Ad Hoc Committee on a Multilateral Legal Framework for Sovereign Debt Restructuring Processes

First Working Session (3-5 February 2015), New York

Yuefen Li

Special Advisor on Economics and Development Finance, South Centre

(Spoke in the morning of 4 Feb. 2015 at Panel discussion on " Options for moving forward")

Thank you very much for inviting me to this very important meeting. This Ad Hoc Committee is probably **the** intergovernmental body which is the highest in level and also with the largest country representation **mandated** to deal solely with the issue of legal framework of sovereign debt restructuring, I agree with the distinguished delgegate of El Salvador completely that , having the meeting by the Ad Hoc Commission at the GA, by itself is already of great significance and a step forward in the international debate on the topic.

Previous speakers have eloquently dealt with the gaps of the current debt restructuring system. At the beginning of the global financial crisis, some people still had some misgivings as whether or not the lack a formal sovereign debt restructuring legal framework is a serious deficit or missing link in the international financial architecture. Economic and legal events since 2008 have brought a great deal more **convergence** to this topic. The acknowledgement of this as a systemic issue as a governance issue has taken a stronger hold.

Right now, t**he centre of the debate has shifted to "options for moving forward"**. This is naturally a crucial stage. The outcome of the international debate could end up with some contractual improvements, which are good, and yet leaving the fundamental problems unsolved to the next crisis, just like the 2002 debate. The other option is to try to take big steps forward in filling the gaps. This ad hoc committee is having this ambitious aim. Allow me to offer my two cents regarding how to move

forward. To fill in the gap in debt restructuring processes would require **an inclusive process**, the active engagement of Member States and stakeholders the private sector, the IMF and the civil societz. Unfortunately, the international debate has been, as in the past, unnecessarily polarized, giving rise to misconstrued fears of a multilateral legal framework on debt restructuring processes. Such fears need to be first of all dispelled or lessened. This could be the first step of our way forward. A process lacking inclusiveness would challenge the legitimacy of the outcome of the process.

I. Thus the first step could be to **Dispel misconstrued fears of a multilateral legal framework and make the GA process inclusive**

1. **One fear is that the introduction of a mechanism would lead to loss by creditors from the developed countries and gains for debtors from the developing ones.** This has turned the debate to an ideological fight between two camps, which was well reflected by the outcome of the vote for the United Nations General Assembly resolution for creating a "multilateral legal framework for sovereign debt restructuring" on 9 September 2014 in New York. Almost all the 52 countries abstained or voted against the resolution were developed economies. The global economic landscape has changed dramatically in the past few decades with globalization and i**nternationalization of finance**. Creditors and debtors have been very much blurred nowadays. As a norm rather than exception, one country's debt would be held by both developed and developing countries, and by foreign and domestic residents. Messy and delayed debt restructurings would incur political and economic losses and human sufferings to developing and developed countries alike, in some cases extremely unsettling politically and socially. In addition, sovereign-debt crises are **no longer just a problem for developing countries**, but also a major concern and burning problem for some developed countries as well.

2. The fear, which has been existing since the first time the idea of a legal framework was surfaced, is the **moral hazard problem**. To make sovereign default too easy is like a nightmare haunting policy makers as if creating a legal framework amounts to creating a monster. However, many studies have shown that delayed defaults outnumber by many times strategic defaults. That is why "too late and too little" debt restructurings have been the most generally used for arguing in favor of a mechanism. Contrary to causing moral hazard, a mechanism aiming at more efficient and fairer debt restructurings would to various extents address the moral hazard problem as timely debt workout would minimize private sector bailouts like the massive socialization of private debt during the current global financial and economic crisis which could be considered as a much more serious and frequently occurred moral hazard problem during debt crisis than the possible strategic default.

3. Another big fear is that a mechanism would lead to the **loss of sovereignty** even though maintaining sovereignty under the current procedure is a struggle for the debtor governments once they have to go through debt restructuring exercises. The ongoing legal fights between hedge funds and Argentina is a case in point.

4. The fear that **the introduction of a mechanism would compromise debtor credit worthiness and lead to increased cost of borrowing** is another long-standing fear. However the smooth introduction in debt contracts since 2003 of CACs without apparent cost and the recent surprisingly uneventful use of ICMA's tightened up language of *pari passu* in debt contracts of Kazakhstan ,Mexico and Viet Nam without increased cost have proved to the contrary of this fear.

All stakeholders should participate in this process, developed and developing countries alike. It is hoped the IMF, the regional economic commissions, the Paris

Club, the private sector and the civil society all adopt an engaging attitude. Only so can all their concerns be taken into consideration in the process. In my previous incarnation of being the head of the UNCTAD debt and development branch we had such an inclusive process in the formulation of the principles on promoting responsible sovereign lending and it was a very rewarding and cohesive process.

II. The second step forward could be to identify guiding principles in conducting debt restructuring

For the second step forward, you might want to consider identifying guiding principles in conducting debt restructuring

As the topic has been discussed for decades, the aspirations of the legal framework on debt restructuring seem to converge: orderly, timely, equitable and comprehensive debt restructurings, which can restore medium term debt sustainability, was the aspired debt restructurings.

The identification of guiding principles for debt restructuring should be unpinned by achieving these aspirations. It is meant to have a common understanding of the assumed norms, which are regarded as **the standard of correctness in behavior and practices.** Its moral force could also be of valuable significance.

UNCTAD started a project in 2014 to work on sovereign debt restructuring mechanism. A working group was set up comprising senior legal and economic experts (including those from the civil society) with well-established expertise in the fields and representative of different stakeholders. The Group identified **legitimacy, impartiality, transparency, good faith, and sustainability** as the main principles which would uphold public interest and redress the weaknesses in conducting debt restructurings. Scholarly papers were written to elaborate these principles, which are on the UNCTAD website. Some of the principles have already been enshrined in domestic legal order such as transparency and legitimacy.

The principles of **good faith and transparency** in the context of sovereign debt restructuring have been considered as essential. Good faith requires treating the other party fairly; represent one's motives truthfully, and to refrain from taking unfair advantage of them. The behaviour of vulture funds is considered as completely against this principle at several levels. It is fraudulous and should be constrained by legal framework. I do not see why countries would be afraid of having legally binding arrangement on this with immediate enforecement on this. Coming back to good faith, it is closely related to transparency. Data and process transparency would be crucial for the success of debt restructuring. However, the timing and limits of transparency should also be defined so as not to jeopardize the confidentiality of the negotiation process.

The principles **of Legitimacy and Impartiality for** debt restructuring cannot be overemphasized. There are three different types of impartiality: institutional impartiality, actor impartiality and informational impartiality. With institutional impartiality, it is important to avoid systematic bias in favor of one interest group. This would contribute to arriving at impartial and balanced outcome to the benefit of both creditors and debtors.The legal framework should emphasize *institutional independence,* including attentiveness to *financial* independence, *personnel* independence, and *physical* independence (i.e. geographic location in a neutral setting) as well as *transparency and review.* Impartiality of the actors involves independence of decision-makers and mediators from the negotiating parties.

The principle of **sustainability** refers to the ability of restoring medium term debt sustainability through debt restructuring. This is to avoid repeated debt restructurings within a short period of time.

To broadly agree on the guiding principles for debt restructuring could give orientation to the design of debt restructuring legal framework.

III. The third step forward could be to identify complementarities between contractual and statutory approaches in the introduction of a debt restructuring mechanism could be the third step

The debate on debt restructuring has been historically framed in the context of **a "contractual approach" *vis-à-vis* "statutory approach",** as if they are mutually exclusive. This does not really reflect the true nature of the issue. It has made reaching an international consensus on designing a legal framework on debt restructuring more contentious than it warranted. Contractual approach, also named as market approach, is considered as an approach aimed at making debt restructuring smoother through improvements of debt contracts. While statutory approach has been considered as a legally binding compulsory process with or without a supranational legal setup. Many people get cold feet on hearing the word "statutory ". Rationally these two approaches do not have to be mutually exclusive. Contractual approach is always there. When debt contracts are better designed, debt servicing can be better self-enforced and there would be less probability of the need for debt restructuring. Regarding a legal framework, since so far it is still at the international debate stage, the concern of maintaining sovereign to the extent possible could be well taken into consideration in designing the legal framework. It could also be incremental, moving from a voluntary one to gradually hardening up, as the framework is being perfected and also more generally accepted.

In designing such a framework, a clear idea of what debt restructuring problems contractual approach cannot address would be helpful.

However good the contractual approach is it has some huge limitations: 1. **Inability of contractual improvements to address some fundamental and systemic problems facing sovereign debt restructuring like *Procrastination or "too late and too little"* 2. *Legal forum fragmentation. 3. Lack of comprehensiveness in debt restructuring 4.*** The problem of ***interim financing*****, 5. The long phase in period of contractual improvements.** It could take decades for the strengthened debt contract

clauses to be adopted widely, depending on the life span of debt instruments. In between one two debt crises could have taken place already. It is like kicking the can down the road**. 6.** Even to phase in fully Super CACS with aggregation clause may not be able to protect countries with small quantities of bonds. For hedge funds with deep pockets, it is peanut to buy over 25% of the total bonds to block debt restructuring agreements. However, these countries tend to be new comers to the international capital market or small and poorer economies, the countries which are more vulnerable to debt crisis. 7. **Other boilerplate clauses in debt contracts in addition *to pari passu* can also cause problems in the future.**

It is hoped that a legal framework could address the above limitations of the contractual approach and contribute to de-stigmatizing debt restructuring, make it more predictable, consistent and fairer. This would hopefully give sovereigns with unsustainable debt more confidence to go through debt restructuring in a timelier manner to the benefit of both debtors and creditors.

IV. The fourth step, with guiding principles and also a clear idea of pros and cons of contractual approach, it is important to build consensus on the major building blocs of the legal framework which will be balanced and offer incentives to both debtor and creditor and with the IMF playing and important but not leading role.

After decades of international debates, there have been relatively broad agreements on major elements of a legal framework for debt restructuring. Following major elements could be considered:

1. Decision by debtor countries to initiate debt restructuring based **on** debt and economic data indicating severe difficulties and inability in debt servicing,

2.With validated data, introduction of debt **standstil**l, which would have a stay on litigations and debt servicing. Here arrangements should be made to avoid the triggering of CDS.

3.Interim financing should be arranged with seniority status.

4.Comprehensive treatment of different types of debt in one single taking if desired and give differentiated treatment in line with their different features.

5. **An inclusive negotiation process** which will make the negotiation of the terms of debt restructuring a broadly representative process of all creditors and the debtor country
6. Decisions by super majority of creditors regarding terms of debt restructuring bind all creditors. This is in line with the **CACS**. Yet with immediate enforcement even the restructured debt do not have CACs or CACs with aggregation clause in their debt contracts.
7. **-Independent and impartial body to oversee the process.**

The above proposed possible steps for the way forward are just for the consideration of the audience here, many of whom are experts in field with greater insights on the issue than me.