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SOVEREIGN DEBT RESTRUCTURINGS: impact of soft and hard laws as well as investment and trade agreements

Special Event of the Second Committee of the UN General Assembly, New York, 26 Oct. 2016

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National and international measures: Lessons learned

UNCTAD organized a special event of the Second Committee of the United Nations General Assembly on 26 October 2016 in New York on “SOVEREIGN DEBT RESTRUCTURINGS: Lessons learned from legislative steps taken by certain countries and other appropriate action to reduce the vulnerability of sovereigns to holdout creditors”. Ms. Yuefen Li, Special Advisor on Economics and Development Finance of the South Centre, spoke as a panelist and alerted the UN Member States of the current legislative challenges facing the sovereigns when it comes to the need for sovereign debt restructuring including the impact of the plurilateral and bilateral trade and investment agreements.

The recent global financial crisis was mainly caused by too much debt. However, the crisis resolution so far has been largely through creating more debt. With sluggish global demand, declining international trade and the end of the commodity super cycle, there have been plenty of warnings by the UN, the IMF, investment banks and etc about the increasing vulnerabilities of countries from different income groups in maintaining debt sustainability. In the current situation, the lack of sovereign debt restructuring mechanism has been considered by more and more people as a missing link of the international financial architecture. Yet when it comes to legislative steps, it has been proven to be extremely difficult. The tempo of such legislative developments has been one step forward and two steps backward, meaning we have seen small progresses yet some big setbacks.

The following is a brief account and analysis of some recent major developments relating to legislative steps at multilateral, plurilateral, regional and national levels. It will be by no means exhaustive:

At the multilateral level, legislative steps for sovereign debt restructuring have taken too long and achieved too little. Since a few major countries put to sleep the 2003 IMF-led initiative on the Sovereign Debt Restructuring Mechanism (SDRM), the United Nations General Assembly (UN GA) resolution of September 2015 on “Basic Principles on Sovereign Debt Restructuring Processes” has been the major positive progress. The UN resolution should be considered as a milestone. The resolution was based on years of research and consensus building

by the UNCTAD secretariat. The principles laid the foundation and the premises of sovereign lending and borrowing. However, political resistance has made it difficult for the UN to push the initiative to a more inclusive and substantive phase. This situation should be reversed. Recent communiqués from the G20 and BRICS summits have indicated renewed international attention to the issue. Even though the UN GA principles are voluntary, their significance is great because it was from UN and endorsed by most of the UN Member States.

Like what happened after the SDRM debate, with the global financial crisis, main attention has been turned to contractual improvements of bonds, whose outcomes are welcoming and important, but cannot solve systemic issues. For instance the new Collective Action Clause (CAC) can be almost irrelevant in cases when the issue of a bond is very small as holdout creditors could easily buy up bonds up to the threshold level of 75% even with the aggregation clause; when there is 100% ownership of one bond or note; and most importantly for outstanding bonds without CACs. So the stock problem is a major challenge. In addition systemic issues and coordination problems among different types of bonds are not addressed. Therefore the need for a mechanism is still very much there.

At the plurilateral level, we have seen an explosion of investment and trade agreements and treaties, the most well known being the Trans Pacific Partnership (TPP) Agreement which has been signed but not yet ratified and the Trans Atlantic Trade and Investment Partnership (TTIP) Agreement which is still under negotiation. The TPP has an investment chapter which includes investor-state dispute settlement (ISDS) which in a complicated way subjects sovereign debt restructuring to ISDS. The Comprehensive Economic and Trade Agreement has similar arrangements. For TTIP, it considers bonds as a type of investment, thus ISDS will also prevail. Meanwhile, the International Centre for Settlement of Investment Disputes (ICSID) of the World Bank has already accepted its jurisdiction over sovereign debt disputes. Such developments are potential major legislative setbacks in achieving fair, efficient and orderly debt restructuring. Because we know bondholders are not traditional investors, we know under bilateral trade and investment agreements holdout creditors have repeatedly used arbitration in ICSID to get the highest returns on their holdout bond. We also know that judges in ICSID are not elected like the judges in the appellate body of the WTO. There are also complaints about their qualifications which should be looked into. According to these complaints, some ICSID judges are or have been linked with the private sector economically, can defend private investors in one case and sit in the chair of the judge for the next case. The issue of conflict of interests has been repeatedly raised. It is highly doubtful that the current setup of ICSID could handle sovereign debt disputes fairly.

The North American Free Trade Agreement (NAFTA) excludes sovereign debt from the definition of investment altogether. It would be very important to exclude bond debt from international investment agreements (IIAs) which are binding and enforceable. The leaked out content of the Regional Comprehensive Economic Partnership has specifically mentioned that bonds including government issued bonds are protected as investment. In the case that it is agreed to and implemented in the future, legal fragmentation in debt restructuring would be further complicated.

What's the point of the UN and the IMF discussing a debt workout mechanism when the IIAs have already laid out the framework (to be elaborated) and ICSID has already been passing rulings on sovereign debt disputes?

For legislative steps taken at regional level: The European Stability Mechanism (ESM) has made some legislative progress. The ESM does not only make CACs mandatory which is good, but also has a Shark cage approach which extends the sovereign immunity to assets meant for crisis resolution. The sharks refer to holdout creditors, the cage refers to the immunization of assets. The sharks cannot attack or attach these assets, thus reducing the incentives for holdout creditors. It is in the same vein for the UK's and Belgium's legislative actions. In principle, the more assets are being immunized the better, and the less incentives for the holdout creditors. However, whether or not TTIP could override such ESM is a question being examined.

For legislative steps taken at national level, both Belgium's and the UK's laws are effective in reducing the incentives of holdouts. The UK Act is strictly limited to Heavily Indebted Poor Countries (HIPC) debts. The Belgian 2015 law is broader. I admire and applaud Belgium which has had two laws, in 2008 and 2015 against vulture funds. The latest one is very significant. It is to cap the returns for the bonds vulture funds bought at the secondary market. The law takes holdout creditors insisting being paid 100% of the face value of the bonds bought at dirt cheap price as having "illegitimate advantage". It is remarkable that the law was endorsed in the parliament with 100% endorsement. I gave an example in a published piece of mine. The example is if a person buys something during Christmas sales at a huge discount and goes back to the shop to demand reimbursement at the original price, people would think this guy is insane and unethical. But for holdout creditors who bought when creditors are facing economic difficulties, they think it is their birth right to claim the face value of the bonds. If we reach international consensus on what is an 'illegitimate advantage' on the part of holdout creditors, we will basically reduce drastically the incentives for holdouts. However, this is a big if, because the law has already been legally challenged by some hedge funds.

Some commentators think the UK legislation is very narrow as it covers only HIPC debt and only within UK soil. Nevertheless it is valuable. It does reduce the incentives for holdouts and stopped one very unethical case against a low income country.

However we also have set backs at the national level. Among the major ones, are losses caused by bilateral investment and trade agreements. In the absence of a clear and coherent regime, some investors have made their claims through ICSID. The international community should make it very clear that bilateral trade and investment agreements are not equipped to govern global financial issues when it comes to sovereign debt restructuring.

There are other setbacks at national level. The NML big win over Argentina is a setback for sovereign debt restructuring, even though it is necessary for Argentina to reenter the international capital market. The case of Greece is another. There are also other cases.

In conclusion, the United Nations should continue to work on the issue based on the 2015 GA resolution. In addition it is of paramount importance to ensure that the TPP, TTIP and other plurilateral and bilateral trade and investment agreements do not govern sovereign debt

restructuring matters and leave sovereign debt to national governments and multilateral institutions including the United Nations and the IMF.