

Creating a Soft Law Regime for Sovereign Debt Restructuring Based on the UN Principles

(based on joint paper with Martin Guzman)

Joseph E. Stiglitz

New York

October 31st 2016

Why sovereign debt restructuring matters

- No economic recovery without restoration of debt sustainability
 - More unemployment, inequality, poverty, social suffering
- Restructuring must be aligned with the development goals of the distressed debtor
 - A system for sovereign debt restructuring must ensure lending efficiency, crises resolution efficiency and equity
 - It must be principles-based

The current non-system

- The current non-system is flawed and doesn't work
- More often than not, restructuring does not restore “sustainability with high probability”
- Since 1970, more than half of the restructurings with private creditors were followed by another restructuring with private creditors or default within 5 years
 - Difficult to reconcile with any sensible conception of “restoring sustainability with high probability”

The current non-system

- Characterized by bargaining between a distressed debtor and its creditors based on decentralized market-based instruments
- The IMF often plays the role of the facilitator in the process of bargaining
- But it often fails to ensure that restructuring needs are addressed timely

The vulture funds

- The gaps in the international financial and legal architecture create perverse incentives for legal arbitrage and work against cooperation
- They led to the emergence of vulture funds
- Buy distressed debt at bargain prices, hold out from negotiations, and litigate claiming full payment (full principal and full interest)
 - Distort the functioning of sovereign lending markets
 - May make restructuring impossible to finalize
 - The problem got aggravated with recent victory over Argentina
 - Some vulture funds got returns larger than 1,000 percent over their “investments”

Creating a framework for sovereign debt restructuring that works

- Proposals on the table:
 - Improvements in contractual language
 - Will help but will not fully resolve important coordination problems
 - And it will not resolve a more fundamental problem: complex sovereign debt restructuring disputes will be decided by judges from major lending jurisdictions that do not understand the goals of a restructuring
 - As Judge Griesa in the dispute of Argentina with NML Capital and other vulture funds
 - Improvements in domestic legislation (anti-vultures legislation)
 - A principles-based framework (UN GA Resolutions 68/306 and 69/319)
- These different approaches are complementary

Proposal: soft law regime based on the UN principles

- The UN Principles:
 - Sovereignty
 - Good faith
 - Transparency
 - Impartiality
 - Equitable treatment of creditors
 - Sovereign immunity
 - Legitimacy
 - Sustainability
 - Majority restructuring
- They have not been respected in many recent restructurings

Proposal: soft law regime based on the UN principles

- The principles need to be codified for practical purposes
- Proper codification of the principles could provide guidance to domestic courts

Proposal: soft law regime based on the UN principles

- Good faith:
 - Vultures funds' behavior does not respect it
 - Also, creditors who lend at an interest rate that includes compensation for risk cannot in good faith bargain to receive treatment as if the lending were risk-free
 - A debtor acting in good faith in a restructuring process should negotiate with the goal of achieving a level of debt relief that ensures the recovery of sustainability with high probability, but no more
 - US Courts defined Argentina as a recalcitrant debtor not acting in good faith, but what is the evidence that Argentina was getting larger relief than the one compatible with the principles ex-ante?

Proposal: soft law regime based on the UN principles

- Transparency:
 - May be violated by SCDS's trading in opaque markets
 - Impossible to know SCDS positions of those at the bargaining table
 - Possible conflicts of interests
 - Example: Elliott Management, vulture fund suing Argentina, was one of the 15 members of the ISDA Determination Committee that had to classify whether Argentina's impossibility to pay exchange bondholders due to Judge Griesa's injunction was a credit related event

Proposal: soft law regime based on the UN principles

- Impartiality:
 - It restricts the set of institutions that could host a mechanism for sovereign debt restructuring
 - Institutions that have a biased representation of the stakeholders involved or are creditors themselves are not suitable hosts for such a mechanism

Proposal: soft law regime based on the UN principles

- Equitable treatment of creditors:
 - Recent rulings in favor of vulture funds violated this principle
 - Besides, equitable treatment does not mean identical treatment when creditors are different
 - It could be justifiable to give seniority status to creditors that lend into arrears, helping the distressed debtor to continue the provision of essential services or to run countercyclical macroeconomic policies at the time they are most needed

Proposal: soft law regime based on the UN principles

- Sovereign immunity:
 - It's one of the most critical principles
 - It implies that the validity of any sovereign debt contract is constrained by the principle of international law that no country can renounce its sovereign immunity
 - Just as no person can sell himself into slavery
 - It puts a limit to the extent to which one democratic government can bind its successors
 - It places limits on the reach of foreign law

Proposal: soft law regime based on the UN principles

- Legitimacy:
 - It requires impartiality on the part of any party serving as mediator/arbitrator
 - It requires transparency
 - More generally, any restructuring that violates any of the other principles could be viewed as lacking legitimacy
 - A debt restructuring conducted under the threat of economic sanctions, as in the case of Judge Griesa's ruling that effectively precluded Argentina from accessing international credit markets, would also lack legitimacy
 - Any debt restructuring that resulted in the country violating its constitution or the UN Declaration of Human Rights would lack legitimacy as well

Proposal: soft law regime based on the UN principles

- Sustainability:
 - Restoring sustainability is the ultimate goal of a restructuring process
 - The UN sustainability principle recognizes that the relevant stakeholders in a restructuring process are not only the formal, but also the informal creditors (such as pensioners and workers)
 - The restoration of sustainability must not only balance fairly the rights of foreign and formal creditors but also those of other claimants, and promote sustained and *inclusive* development
 - Any computation of the necessary debt relief for achieving sustainability should be done in light of the UN broader definition of sustainability
 - Should take into account how debt relief affects economic performance
 - And should respect the other UN principles as well

Proposal: soft law regime based on the UN principles

- (Super)-Majority restructuring:
 - It will help to impede holdout strategies such as the ones successfully pursued by vulture funds
 - Recent contractual language suggested by ICMA improves the old terms
 - But it's just one piece of what a system that works needs

The usefulness of the UN principles

- The adoption of the UN principles contributes to a positive norm setting process
- Even if domestic legislations do not adopt them, local courts might follow them as a guide when they interpret and apply the law in reference to disputes related to sovereign debt
- The UN principles are also desirable because general principles of law are sources of international law
 - States need to comply with them as a matter of international law

A soft law mechanism with a mediating institution based on the UN principles

- What can be done to improve matters in the current juncture?
- Our proposal: to establish a *soft law mechanism* with a mediating institution
 - An incremental approach that builds on the UN principles and can be complemented by contractual improvements
- Soft law has the potential to create a healthier environment for debtors and creditors
- It relies on social norms and market acceptance, rather than on legal forces, to induce compliance
 - This incremental approach inspired the 2015 UNCTAD Roadmap and Guide, and was followed by the UN GA in the resolution that adopted the UN principles

A soft law mechanism with a mediating institution based on the UN principles

- A soft law instrument that codifies the UN principles for practical purposes could serve as a guide for domestic legislations
- The codification of the principles might remind courts of the big picture in a sovereign debt restructuring process, possibly mitigating biases towards narrower interpretations of debt contracts

A soft law mechanism with a mediating institution based on the UN principles

- It could retain a registry of recalcitrant holdout bondholders and their parent companies
 - The registry could serve as a guide for domestic and international courts when they have to decide whether bondholders violated the principle of good faith
- It could host a comprehensive, searchable public database of past restructurings, including financial and legal terms, the treatment of public, private, domestic and foreign claims, and any underlying assumptions used for achieving a restructuring plan

A soft law mechanism with a mediating institution based on the UN principles

- It could create its own Debt Sustainability Analysis framework
- It would encourage cooperation in order to achieve a level of relief that respects their sustainability assessments and satisfies the other UN principles
 - In a process of sovereign debt restructuring initiated by the sovereign, the institution would first produce a preliminary DSA and transmit it to the government for a response
 - The government would be required to disclose information and data necessary for the assessment and to respond to the DSA
 - Next, the preliminary DSA and the government's response would be made public to the creditors, other international institutions, and the general public, all of whom would have an opportunity for comment
 - After a reasonable time period, the institution would publish a final DSA taking into account the government's response and public comment
 - The final DSA would give reasons that justify the determination made and would indicate possible disagreement with the government, international institutions, or creditors' committees
 - The statements of the institution would not be enforceable, but could be used as a legitimate guide (especially for domestic courts) on what is sensible practice in a debt restructuring process

Conclusions

- The current no-system does not work
 - It delays the resolution of sovereign debt crises and does not address restructuring needs, with negative social consequences
- We believe the creation of a soft law mechanism with a mediating institution based on the UN principles can mitigate some of the current deficiencies