THE UNIVERSITY OF WARWICK

Aug 2013 No.144

Eurozone Sovereign Debt Restructuring: promising legal prospects?

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WORKING PAPER SERIES

Centre for Competitive Advantage in the Global Economy

Department of Economics

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Eurozone Sovereign Debt Restructuring: promising legal prospects?♣

July 2013

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Abstract

The Eurozone debt crisis has stimulated lively debate on mechanisms for sovereign debt restructuring. The immediate threat of exit and the breakup of the currency union may have abated; but the problem of dealing with significant debt overhang remains. After considering two broad approaches - institutional versus contractual – we look at a hybrid solution that combines the best of both. In addition to debt contracts with Collective Action Clauses, this includes a key amendment to the Treaty establishing the European Stability Mechanism, together with innovative state-contingent contracts and a Special Purpose Vehicle to market them.

♣ Department of Economics and Adam Smith Business School, respectively. We are grateful to Anna Gelpern, Sayantan Ghosal and Julian Schumacher for conversations on the topic. The paper has benefitted from discussant comments from Christopher Bliss and editorial direction from Christopher Bowdler and Rui Esteves. We also wish to thank Hugh Bredenkamp for drawing our attention to the IMF 2013 policy paper on sovereign debt restructuring and to his colleagues Varapat Chensavasdijai and Tamon Asonum for their comments. Thanks to Katie Roberts for research assistance funded by ESRC/CAGE.

“The European Union was meant to be a voluntary association of equal states but the crisis has turned it in to a creditor/debtor relationship from which there is no easy escape.”(George Soros, 2013)

I. INTRODUCTION

In a prescient paper written in 2011, Paul de Grauwe argued that:

> National governments in a monetary union issue debt in a “foreign” currency, i.e. one over which they have no control. As a result, they cannot guarantee to the bondholders that they will always have the necessary liquidity to pay out the bond at maturity. This contrasts with “stand alone” countries that issue sovereign bonds in their own currencies [which] allows these countries to guarantee that the cash will always be available to pay out the bondholders. (p.2)

He concluded that the European Central Bank would need to act as a lender of last resort in sovereign bond markets to prevent liquidity crises. Such a policy was adopted by the ECB in late 2012 under the label of Outright Monetary Transactions (OMT) – so-called as it improves the monetary transmission mechanism by harmonising interest rates across Europe. It could also be described[1] as the issue of a put on sovereign bonds – a ‘Draghi put’ – with moral hazard aspects covered , in principle, by fiscal conditionality.

So far, so good. But what about solvency crises? How are they to be prevented or resolved? Given the analogy between members of the Eurozone, who issue debt in Euros, and emerging market countries borrowing in US Dollars, it is hardly surprising that the current anguished discussion of European debt problems echoes earlier debates at the IMF and elsewhere on sovereign debt restructuring. Those debates became polarised between those advocating *institutional solutions*, notably Anne Krueger (2002) who proposed a Sovereign Debt Restructuring Mechanism (SDRM), and those like the US Treasury who favoured *market-driven contracts* including Collective Action Clauses (CACs) that permit restructuring subject to supermajority voting.

[1]As in Miller and Zhang (2013)

Anne Krueger's (2002) proposal, made when she was at the IMF, was inspired by Chapters 9 and 11 of the US bankruptcy code; but it was seen as too ambitious in an international context - particularly since the IMF itself would face a conflict of interest as both creditor and judge. Market resistance - possibly reflecting the view that making debt restructuring difficult *ex post* would help motivate sovereigns avoid default (Dooley, 2000) – led to the shelving of the formal SDRM proposal and with it the salience of *ex ante* solutions to sovereign debt crisis. Instead, following the lead of Mexico in 2003, sovereign states replaced the unanimous consent required to restructure US bonds by CACs that rely instead on a supermajority vote as the dominant mechanism for resolving debt crises *ex post*.

Before turning to the current debate in Europe, we look in section II at procedures in two recent European cases, namely the Greek sovereign debt restructuring and the Cyprus bank restructuring. The feasibility of a formal bankruptcy mechanism to address the problems in the Eurozone is considered in section III – focusing on the European Crisis Resolution Mechanism (ECRM) recently proposed by Anne Krueger and colleagues. In section IV we examine how the 'pure' contractual or market driven framework has evolved to deal with sovereign crises. This leads to the key contribution of this paper in section V– an analysis of initiatives which combine statutory and market driven features. These include the statutory modification of the Treaty establishing the European Stability Mechanism (ESM) as proposed by Buchheit et al. (2013), and complements to CACs - principally in the form of creditor committees and GDP-bonds . Brief conclusions follow.

II. TWO CASE STUDIES: GREECE, CYPRUS

What lessons do the Greek debt workout and the recently concluded Cypriot bailout have for the future? They reveal, we believe, an incipient policy framework that encompasses both statutory interventions and market innovation.

The Greek debt workout

On 24 February 2012, Greece invited its bondholders to exchange their existing holdings for new rescheduled debt, with some sweeteners. It was the largest developed-country insolvency ever and involved the Euro, the second largest currency in the world. Indeed, the size of its debt relative to GDP was probably attributable to the assumption the market made that membership of the Eurozone immunized Greece from default.

Bonds involved in the exchange

The total amount of bonds eligible for restructuring was almost the same as Greek annual GDP of about €200 billion. It entailed Private Sector Involvement (PSI) and set a template for how the private sector might share the pain of a workout. The recognition that PSI will be relied on in debt workouts has since been institutionalised in the ESM treaty (recital 12)[2]. The Greek debt workout made five bonds subject to the offer (in 135 different bond series): foreign law (mostly UK law) bonds , Greek law bonds (€177 billion),foreign law bonds of Greek companies guaranteed by Greece, other guaranteed bonds and a small number of Swiss law bonds.

In most cases, the bondholders were effectively offered 15 percent in cash plus accrued interest (in both cases represented by short-term European Financial Stability Facility (EFSF) notes), a new Greek government bond with a nominal value of 46.5 percent of the original bonds and a detachable GDP warrant whereby Greece would pay a sum (capped at 1 percent per annum of the outstanding amount of the new bonds) if GDP exceeded certain official predictions. The new bonds were payable in thirty years, commencing in year 11 with an initial coupon of 2 percent increasing to around 3.4 percent - both under market rates. The final amount of new debt issued was about €70 Billion or almost 50 percent of GDP (Zettelmeyer et al.,2012).

Retrofitting of Collective Action Clauses(CACs)

The day before the offer, the Greek government passed a law allowing it to insert CACs in existing Greek government bonds. (Most foreign law bonds already contained CACs, and Greece made the same offer to foreign bondholders with modifications). The clauses make it possible to 'cram down' all domestic bondholders if a supermajority of 66 percent or more accept the offer. The invocation of CACs in

[2] The extent and scope of PSI involvement is *ad hoc* and determined on a case by case basis, however, and the resulting uncertainty raises litigation risk. The implications of this is on debt restructuring is discussed in more detail later in this paper.

the domestic law bonds eventually led to more than 97 percent of bondholders accepting the offer - up from 83.5 percent before invocation. But the 3 percent holdouts held foreign law bonds and were paid in full to avoid litigation. In fact, of the 36 bonds governed by English law with CACs that were eligible to participate in the debt exchange, only 17 were successfully restructured using CACs[3]. This resulted in holdout claims of about € 6.5 billion, accounting for 30 percent of the total value of debt governed by foreign law[4]. The significance of the holdout problem is taken up later.

Size of write-down

Zettelmeyer et al. (2012) see the Greek restructuring as a considerable success in promptly securing high participation and significant relief with little market disruption. The main features of the settlement were aggregate private sector losses of about 55-65 percent - more or less in line with the Brady Plan for Mexico - though the 'haircuts' varied considerably with maturity (at the short end, present value losses were 75 percent or more while at the long end losses were below 50 percent). The debt exchange resulted in a transfer of just under €100 billion from creditors to the sovereign debtor or about 45 percent of GDP in present value terms (Zettelmeyer et al. 2012).

Creditor committees involved

The workout was settled in about ten months which compares very favourably with the Argentine debt restructuring - still unresolved after almost a decade. The expeditious workout could in part be attributed to another key development: "the rebirth of the creditor committee" (Zettelmeyer et al., 2012, p.4). In the debt negotiations, Greece engaged with a steering committee of creditors and did not have to wait for dispersed creditors and institutional investors to organise themselves, as was the case in Argentina. The revival of the steering committee resolved the issue of creditor organisation and has been attributed to the fact that much of Greece's outstanding debt was held by large Western banks. Further, instead of arm-twisting

[3] And the invocation of CACs and the "cram-down" was deemed to be a default event by the International Swaps and Bonds Association, which triggered Credit Default Swaps.
[4] Thus English-law governed bonds with an outstanding face value of €435 million - owned mostly by Dart Management, a specialist holdout, were repaid in full to avoid litigation-related delays (Zettelmeyer et al, 2012, p.9).

potential free-riders to participate with veiled threats, the ‘Greek authorities relied on a mix or carrots and sticks embedded in the exchange offer itself’ (Zettelmeyer et al., 2012, p.3).

Administrative restructuring

The recapitalisation of its banks was conditional on Greece submitting to EFSF/ESM programme conditionality, which included a substantial dose of fiscal austerity. There were accompanying legal changes to make regulators (rather than courts and creditors) responsible for conducting the restructuring of banks[5]. The absence of creditor litigation and court intervention in the Greek debt workout was a consequence of the Greek authorities eliminating litigation risk by satisfying holdout claims in full. The alternative of limiting litigation risk through statutory change is what we discuss in Section V below.

Official sector priority

The Greek debt workout was also marked by the “special treatment accorded to the holdings of Greek bonds by the ECB and various Eurozone Central Banks” (Zettelmeyer et al., 2012, p.34). In general, established state practice maintains the priority of official sector debt over private sector debt. Thus so far the repayment of IMF debt for instance has to be kept current and cannot be restructured. One justification for the evolution of this state practice is that a significant percentage of bailouts are provided by the official sector, so it is similar to ‘debtor –in –possession financing’, or the provision of ‘new money’. There is however no similar established state practice in the Eurozone. As most of Greek debt is now owed to official lenders, it is likely that future workouts will be under the aegis of the Paris Club, with implications on the extent of ‘matching’ PSI in debt workouts.

The priority of official sector debt over private debt in the Greek workout has been underpinned by the Treaty establishing the ESM under which ‘ESM loans will enjoy preferred creditor status in a similar fashion to those of the IMF.’ There are two points to note here. The IMF policy on Lending in Arrears (LIA) - debt that cannot be restructured – is applicable only to sovereigns who fail to repay the debt owed to private creditors as part of a restructuring. This was inapplicable to Greece which

[5] Such administrative restructuring avoids the delays usually associated with judicial restructuring - and has since been used to fulfil a key condition of the Cyprus bailout, discussed below.

restructured its debt pre-emptively. In any event the IMF LIA policy has been criticised for being inconsistent (Lerrick, 2005; Weber,2005). It is unclear to what extent this will delay workouts in the future.

Haircuts declined with maturity

Greece applied a ‘one-size-fits-all’ approach for all investors and “haircuts tended to decline with maturity...This reflected the fact that the exchange offer was not tailored to the maturity of the instrument held by the investors and hence offered everyone the same value even though longer-term investors held lower value claims” (Zettelmeyer et al., 2012, p.2).

The Cyprus bank bailout

As Paul De Grauwe (2011) notes, private sector bank debt in many cases dwarfs local sovereign borrowing. This was true for Cyprus (where bank indebtedness was more than three times GDP); and an interesting aspect of the crisis intervention there is that it mainly involved restructuring bank not sovereign liabilities. Rather than waiting for the sovereign to bail out the banks - and then restructuring sovereign debt - the idea was to deal directly with the bank debt, with the aim of lowering the bank debt to GDP ratio to under 150 percent.

Levy on large deposits and bank restructuring

The initial plan involved a huge blunder, however, in that all depositors, including insured depositors, were threatened with a haircut – a step that threatened to spread contagion right across Europe. The issue was eventually dealt with by major restructuring of the two principal banks with a levy of 60 or more percent imposed on deposits above the insurance limit of €100,000 in exchange for equity. To prevent a run on banks after the levy was announced, capital controls became necessary. The bailout has reduced the debt overhang in the interregnum as desired, and prevented an exit from the Eurozone; but it has shaken the confidence of bank depositors in other Eurozone countries; and will, moreover, require significant accompanying changes in the economy.

Bond Exchange

With the approval the European Commission and the IMF, the Government has also carried out a debt exchange which lengthened the maturity of € 1 billion with no change in principal or in the coupons – a lock-in to enhance the sovereign's liquidity rather than a write-down to improve solvency. Market reaction has been mixed: but, as Buchheit (2013) wryly observes, "a principal extension of this kind is the most clement of the three instruments in the restructurer's tool box, the other two are surgeon's saws labelled, respectively 'principal' and 'interest'.

Economic restructuring

The conditions of the bailout require a radical overhaul of the existing business model of the island economy - judged to be overly reliant on the banking sector. Set against the loss of revenues from this source, however, is the prospect of substantial dividends from offshore natural gas deposits yet to be developed: and we discuss the option of issuing GDP and natural-resource-linked bonds later.

What is the best way forward for orderly, quick and voluntary debt workouts within the constraints of a currency union? Consider first a recent proposal for statutory change in Europe.

III. THE 'STATUTORY' OR INSTITUTIONAL APPROACH TO SOVEREIGN BANKRUPTCY

From their study of sovereign debt crises over eight centuries, Carmen Reinhart and Kenneth Rogoff conclude the "the most fundamental "imperfection" of international capital markets, [is] the lack of a supernational legal framework for enforcing debt contracts across borders" (Reinhart & Rogoff, 2009, p.53). Whether they would endorse a permanent statutory bankruptcy court for all sovereigns, or statutory intervention across borders, is not clear. Here we examine the European Crisis Resolution Mechanism (ECRM) proposed in 2010 in light of the fact that policy makers in the Eurozone were caught off-guard, with no rules, guidance or policy tools to help resolve the imminent sovereign debt crisis[6].

[6] Another justification for the ECRM was the "credibility problem of the unconditional no bailout clause" as set out in Article 125 of the European Union Treaty (Gianviti et al, 2010, p.9). The idea was to avoid repeating the experience of Argentina "where the emergence of a fortuitous bad equilibrium

The ECRM is intended not as an *ad hoc* solution for a specific crisis but as a permanent structure ‘to improve the working of the European Monetary Union.’(Gianviti et al, 2010). It was proposed as an institutional solution to resolve a new problem: the restructuring of outstanding public debt that was mostly in the form of government bonds rather than bank loans or intergovernmental credit. As far as Eurozone sovereigns are concerned, this proposal appears to replace Paris Club deliberations.

Details of the mechanism are set out in the box below.

The European Crisis Resolution Mechanism (ECRM)

The ERCM is a permanent, statutory mechanism of three, functionally distinct bodies designed to act together to promote orderly debt restructuring.

The Legal body – A special chamber of the Court of Justice of the European Union. It will trigger the restructuring procedure on the request of a Euro-area sovereign (backed up by approval of the Economic body confirming the requesting debtors’ insolvency). It will sort and assess claims, rule on disputes between parties, aggregate claims, stay all litigation and debt servicing, agreement and finally enforce the agreement reached.

The Economic body – The EC /jointly with the ECB. After the process is initiated, this body will call for meetings, guide negotiations with a view to reaching an agreement. It will review the accuracy of a borrowers representation of its economic and financial situation, evaluate the implications of any debt restructuring proposal for the debtors outstanding debt (i.e. the extent of the haircut) and its sustainable level of debt going forward.(i.e. the projected future path of primary budget surpluses).

The Financial body – The EFSF (with permanent status and seniority) to provide short - or –medium term financing. (Access to this body to be open to any Euro-area country that is facing short term liquidity problems but is otherwise current

results from the anticipation of the break-up of the currency board.” (Cavallo and Fernando -Arias, 2012). This problem has, however, subsequently been resolved with an interpretation of the Article that effectively allows bailouts.

on its debt).

The ERCM proposal does not envisage a formal role for the IMF

For some, the main objection to an overarching, sovereign bankruptcy framework structured along the lines of Chapters 9 and 11 of the US Bankruptcy Code is that it ‘ranks quite high on just about any scale of intrusiveness one can imagine when it comes to dealing with sovereign debt issues’(Bolton and Skeel, 2004, p.770).

Another reservation of the ECRM as it stands is the absence of a statutory priority structure, a standard feature of corporate bankruptcy codes. Before the courts get involved, corporate workout negotiations between creditors occur in the shadow of prescriptive bankruptcy codes, which determine the position of the creditors in any judicially supervised workout. The incentive for creditors to arrive at a negotiated settlement by organising themselves is that they control the outcome rather than the court. Sovereign workouts are different in that there is no statutorily prescribed order of priorities.[7]

Finally, given recent institutional changes - including the ratification of the ESM treaty by individual sovereigns - it is unclear whether Eurozone sovereigns could unilaterally choose to adopt a statutory framework of the kind proposed[8].

There is, we believe, little prospect of such a statutory framework being adopted on a Europe-wide basis any time soon. Nevertheless, in their handling of the Greek and Cypriot crises, policy-makers have, it seems, followed some of its key recommendations.

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[7] This revives an earlier debate Gelpern (2004) on whether there should be an enforceable priority structure to facilitate sovereign debt restructurings.

[8] Recent decisions and opinions of the European courts make it unlikely that a member state that has ratified the ESM Treaty can unilaterally enter into an international agreement to set up an international bankruptcy court ([1971] ECR 263; Opinion 2/91 [1993] ECR 1-1061;Opinion 1/03[2006]ECR 1-1145).

- The *ad hoc* and temporary EFSF has been replaced by the permanent but independent ESM to provide debtor-in- possession financing; and the receipt of ESM support is linked to programme conditionality.
- There is a framework of informal but customised rules of engagement for each crisis as it arises.
- The 'troika' (ECB, IMF and European Commission) have developed a template for liquidity support, with the promise of Outright Monetary Transactions (OMT) by the ECB reducing uncertainty in the way set out in the ECRM.

IV. THE PURELY CONTRACTUAL OR 'MARKET-DRIVEN' APPROACH TO SOVEREIGN BANKRUPTCY

Sovereigns are undoubtedly prone to debt crises – there have been about 190 debt exchanges since 1950. But, on the whole, sovereign debt workouts have been orderly despite the absence of an international bankruptcy law for sovereigns. This has led some observers to argue for a purely contractual or market-driven approach that allows "parties more or less to decide what they like, subject to some very basic and primitive threshold rules" (Wood 2012, p.11)[9].

Collective Action Clauses (CACs)

CACs permit creditors to collectively modify contract terms, giving the debtor partial relief and thereby avoiding default. These are usually comprised of three clauses (Choi et al., 2012, p.141). First, those that permit creditors to modify **non-payment terms** or terms other than interest, capital and time of payment provided the requisite threshold is reached. Second, clauses that allow for the modification of **payment terms**. In bonds issued under New York law payment terms can be modified by a vote of 75 percent of the bonds. In bonds issued under English law, there is a requirement of a physical meeting of bondholders. Typically, 50 percent is the quorum for the first

[9] This view that debt workouts are 'spontaneous orders' reliant exclusively 'on the bargaining power of the parties' overlooks the extent to which contract terms evolve in response to political risk on the whole achieving outcomes that mimic corporate bankruptcy as detailed in Choi et al. (2012).

meeting and 75 percent of these holders have to vote for there to be a binding modification of the payment terms (Choi et al, 2012, p.141).

Aggregation

The third clause allows for **aggregation**. Unlike clauses that usually operate within a single bond issue, aggregation clauses operate across all of the sovereign's bond issuances. The typical CAC requires that a minimum percentage, 66. 7 percent, of the bonds of a particular issuance to agree to a proposed modification of payment terms. The aggregation clause also requires agreement among all bondholders aggregated across all of the issuances of the sovereign (typically, at the 85 percent level in terms of monetary value of all issuances). If both conditions are met then the restructuring agreement becomes mandatory, binding all bondholders. (Choi et al, 2012, p.141).

Aggregation across issues is not yet a standard feature of CACs and its resolution typically requires external intervention. Thus the aggregation issue can be handled in the short-run by treating the debt as a whole as when the debtor makes a 'one-size-fits-all' offer. The Greek workout is an example. This can also be achieved when the court adjudicating creditor claims temporarily suspends holdout attempts to stymie the workout by attaching the exchanged debt. This strategy was used successfully in the first Argentine debt workout (Miller and Thomas, 2007); but once the temporary judicially-mediated suspension lapsed, the holdout problem resumed.

Supermajority voting

As in corporate bankruptcy, CACs resolve the problem of holdouts in debt renegotiation by allowing a supermajority of creditors to outvote minority holdouts. Much depends on the nature of the clauses in each contract, however (Choi et al., 2012, p.142): hence our view that debt workouts should count on a combination of CACs and statutory changes.

Governing law

The 'choice of law or governing law' clauses were instrumental in the success of the recent Greek debt workout, which was settled with a significant 'haircut' imposed on a majority of both foreign and domestic law denominated bondholders. As most Greek debt was held in Greek law, this allowed the sovereign to retrofit CACs into its own bonds (replacing clauses requiring unanimous consent) as a legitimate exercise of sovereign power (which applied only to domestic law debt, however).

A majority of foreign-law-denominated bondholders also accepted Greece's offer. This was possible as creditor committee of a majority of creditors was amenable to a restructuring; and, as noted above, potentially disruptive holdout litigation was eliminated by paying the holdouts in full. This is how workouts generally settle - Argentina's refusal to repay its holdout creditors in full being the exception (Porzecanski, 2005). Thus, while CACs were instrumental in achieving a successful restructuring, their insertion required a statutory act

Limitations of CACs: aggregation and litigation

Failure to Aggregate

Though CACs were critical for the Greek debt workout, they have their limitations. In particular, the foreign-law denominated debt holdouts had to be repaid in full. As the on-going holdout litigation in relation to outstanding Argentine debt indicates, moreover, resisting such claims may lead to a technical default (see Appendix). The limitations of CACs and the problem of aggregation will persist even though the ESM Treaty has mandated the inclusion of standardized aggregation clauses in all new euro area government bonds with a maturity above one year, starting from January 1, 2013.

Holdout Litigation

Sovereign debt restructuring negotiations are exposed to enforcement litigation by holdout creditors not willing to participate - litigation which could stymie or undo settled workouts by triggering defaults down the line (a possible outcome in the Argentine case). In the face of this threat, a distressed and time-pressured sovereign may have no choice but to repay the holdouts in full – as in the Greek case.

For observers such as Schumacher et al. (2013), litigation appears as an increasing threat to successful restructuring. Their conclusions are drawn from "data sets of lawsuits filed against defaulting governments in the US and the UK between 1976 and 2010...[which] show a drastic rise of creditor litigation against sovereigns" (Schumacher et al., 2013, p.1). It is true that the threat of litigation has been a "standard ingredient of sovereign debt renegotiations" as the authors argue (Schumacher et al., 2013, p.21). This is demonstrated in Figure 1 where the light bars measure the number of sovereign debt restructurings implemented each year, and the dark bars the subset affected by at least one creditor filing suit in a US or UK court. As is indicated by the solid line giving a five-year average, the ratio of debt restructurings affected versus those not affected has risen substantially over time, from virtually zero to fifty percent (see right hand axis). This is, it should be said, a rising fraction of a falling trend.

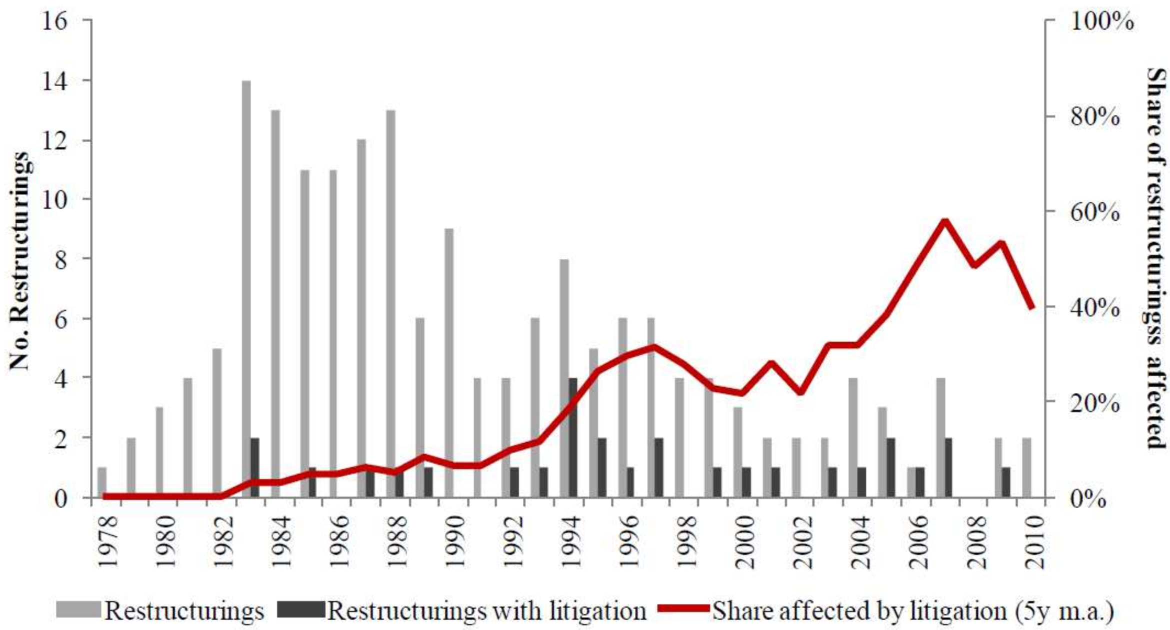

Figure 1. Restructurings with and without Litigation.
(Source: Schumacher et al., 2013, p.29)

Does this prove that litigation will inevitably stymie workouts in the future? As far as Eurozone workouts are concerned, the situation in the short term is in flux for two key reasons. First, the recognition that PSI could be sought for debt workouts as evidenced by recital 12 of the ESM treaty which states:

'In accordance with IMF practice, in exceptional cases an adequate and proportionate form of private sector involvement shall be considered in cases where stability support is provided accompanied by conditionality in the form of a macro-economic adjustment programme.'[10]

[10] Text available at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/126658.pdf

The second complicating factor arises from the creditor profile of Eurozone sovereigns like Greece. After the workout discussed above, most of Greek debt is to owed to official creditors which – contrary to conventional state practice – has been restructured.. There is thus a lack of clarity on whether the ESM has preferred creditor status on par with the IMF.

In the short and medium term, the inevitability of PSI in debt workouts to restore sustainability enhances litigation risk in line with the evidence presented by Schmacher et al (2013). In the long term, however, we argue that four factors make litigation threats less of a problem.

- First, as mentioned above, aggregation clauses are now mandatory in new issues. This change does not necessarily facilitate creditor coordination in the event that holdouts obtain a blocking position in particular bond issues to disrupt workout negotiations: but the costs of holding out in this way can be increased, making holding out less financially attractive.

- Second, there is now a working template of incentives available to policy makers to induce the formation of creditor committees. The quicker they form to influence workouts, the lesser the benefits of litigation.
- Third, the Greek workout and Cyprus bailout set out a template for administrative rather than judge-mediated debt restructuring which will significantly reduce the scope for judicial intervention in debt workouts. The only problem that remains is the delay in the official sector response to deteriorating debt sustainability.

- Finally, policy-makers can mandate capital controls as part of conditionality: Cyprus is an example. This threat reduces the 'economic openness' of distressed Eurozone sovereigns and increases the costs of holdout litigation.

V. EMERGING ALTERNATIVES: COMBINING CONTRACTS WITH STATUTORY INTERVENTION

We discuss a feasible framework for achieving bankruptcy-like outcomes by complementing CACs with statutory provisions on the one hand and new market initiatives on the other. The former are designed to expedite the resolution of insolvency crises: the latter to help avoid them.

1) Modifying the Treaty establishing the ESM

The first key element we recommend is to adopt the cost effective and non-interventionist *ex ante* solution to the problem of holdout litigation proposed by Buchheit et al. (2013). This involves amending the Treaty establishing the European Stability Mechanism[11](ESM Treaty), in such a way as legally to immunize from seizure by holdouts refusing to participate in the ongoing debt restructuring negotiations "the assets and revenue streams of an ESM member receiving stability support under [it] which are held in, originate from, or pass through the jurisdiction of the ESM member" (p.8).[12]

The amendment will cover all claims "eligible to participate in the restructuring of the debt of the beneficiary ESM member" (p.8). In the face of imminent default (and with the receipt of 'new' money), the immunisation of debtor assets would act as a 'temporary stay' on recovery by immunizing all assets within the territory of the ESM member state. As the trigger for the stay is the release of 'new money', which signals that the distressed sovereign is under an active debt workout programme, the amendment would give policy-makers, the debtor and creditors the breathing space to focus on a workout. This is a benefit available for both the existing debt stock and future debt with aggregated CACs. The enforcement actions of all foreign law-governed holders would be temporarily suspended but will revive once the active phase of the ESM programme is over. This amendment thus preserves creditor entitlements as it relies on temporary suspension rather than extinction.

The location-specific immunisation of assets proposed has been used before. As a precedent, the authors cite the UN Resolution that protected Iraq's oil assets pending the prompt restructuring of the $140 billion debt stock that Saddam Hussein had

[11] The ESM is a permanent body (replacing the temporary EFSF) that provides liquidity support and bailout funds to distressed sovereigns.
[12] The extent to which this intervention could be interpreted to be an expropriation or compensable taking of creditor property is outside the scope of this paper.

accumulated during his tenure as President. Pursuant to this, almost all private creditors (holding $21 billion) accepted the 90% write down in net present value that applied to official Paris Club creditors. “The UNSC-mandated immunization of Iraqi assets undoubtedly helped to dampen any hope that a better recovery would be achieved at the sharp end of a litigation.” Buchheit et al. (2013, p. 10).

The suggested amendment to the ESM Treaty would require member states to introduce legislation that prevents attachment of the assets of a member state currently receiving ESM support. This would apply to bonds issued under domestic law or the law of other ESM members. In the case of foreign law denominated bonds the benefits of such a modification arise from a sharp increase in the costs of holding out when compared to the costs of participating in a workout. Holdouts typically use enforcement orders issued by US courts to attach sovereign assets in other jurisdiction[13].

What of the objection that for bonds issued under foreign denominated law the problem of holdouts refusing to participate in the debt restructuring negotiations would remain unresolved? In the amendment proposed, the authors note that it would be best if UK law legislated similar immunities.[14] In the absence of this additional protection, it is useful to distinguish between the substantive and procedural aspects of a creditor claim. The proposed amendment temporarily – pending the termination of an ESM programme - suspends the attachment of a debtor’s assets to satisfy the enforcement of summary judgements. This is aimed at changing the calculus that makes vulture litigation a viable and profitable option. It suspends the threat of attachment that has in the past delayed the settlement of workouts, forcing the debtor to satisfy vulture claims in full, as in the Greek debt workout.

Thus the proposed amendment would significantly increase the cost of holding out when compared to the benefit of participating in a workout. It is true that this proposal may not work in the case where a vulture obtains a holding position in a

[13] In the case of Elliott Associates v. Banco de la Nacion, the U.S. Court of Appeals for the Second Circuit reversed the original dismissal and granted a $56 million judgment in favour of Elliott, and the Brussels Court of Appeal authorized its execution through an order to block any payment in favour of Brady-bond creditors. It was in response to this threat that Peru had to repay holdouts in full.

[14] In UK law, there is already an awareness of vulture action in relation to developing countries see for instance, The Debt Relief (Developing Countries) Act, 2010

bond series and across the debt issuance. But, the percentage held would need to dominate the two-tier thresholds in aggregated CACs. This would entail a significant increase in vulture holdings. Could it be that an unintended consequence of this amendment would be to make vultures virtuous – interested in the stability of the market as a whole rather than the satisfaction of their individual claims at any cost?

The other issue that arises from this proposal relates to the feasibility of the suggested amendment to the ESM treaty and whether this would be acceptable to ESM members. The legal basis of the ESM Treaty is in fact the new Article 136 (3) of the Treaty on the functioning of the European Union (TFEU) :

> ‘ The Member states whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the Euro area as a whole. The granting of any required financial assistance under the mechanism will be subject to strict conditionality’

The amendment to the TFEU has since been ratified by member states and is now compliant with their individual constitutions. Once the legal basis for the ESM Treaty has been constitutionally embedded, any Treaty changes need to be agreed to by member states.

An early example of an ESM Treaty change was in response to an agreement entered into by Eurozone heads of state on December 9, 2011 that explicitly recognised the need for PSI in debt workouts, as discussed earlier. Recital 12 of the ESM Treaty was modified to reflect this agreement.[15] *There is thus clear precedent for amending the ESM Treaty to reflect a political agreement between heads of member states.*

The Board of Governors of the ESM (comprised of finance ministers of the Eurozone member states) is its decision making body. The ESM Treaty also includes an emergency procedure which was introduced to prevent situations in which member

[15] The text for this amendment is available online at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdate/en/ec/126658.pdf.

states can block proposals that are required by the wider Eurozone[16]. The emergency procedure is triggered when the European Commission and the ECB are both of the opinion that a failure to adopt a decision would threaten the economic and financial stability of the Eurozone. *This statutory procedure is another institutional template provided in the ESM Treaty which is consistent with the procedure envisaged in the ESM modification proposal.*

The proposed amendment offers a pragmatic and feasible institutional solution to the enhanced litigation risk that will otherwise stymie workouts in the short and medium term. As the authors point out, moreover, the proposed amendment would, together with other measures already taken within the Eurozone, "substantially replicate the key features of most corporate insolvency regimes and would cover much of the ground that the IMF's proposed SDRM sought to address in 2002." Buchheit et al. (2013, p. 10).

To expedite workouts once the litigation risk is reduced, the proposed statutory amendment can be combined with other market-driven 'legal innovations such as minimum participation thresholds and exit consents... to coordinate creditors and achieve high participation' (Bi et al., 2011).

2) Facilitating Creditor co-ordination

The formation of an ad hoc Creditor Committee proved to be crucial in expediting the Greek debt workout. Significantly, the formation of the steering committee of creditors was a response to the incentives on the table. "The most important carrot was an unusually high cash payout: creditors received more than 15 percent of the value of their old bonds in cash-like short-term EFSF bonds. A second carrot consisted in legal and contractual terms that gave the new bonds a much better chance of surviving future Greek debt crises relatively unscathed than the old ones" (Zettelmeyer et al., 2012, p.3). This example may be a valuable template for the future: given the crucial role of creditor coordination, incentives should surely be given for the creation and maintenance of such committees. New research on bondholder committees suggests that bondholder coordination has historically been

[16] The need for such a procedure arose in 2010 when the Slovak Parliament refused to participate in the first Greek bailout.

achieved through institutional interventions in the market rather than being engendered by informal bondholder committees (Flandreau,2013).

3) GDP-bonds

One of the obvious problems sovereigns face is the inflexibility of their liabilities – debt contracts where the creditor bears none of the risk *unless there is default*. Inflexible loan contracts can of course be justified in circumstances where it is difficult to verify the state of the borrower's finances, the so-called Costly State Verification (CSV) paradigm (Freixas and Rochet, 1997, Chapter 4.2); but surely this is not applicable to most member states of the EU. For them, rather than debt-with-costly-default, more efficient sharing of risk could be achieved by state-contingent contracts[17]. To put it another way, the troubled periphery countries of the EU could surely benefit from a debt equity swap!

For sovereigns, the obvious way of switching from debt to equity would be the issuance of GDP bonds - perpetual claims to a fraction, e.g. one trillionth, of a country's GDP, (Shiller, 1993; 2003). The GDP link that was in fact included in the Argentine bond swap of 2005 is described by Choi et al. (2011, p.150) as follows:

> Under the GDP clause, a country pays back at a higher rate of interest if GDP has risen beyond a threshold at the time of repayment and otherwise back at a lower rate of interest. This bond is an interesting attempt to identify the good and bad states by contract, and should be successful as long as a high GDP growth rate is positively correlated with the good state, which seems plausible. In addition, the clause blunts the incentives of debtors to engage in high-risk strategies by forcing them to share some of the upside with creditors.

A comparison between the Argentine GDP-linked securities and those issued by Greece is provided by Griffith-Jones and Hertova (2012, Chapter 7), who also challenge the view that moral hazard will pose an unsurmountable problem. They argue

> It does not make sense for governments to suppress growth just so that their debt servicing bill would be lower, as the benefits would be very small compared to the costs of curbing growth. Under-reporting of growth may be of more concern. Again, this is not likely, for political and technical reasons.

[17] Well before the current crisis, Rogoff (1999, p.40) argued that "in an ideal world, equity lending and direct investment would play a much bigger role" than debt.

> First, politicians like to report that the economy has been growing during their time in office. It would not be beneficial for them to under-report growth. Second, from the technical perspective, substantially under-reporting growth and for extended periods of time would be very difficult. Finally, any misreporting by governments would come to the attention of ,markets and most probably be punished. Markets would allow for such behavior in the pricing of new issues of securities, and it would become more costly for the country to borrow in the way of growth-linked securities in the future.(p. 130)

The same paper contains a useful discussion of the issue of data revisions and how they may be handled.

A recent study by economists at the Bank of England (Barr et al., 2012) indicates how the risk-sharing afforded by such instruments could substantially reduce the incidence of sovereign debt crises. From their simulations, they conclude that "GDP-linked bonds raise the maximum sustainable level of debt for a sovereign and reduce the probability of default. A default, in the conventional sense of reneging on an existing bond contract, is replaced by a contracted decline in the redemption value of the bond, where the avoidance of the significant deadweight costs associated with sovereign default benefits both creditors and debtors."

What of the objection that such GDP-indexed contracts are too unfamiliar for lenders to accept? First, it's worth remembering that linking government debt contracts to the price index was once seen as unacceptable: but inflation-indexed debt instruments are now widely held[18]. Maybe there is a coordination problem to be solved here – that new instruments will only be accepted when individual traders are confident that others will accept them too[19]. In the case of CACs, this problem was solved by getting a sovereign whose credibility was not in question to move first – so Mexico issued CACs at very little discount in 2003 and this led the way for others. In the case of GDP bonds, however, the auguries look less propitious: countries who have chosen to issue these instruments have been those in distress, such as Argentina and Greece, with the bonds being sold at significant discount. Why not have a country like Germany as the first mover – or indeed the UK, issuing GDP bonds instead of the usual gilt-edged stock when it acts to reverse QE for example?

[18] In fact the NS&I Index-linked Savings Certificates are currently so popular that they have to be rationed!
[19] As discussed in Borenzstein and Mauro (2002).

Or could Cyprus be first-mover? Substantial reserves of natural gas have been found off the south coast of Cyprus and an indexed GDP bond would have the attraction of a natural resource link. This could be formalised by offering a conversion option – where, “after 10 years, the bondholder is allowed to convert the bonds into natural gas … In effect, the gas linked option collateralises the loan with gas, reducing it riskiness.” (Trigeorgis, 2013). It is argued that such GDP-linked commodity-convertible bonds would be attractive to sovereign wealth funds, hedge funds, pension and insurance funds[20].

4) A supranational Special Purpose Vehicle (SPV)

As an alternative to such a market-leading or market-making initiative, consider an institutional approach that might help solve the coordination problem - specifically, an official, EU-sponsored SPV which acquires such debt on its balance sheet against the issue of standard, non-indexed liabilities for private portfolios. George Soros (2013) argues that the creation of a Eurobond will be the principal step to resolving the debt crisis in Europe. This could presumably be done at the individual country level, with national debt issues of Eurobonds being severally guaranteed. Alternatively, it could be achieved by an SPV which buys individual country debt and itself issues Eurobonds. If such a supranational SPV were to be created, it could facilitate the introduction of GDP indexed bonds, taking them on to its books until the wider market was ready.

In a recent working paper Hill and Michalski (2013) show that ambiguity aversion can lead to a much higher ratio of debt to equity in international capital flows than is first best. Their logic is essentially a variety of Costly State Verification, in that the investor is unsure which distribution best describes equity payoffs. If this is the source of debt preference, an SPV along the lines proposed could help solve it.

VI. CONCLUSIONS

Prior to the Greek debt restructuring, the handling of sovereign debt crisis in Europe showed an eerie similarity to what happened in Latin America before the Brady Plan:

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[20] Contingent Convertible or CoCo bonds offer another conversion option that might be useful for sovereigns in distress. They are being used increasingly by banks (Jenkins, 2009; Tett, 2009) under new regulations requiring higher capital: why not sovereigns too?

the main policy response was protracted debt rescheduling to secure just enough liquidity to avoid default.

The pre-emptive Greek debt restructuring however marked a turning point. European sovereign debts no longer have to be paid in full and on time in all circumstances: with majority creditor consent, debt can be restructured. The Greek workout was however an ad hoc exercise which has left many issues unresolved. Further fiscal adjustment through austerity is politically too costly for policy makers across the Eurozone. The threat of Eurozone exit has diminished but the need for systematic and regular pre-emptive restructuring remains.

In this paper we identify mechanisms to avoid debt crises where possible and to resolve them rapidly, efficiently and equitably when they occur. They include a key amendment to the ESM, sustained Creditor Committees, together with innovative state-contingent contracts and a SPV to facilitate their introduction.

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Appendix

The Argentine holdout litigation and the *pari passu* clause

The Argentine debt litigation is an on-going attempt by a group of holdout creditors to make Argentina repay the face value of their bonds relying on an unconventional interpretation of the *pari passu* clause in their contracts. In the absence of aggregated CACs in the bonds, the holdouts could not be crammed down in the debt workout. Hence the litigation.

Doctrinally, the holdout (and now judicially favoured) interpretation of the *pari passu* clause is that debtors are obliged to make a ‘ratable payment’ to all equally-ranked creditors. This interpretation prevents Argentina from paying the creditors that participated in the two debt workouts so far without also paying the holdout creditors the face value of their bonds. This interpretation of the clause is much broader than the more conventional interpretation, where the clause applies only ‘to a narrow set of situations where creditors have been historically subordinated – such as when pre-existing local laws permitted an unsecured creditor to obtain priority over other creditors unilaterally (particularly when domestic creditors were favoured over foreign creditors)’ (Choi et al., 2012, p.146; Buchheit and Pam, 2004, p. 903-906, 914-917).

At the time of writing, in response to an order of the Second Circuit Court of Appeal, Argentina has submitted a proposal offering the holdouts similar terms to those offered to the majority of creditors who participated in the debt workouts (Salmon, 2013). But it is highly unlikely that the holdouts will accept the almost 70 percent reduction of their outstanding claims on offer ($720 million). The court can enforce its order by threatening to prevent existing debt payments from being processed through the Bank of New York. In the event this offer is not accepted Argentina could technically default.

Commentators have also suggested that the ‘broader’ interpretations of the *pari passu* clause can have wider implications, impacting on creditor incentives to restructure their debt in the future. As far as the Eurozone debt restructuring is concerned, aggregation remains a problem for the existing stock of debt; but not in the long term with the adoption of Aggregated CACs across the Eurozone issues. The removal of the unanimous consent requirement for debt restructuring in US and UK bonds will limit but not necessarily resolve the aggregation problem in the absence of interventions that incentivize creditor coordination.