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Facing the Debt Challenge of Countries that are Too Big to Fail

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Facing the Debt Challenge of Countries That Are "Too Big To Fail"

Steven L. Schwarcz[1]

The recent financial woes of Greece and other nations have reinvigorated the debate over whether to bail out defaulting countries or, instead, restructure their debt. Bailouts are expensive, in the case of Greece costing potentially hundreds of billions of euros. Although the European Union and the International Monetary Fund (IMF) are underwriting the Greek bailout, the IMF's payment is funded by all IMF member nations—the U.S., for example, provides 17% of IMF funding—so we all share in the burden.[2]

In the case of Greece, a bailout was virtually inevitable because a default on Greek debt was believed to have the potential to bring down the world financial system, whereas an orderly debt restructuring was impractical. This is a growing problem. As global capital markets increasingly (and inevitably) embrace sovereign bonds, the potential for a country's debt default to trigger a larger systemic collapse becomes even more tightly linked.

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[2] Nor are IMF payments made to bail out sovereign countries necessarily profitable investments for the member nations. Member nations earn interest on their deposits in the IMF, but repayment by the IMF, although anticipated, is not assured. Furthermore, the IMF pays member nations less than a market rate of interest on their deposits. Steven L. Schwarcz, *'Idiot's Guide' to Sovereign Debt Restructuring*, 53 EMORY L.J. 1189, 1195-96 (2004).

Too Big To Fail

This reveals a phenomenon viewed until recently as limited to large banks—the problem of "too big to fail." A bank whose default could trigger an economic domino effect is, or at least may be perceived to be, too big to fail. It therefore must be bailed out by public funds. This can foster moral hazard: anticipating a bail-out, the bank may lack incentive to take a prudent economic course.[3]

Countries, even those as small as Greece, can likewise be seen as too big to fail if their default could trigger wider economic collapse. That too can foster moral hazard. The Greek government, for example, did little to impose fiscal austerity even as debts accumulated.

An Alternative to Bailouts

Bailouts are not, however, the only way to prevent defaults. Just as policymakers have been proposing orderly resolution procedures for troubled banks and other large financial institutions, an orderly resolution procedure for troubled countries can bypass the need for a bailout.

Countries are very different than banks, of course. Nonetheless, there are meaningful ways to create debt resolution procedures for troubled nations. Perhaps the most notable is the concept of a sovereign debt restructuring mechanism (SDRM), originally proposed by scholars (including the author) and later refined by the IMF into a template for an international convention. The template was never adopted as a treaty, however, because of political opposition in the United States by the second Bush Administration. Although the basis of the Administration's opposition was not clearly articulated, it appeared to reflect the philosophical dogma that free-market solutions always ought to trump legislative ones.

The Holdout Problem and the Funding Problem

[3] Moral hazard more generally refers to the tendency of people who are protected from the consequences of risky behavior to engage in such behavior.

In the sovereign debt restructuring realm, however, free-market solutions are inadequate because of market failures—of which the two most important are the holdout problem and the funding problem. The holdout problem is that any given creditor has an incentive to strategically hold out from agreeing to a reasonable debt-restructuring plan, hoping that the imperative of others to settle will persuade them to allocate the holdout more than its fair share of the settlement or purchase the holdout's claim.[4] The funding problem is that a country is likely to need to borrow new money to pay critical expenses during the debt restructuring process but no lender is likely to be willing to lend such funds unless its right to repayment has priority over existing debt claims. Any effective SDRM would at least have to address these two problems.

Addressing the Holdout Problem

The holdout problem can be addressed by legislating, through international treaty, a form of "super-majority" voting on sovereign debt-restructuring plans, in which the vote by the overwhelming majority of similarly situated creditors can bind dissenting creditors. This is the tried-and-true method by which insolvency law, including Chapter 11 of the Bankruptcy Code in the United States, successfully and equitably addresses the holdout problem in a corporate context and achieves consensual debt restructuring. Because only similarly situated creditors can vote to bind dissenting creditors, and because any outcome of voting will bind all those creditors alike, the outcomes of votes should benefit the claims of holdouts and dissenters as much as the claims of the super-majority.[5]

Many have argued, nonetheless, that the holdout problem can be addressed contractually through what are referred to as collective-action clauses (CACs), allowing essential payment terms of a loan facility to be changed through super-majority, as opposed to unanimous, voting.[6] There are, however, two fundamental problems with

[4] *'Idiot's Guide,' supra* note 2, at 1193.
[5] Steven L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, 85 CORNELL LAW REVIEW 956, 1006 (2000).
[6] *See, e.g.*, BARRY EICHENGREEN, TOWARDS A NEW INTERNATIONAL FINANCIAL ARCHITECTURE 65-70 (1999); Christopher Greenwood & Hugh Mercer, *Considerations*

CACs. First, CACs are not always included in sovereign loan and bond agreements. In the Greek debt crisis, for example, 90 percent of the total debt was *not* governed by CACs.[7] Although creditors could consider agreeing during a crisis to include those clauses in their agreements, the likelihood of achieving that is small.[8]

Secondly, even if every sovereign loan and bond agreement included CACs, such clauses would work on an agreement-by-agreement basis. Therefore, any one or more syndicate of banks or group of bondholders that fails to achieve a super-majority vote would itself be a holdout vis-à-vis other creditors. It therefore is unlikely that CACs can ever effectively resolve the holdout problem in sovereign-debt restructuring.[9]

It also is unlikely that the holdout problem will be addressed judicially. To the contrary, some courts have encouraged holdout behavior. In *Allied Bank Int'l v. Banco Credito Agricola de Cartago*,[10] for example, the court upheld a holdout-creditor's claim. A member of a bank syndicate that refused to join a restructuring agreement between Costa Rican sovereign debtors and other syndicate members sued in the United States for repayment of its defaulted loan.[11] The court granted summary judgment in favor of the holdout bank on the basis that the loan was clearly due and payable, notwithstanding Costa Rica's unilateral regulation suspending its external debt payments.[12] Similarly, in *Elliott Assocs. v. Banco de la Nacion*,[13] the holdout was a vulture fund (one that invests in distressed debt) that had bought debt of two government-guaranteed Peruvian banks at a deep discount. The Fund then received, but refused to participate in, an offer to

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of International Law, *in* BARRY EICHENGREEN & RICHARD PORTES, CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS (1995), at 110; [•cite to Gulati also].

[7] Lee Buchheit & Mitu Gulati, *Buchheit & Gulati on How To Restructure Greek Debt*, THE FACULTY LOUNGE (blog), May 9, 2010 (last visited May 13, 2010).

[8] "*Idiot's Guide,' supra* note 2, at 1203.

[9] *See* Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debt,* 37 INT'L LAW. 103, 129 (2003) (concluding that "[t]he insertion of collective action clauses in sovereign bonds is an exercise in futility").

[10] 757 F.2d 516 (2d Cir. 1985).

[11] *Id.* at 519.

[12] *Id.* at 522-23.

exchange that debt for new bonds, instead suing Peru for payment. The Fund was granted judgment on appeal, but the parties ultimately settled.[14]

Addressing the Funding Problem

For these reasons, I believe that an international convention, in which super-majority voting can bind all of a nation's creditors, is needed to solve the holdout problem. Such a convention also could address the funding problem by granting a first priority right of repayment to loans of new money made to enable a country to pay critical expenses during the debt restructuring process. Existing creditors can be protected by giving them the right to object to a new-money loan if its amount is too high or its terms are inappropriate. Existing creditors will also be further protected because a country that abuses new-money lending privileges will be unlikely to receive super-majority creditor approval for a debt-restructuring plan.

Consensus and Disputes

Once these two market failures have been addressed, the remainder of the sovereign debt restructuring process can be consensual. A consensual process would not undermine the rule of law, as would an attempt by a nation to impose a "haircut" on its bonds such as by unilaterally reducing the principal amount of the bonds or the rate of interest payable thereunder. Nor should a consensual restructuring increase borrowing costs for other nations. Indeed, a nation whose debt has been consensually restructured should itself be able to borrow new money at attractive rates. In the non-sovereign context, by analogy, lending rates to companies with consensually restructured debt are much lower than rates charged before the restructuring. Admittedly, the lower rates in part reflect that companies, after restructuring their debt, have a more conservative capital structure. After a *consensual* debt restructuring, however, new-money lenders are less likely to charge a risk premium reflecting uncertainty as to whether the debtor will again try to unilaterally reduce its debt.

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[13] 194 F.3d 363 (2d Cir. 1999).
[14] *'Idiot's Guide,' supra* note 2, at 1193 n. 14.

Nor would a sovereign debt restructuring process need to depend on the creation of a "bankruptcy" court or other costly institutional arbiter. Indeed, the experience of corporate debt restructuring in the United States under Chapter 11 confirms that the parties themselves do most of the negotiating.[15] There may nonetheless be circumstances when parties have disputes. I have suggested that a relatively low-cost and straightforward procedure already exists under international law for this purpose.[16] The International Centre for Settlement of Investment Disputes (ICSID), an autonomous body created under the auspices of the World Bank, provides facilities for arbitration of investment disputes.[17] The ICSID arbitration procedure is well established, commonly used, and widely accepted, and it should be a useful model to the extent that a tribunal is needed to resolve sovereign debt restructuring disputes.[18] Others have similarly proposed creation of an international arbitral panel for this purpose.[19]

Conclusion

As finance becomes more intertwined, sovereign debt defaults will become even more likely to trigger larger systemic collapses. That, in turn, will make most nations too big to fail. Without an effective sovereign debt restructuring mechanism, defaulting nations will expect to—and in most cases, by necessity, almost certainly will—be bailed

[15] James B. Hurlock, *The Way Ahead for Sovereign Debt*, INT'L FIN. L. REV., July 1995, at 12 ("most U.S. bankruptcies are self-executing in that creditors, in concert with the debtor, collectively determine the economic terms upon which the enterprise will be restructured."); DAVID G. EPSTEIN ET AL., BANKRUPTCY § 10-2, at 734 (1993) ("It would be wrong to think of the Chapter 11 process as primarily a litigated, judged-ruled adversarial process. Plans proposed and adopted in Chapter 11 almost always have been produced by negotiation, not by litigation.").
[16] *'Idiot's Guide,' supra* note 2, at 1210.
[17] Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, *opened for signature* Mar. 18, 1965, art. 1, 17 U.S.T. 1270, 575 U.N.T.S. 159. The ICSID Convention applies to disputes between contracting countries and nationals of other contracting countries, but I suggest it as a model for a parallel sovereign debt dispute adjudication procedure.
[18] *See 'Idiot's Guide,' supra* note 2, at 1210-1211.
[19] Christoph G. Paulus & Steven T. Kargman, "Reforming the Process of Sovereign Debt Restructuring: A Proposal for a Sovereign Debt Tribunal," Apr. 7, 2008 unpublished draft.

out by the international community. We then will all end up subsidizing nations that lack the political will or ability to be fiscally responsible.