chapter 9 into debt contracts.

6. The background legal framework is critical in determining the nature of the bargaining process and outcomes. Judge Griesa's decision and New York State's legislation eliminating the champerty defence are examples of changes in legal frameworks with possibly profound consequences (and interestingly, representing major changes in property rights, occurring retroactively to the issuance of the bonds, and in that sense, providing what some participants thought of as unjust enrichment for bondholders.)

7. The IMF's lending policy is also critical in determining the nature of the bargaining process and outcomes. The IMF's policies can be, de facto, a full bailout for the private lenders, even for loans made to private borrowers, as debts are socialized. In some cases, the reprofiling of debt provides the opportunity for short-term creditors to get repaid. There is, in effect, a redistribution between short-term and long-term creditors; the bailout allows the short-term creditors to escape while the long-term creditors have to take a bigger haircut than they otherwise would have had. IMF loans have effectively preferred creditor status, and in the subsequent restructuring, there is as a result a larger haircut for long-term creditors than there would have been in the event of an immediate "bankruptcy" proceeding. In the case of heavily indebted countries with large primary deficits, the IMF can force the debtor to agree to terms that are very favourable to the creditors. On the other hand, they can force a bail-in of the private sector — of existing creditors.

8. The IMF's lending policy — even were it able to judge accurately debt sustainability and to engage in debt reprofiling, a proposition that is challenged by the recent IMF flawed output growth forecasts for countries in distress — is not enough to resolve the problems posed by debt burdens beyond the country's ability to pay. Even IMF restructuring of this limited form faces some difficult problems that need further discussion: What interest rate

should be used? Should it be the high interest rate that reflected the market's judgment of the risk of default *in the absence of an IMF restructuring?* But the restructuring itself should resolve some aspects of that risk — indeed, going forward, if the IMF has done its job so that the reprofiling ensures debt sustainability, there is no risk of default; hence a very low interest rate should be used. But then, will creditors accept the reprofiling? What is the nature of the bargaining relationship between creditors and the IMF — especially if the executive directors in the IMF disproportionately represent creditor interests?

More generally, many discussions of debt sustainability miss the key issue of the stochastic nature of the economic environment. A good debt reprofiling simply increases the probability that further assistance will not be needed, that there will not be a later crisis. One is always assessing trade-offs at the margin: the cost of a deeper re-reprofiling versus the benefit of a slightly lower probability of a crisis down the line.

The IMF can also play a catalytic role in encouraging, for instance, the use of GDP bonds.

9. CDSs — especially when they are not transparent — have changed in a fundamental way the nature of debt resolution between creditors and debtors. Creditors may or may not have an interest in the smooth resolution of the problem. They could be better off in the event of a default than if there is a debt restructuring. There is no way to ascertain whether they are bargaining in good faith. While CDSs held by those with no insurable interest are an invitation to mischieve — and proposals to ban them should be given serious consideration — the problem would remain that the economic interests of those at the bargaining table may be markedly different from what their ownership claims in bonds would suggest.

10. While they might work well if there were a single class of bondholders, CACs face inherent problems in aggregation across classes. A simple supermajority rule could lead to a situation where junior creditors vote to have themselves treated equally with more senior creditors. These coordination problems are increased further when there are bonds written in different currencies and in different jurisdictions, as establishing priority of claims could be a daunting task, with multiple contradictions. And how are informal claimants (pensioners) to be aggregated with formal claimants? There was a consensus that none of the proposals for addressing the aggregation do so in a fair and effective way.

11. Creditor committees may enhance support for consensual deals, reducing the risk of holdout behaviour. However, they can also increase collusive behaviour among creditors.

12. There are inter-debtor coordination problems that may lead to a suboptimal global equilibrium. In a context of heterogeneous debtors and imperfect information, each of them might choose to issue debt under "tough" jurisdictions to signal that the probability of default is low. Then, the resulting equilibrium would feature a situation where debt restructuring would be too difficult.

13. Even with the best design of CACs, the described coordination problems could not be fully solved. Besides, there would be a difficult problem posed by the hundreds of billions of dollars of existing debt without CACs and with existing *pari passu* clauses. It might be desirable to encourage voluntary exchanges with debt contracts with such clauses, but what is to be done about holdouts? And if there are holdouts, why would others give up their rights? The only way out appears to be a new global framework.

14. Because of the problems noted above, the private contractual approach is not adequate. These problems have been recognized before the recent events (for example, by the UN Commission of Experts and by the IMF), but recent events have made the case even more compelling. What is required is a new global framework for sovereign debt restructuring. (If a private contractual approach were adequate, then why has no country domestically opted for this? Indeed, a central piece of IMF advice to countries is that they *need* a bankruptcy code. As we noted in paragraph 4, sovereign debt restructurings are even more difficult, because of the ambiguity concerning claimants.) Possible designs of such a global framework for sovereign debt restructurings are briefly described in the Report of the UN Commission of Experts.

15. There are, however, difficult political problems in the adoption of a legally binding framework, analogous to the intense political conflicts within some countries in the design of their own bankruptcy codes (which itself is testimony to the fact that such frameworks *are* relevant). Here, the usual conflicts are compounded by conflicts of interest within countries and the democratic deficits that exist even in the seemingly strongest democracies. While it has been argued persuasively that some of the reforms discussed above (such as clarification on the *pari passu* clause and the restoration of variants of the champerty defence) would be in the broader interests of the US bond market, it appears that the position of the United States may be overly influenced by a very small fraction of the US financial market, the vulture funds. The geopolitical difficulties are being reflected in the reported opposition of the US Treasury to UN efforts to create a framework for sovereign debt restructuring, even though that initiative had the overwhelming support of the General Assembly, including all developing countries with one abstention (Mexico).

16. Short of a global agreement, national legislation may go some way to improving matters. Legislation could incorporate variants of the champerty defence, impose conditions similar to Chapter 9 of the US bankruptcy code (giving voice to claimants other than the formal creditors), insist on transparency concerning holdings of CDSs by all creditors participating in the restructuring discussion (and adjust voting rights, if there is a CAC, accordingly), clarify the meaning of pari passu clauses. National legislation cannot resolve conflicts arising when bonds have been issued in different jurisdictions. This requires a global framework.

17. Even if a formal global agreement among all countries is not feasible, there is scope for an international commission to help set norms and mediate among parties, to provide independent assessments of debt sustainability and the legitimacy of various formal and informal claims, and to mediate among the parties. It is possible that such a "soft law" approach could evolve into the more formal framework called for in paragraph 14.

CONFERENCE AGENDA

November 17, 2014, 8:30 a.m.–5:10 p.m.

Seminar Room 1, Faculty House, Columbia University
(2nd floor of Faculty House)

8:30–9:00 a.m. — Breakfast and Introduction to the Conference

Jan Svejnar (Columbia University)

9:00–10:00 a.m. — Implications of Recent Events

9:00–9:35 a.m.

Topics:

- Implications of the Argentine sovereign debt restructuring and litigation for the international financial architecture
- The United Nations' Resolution: "Towards a multilateral legal framework for sovereign debt restructuring processes"

Panellists:

Lee Buchheit (Partner, Cleary Gottlieb Steen & Hamilton LLP, New York)
Sergio Chodos (IMF, Alternate Executive Director for Argentina)
Guilherme de Aguiar Patriota (United Nations, DPR from Brazil)

Moderator:

José Antonio Ocampo (Columbia University)

9:35–10:00 a.m.

Topics:

- Current Debate on the Reform of the IMF Lending Framework

Panellists:

Hugh Bredenkamp (IMF)
Susan Schadler (CIGI)

Moderator:

José Antonio Ocampo (Columbia University)

10:00–10:30 a.m. — Objectives and Challenges of Sovereign Debt Restructuring

Keynote Speaker: Joseph E. Stiglitz (Columbia University)

10:30–10:45 a.m. — Coffee Break

10:45 a.m.–12:45 p.m. — The Private Contractual Approach

Topics:

- Issues in sovereign debt restructuring
- Can the private contractual approach provide efficient and equitable solutions to SDR?
- What is the optimal design of contracts?
  - Collective Action Clauses. How do we weigh different classes of creditors? How do we determine priority with bonds issued under multiple jurisdictions?
  - Champerty. Can it be included in bond contracts?
  - Aggregation and *pari passu*
- How can provisions of Chapter 9 be incorporated into contracts?
- What are the limitations of the private contractual approach?
- Lending into arrears
- Standstills in debt contracts
- Credit Default Swaps. Issues of transparency and disclosure
- Can provisions of Chapter 11 be embedded into contracts?
  - Role for GDP indexed bonds

Panellists:

Lee Buchheit (Partner, Cleary Gottlieb Steen & Hamilton LLP, New York)
Richard Conn (Innovate Partners, LLC)
Timothy B. DeSieno (Bingham McCutchen LLP)
Jonathan Eaton (Brown University)
Jim Haley (CIGI)
Robert Howse (New York University)
Eric Santor (Bank of Canada)
Joseph E. Stiglitz (Columbia University)

Moderator:

Martin Guzman (Columbia University)

12:45–2:15 p.m. — Private Lunch Panel: Discussion on the Context of the Debate

Topics:

- The view of the IMF
- The view of the UN
- Should the recent decision be viewed as an aberration, and are there quick fixes?

Speakers:

Sean Hagan (IMF, General Counsel and Director of Legal Department)
Domenico Lombardi (CIGI)
Benu Schneider (UN)

Moderator:

Jan Svejnar (Columbia University)

2:15–2:30 p.m. — Coffee Break

2:30–4:30 p.m. — Proposals for Multilateral Legal Frameworks for SDR

Topics:

- Provisions for an International Bankruptcy Law
- The reach of the soft law
- The institutional structure
- The institutional process to create it
- Improvements over the Paris Club ongoing process

Panellists:

Patrick Bolton (Columbia University)
Barry Herman (The New School)
Brett House (Jeanne Sauvé Foundation)
Jurgen Kaiser (erlassjahr.de NGO)
José Antonio Ocampo (Columbia University)
Kunibert Raffer (University of Vienna)
Shari Spiegel (United Nations)

Moderator:

Joseph E. Stiglitz (Columbia University)

4:30–4:40 p.m. — Coffee Break

4:40–5:10 p.m. — Conclusions — Towards a Consensus

Leaders:

Jan Svejnar (Columbia University)
Marilou Uy (G24, Director)

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ABOUT THE AUTHORS

Joseph E. Stiglitz is co-president of the IPD, and chairman of the Committee on Global Thought at Columbia University. He is university professor at Columbia, teaching in its Economics Department, its Business School and its School of International and Public Affairs. He chaired the UN Commission of Experts on Reforms of the International Monetary and Financial System, created in the aftermath of the financial crisis by the president of the General Assembly. He is former chief economist and senior vice-president of the World Bank and chairman of President Clinton's Council of Economic Advisors. He was awarded the Nobel Memorial Prize in Economics in 2001.

Martin Guzman is a postdoctoral research fellow at the Department of Economics and Finance at Columbia University Business School. He holds a Ph.D. in economics from Brown University, and is a co-chair of the IPD Taskforce on Debt Restructuring and Sovereign Bankruptcy.

José Antonio Ocampo is co-president of the IPD, professor of professional practice in the School of International and Public Affairs and Fellow of the Committee on Global Thought at Columbia University. Prior to his appointment at Columbia, José served as the United Nations Under-Secretary-General for Economic and Social Affairs, and head of UNDESA, as executive secretary of the UN Economic Commission for Latin America and the Caribbean, and has held a number of high-level posts in the Government of Colombia, including minister of finance and public credit, director of the National Planning Department, and minister of agriculture. He is author or editor of over 30 books and has published over 200 scholarly articles on macroeconomic theory and policy, international financial issues, economic development, international trade, and Colombian and Latin American economic history.

Domenico Lombardi is director of CIGI's Global Economy Program, overseeing the research direction of the program and related activities. He also serves as Chair of The Oxford Institute for Economic Policy and sits on the advisory boards of the Bretton Woods Committee in Washington, the G20 Research Group and the G8 Research Group at the University of Toronto, and the Istituto Affari Internazionali in Rome. He is a member of the *Financial Times* Forum of Economists and editor of the *World Economics Journal*.

Jan Svejnar is the James T. Shotwell Professor of Global Political Economy and director of the CGEG at the School of International and Public Affairs, Columbia University. He previously served as director of the International Policy Center at the Gerald R. Ford School of Public Policy at the University of Michigan. He is a founder and Chairman of CERGE-EI in Prague (an American-style Ph.D. program in economics that educates economists for Central-East Europe and the Newly Independent States). He serves as the chairman of the Supervisory Board of CSOB Bank and co-editor of *Economics of Transition*. He is a fellow of the European Economic Association and research fellow of the Center for Economic Policy Research (London) and Institute for the Study of Labor (IZA, Bonn).

ABOUT CIGI

The Centre for International Governance Innovation is an independent, non-partisan think tank on international governance. Led by experienced practitioners and distinguished academics, CIGI supports research, forms networks, advances policy debate and generates ideas for multilateral governance improvements. Conducting an active agenda of research, events and publications, CIGI's interdisciplinary work includes collaboration with policy, business and academic communities around the world.

CIGI's current research programs focus on three themes: the global economy; global security & politics; and international law.

CIGI was founded in 2001 by Jim Balsillie, then co-CEO of Research In Motion (BlackBerry), and collaborates with and gratefully acknowledges support from a number of strategic partners, in particular the Government of Canada and the Government of Ontario.

Le CIGI a été fondé en 2001 par Jim Balsillie, qui était alors co-chef de la direction de Research In Motion (BlackBerry). Il collabore avec de nombreux partenaires stratégiques et exprime sa reconnaissance du soutien reçu de ceux-ci, notamment de l'appui reçu du gouvernement du Canada et de celui du gouvernement de l'Ontario.

For more information, please visit www.cigionline.org.

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