TTIP and Sovereign Debt Restructuring

Avoiding a collision

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As members of the Eurozone are now acutely aware, the lack of a sovereign debt-restructuring regime is one of the most glaring gaps in the international financial architecture. In the absence of a clear and coherent regime, some investors have sought to investor-state-dispute systems (ISDS) in bi-lateral investment treaties (BITs) and the investment provisions of free trade agreements (FTAs) as instruments to circumvent important restructurings that have occurred. Under investment treaties, Argentina has been challenged for its sovereign debt restructuring of the early 2000s and Greece was challenged for the restructuring conducted by the International Monetary Fund, European Commission, and the European Central Bank. The trade and investment treaty regime is not equipped to govern global financial stability in general and sovereign debt restructuring in particular. It is paramount to ensure that the Trans-Atlantic Trade and Investment Partnership (TTIP) does not govern these matters and leaves sovereign debt to national governments and international financial and monetary authorities.

FEPS
POLICY BRIEF

JULY 2016

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Introduction

If managed appropriately, government borrowing can be an essential ingredient for economic development, and has been for centuries. However, as we are witnessing in Europe, even when nations manage to keep debt to GDP ratio in good shape, they can still spiral into a debt crisis—simply defined as when a nation cannot (or is no longer willing) to service its debt.

Sovereign debt restructuring (SDR) is often what occurs when a nation cannot repay its debts. However, the international community views the SDR regime to be greatly lacking. When a sovereign government is no longer willing or able to pay its debts, sovereign restructurings occur during what amounts to a formal change to debt contracts negotiated between creditors and debtors. SDRs (or "workouts") often take the form of reducing the face value of the debt, "swaps" where new bonds with lower interest rates and longer maturities are exchanged for the defaulted bonds, and so forth. Such workouts are usually highly discounted and result in a loss for bondholders. Losses or discounts are commonly referred to as "haircuts".

In the early 2000s the IMF proposed a "Sovereign Debt Restructuring Mechanism" (SDRM). The SDRM sought to provide a fair forum for negotiation between bondholders and governments; a standstill clause whereby bondholders can't yank their money out of a debtor nation in a herd; a facility to provide short-term financing and to prioritise a debtor nation's debt schedule; and clauses that limit the ability of disgruntled minority bondholders to file lawsuits against debtor nations. The SDRM was swiftly rejected by the US government and the business community.

Instead, the US proposed normalizing the use of collective action clauses (CACs). CACs have the following features: a *collective representation* component where a bondholders' meeting can take place where they exchange views and discuss the default/restructuring; a *majority restructuring* component that enables a 75% "supermajority" of bondholders to bind all holders within the same bond issue to the terms of restructuring; and a *minimum enforcement* component whereby a minimum of 25% of the bondholders must agree that litigation can be taken. Unfortunately, the majority of the bonds in the Eurozone do not have CACs and even if they did, a restructuring would not be burden free. The International Swaps and Derivatives Association can rule out a CAC and pay out insurance to bondholders instead. CACs also do not apply across bond issuances and thus it may be hard to get agreement on a whole swath of debt that a nation in trouble would like to swap.

This short policy brief shows how the fledgling system of sovereign debt restructuring could be jeopardized under the TTIP and proposes three ways that would safeguard the ability of parties to the TTIP to ensure that nations had the proper flexibility to restructure sovereign debt in crisis situations.

SDR and Trade and Investment Treaties

Both Argentina and Greece have been subject to ISDS cases where private investors claimed that the haircut on an SDR was in violation of host countries obligation under the treaty. If the TTIP includes the language now found in most trade and investment treaties that sovereign bonds are investments covered under the treaty—sovereign debt restructurings could be unraveled by the TTIP.

When Argentina restructured its debt in 2005 close to 180,000 Argentine bondholders filed a claim under the Italy-Argentina BIT for approximately $4.3bn. Some of those investors settled in a 2010 restructuring and now there are believed to still be approximately 60,000 Italian bondholders seeking

upwards of $2 billion from Argentina at ICSID. In September of 2014, a majority of a private World Bank tribunal decided that Argentina's bond restructuring indeed does fall under the jurisdiction of these treaties. The case will therefore continue, despite a scathing dissent from a third member of the tribunal (IAR, 2011). The bondholders seeking their investments through the trade treaty are among the few remaining holdouts.

After Argentina, Greece undertook an even more costly sovereign debt restructuring in 2012, in the wake of the financial crisis. Greece restructured $262.3 billion of sovereign debt in an attempt to maintain the stability needed to stay in the Eurozone. Unlike Argentina, Greece took extensive steps to negotiate with its private creditors and even did it with the blessing of the EU and the IMF. Still, holdout creditors decided to pursue their interests at the ICSID (International Center for Settlement Investment Dispute) forcing Greece to face an investor-state dispute as well. Poštová banka, and its shareholder Istrokapital, brought investor-state claims under the Slovakia-Greece BIT (1991) and the Cyprus-Greece BIT (1966), respectively. A tribunal was formed and the issue of jurisdiction first addressed. Despite Poštová banka's earnest effort to show that there was a protected investment under the BIT, the award (in favor of Greece) turned primarily on the specific language of the BIT which expressly includes corporate bonds, but makes no reference to sovereign bonds. The court highlighted and distinguished this outcome from that of *Abaclat*, in which the tribunal did find jurisdiction at least in part because of the wording of the "investment" definition (*Poštová banka v. Greece* 2015). Thus this case was dismissed, but would likely not have been dismissed if the Slovakia-Greece BIT looked like proposed language to the TTIP.

Box 1 outlines where trade and investment treaties can tangle with sovereign debt restructuring.

Box 1: Trade and Investment Treaties and Sovereign Debt Restructuring

Jurisdiction: If IIAs are deemed to cover "any kind of asset" then it can be argued that sovereign debt falls under the jurisdiction of the treaty.

Expropriation: SDR could be seen as an indirect expropriation because a restructuring reduces the value of the sovereign bond.

Fair and Equitable Treatment (FET): Insofar as FET is seen as protecting investors' legitimate expectations, a bond swap that was not expected during the initial investment period could be seen as a violation of that standard.

National Treatment: In some financial circumstances, it may be important to treat domestic bondholders differently than foreigners. This could be seen to violate National treatment, however.

Some of the recent treaties negotiated by the United States clearly define sovereign bonds as covered investments and provide explicit guidelines for the interaction between SDR and certain treaties. The US is usually reluctant to negotiate such guidelines, as it sees CACs as sufficiently safeguarding sovereign debt restructuring. **However, when negotiating partners insist, the US is sometimes willing to compromise with an annex that grants deference to negotiated restructurings.**

What is found in the US-Uruguay BIT, and in FTAs with Central America, Chile, Peru, and Colombia, and most recently the pending Trans Pacific Partnership (TPP) is a special annex on sovereign debt restructuring. Though the specific text varies across the treaties with such an annex, they usually prohibit claims against 'negotiated debt restructuring', unless an investor holds that a restructuring violates national treatment (NT) or (MFN). Such treaties usually define "negotiated restructuring," as a restructuring where 75% of the bondholders have consented to a change in payment terms. If an investor does file a claim in the event of a restructuring that is not a "negotiated" one, s/he must honor a 'cooling off' period usually lasting 270 days before a claim may be filed. There is no cooling off period for a non-negotiated or negotiated restructuring that violates NT or MFN.

These annexes are not standard in US treaties after NAFTA (NAFTA excludes sovereign debt from the definition of investment altogether). Indeed, the US-Australia, US-South Korea, US-Morocco, US-Oman, US-Panama and US-Singapore agreements included bonds and debt as covered investments but do not include annexes for sovereign debt restructuring.

The Dominican Republic-Central America Free Trade Agreement resembles the Chile FTA much more closely. Like the above agreements, bonds and other debt instruments are considered covered investments under the agreement. Annex 10-A then specifies very clearly that sovereign debt restructuring is subject *only* to Articles 10.3 (National Treatment) and 10.4 (MFN). The additional cooling off period does not seem to apply and there is no mention of "negotiated restructuring" as a prerequisite.

These annexes can be seen as a step in the right direction given that parties to the agreement recognize that restructuring is a special case, yet they remain far from adequate for at least four reasons. First, CACs will not alleviate the possibility that nations will seek claims for restructuring. As indicated earlier, vulture funds and other holdouts can acquire a supermajority within a bond issuance and neutralize the bond issue and a 25 percent minority can still agree to litigate and arbitrate. Second, the definition of investment and umbrella clauses allow for investor-state arbitration under treaty obligations regardless if such obligations are also covered by domestic law. Third, most restructurings are multi-issue restructurings and suffer from the aggregation problem described above. Again, collective action clauses only apply within a bond issue, not across multiple issues that are often bundled together in a restructuring.

Fourth and very importantly, economists and international financial institutions have repeatedly held that, in contradiction with the national treatment principle, domestic bondholders and financial institutions sometimes needed to be treated differently during a crisis. Prioritizing domestic debt may be in order so as to revive a domestic financial system, provide liquidity and manage risk during a recovery (Gelpern and Setser, 2004, 796).

The safeguards and exceptions in many IIAs are not adequate enough to provide cover for nations to restructure their debt. For most cases the only possible safeguard are "essential security" provisions. A handful of the United States' treaties have an annex that discusses sovereign debt restructuring that is very limited.

It may be possible that a nation can claim that actions taken during a financial crisis are measures needed to protect the 'essential security' of the nation. Language like Article 18 of the United States Model BIT is found in many treaties:

"… to preclude a Party from applying measures that *it considers* necessary for the fulfilment of its obligations with respect to the maintenance or restoration of international peace or security, or the protection of its own essential security interests (USTR, 2004)."

The article does not mention economic crises per se, but "all tribunals that have considered the matter thus far have interpreted the rules broadly enough to include such crises" (Salacuse, 2010: 345). However, tribunals differ greatly over how grave the difficulties may be. In Argentina, again, tribunals came to opposite conclusions, and only one of three tribunals ruled that Argentina could not be held liable for actions it took to halt its crisis. A key matter is whether or not a measure by a nation to stem a crisis can be seen as "self-judging". In other words, can the host nation using the control be the judge of whether or not the measure taken was necessary to protect its security. The language quoted above in the 2004 Model BIT, which says "that *it* considers" is now seen as to mean that a measure is self judging (because of the "*it"*), but Argentina's BITs with the United States and others did not include as precise language at the time (Salacuse, 2010).

The TTIP financial stability

It is in the interests of the U.S. and its trading partners to have adequate policy space to prevent and mitigate financial crises. This last section of the brief outlines a number of (non-exclusive) options are possible.

With respect to sovereign debt restructuring, the following are three non-exclusive policy remedies that would enable the TTIP to grant nations the policy space to conduct effective SDRs in the future:

1) **Exclude sovereign debt from the treaty.** The exclusion of sovereign debt from "covered" investments under future treaties would relegate sovereign debt arbitration to national courts and to international financial bodies. Some IIAs already exclude sovereign debt, such as NAFTA and others. Argentina's new model BIT is reported to be moving in this direction as well.

2) **Clarify that mitigating financial crises is "essential security".** Clarify that the Essential Security exceptions cover financial crises and that sovereign debt restructuring taken by host nations is 'self-judging' and of 'necessity.'

3) **State-to-State dispute resolution for SDR and crisis related instances** may be more prudent than investor-state arbitration given that governments need to weigh a host of issues in such circumstances. States attempt to examine the economy-wide or public welfare effects of crises whereas individual firms rationally look out for their own bottom line. Investor-state tips the cost-benefit upside down, giving power to the "losers" even when the gains to the "winners" (the larger public and the future of a nation) of an orderly restructuring may far outweigh the costs to the losers.

The global financial crisis in general and the sovereign debt restructurings in the Eurozone has made it all too obvious that granting our trading partners the flexibility to use legitimate policies to prevent and mitigate financial crises is also good for the United States. When its trading partners fall into financial crisis, the United States loses export markets and subsequently jobs in the export sector.

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