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How Ontario Could Lead the World in Sovereign Debt Restructuring

Mark Jewett and Maziar Peihani

Key Points

- The world of sovereign debt remains deeply dysfunctional. No treaty exists to allow for restructuring of unsustainable sovereign debt, and the contractual reforms intended to address the holdout problems have had only limited success.
- The Sovereign Debt Restructuring Model Law is a novel governance initiative that can address the unresolved sovereign debt issues that continue to haunt sovereign debtors and their creditors.
- The model law provides the province of Ontario with a unique leadership opportunity. By adopting the model law, the province will bring the rule of law and fairness into sovereign debt restructurings and further enhance Toronto's position as a world-class financial jurisdiction.

Introduction

In recent decades, sovereign debt crises — especially in Greece and Argentina — have spurred both controversy and interest. The world of sovereign debt is deeply dysfunctional. A true sovereign bankruptcy regime — most notably the Sovereign Debt Restructuring Mechanism (SDRM) proposed by the International Monetary Fund (IMF) in the early 2000s — remains politically infeasible, and the prospects for establishing a comprehensive treaty on sovereign debt are bleak. Meanwhile, the contractual reforms intended to address the holdout problems, while welcome, have had only limited success. Between these two approaches is a third way: a model law on sovereign debt restructuring adopted by a legislature, as described in this policy brief.

The dysfunctional nature of the restructuring problem is clearly illustrated by the lingering fallout from the Argentinian sovereign debt crisis. In June 2014, the US Supreme Court refused to hear Argentina's appeal from New York court decisions, thereby letting the lower courts' rulings in favour of the holdout creditors stand.[1] Those rulings found Argentina in violation of the *pari passu* clause in its bonds that were governed by New York law and

1 *Argentina v NML Capital, Ltd*, 134 S Ct 2250 (2014); *NML Capital, Ltd v Argentina*, 727 F (3d) 230 (2d Cir 2013); and *NML Capital, Ltd v Argentina*, 699 F (3d) 246 (2d Cir 2012) [*NML* 2012].

About the Authors

Mark Jewett is a senior fellow with the International Law Research Program (ILRP) at the Centre for International Governance Innovation (CIGI), researching and writing on recent legal developments in sovereign debt management and the possibilities of a model law on sovereign debt restructuring. Mark is counsel to the law firm Bennett Jones, based in the firm's Ottawa offices. Prior to joining Bennett Jones, he was the general counsel and corporate secretary of the Bank of Canada from 2001 to 2008, and prior to that was senior assistant deputy minister at both the federal finance and justice departments. Mark has published extensively, primarily in the fields of international law, taxation, insolvency (financial institutions) and central banking (governance).

Maziar Peihani is a post-doctoral fellow in the ILRP. Maziar's research at CIGI is focused on international financial law, including sovereign debt resolution. Specifically, he assesses the legal and regulatory dimensions of the reform initiatives currently unfolding in international sovereign debt markets. In addition, Maziar works on the legitimacy of the global governance regime of banking and the legal aspects of cross-border crisis management and bank resolution. Prior to joining CIGI, Maziar was a post-doctoral fellow at the National University of Singapore in the Centre for Banking and Finance Law. Maziar has a Ph.D. in law from the University of British Columbia.

banned the sovereign from making payments on its restructured bonds unless it paid holdout creditors in full.[2] The legal action and the combined rulings effectively meant that Argentina lost a legal battle of more than a decade. Additionally, the rulings demonstrated how a small group of creditors can extract preferential treatment and cause disruption for everyone else. Most commentators regard this development as decisively tilting the delicate balance between debtors and creditors, making settlements much harder to reach because of the advantage given to holdout creditors.

The contractual reforms intended to address the holdout problems, as mentioned above, have had only limited success. Currently, a substantial stock of sovereign bonds lack robust aggregate voting mechanisms, and despite recent improvements it seems unlikely that all future sovereign bond issuances will contain enhanced contractual provisions to prevent holdout litigation.[3]

Considering such deficiencies, this policy brief recommends that the Province of Ontario adopt the Sovereign Debt Restructuring Model Law. It argues that, by adopting the model law, the province will bring the rule of law and fairness into sovereign debt restructurings and further enhance Toronto's position as a world-class financial jurisdiction.

2 The *pari passu* clause contained a representation that the debt instrument ranked equally (*pari passu*) with other senior debt obligations of Argentina. This equal treatment was to be maintained in future and was also extended to the republic's payment obligations. The District Court held that the *pari passu* clause prevented Argentina from making payments on restructured bonds so long as payments due under bonds held by holdouts remained outstanding. The Second Circuit affirmed this interpretation as well. See *NML* 2012, *supra* note 1.

3 As of October 2016, the outstanding stock of debt without enhanced clauses stood at about US$846 billion. In addition, 74 out of 228 bond issuances made from October 2014 to October 2016, representing US$68 billion, lacked enhanced contractual provisions. See IMF, "Second Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts" (January 2017) at 3, 6–7, online: <www.imf.org/en/Publications/Policy-Papers/Issues/2017/01/13/PP5085-Inclusion-of-Enhanced-Contractual-Provisions-in-intl-Sovereign-Bond-Contracts>.

A Primer on the Sovereign Debt Restructuring Model Law

The model law is a novel governance initiative that seeks to address the unresolved sovereign debt issues that continue to haunt sovereign debtors and their creditors.[4] It is specifically designed to facilitate a voluntary, timely and orderly debt restructuring when a sovereign faces an unsustainable debt burden. The model law seeks to prevent disruptive litigation, as witnessed in recent years, while protecting essential creditor rights. A comprehensive review of the model law's provisions can be found in an earlier policy brief by CIGI Senior Fellow Steven Schwarcz.[5] Here, it suffices to say that the model law allows the bondholders to vote on a restructuring proposal, with the outcomes of a super majority vote being binding on all bondholders.

In addition to its robust aggregation feature, the model law addresses the critical need of a financially distressed debtor for liquidity during the restructuring process. Obtaining new sources of funding has always been a major difficulty for distressed sovereigns because new lenders are reluctant to lend money in the absence of gaining priority for the repayment claim. The model law addresses this problem by granting a priority to new lenders over existing creditors, provided that those creditors have notice and the opportunity to block the lending if the loan is too large or the terms are inappropriate. Furthermore, the model law brings about legal certainty and fairness by providing for a neutral supervisory authority to oversee and discipline the restructuring process, as well as an arbitration mechanism to settle any disputes arising between the parties.

A distinct advantage of the model law is that it does not require adoption of a treaty or an international agreement, an ambition that has proven futile in past decades. Instead, it relies on national or subnational jurisdictions to take the steps necessary to make the law effective in their jurisdictions. In this respect, the model law draws upon the reform experience in other areas of law that proved contentious for many years. A leading example is the United Nations Commission on International Trade Law (UNCITRAL) Model Law on International Commercial Arbitration, which became a major success due to its informal character and incremental approach to reform.[6] It is worth noting that Canada was the first country to adopt the UNCITRAL model law and has played a key role in its development and judicial interpretation. Provinces played an essential role and were unanimous in its implementation. Today, the UNCITRAL model law has been adopted by 104 jurisdictions.[7]

The Model Law — A Unique Leadership Opportunity for Ontario

Similar to the experience with the UNCITRAL Model Law on International Commercial Arbitration, Schwarcz's model-law proposal provides Canada, and in particular the Province of Ontario, with a unique opportunity to lead the world in the development of international norms. As will be discussed more fully below, Ontario has the constitutional authority to adopt the model law. In fact, federal and Ontario bonds are predominantly issued under Ontario law (and the laws of Canada as applicable in Ontario) and benefit from the legal infrastructure available in the province.[8]

Ontario is also well positioned to take the lead on the model-law initiative, with Toronto being the principal financial centre of Canada, as well as a global financial centre. Toronto, which is home to many leading banks, insurers, securities dealers and pension funds, continuously ranks as

4 Steven L Schwarcz, "Sovereign Debt Restructuring: A Model-Law Approach" (2015) 6:2 J Globalization & Dev 343.

5 Steven L Schwarcz, "A Model-law Approach to Restructuring Unsustainable Sovereign Debt" CIGI, CIGI Policy Brief No 64, 21 August 2015.

6 See UNCITRAL, "Status of UNCITRAL Model Law on International Commercial Arbitration (1985), with amendments as adopted in 2006", online: <www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration_status.html>.

7 *Ibid*.

8 See e.g. Canada, Department of Finance, "Legal Terms and Conditions for Government of Canada Domestic Debt Securities" (2015), online: <www.fin.gc.ca/invest/dds-tmi-eng.asp>.

one of the best financial centres in the world. For instance, it ranked seventh in *The Banker*'s 2012 study of international financial centres.[9] As well, Toronto is an excellent investment destination for major international financial institutions. In 2015, it ranked fifth among North American cities for inward foreign direct investment (FDI) in financial services, accounting for investment of US$95.5 million.[10] In terms of outward FDI, Toronto ranks second only to New York, accounting for more than US$1 billion.[11] Moreover, Canadian capital markets raised CDN$382 billion during 2015 and the TMX Group's market capitalization stood at CDN$2.8 trillion as of the end of March 2017.[12] Adding a facility to resolve sovereign debt to Ontario's tool kit of finance-related services would strengthen the province's standing in a competitive, but changing, global marketplace. The uncertainty created by Brexit and the US President Donald Trump administration's criticism of the global trading system can have important implications for financial markets around the world. Ontario's reputation for political stability and rule of law give the province a unique advantage to advance its competitive position with the model law, by being a first mover in leading with this initiative.

The adoption of the model law is well aligned with the Ontario government's priority to advance the success of the financial services industry and increase jobs and investments in the sector.[13] An Ontario-adopted model law that strikes the right balance between the interests of creditors and debtors would be attractive to foreign issuers. Developing economies would find it particularly attractive to issue debt in Toronto and to choose Ontario law to govern their contracts. It is worth noting that both New York and London rose to the top in global finance at least in part through changes they introduced to their legal regimes.

Both jurisdictions facilitated the issuance of foreign bonds by allowing sovereigns to choose New York or English laws to govern their transactions, even when the bonds were actually listed elsewhere.[14]

In addition to its attractiveness to sovereign borrowers, Ontario law would be an appealing choice for foreign investors, who are often reluctant to buy debt governed by the issuer's domestic law. These investors fear that the sovereign debtor could unilaterally change its law to discharge its obligations and defeat their legitimate contractual expectations. Such concerns, however, do not apply if Ontario law governs, given Canada and Ontario's reputation for the rule of law, an independent and fair judiciary, and legal safeguards to protect creditors' reasonable expectations.

The model-law initiative would create business opportunities for Canadian financial institutions to act as intermediaries in sovereign debt transactions and could also be conducive to growing the legal profession in Ontario. It is common practice for parties to a sovereign debt contract to submit to the jurisdiction of the courts in the same jurisdiction of the law governing the contract. English and New York courts, for example, are the two primary fora for sovereign debt disputes, given that most foreign sovereign bonds are also governed by English and New York law. Similarly, Ontario arbitrators and courts could be designated to hear disputes arising from contracts governed by Ontario law.

Constitutional Considerations

If Ontario wishes to adopt the model law, one immediate question that arises in the context of the Canadian Constitution is whether the Ontario legislature has the authority to do so. The federal and provincial spheres of jurisdiction concerned here fall under two heads of powers in the Constitution Act, 1867:[15] section 91(21) grants the Parliament of Canada exclusive

9 Toronto Financial Services Alliance, "Toronto Ranks Consistently in the Top as a Global Financial Centre", online: <www.tfsa.ca/toronto-advantage/rankings/>.

10 Silvia Pavoni, "New York Leads, Toronto Gains", *The Banker* (1 December 2015).

11 *Ibid*.

12 See "Dealmakers 2016", *Financial Post* (28 January 2016), online: <http://business.financialpost.com/investing/outlook-2016/dealmakers-2016-click-here-for-all-our-data>; "TMX Group Equity Financing Statistics — March 2017", *TMX Money* (7 April 2017), online: <http://web.tmxmoney.com/article.php?newsid=7604795236533080&qm_symbol=X>.

13 See Ontario, *2016 Ontario Budget*, Chapter I, Section A, online: <www.fin.gov.on.ca/en/budget/ontariobudgets/2016/ch1a.html#s27>.

14 Dilip Ratha, Supriyo De & Sergio Kurlat, "Does Governing Law Affect Bond Spreads?" (October 2016) World Bank Policy Research Working Paper WPS7863 at 3.

15 *Constitution Act, 1867* (UK), 30 & 31 Vict, c 3, reprinted in RSC 1985, Appendix II, No 5.

jurisdiction over "Bankruptcy and Insolvency," and section 92(13) gives provinces a similar jurisdiction over "Property and Civil Rights in the Province," which we may refer to as civil law.

While section 91(21) of the Constitution Act, 1867 gives extensive jurisdiction over bankruptcy and insolvency to Parliament, the federal jurisdiction cannot unduly hamper provincial legislative action. In fact, there is a very close relationship between the bankruptcy law and laws enacted under the property and civil rights power. These two branches of law are a part of private law. Insolvency occurs because a person cannot meet the civil liabilities already assumed. Bankruptcy law is thus superimposed on civil law provisions because the normal operation of such provisions is disturbed by the debtor's insolvency. However, the civil law may not close its eyes to the fact that a number of debtors may become insolvent. To function, it must take this reality into account in regulating the legal relations of debtors and creditors. In this way, the provincial legislature pursues its own purposes without invading the legislative field reserved to the Parliament of Canada or putting itself in a position in which it could be accused of pursuing legislative goals that fall under the powers of the federal Parliament. In other words, subsection 91(21) of the Constitution Act, 1867 is intended to allow the Parliament of Canada to regulate situations of insolvency, but not to sterilize legitimate provincial action within its sphere of jurisdiction.

Apart from their jurisdiction over the civil effects of insolvency, the provinces have a strong case that they can, in an incidental and accessory manner, generally restructure the assets of an insolvent debtor. The jurisdiction follows from the conspicuous effects of insolvency on legal relations in general. Indeed, with the exception of the principle of the discharge of the bankrupt, it is hard to imagine a rule of bankruptcy law that provinces cannot validly enact as incidental or ancillary to their powers. Bankruptcy legislation is an organic and complementary part of private law, from which it may not be severed without affecting the harmony and coherency of the whole.

In sum, Ontario arguably has the constitutional authority to adopt the model law, based on the property and civil rights power, although complementary federal legislation would also be highly desirable because of the need to minimize uncertainty. The best way forward is for the province to take the initiative on enacting the model law and then engage with the federal government for complementary legislation. Having both levels of government acting together would guarantee the successful implementation of the initiative and provide contracting parties with full legal certainty to have the debt governed by Ontario law.

The Model Law's Impact on Ontario's Public Debt

An important issue that merits consideration is whether the adoption of the model law entails any costs or adverse consequences for Ontario. Two potential areas of concern can be identified: reputational concerns associated with sovereign defaults; and the impact of the model law on the province's debt. The first issue points to concerns that future sovereign defaults could have a potential negative impact on Ontario law or on Toronto's image as a global financial centre. This outcome is unlikely to materialize as markets would not blame Ontario law for a sovereign default, anymore than New York or English law are blamed when a foreign sovereign defaults. Performance or default are external events that cannot be attributed to the governing law. Importantly, the model law seeks to mitigate the negative consequences of default by allowing the parties to work out a fair and balanced debt restructuring. A sovereign default should not, therefore, pose any reputational risks to the province's financial or legal reputation. Quite conversely, a mechanism for the orderly resolution of such sovereign defaults under Ontario law should serve to enhance the province's reputation worldwide.

In regard to the second concern, it needs to be acknowledged that Ontario law is the primary choice of law for the province's debt. The province is therefore self-interested and sensitive to any legislative changes that would impact its public finances. There seems to be little downside or risk associated with adopting the model law; it offers a legal solution to the outside world, especially those low-income and developing economies that have been haunted by recent holdout episodes. Choosing Ontario law in this respect is no different from choosing New York or English law as the governing law. While these laws are frequently used to govern sovereign debt contracts, they have not raised any doubt about New York's or the United Kingdom's public finances. In addition, the model law can only apply to future issuances and should not in principle have any effect on Ontario's outstanding debt stock, unless the legislature should expressly choose to affect it.

Furthermore, there is currently no concern about the province's creditworthiness. As of March 2016, the province's outstanding debt was CDN$327.4 billion, of which CDN$254 billion or 77 percent was denominated in Canadian dollars. In 2015–2016, the province's net debt-to-GDP ratio was 38.6 percent of GDP and is expected to decrease to 38.3 percent in 2016–2017.[16] Canada's net debt-to-GDP ratio stood at 27 percent in 2015 and is expected to fall below 20 percent by 2021. The IMF considers Canada's overall public debt to be on a sustainable trajectory, projecting the country's net debt-to-GDP ratio to fall below 20 percent by 2021.[17] The province currently enjoys an Aa2 rating by Moody's investor service, indicating that the province's obligations are of high quality and subject to very low credit risk.[18] The province has similar ratings by other credit rating agencies. Taken together, these factors suggest the adoption of the model law is unlikely to send a negative signal to the market (and hence should not adversely affect provincial or federal public finances).

Finally, it should be noted that Ontario, as the legislating jurisdiction, maintains complete sovereignty over its domestic law. The province has the power not only to adopt the model law, but also to determine its scope of application, including the extent to which, or whether at all, it should apply to Ontario's debt. This sovereignty is clearly reflected in the contractual provisions of the province's debt, which explicitly state that the Ontario law governing the bonds can change at any time.[19]

Catalyzing Change: Drawing Lessons from Previous Reforms

The experience with other international reforms offers valuable lessons on how to succeed with the model law. In light of the existing political constraints on a treaty-based regime or an SDRM-like mechanism, recent reforms to improve sovereign debt restructuring have mainly focused on market-based and contractual approaches. A notable example of such reforms is the second-generation collective action clauses (CACs 2.0) that were introduced by the International Capital Market Association (ICMA) following difficulties in resolving claims in Argentina's and Greece's debt restructuring, due to holdout creditors.[20] CACs 2.0 allow the bondholders to vote on a restructuring proposal, with the outcomes of the vote binding on all bondholders. There is also a new standard *pari passu* clause that ICMA drafted to avoid the difficulties that Argentina faced in the New York courts.[21]

Following their introduction, CACs 2.0 were endorsed by the IMF executive board and the G20 finance ministers and central bank governors.[22] In November 2014, Mexico made the first public offering with the new clauses under New York law, selling US$2 billion in 10-year bonds. A significant point about the Mexican issuance is that it contradicted the speculation that markets would demand a greater interest rate for the inclusion of CACs. In fact, the 2014 issuance locked in the lowest interest rates in Mexican history and CACs 2.0 had no impact on the bonds' pricing whatsoever.[23] Since then, there has been a substantial uptake of CACs 2.0 in new bond issuances, without

16 Ontario Financing Authority, "Province's Consolidated Debt Portfolio", online: <www.ofina.on.ca/borrowing_debt/debt.htm>.

17 IMF, "Canada: 2016 Article IV Consultation–Press Release; and Staff Report" (June 2016) IMF Staff Country Reports No 16/146 at 54.

18 Ontario Financing Authority, "Province of Ontario Credit Ratings", online: <www.ofina.on.ca/ir/rating.htm>.

19 For example, the prospectus supplement for Ontario's 1.95 percent bonds due January 27, 2023, which is filed with the US Securities and Exchange Commission, provides: "The laws governing the Bonds may change." See Prospectus Supplement Filed pursuant to Rule 424(b)(2) of the Securities Act of 1933 Nos. 33209852 and 333165529, S-9, online: <www.sec.gov/edgar/searchedgar/webusers.htm>.

20 ICMA, "ICMA STANDARD CACs — August 2014", online: <www.icmagroup.org/resources/Sovereign-Debt-Information/>.

21 ICMA, "ICMA STANDARD PARI PASSU PROVISION — August 2014", online: <www.icmagroup.org/resources/Sovereign-Debt-Information/>.

22 See IMF, Press Release 14/466, "Communiqué of the Thirtieth Meeting of the International Monetary and Financial Committee, Chaired by Mr. Tharman Shanmugaratnam, Deputy Prime Minister of Singapore and Minister for Finance, October 11, 2014" (11 October 2014); G20, "G20 Leaders' Communiqué, Brisbane" (16 November 2014).

23 Mark Sobel, "Strengthening Collective Action Clauses: Catalyzing Change — The Back Story" (2016) 11:1 Cap Markets LJ 3 at 10.

any observable impact on the bonds' pricing.[24] Of course, the CACs reform faces the important limitation that the existing stock of bonds worth US$846 billion does not include them.[25] The existing data also suggests that a considerable number of future bonds may also not include CACs 2.0.[26]

In spite of such limitations, the CACs reform process offers important lessons for the model-law initiative. First, it suggests that the robust aggregation mechanisms of the model law, which also address the *pari passu* issue, are unlikely to affect the bonds' pricing. The model law can be an even more attractive option than CACs 2.0, as it includes provisions regarding the supervision of the restructuring process and the settlement of disputes through arbitration. Such provisions provide creditors with greater confidence that their legal rights will be reasonably protected in the forum and that they will receive a fair remedy in case of default or disputes.

Second, the CACs reform highlights the importance of signalling and issuing the bonds in good times. That is to say, if a sovereign issuer is in sound financial condition and there is no looming question about its debt sustainability, issuing debt under Ontario law should not send a negative signal to markets. The final lesson is on the importance of outreach and building alliances to overcome collective action problems. The Mexican issuance with the enhanced CACs helped policy makers overcome their first-mover challenge and provided the markets with the essential confidence to take up the enhanced clauses in new bonds. Given that Canada is politically stable and has a sound reputation for the rule of law and an independent judiciary, it should be possible to convince a sovereign borrower with sustainable debt dynamics to issue debt under Ontario law. The first issuance will then pave the way for the greater uptake of Ontario law in future sovereign debt issuances.

Conclusion

The search for an abiding SDRM has been going on for a very long time. Since the 1930s, various attempts have been made to establish a statutory restructuring mechanism, most notable of which was the IMF's SDRM, which has now been abandoned or left in limbo.[27] While these attempts recognized the inadequacy of contractual reforms, they failed to generate sufficient support because they relied on concerted multilateral action. The model law is the only reform initiative that offers the predictability and effectiveness of a statutory approach without foundering on the obstacles that frustrated previous reforms.

As this policy brief argues, the model law provides a unique leadership opportunity for Ontario, enabling the province to establish an orderly sovereign debt resolution regime under the rule of law. The model law is unlikely to increase borrowing costs or adversely affect the province's public finances. By its adoption, significant benefits accrue to debtor states and creditors, and Ontario could further develop its capacities as a world-class financial jurisdiction. Both Ontario and the deeply dysfunctional sovereign debt world would benefit.

24 IMF, "Second Progress Report on Inclusion of Enhanced Contractual Provisions in International Sovereign Bond Contracts" (27 December 2016) IMF Policy Papers at 6.

25 *Ibid*.

26 See *supra* note 3.

27 Eric Helleiner, "The Mystery of the Missing Sovereign Debt Restructuring Mechanism" (2008) 27 Contributions Political Econ 91 at 95; Skylar Brooks & Domenico Lombardi, "Governing Sovereign Debt Restructuring through Regulatory Standards" (2016) 6:2 J Globalization & Dev 287 at 290–93.

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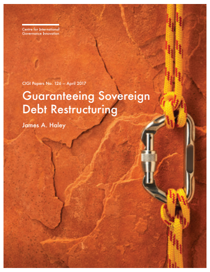

Guaranteeing Sovereign Debt Restructuring

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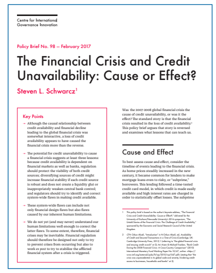
The recurring nature of efforts to facilitate the timely restructuring of sovereign debt is explained by the fact that protracted delays in restructuring private sector claims can lead to deadweight losses. Such delays may stem from two sources: intra-creditor coordination failures; and factors that impede efficient bargaining between the debtor country and private creditors. A well-designed guarantee of restructured debt that addresses these problems could promote timely restructuring and reduce the potential risks to the global economy associated with severe indebtedness.



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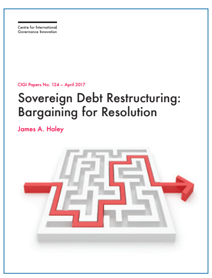

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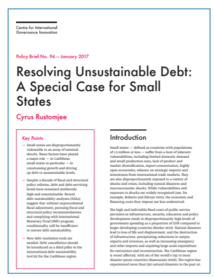

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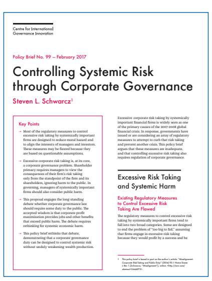

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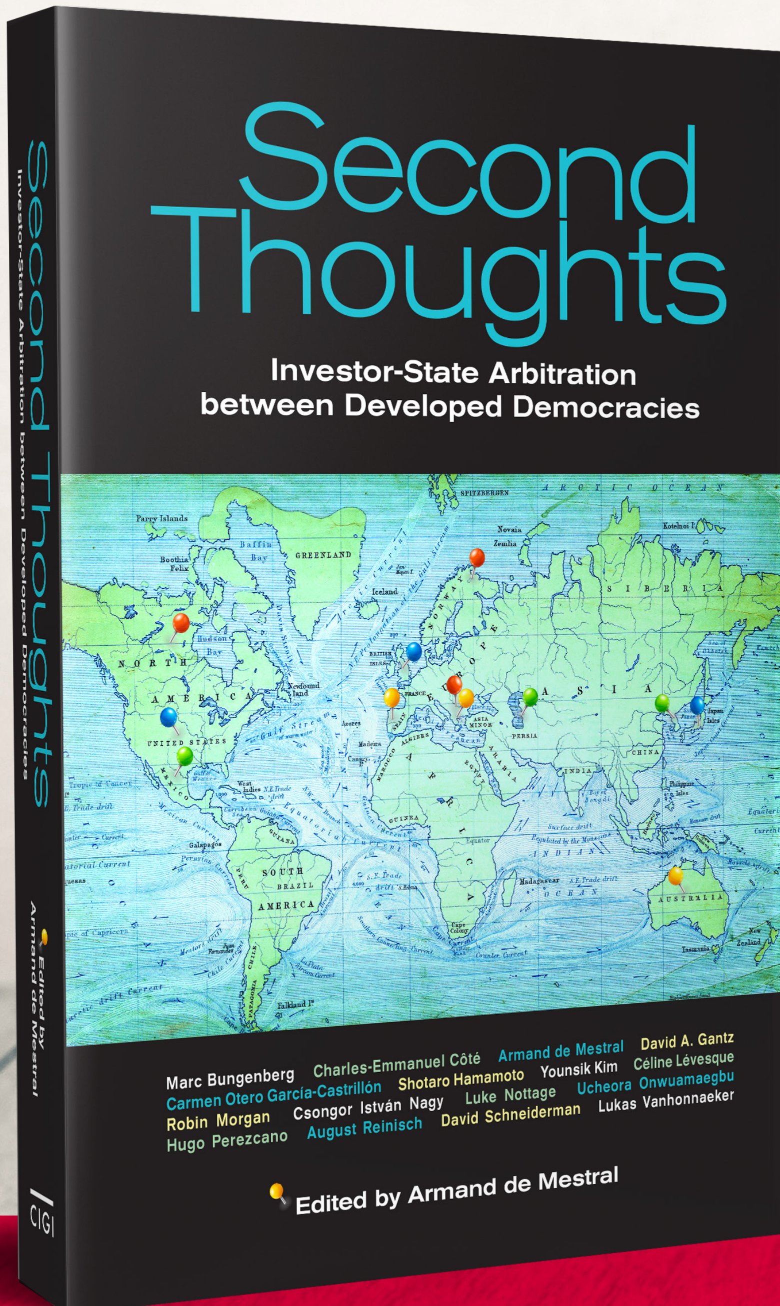

Second Thoughts

Investor-State Arbitration between Developed Democracies

Edited by Armand de Mestral

Since the first international investment agreement was negotiated nearly six decades ago, developed countries have sought to protect their investors against the possible failure of host countries (usually a developing country) to respect treaty standards. The North American Free Trade Agreement and the European Energy Charter, both dating from 1994, marked the first instances of developed countries signing an agreement containing provisions for investor-state arbitration (ISA) between themselves. Since then, ISA has become a standard feature of international investment agreements, even as the chorus of protest against ISA from civil society groups (and some nations) has grown louder.

Second Thoughts gathers the reflections of 16 international investment experts, examining experiences of ISA in Canada and various parts of the world, and asking whether ISA is appropriate between developed democracies.

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Nos programmes de recherche ont trait à la gouvernance dans les domaines suivants : l'économie mondiale, la sécurité et les politiques mondiales, et le droit international, et nous les exécutons avec la collaboration de nombreux partenaires stratégiques et le soutien des gouvernements du Canada et de l'Ontario ainsi que du fondateur du CIGI, Jim Balsillie.

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67 Erb Street West
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