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THE NEW ERA OF SOVEREIGN DEBT RESTRUCTURING

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INTRODUCTION

The subject of this thesis is sovereign debt and the restructuring of sovereign debt, which is analysed in a historical prospective, going through the cycle of restructurings that hit developing countries in the 1980ies and 1990ies, moving to very recent cases, which affected not yet emerging economies but European countries.

Debt restructurings are a recurrent theme in the history of countries and was recently back on the spotlight due to the financial crisis that required the debt of certain European countries to be restructured, challenging the idea that sovereign debt restructuring is an issue concerning developing countries only.

The financial issue of the unsustainability of the debt is also put into a social context, to highlight the consequences on the population, which ultimately pays the price for the default of its own country. The international community realised and recently promoted the idea that the concept of sustainable development is intertwined with a sustainable debt profile of each state, given that the funds required to service an unsustainable debt service are ultimately diverted from social uses and to the extent multilateral financial aid is destined to repay the external indebtedness of the country, no social development can be expected.

The focus of the thesis is on the techniques used in past and recent sovereign crisis to deal with the restructuring of the debt and the changed panorama in which restructurings take place, comparing the Latin American restructurings of the 1980ies against more recent cases, such as Greece.

It is, first of all, worth noting that experience plays an important role: the more the financial communities and the practitioners themselves are used to deal with this kind of situations, the fastest and more organised the process of restructuring becomes, due to the fact that both the investors and the sovereign countries (and respective advisors) know what they will be dealing with and what the possible outcomes are.

During the Mexican crisis, in the 1980ies, a considerable amount of time was spent in order to find viable financial structures to implement the restructuring and to coordinate the parties involved. On the other hand, the Greek restructuring was extremely fast and efficient in terms of choosing and implementing the technical structure required to complete the reprofiling of the indebtedness, proving that the experience matured in the past decades created a valuable know how which is now a key element for successful debt restructurings.

There is no fix pattern in sovereign debt restructuring, as each country has its own peculiarity in terms of structure of the debt and creditors and historical background, however, each process uses a set of instruments which are combined and tailored to the specific cases, such as

“haircuts”, rescheduling of the debt, exchange of “old” debt with new debt, equity swaps, which are all analysed in chapter three and four of this thesis.

A key element in distinguishing sovereign restructurings is the moment in time when the negotiations with its creditors begin: in some cases, governments prefer to engage with the creditors at an early stage of the financial crisis, when service of the debt is still kept current, but it is known that payment of such debt is not sustainable in the long term. This kind of approach is often referred to as “pre-emptive” restructuring, and they generally tend to be concluded within a short timeframe and with widespread cooperation and recovery of access to the international financial markets shortly after.

In some other cases, on the other hand, governments do not approach their creditors prior to the default, but they do announce to the market that they are not in a position to service their debt and therefore a restructuring process is required (so-called “post-default restructurings”) and payment of the debt is not restored until a settlement is reached. In this second scenario, it has been observed that the sovereigns may obtain a larger debt relief, given that the act of defaulting results into a shift of bargaining power, due to the fact that there are no other options and the creditors are more or less “forced” to accept the proposal put forward by the relevant government in order for the service of the debt to be restored.

It has been observed that the choice of the countries to opt for pre-emptive restructurings is usually linked to the willingness to avoid reputational losses on the market and preserving the image of creditworthiness amongst the other players in the sovereign debt context.¹

It is also worth noting, on the other hand, that the decision of certain governments to default is usually linked to domestic political, institutional and social factors: for instance Argentina defaulted following the fall of an elected government and the decision to default was also connected to the political need to settle social unrest which was spreading throughout the country and sending to the population a message that there had been a change in the course of economic policies to be implemented.

The complexity of sovereign restructurings is linked to the multiple elements that need to be factored in when taking decisions: pure financial issues are intertwined with social domestic unrest, international politics and relationships with public and private creditors (naming merely a few of them), turning the negotiations into measured assessments of compromises and assessments of pros and cons.

In the past 60 years, we assisted to more than 600 cases in 95 countries, of which 450 involved public creditors (in particular bilateral loans between governments) and 186 with private sector creditors. Historically debt restructurings involving the private sector would consist of bank loans rescheduling, however the implementation of the Brady plan in the late 1990ies (see chapter

¹ J. Diaz-Cassou, A. Eroo-Dominguez and J. Vasquez-Zamore, *Recent Episodes of Sovereign Debt Restructurings: a case study approach*, Documentos Ocasionales n. 0804, Banco de Espana, available at: www.dbe.es.

three) resulted into a switch from bank loans to bonds so that recent cases of debt restructurings consisted in exchange of existing bonds with newly issued bonds with different economics, marking a new era of sovereign debt restructurings, with features which closely follow corporate restructurings.

The aim of most of the researches on this subject is the study of a model which can ensure a high level of predictability in terms of outcome of the restructuring process. The comparison is usually made with corporate restructuring procedures, whereby corporations facing financial issues can choose between the statutory procedures that each jurisdiction offers in order to achieve the best outcome with minimal losses and the required level of protection offered by national courts.

In the international context, there are neither statutory procedures nor international courts that can overview such procedures, hence the quest for a framework which can grant the same features that national procedure can offer, namely: (i) protection from enforcement procedures during the negotiation of the restructurings; (ii) rescue financing which receives super priority status, in order to provide new finance to alleviate liquidity issues in defaulted countries; (iii) cram-down procedures to protect debtors from hold out creditors taking advantage of the weakness of the defaulted borrower to obtain highly remunerative pays out at the expenses of the population and of multilateral creditors granting debt relief and loans at concessional terms.

In the following chapters the two main proposals to deal with the lack of an established mechanism to deal with sovereign debt restructurings will be analysed. Certain members of the International Monetary Fund advocated the first proposal, in particular the First Deputy Managing Director of the International Monetary Fund Anne Krueger, which suggested a statutory approach, the so called Sovereign Debt Restructuring Mechanism (SDRM), to be adopted by the market participants by means of an amendment to the Articles of Agreement of the IMF itself. The SDRM however met several critiques and remains a theoretical approach which did not convinced the market players.

The second proposal involves contractual techniques rather than statutory changes and advocates the introduction of Collective Action Clauses in the instruments regulating the terms of sovereign bonds, in order to set out the process to be followed between creditors and debtors in the context of a restructuring in terms of negotiations and voting provisions, dealing in particular with the issue of hold out creditors and lack of cram-down procedures.²

² On the comparison between SDRM and market based approach see J. Sedlak, *Sovereign Debt Restructuring: statutory reform or contractual solution?*, University of Pennsylvania Law Review, 2004, pp. 1483-1515 and D. K. Tarullo, *Neither order nor chaos: the legal structure of sovereign debt workouts*, Emory Law Journal, 2004, pp. 657- 689.

Furthermore, to better understand the context of debt restructuring, the second chapter sets out an overview of the kind of debt that developing (and non developing) countries may find on the market and the main characteristics of each type of debt. As it will be further explained in the following chapters, the kind of debt will also influence the kind of restructuring that will be required (although, as mentioned, the predictability of sovereign debt restructuring is quite limited, due to the multiplicity of economical, political and social issues involved).

Although there are no full answers yet, the aim of this thesis is to highlight the progresses which have been made in the contractual sovereign debt restructuring techniques, whose development was favoured by the mutated financial context, whereby bonds debt replaced the vast majority of bank loans debt, establishing the beginning of a new era in the sovereign debt restructuring.

CHAPTER ONE

SUSTAINABLE DEBTS

1) THE UNITED NATIONS SUMMIT ON DEVELOPMENT FINANCE - MONTERREY 2002

The concept of sustainable development was proclaimed as one of essential objective of the international community in 1992, at the United Nations Conference on Environment and Development in Rio de Janeiro (UNCED or Earth Summit). Sustainable development includes ecologically sustainable human development, which involves economic development as well. The acknowledgment of the interconnection between poverty and environmental degradation pushed the international community to seek to address these problems together, adding the adjective “sustainable” to “development”. The idea underlying this new approach was to protect and restore the environment and promote peace and security, economic and social development at the same time.

The outcome of the UNCED was an ambitious action plan called “Agenda 21”³, that includes a comprehensive international program for the twenty first century and a declaration of principles, the Rio Declaration on Environment and Development⁴, whereby the right to a healthy environment and the right to development, for present and future generations of humankind was stated.

Agenda 21 makes reference to economical and financial aspects acknowledging that promoting a sustainable development pattern would have requested a considerable financial support to developing countries.

Amongst the objectives to be reached by the plan of action of the international community, purely financial aspects are highlighted, namely:

- negotiation of commercial bank debt reduction for heavily indebted countries;
- negotiation mentioned above has to take due account of both the medium-term debt reduction and new money requirements of the debtor country;
- engagement of multilateral institutions strengthening international debt strategy to continue to support debt-reduction packages related to

³ See <http://www.un.org/esa/dsd/agenda21/>

⁴ the Rio Declaration is composed by twenty seven principles set out in order to guide the implementation of Agenda 21. See <http://www.unep.org/Documents.Multilingual/Default.asp?documentid=78&articleid=1163>

commercial bank debt with a view to ensuring that the magnitude of such financing is consonant with the evolving debt strategy;

- creditor banks to participate in debt and debt-service reduction;
- policies to attract direct investment, avoid unsustainable levels of debt and foster the return of flight capital.

Following the Earth Summit, the concept of sustainable development has been included in several multilateral and regional treaties, including the constituent treaty of the World Trade Organisation (WTO) dated 1994⁵, in the Treaty on the European Union dated 1992⁶, and in other international instruments, as the 1992 Climate Change Convention⁷ and the 1992 Biodiversity Convention⁸. Sustainable development was also discussed in judgments of the International Court of Justice⁹ and of the dispute settlement body of the WTO.¹⁰

A second important international acknowledgment to sustainable development was made in 2000, in the Millennium Declaration¹¹ of the General Assembly fixed the Millennium Development Goals which, make express reference to achieving sustainable environmental development.

⁵ The treaty recognises: “ that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services, while allowing for the optimal use of the world’s resources in accordance with the objectives of sustainable development, seeking both to protect and preserve the environment and to enhance the means for doing so in a manner consistent with their respective needs and concerns at different levels of economic development”, *Agreement Establishing the World Trade Organisation*, Marrakesh, 15 April 1994 see at https://www.wto.org/english/docs_e/legal_e/04-wto.pdf.

⁶ Article 6 of the Treaty on the European Union sets the objective of “economic and social progress as well as a high level of employment and the achievement of balanced and sustainable development”, *Treaty on European Union*, Maastricht 7 February 1992, see at <http://eur-lex.europa.eu/en/treaties/dat/11992M/htm/11992M.html>.

⁷ See full text at <http://unfccc.int/resource/docs/convkp/conveng.pdf>.

⁸ See full text at <http://www.cbd.int/doc/legal/cbd-en.pdf>.

⁹ The full recognition of the principle of sustainable development was given in the *Gabcikovo-Nagymaros Project Case*: “new norms and standards have been developed, set forth in a great number of instruments during the last two decades. Such new norms have to be taken into consideration, and such standards given proper weight, not only when States contemplate new activities, but also when continuing activities begun in the past. The need to reconcile development with protection of the environment is aptly expressed in the concept of sustainable development”. *Gabcikovo-Nagymaros Project Case (Hungary/Slovakia) Judgement*, 25 September 1997, ICJ Reports 1997, p. 241.

¹⁰ The decision which clearly stated the relevance of the principle of sustainable development is in the *Shrimp-Turtles case* in 1998, whereby the Appellate Body states: “ (...) the preamble attached to the WTO Agreement shows that the signatories to the Agreement were, in 1994, fully aware of the importance and legitimacy of environmental protection as a goal of national and international policy. The preamble of the WTO Agreement – which informs not only the GATT 1994 but also the other covered agreements- explicitly acknowledges ‘the objective of sustainable development’”. *United States- Import Prohibition of Certain Shrimp and Shrimp Products*, Report of the Appellate Body, Doc WT/DS58/AB/R, para 129.

¹¹ Millennium Declaration, see full text <http://www.un.org/millennium/declaration/ares552e.htm>.

The Millennium Development Goals take also into account the financial point of view, defining the eighth goal also as: “worldwide collaboration to promote development must be formalised with agreements on good governance, the development of an open, honest, predictable, rule based and non-discriminatory trade and financial system, a solution for the debt problem and the transfer of new technology”.¹²

Millennium Development Goals generally and in particular goal no. 8 are the starting point of a new focus on the issue of how to finance sustainable development and the issue of debt sustainability of developing countries. In order to find an answer to the issue of how to find the economical resources to achieve the Millennium Development Goals, in 2002 a UN summit on development finance was held in Monterrey, also known as the Monterrey consensus on development finance¹³.

The Monterrey consensus represents the first international forum dedicated entirely to the issue of how to finance development. Its importance is also given by the fact that it was able to bring together all relevant stakeholders in an unprecedented inclusive way. All parties contributed to create a policy framework to guide their respective future effort to deal with the issue of financing development at national, regional, international and systemic levels.

The final report of the conference highlights six main actions to be carried out by the international community, namely:

- the need to mobilise domestic finance resources for development;
- the need to mobilise international resources, either as foreign direct investments and other private flows;
- international trade;
- increasing international financial and technical cooperation for development;
- debt sustainability; and
- promoting coherence, governance and consistency of the international monetary, financial and trading systems.¹⁴

The first point addressed by the Monterrey Consensus relates to the importance of the domestic financial resources of a country. The elements that need to be improved in such context are several: starting from the macroeconomic policy of a country, good governance and market oriented policies, together with establishing a regulatory

¹² See Un fact sheet at http://www.un.org/millenniumgoals/pdf/MDG_FS_8_EN.pdf.

¹³ See final text of the Monterrey Consensus at <http://www.un.org/esa/ffd/monterrey/MonterreyConsensus.pdf>

¹⁴ See above, final text of the Monterrey Consensus.

framework to encourage public and private initiatives and fight against corruption. Tax policies are mentioned as well both as need for prudent fiscal policies and fiscal sustainability.

The second point focuses on how to attract international funds either by means of private initiative, foreign direct investment and other sources such as multilateral development banks (such means of providing finance to developing countries will be analysed in the following chapter).

The parties gathered in Monterrey urge banks and other financial institutions to take into account, in doing their business, social and environmental implications and welcome new initiatives, which can satisfy such requirements and meet developing countries needs.¹⁵ Furthermore, the parties specifically highlight one of issues which would often affect countries in financial crisis: the stability of financial flows and a not sufficiently developed and regulated financial market.¹⁶ Such issues will be further analysed in the context of the analysis of the causes of sovereign debt restructuring in the following chapters.

The third point deals with international trade and its key role for economic development. One of the initiatives supported in relation to international trade is the accession of developing countries to the WTO, in light of a general reduction of trade barriers.¹⁷

Next point on the list is the need for “increasing international financial and technical cooperation for development”.¹⁸ As first observation, the importance of ODA is highlighted especially for those countries not able to attract foreign investments. A call for a general rise in the level of ODA granted by developed countries is made, fixing the

¹⁵ See para 22 of the Monterrey Consensus: “While Governments provide the framework for their operation, businesses, for their part, are expected to engage as reliable and consistent partners in the development process. We urge businesses to take into account not only the economic and financial but also the developmental, social, gender and environmental implications of their undertakings. In that spirit, we invite banks and other financial institutions, in developing countries as well as developed countries, to foster innovative developmental financing approaches. We welcome all efforts to encourage good corporate citizenship and note the initiative undertaken in the United Nations to promote global partnerships.”

¹⁶ See para 25 of the final text of the Monterrey Consensus: “We underscore the need to sustain sufficient and stable private financial flows to developing countries and countries with economies in transition. It is important to promote measures in source and destination countries to improve transparency and the information about financial flows. Measures that mitigate the impact of excessive volatility of short-term capital flows are important and must be considered. Given each country’s varying degree of national capacity, managing national external debt profiles, paying careful attention to currency and liquidity risk, strengthening prudential regulations and supervision of all financial institutions, including highly leveraged institutions, liberalizing capital flows in an orderly and well sequenced process consistent with development objectives, and implementation, on a progressive and voluntary basis, of codes and standards agreed internationally, are also important. We encourage public/private initiatives that enhance the ease of access, accuracy, timeliness and coverage of information on countries and financial markets, which strengthen capacities for risk assessment. Multilateral financial institutions could provide further assistance for all those purposes.”

¹⁷ See final text of the Monterrey Consensus paragraphs from 26 to 38.

¹⁸ See point D of the final text of the Monterrey Consensus.

goals of reaching 0.7 of gross national product (GNP) as ODA to developing countries and 0.15 to 0.20 of GNP to least developed countries.¹⁹ A call is made to multilateral and bilateral financial and development institutions to move towards a more effective and more coordinated action to support economical growth of developing countries, including by reducing transactions costs by harmonizing their operational procedures, offering more flexible and tailored approaches and promoting the use of ODA as means to attract private funds, leveraging additional financing for development.²⁰

As specific point, the relevance of debt sustainability is mentioned as well. It is acknowledged the connection between the sustainability of the external debt of countries and their actual capacity to develop and to reach the goals set out in the Millennium Development Goals. This link will be at the heart of this thesis, which aims at highlighting the relevance of the debt situation of a country and the relevance of finding solutions to financial crisis in a fast and efficient way in order to minimise the collateral effect on the country and allow it to progress on a sustainable development path.

The parties to the conference state the joint liability of debtors and creditors in preventing and sorting out issues of debt sustainability. Such position represents a relevant step forward in order to require a more ethical approach from lenders, whose behaviour would then be under scrutiny together with the debtor's conduct. Such view is shared by some authors which condemn the violation by lenders (both private and public lenders) of ethical norms in the context of global finance.²¹ In particular reference is made to the fact that sophisticated lending institutions have taken advantage of their strength in order to get more convenient results at the expenses of developing countries, the breach of good faith principles by means of providing bad advice to such countries and a lack of cooperation in order to help most disadvantaged country. Some examples of such unethical approach will be highlighted in the context of the analysis of some sovereign debt restructuring processes in chapters three and four.

The shift in the approach to the debt crisis of developing countries in the international debate occurred at the end of the 90'ies. At the time of the financial crisis of Malaysia the IMF and World Bank rhetoric began to be more borrower sympathetic and started to address responsibilities for bad loans to both lenders and borrowers. In 1999 the U.S. Treasury Secretary at the time, Robert Rubin, commented on the Malaysia debt crisis: "markets by themselves do not necessarily create the conditions that enable markets to work most effectively [...] it means [...] acting to induce creditors and investors in industrial countries to weight risks more appropriately, so as to help avoid the excesses

¹⁹ See para 42 of the final text of the Monterrey Consensus.

²⁰ See para 43 of the final text of the Monterrey Consensus.

²¹ See C. Jochnick and F.A. Preston, *Sovereign debt at the crossroads*, Oxford Scholarship Online, 2006.

in flows – flows of credit, flows of portfolio investment – that have contributed significantly to the crises, and also to reduce the leverage that has contributed significantly to the crisis”.²²

The need for a more central role played by ethical considerations in the financial field is key in order to give guidance to the several players in such complex field such as international finance in a globalised world.²³

The relevance of external debt relief and other approaches which aim at reducing the burden of the most indebted countries is stressed and as further relevant point, the need for a structured and efficient mechanism to deal with financial crisis due to the over indebtedness of developing countries.²⁴

As final point, the importance of an integrated approach to the issue of financing development, taking into account the deep interconnection between international monetary and financial system and the opportunity of development is discussed. A globalised world requires a globalised approach to issues so interconnected.

The global financial crisis proved the analysis carried out by the parties to the Monterrey Conference to be right, showing how in a globalised world issues apparently belonging exclusively to certain countries affect other members of the financial international community requiring therefore an integrated and comprehensive answer.

²² As cited in R. P. Buckley, *Lessons from the Globalisation of the Emerging Debt Markets*, in *Journal of International Business Law*, 2000, p. 108. To compare such approach with the previous one, held during the debt crisis in the 80'ies, in 1983 Donal Regan, Secretary of the U.S. Treasury at the time, stated: “I don't think we should just let a nation off the hook because we are sympathetic to the fact that they are having difficulty. As debtors, I think they should be made to pay as much as they can bear without breaking them. You can't just let your heart rule your head in these situations”, as cited in R. P. Buckley, *Lessons from the Globalisation of the Emerging Debt Markets*, in *Journal of International Business Law*, 2000, p. 108.

²³ “[...] it is clear that governments of advanced industrial countries and the international institutions that they dominate have tried to manage globalization in ways that benefit themselves, and in particular special interests within their boundaries. Principles of social justice (or even democratic processes) that have motivated political activity within countries have played little role in driving global economic policies or in shaping the global economic institutions. In a sense, economic globalization has outpaced political globalization, if by that we mean the creation of polity in which shared values of democracy, social justice and social solidarity play out on a global scale. Globalization – the closer integration of the countries of the world- implies greater interdependence and therefore a need for greater collective action. Although determining the principles that should underlie this collective action is no easy matter, this much is clear: given asymmetries of information and resulting market failures, processes I which each nation attempts to push for those policies that are narrowly in their own self interest are not likely to produce outcomes that are in the general interest. Ethics may be an uncertain and imprecise compass, but it at least provides some guidance in a world in which the only beacon, all too often, points in the wrong direction.”, C. Jochnick and F.A. Preston, *Sovereign debt at the crossroads*, Oxford Scholarship Online, 2006, p. 16.

²⁴ See para 51 of the final text of the Monterrey Consensus: “While recognizing that a flexible mix of instruments is needed to respond appropriately to countries' different economic circumstances and capacities, we emphasize the importance of putting in place a set of clear principles for the management and resolution of financial crises that provide for fair burden-sharing between public and private sector and between debtors, creditors and investors. We encourage donor countries to take steps to ensure that resources provided for debt relief do not detract from ODA resources intended to be available for developing countries.”

2) THE IMPLEMENTATION OF THE MONTERREY CONSENSUS – DOHA 2008

The importance of the Monterrey Consensus is further confirmed by the fact that it was followed by a second conference in 2008, in Doha, named “Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus”, summoned in order to check the level of implementation and the results achieved in relation to the priorities set out in the Monterrey Consensus.

As further aim, upon review of the status quo, there is the selection of the new goals for the coming years. The conference produced, as per the Monterrey event, a final declaration, the “Doha Declaration of Financing for Development: outcome document of the follow-up international conference on financing for development to review the implementation of the Monterrey Consensus” (the Doha Declaration).²⁵

As general observation, the parties to the conference acknowledged that since 2002 an increase in the private and public financial flows towards developing countries had taken place, improving the situation of many countries. However, the global financial crisis forced the international community to face new challenges and required to work in a very different context in respect of 2002.²⁶

The consequences of the change of the international context had an impact on the six points of the Monterrey Consensus.

In relation to private initiative, the Conference acknowledged that many developing countries benefitted of increasing private investments, however, the distribution of such flows between the developing countries was not even, requiring an international intervention to support those countries not able to attract private international capital flows (i.e. African countries, landlocked developing countries, countries emerging from conflict and recovering from natural disasters). The importance of bilateral treaties and tax treaties is stressed in order to facilitate foreign investments and the need to provide such countries with technical and financial assistance is further confirmed.

²⁵ The Conference was held in Doha from 29 November to 2 December 2008. See full text of the Doha declaration on Financing for Development at http://www.un.org/esa/ffd/doha/documents/Doha_Declaration_FFD.pdf.

²⁶ See para 3 of the Doha Declaration: “We recognize that the international context has changed in profound ways since we met in Monterrey. There has been progress in some areas, but inequality has widened. We welcome the substantial increase in public and private flows since 2002, which has contributed to higher economic growth in most developing countries and a reduction in global poverty rates. Yet we express our deep concern that the international community is now challenged by the severe impact on development of multiple, interrelated global crises and challenges, such as increased food insecurity, volatile energy and commodity prices, climate change and a global financial crisis, as well as the lack of results so far in the multilateral trade negotiations and a loss of confidence in the international economic system.”

A new acknowledgment is also introduced: since 2002 it was observed that the perception of a country's current economic conditions influences greatly the capital flows from private investors. Hence the necessity of providing investors with high quality information from public sources such as the World Bank and the International Monetary Fund and private ones like investment advisors and credit-rating agencies. The role of these entities will be further analysed in the following chapters, in the context of their role in managing debt crisis of developing countries. Credit-rating agency, in particular, play a significant role in relation with bonds issued by countries, which represent the biggest source of private finance for many developing countries, as it will be described in chapter four.

A big achievement of the Monterrey Consensus is recognised in the rise in the levels of ODA, which recovered from its declining trends before the Monterrey Conference: ODA increased by 40 per cent between 2001 and 2007, thanks also to debt relief policies and humanitarian assistance.²⁷ The focus is now set on the way in which aid is delivered to developing countries, stressing the importance of reducing transaction costs, improving mutual accountability and transparency, the so defined "aid architecture".

In relation to the issue of external debt, the idea of introducing a more "borrower friendly" approach is mentioned, expressing also worries in relation to the behaviour of the so called vulture funds, which are not ethically driven rather profit driven and in the recent sovereign debt restructuring proved to be a tough obstacle to the progress of profitable and constructive negotiations.²⁸ Such issue will be analysed in detail in chapter four.

It is further stressed that the responsibility to maintain the external debt of developing countries sustainable is a shared responsibility of the debtor and of the creditors. Creditors should check the sustainability status of the debt in relation to changes in the debtor situation due, for instance, to natural disasters and create a framework whereby they can jointly operate and coordinate their actions taking into account the social and economic needs of the country.²⁹ In this context the Debt Sustainability Framework³⁰,

²⁷ See para 42 of the Doha Declaration.

²⁸ "We recognize that important challenges remain. Debt service accounts for a significant portion of the fiscal budget and is still unsustainable in a number of developing countries. The existing international debt resolution mechanisms are creditor-driven, while taking into account debtor country situations. More efforts are needed through international debt resolution mechanisms to guarantee equivalent treatment of all creditors, just treatment of creditors and debtors, and legal predictability. We are deeply concerned about increasing vulture fund litigation. In this respect, we welcome recent steps taken to prevent aggressive litigation against HIPC-eligible countries, including through the enhancement of debt buy-back mechanisms and the provision of technical assistance and legal support, as appropriate, by the Bretton Woods institutions and the multilateral development banks. We call on creditors not to sell claims on HIPC to creditors that do not participate adequately in the debt relief efforts.", para 60 of the Doha Declaration.

²⁹ "[...] Preserving long-term debt sustainability is a shared responsibility of lenders and borrowers. To this end, we encourage the use of the joint IMF/World Bank Debt Sustainability Framework by

introduced by the International Monetary Fund and the World Bank in 2005 and periodically reviewed, play a central role in helping developing countries in keeping their level of debt under control and in making appropriate decision in respect of what kind of financing matches their needs best. Debt burden indicators have been elaborated in order to detect at an early stage the risks related to excessive indebtedness. The Debt Sustainability Framework can help in directing investors as well since they provide rating of the debt situation of the country, both in relation to the debt-distress risk and the debt vulnerability risk, the latter relating to the kind of debt granted to the country, comparing long term financing to short term financing, for instance.³¹

In conclusion, the commitment of maintaining a comprehensive and diverse multi-stakeholder follow-up process, including civil society and private sector, is undertaken together with the commitment of holding a new follow up meeting before 2013.

Summing up, the Monterrey and the Doha Conference highlight the most relevant obstacles in the financial field which developing countries have to deal with in order to progress towards the final goal of a permanent debt sustainability which will allow them to focus on social, environmental, gender and civil issue in order to achieve sustainable development. As it will be shown in the next pages, it is hard to find resources for such concerns when basically all the gross national revenues of a country are used to service its external debt.

The change in the attitude of the international actors has also been registered in such forum: from a debtor's problem to the concept of joint liability of debtor and creditors, from the idea of debt collection to debt rescheduling and finally to debt sustainability.

In next paragraph, a brief overview of the main challenges developing countries have to face in respect of external debt management will be presented.

creditors and debtors, as appropriate. Borrowers should strive to implement sound macroeconomic policies and public resource management, which are key elements in reducing national vulnerabilities. Particular attention should be paid to keeping the debt sustainability frameworks under review to enhance the effectiveness of monitoring and analysing debt sustainability and consider fundamental changes in debt scenarios, in the face of large exogenous shocks, including those caused by natural catastrophes, severe terms-of-trade shocks or conflict [...]" para 64 and 65 of the Doha Declaration.

³⁰ For a short description of the Debt Sustainability Framework, see the International Monetary Fund fact sheet at: <https://www.imf.org/external/np/exr/facts/jdsf.htm>.

³¹ See an example of the debt sustainability analysis carried out by the International Monetary Fund and the World Bank in relation to the Democratic Republic of Sao Tome and Principe, dated 6 July 2012 at <https://www.imf.org/external/pubs/ft/dsa/pdf/2012/dsacr12216.pdf>.

3) SUSTAINABILITY OF SOVEREIGN DEBT

In this paragraph the main issues in relation to the quest for debt sustainability are briefly set out, namely: the need for technical skills, for more transparency and information to attract investors, financial regulation, debt sustainability analysis and the issue of an effective sovereign debt restructuring mechanism whereby bridge financing is available to the debtor and standstill is imposed to creditors in order to avoid opportunistic approaches by aggressive funds.

a. Technical skills

Most of the government of developing countries do not possess the same skills and information as representatives of foreign investment banks, or representatives of more sophisticated and economically mature countries. There is an asymmetry of information which puts the negotiating parties at the table in a position, respectively, of strength for the lenders and of extreme weakness for the inexperienced borrowers. As it will be better explained in chapter three, one of the main reasons of the debt crisis which occurred in the '80ies was the eagerness of bankers to lend the huge amount of liquidity which the so called "petrodollars" had brought in the American and European markets. Many developing countries were "eased" into massive loans which they did not ask for in the first place but were offered by eager bankers which would receive bonuses on proportion to the size of the deal.³²

From such experiences it becomes clear the need for technical assistance and training in the finance field so that a rebalance of the negotiating position takes place and lenders are not in a place where they can take advantage of their more qualified experience and borrowers can get what they really need (for instance more long term credit rather than short term financing and in a reasonable and sustainable amount) from the finance point of view, creating the first step for a sustainability framework.

b. Transparency and information

Being able to offer a clear and complete picture of the financial and economic situation of the country is important for two order of reasons: (i) in order to attract foreign investors; (ii) to prevent irrational market panic.

³² See R. P. Buckley, *International Financial System, policy and regulation*, Kluwer Law International, 2008, on this point.

It is crucial then to create a climate to encourage investment and to make it transparent and stable so that it can be judged as “investors-friendly”.

Information on the economic and financial situation should be always updated and easily accessible to the public. This point is particularly relevant for countries which choose as main source of debt the issuance of bonds, as it occurred after the debt crisis in the ‘80ies, when bank loans financing had dried up for emerging countries.³³

This kind of financing is subject to “contagion” risk: as bonds investor are not always particularly expert of developing countries economies, the crisis of one country can easily be exported in other countries, creating the contagion. The perception that something is going wrong in the country will result into a capital flow out of the country, which may affect an economy otherwise sound. Hence the relevance of offering clear and qualified information on the economy to the public, in order to avoid irrational investors behaviours. In such respect the role played by rating agency will be further analysed as well, as their judgment is often key as it is a trusted source of information by investors.

However, transparency should not be a one-way obligation, as it has been observed by some authors: lending institutions as well should be under an obligation to disclose their exposures, especially overleveraged hedge funds³⁴, in order to facilitate the work of policy makers and also in order to make easier to deal with the problems of the international financial markets.³⁵

³³ “The debt crisis had not curbed the appetite of emerging market borrowers for external financing; it had just changed the method (securities, not loans) and the place (bond markets, not commercial banks) in which that appetite would be sated”, L. C. Buchheit, *A lawyer’s perspective on the new international financial architecture*, Journal of International Business Law, 1999, p. 226.

³⁴ On this point S. Griffith Jones comment: “Concerning portfolio flows to emerging markets, there is an important regulatory gap, because at present there is no international regulatory framework for taking account of market or credit risks on flows originating in institutional investors such as mutual funds (and, more broadly, on flows originating in non-bank institutions). This important regulatory gap needs to be filled, both to protect retail investors in developed countries and to protect developing countries from the negative effects of excessively large and potentially reversible portfolio flows. Institutional investors such as mutual funds can, in view of the very liquid nature of their investments, play an important role in contributing to currency crisis in developing countries.”, S. Griffith Jones, *Developing countries and the new financial architecture*, in Sovereign debt, origins, crises and restructuring, V.K. Aggarwal and B. Granville eds., The Royal Institutes of International Affairs, 2003, p. 134. This point is connected to the following one, concerning financial regulation. It is worthy mentioning that the Financial Stability Board has taken into account this issue and created a specific working group on the highly leveraged institutions (HLIs) whose scope of work concerns: “These included strengthened risk management practices by HLI counterparties and HLIs, enhanced regulatory oversight of HLI credit providers, enhanced public disclosure by HLIs and counterparties, improvements to market infrastructure, guidelines on good practices for foreign exchange trading, and enhanced market surveillance by national authorities.” See the first report of the working group at http://www.financialstabilityboard.org/publications/r_0203b.pdf.

³⁵ See S. Griffith Jones, *Developing countries and the new financial architecture*, in Sovereign debt, origins, crises and restructuring, V.K. Aggarwal and B. Granville eds., The Royal Institutes of International Affairs, 2003, p. 129.

c. Financial regulation

This point makes reference to the debate on the need to find a new financial architecture as the current structure has been proved not to be able to deal with the financial crisis which have widespread especially since the 80'ies.

Solutions to such issue look towards two directions: the first one concerns a reform of the international financial markets³⁶, the second one focuses specifically on developing countries, trying to make the financial markets of such country more robust and less vulnerable to exploitation by unethical investors such vulture funds and to the irrational behaviour of the participants to the market.

An important step forward was the institution of the Financial Stability Forum, founded in 1999 and composed by the main international financial institutions, central banks, ministers of finances whose aim was to create a forum of discussion to deal with the risk of systemic instability of the international financial markets and how to achieve a more stable international financial architecture. It also had a role of control and supervision of the international financial institutions and promoted the cooperation of the member states in the field of financial regulation. In 2009, at the G-20 meeting held in London, it was decided to replace the Financial Stability Forum³⁷ with the International Financial Board.³⁸ This international body tries to be the answer to the observation that in a global market, where the crisis of one country negatively impact on actors in the international financial game across the globe, the lack of a single set of rules and the lack of one authority to supervision is the main source of instability and the reason why illegitimate conducts can be carried out as long as the real crisis explodes. Regulators of a country are left with the hope that regulators in other countries carry on their duty to supervision, however in a multijurisdictional field such as finance it often happens that the entity which should be regulated by multiple jurisdictions are regulated by none.

³⁶ "The two challenges for a new international financial architecture (IFA) that would support, not undermine, development are thus twofold: to prevent and better manage (if they occur) currency and banking crisis, and to ensure that sufficient net private and public flows go to developing countries, including emerging and low-income ones", S. Griffith Jones, *Developing countries and the new financial architecture*, in Sovereign debt, origins, crises and restructuring, V.K. Aggarwal and B. Granville eds., The Royal Institutes of International Affairs, 2003, p. 126.

³⁷ On the establishment of the Financial Stability Forum and the reasons behind it see J. Liberi, *The Financial Stability Forum: a step forward in the right direction...not far enough*, University of Pennsylvania Journal of International Economic Law, 2003, pp. 549 – 575.

³⁸ The Financial Stability Board is located in Basel and is hosted by the Bank for International Settlements. See chart of the Financial Stability Board at http://www.financialstabilityboard.org/publications/r_120809.pdf. See list of its members at http://www.financialstabilityboard.org/about/fsb_members.htm.

In order to deal with such issue, the International Financial Board prepared a set of principles, the Compendium of Standards³⁹, which are the first attempt to create a common set of rules and regulation for authorities around the world. They represent a guideline for implementing reforms in the financial field. The relevance of such principles is also under the expertise sharing point of view, which was raised by the Doha Declaration as well. National authorities of developing countries have access to a forum whereby they can discuss technical points, share views and coordinate their actions. In order to achieve such goal, it is also desirable that the participation to such body by less developed countries is further encouraged: as of today emerging economies such as India and Brazil joined it, however there is still a lot to do under that point of view. In order to create universal rules the participation of the widest number of international actor is fundamental.

From the developing countries perspective, furthermore, capital control will play a relevant role in order to avoid the risk of sudden capital outflows due either by some difficulty in the country itself or by the so called "Tequila Effect"⁴⁰ or contagion. Capital control can be structured either as a restriction on foreign exchange transaction or on capital account transactions (both on capital inflows and capital outflows) that the government can shape as taxes or quantitative restrictions to such transactions.⁴¹

³⁹ For more information on the Compendium of Standards see http://www.financialstabilityboard.org/about/fsb_members.htm. Standards are organised for sector and function. A general set of principles on "Key Standards for sound financial system" have been elaborated as well, which aim at being, *inter alia*, universal and flexible in order to be functional for as many countries as possible.

⁴⁰ The name comes from the crisis of Mexico in 1994, due to the depreciation of the peso, which had as consequence the increase of the market volatility of many other developing countries in the Latin American area, as a massive outflow of capital was triggered by the loss of confidence of the investors in the area. On financial contagion see R.W. Kolb, *Financial contagion, the viral threat to the wealth of nations*, 2010.

⁴¹ On the relevance of capital control for developing countries see R.P. Buckley, *International capital flows, economic sovereignty and developing countries*, Yearbook of international financial and economic law, 1999, pp. 17-46, according to which: "[...] for as long as a developing nation has a thin financial market, unsophisticated private sector risk management techniques and an unsophisticated and under-resourced capital market regulator, there are good arguments for control on capital in-flows". On the structure of the new financial architecture see also R. Wade, *The Asian debt-and-development crisis of 1997-?: causes and consequences*, World Development, 1998, pp. 1535-1553, where the author suggests: "the debate (i.e. on the international new regime) should focus on questions such as: should we make a sharp distinction between free trade and free capital movements, seeking to encourage the former while constraining the latter? Are international financial markets "efficient", can they fail, can speculation be destabilizing? Has the growth of derivative markets and other forms of leverage created the preconditions for aggressive intermediaries, such as hedge funds, to disrupt the financial markets of smaller countries? Does the growing securitization of credit in response to the emergence of pension funds and mutual funds require the development of new forms of financial supervision comparable to those which have long existed for banks? How can developing countries obtain the benefits of international lending- in terms of investing more than they save- while limiting their exposure to the costs of unstable flows?."

d. Debt sustainability analysis

The concept of debt sustainability is a contentious notion: the debate on how to define it and which indicators should be taken into account, being also a political choice, has lasted for many decades.

The definition of debt sustainability given by some author, and sharable, is “a country debt [is] sustainable if the country can meet its debt-service obligations without recourse to debt relief, rescheduling of debt or the accumulation of arrears and without unduly compromise growth”.⁴²

In next paragraph the relevance of the final part of the definition will be taken into account: the price for servicing massive amounts of debts is the lack of development of the country itself and bitter social consequences for its citizens.

The concept of debt sustainability became quite relevant once the debate on debt relief started and was supported by NGOs and the public opinion which cried out for the injustice of the situation of such countries suffocated by the burden of massive amount of debt.

The outcome of such debate was the institution of the highly indebted poor countries institutions (HIPC) whose objectives “[...] included debt sustainability, regularization of relations with creditors, poverty reduction, and, as a result of these objectives, growth”.⁴³ The HIPC will be further discussed in chapter three.

The analysis of debt sustainability is key also for its preventive function: detect at an early stage the weaknesses of the debt structure of a country can avoid crisis if they efficiently dealt with.

The IMF carries on a program on debt sustainability, which includes public debt of a country and all the external debt (public and private) of such country. The framework has three main objectives:

- assess the current debt situation, its maturity structure, whether it has fixed or floating rates, whether it is indexed, and by whom it is held;

⁴² E. Baldacci, K. Fletcher, *A framework for fiscal debt sustainability analysis in low income countries*, in *Helping countries develop: the role of fiscal policy*, eds S. Gupta, B. J. Clements, G. Inchauste, 2004, p.130.

⁴³ T. M. Callaghy, *Innovation in the sovereign debt regime: from the Paris club to the enhanced HIPC and beyond*, the World Bank publications, see at [http://lnweb90.worldbank.org/oed/oeddoclib.nsf/DocUNIDViewForJavaSearch/4BC77E9BEC2CAAFC85256E4A00536A04/\\$file/hipc_wp_sovereign_debt.pdf](http://lnweb90.worldbank.org/oed/oeddoclib.nsf/DocUNIDViewForJavaSearch/4BC77E9BEC2CAAFC85256E4A00536A04/$file/hipc_wp_sovereign_debt.pdf). In the paper it is analysed the so called “structural dilemma” of developing countries: “A central structural dilemma of our times is the emergence of a group of weak states and economies that have not been able to benefit as easily or quickly from economic reform and democratization as elsewhere in the world. This dilemma poses important difficulties for the functioning and evolution of the international political economy and for international peace and conflict”.

- identify vulnerabilities in the debt structure or the policy framework far enough in advance so that policy corrections can be introduced before payment difficulties arise;
- in cases where such difficulties have emerged, or are about to emerge, examine the impact of alternative debt-stabilizing policy paths.⁴⁴

A further instrument to deal with debt sustainability is the Debt Sustainability Framework, already mentioned in the previous paragraph. The way the Debt Sustainability Framework works is by preparing Country Policy and Institutional Assessments (CPIA) for each borrowing country to classify countries by performance and determine different debt ratio thresholds for the selected indicators. Some authors, however, criticize such approach stating that it is too rigid and it doesn't take into account externalities and sudden shocks of the economies due, for instance, to natural disasters.⁴⁵ It works in relation to the level of debt relief to be granted to each country but it is not a comprehensive and conclusive approach to the issue.

e. Debt restructuring mechanisms

The occurrence of a financial crisis is the final stage for a country with an unsustainable debt burden. Dealing with the crisis in a fast and efficient way is a key point in order not to exacerbate the issue: hence the relevance of the creation of an appropriate debt restructuring mechanism for sovereign debt.

Three key points should be covered by such mechanism: (i) providing bridge financing to the country in difficulty; (ii) create a moratorium regime during the negotiation of the restructuring; (iii) creating a proper framework for negotiation with all parties involved.

The first points deals with the fact the in the international financial structure there is no "lender of the last resort" which can provide finance to countries in difficulties. For many years it has been questioned whether the IMF should play such role, but it became clear that the size of the bailouts needed were above the capacity of such institution. No financial institution is willing to lend into arrears to a developing country during a financial crisis. In order to solve such issue, the example could be national insolvency legislations, whereby a super seniority is granted to the new

⁴⁴ See IMF website on its Debt Sustainability Advice at <http://www.imf.org/external/pubs/ft/dsa/index.htm>.

⁴⁵ B. Ferrarini, *Proposal for a contingency debt sustainability framework*, World Development, 2008, pp. 2547- 2952.

finance granted to the borrower in financial distress. This point is analysed more in depth in chapter four.

The second issue deals with the problem of holdouts. Nowadays the main source of finance for countries is bond financing. When a crisis occurs, negotiating with thousands and thousands of bondholders, of very different nature, from the sophisticated investors such funds and other financial institutions to single private investors around the world becomes very difficult. And while the state is trying to work out a solution with the majority of such bondholders, it often occurs that single creditors break out the negotiation to pursue legal ways, trying to seize assets of the debtor located outside its state. If such kind of approaches were not allowed, by means of an automatic stay as soon as negotiation for the debt restructuring start, opportunistic investors such vulture funds would be discouraged from purchasing bonds purely to act in such way or to make its holdout value been paid by the country. This point as well will be further developed in the forth chapter.

The final point is a general query regarding the structure of the debt restructuring mechanism.⁴⁶ Forum to deal with classes of debt already exist, such as the Paris Club or the London Club, and the intervention of the IMF is also relevant. However a final and global solution is still unfound. Two main proposals, the Sovereign Debt Restructuring Mechanism, promoted by the IMF and the contractual approach, have been raised and will be discussed in the third and forth chapter.

⁴⁶ See E. J. Eichengreen, R. Portes, *Crisis? What crisis? Orderly workouts for sovereign debtors*, 1995, M. Megliani, *Debitori sovrani e obbligazionisti esteri*, 2009, S.L. Schwarcz, *Sovereign Debt Restructuring: a bankruptcy reorganisation approach*, Cornell Law Review, 2000, pp. 956- 1034.

4) SOVEREIGN DEBT CRISIS AND SOCIAL CONSEQUENCES: A MODERN EXAMPLE

This final short paragraph aims at bringing the financial crisis of a nation in the context of social consequences for its citizens. Very often the truly economic nature of the crisis and of the issue do not allow to focus properly on what a debt restructuring process means for the population.

Financial crisis means hunger, unemployment, no funds for education, environment protection and social services such hospitals and social unrest. It affects mainly vulnerable people, which live below the poverty line.⁴⁷

Therefore, the need for fast and efficient means to deal with the crisis, and in particular the institution of a debt restructuring mechanism is key in order to reduce the length of the crisis, which progressively worsens the conditions of the population.

After the Asian crisis in Thailand, such country became one of the top five countries in terms of wealth inequality.⁴⁸ In Mexico, the Tequila crisis in the 90ies had devastating effects on the poorer segments of Mexico's population, as did the crises that preceded it. Between 1994 and 1996, the poverty rate increased from 51 to 62 percent.⁴⁹

In Argentina at the peak of the crisis in 2001, popular masses took to the streets all across Argentina, protesting against the economic decline and hardship brought by the recession. The protesters then organized in a structured movement, called the *piqueteros*, which gained political force and relevance in the national panorama.

As financial crisis have been interpreted as a "developing countries issues" the recent turnaround in the economy of the developed nations shows the financial stability is an issue which concerns all states, globally.

⁴⁷ "External debt harms countries in two ways. Diversion of resources that could otherwise be used for public services and poverty eradication is the more obvious one, and is frequently the focus of debt cancellation campaigns. And indeed, this diversion alone should be grounds for cancellation of debt in deeply impoverished countries that should be feeding, housing, and educating their people rather than shipping 25 percent-and sometimes more-of their national revenues to wealthy Northern institutions. But probably more important is the inextricable link between debt and countries' vulnerability to the demands of multilateral creditors. An indebted government, viewed by private creditors as not creditworthy, has little choice but to obtain a loan from the IMF or World Bank if it wants to remain part of the global economy. Many countries have signed up for multiple structural adjustment loans over the last two decades, but no proof has emerged that more is better. The requirements of the IMF and World Bank constrict economies and hit the most vulnerable people, especially women and children, with disproportionate ferocity." S. Ambrose, *Social movements and the politics of debt cancellation*, Chicago Journal of International Law, 2005-2006, pp. 270-271.

⁴⁸ Data from Thailand Development Research Institute see at <http://www.tdri.or.th/en/php/index.php>.

⁴⁹ See E. Kalter, *Policies for success under globalisation: the case of Mexico*, IMF publication at http://emstrategies.com/uploads/0302cuba1112_1.pdf.

The social consequences of financial distress will be briefly analyzed in relation to a recent case which concerns a European country: Greece.

Since the beginning of the crisis the rate of unemployment in Greece climbed to 23.1%, with nearly 55% of those aged 15-24 out of work.⁵⁰

A online newspaper in March 2012 reported: "A humanitarian crisis is unfolding in an impoverished Greek city where a deepening economic crisis has left thousands seeking food from an international charity more used to helping refugees and bringing aid to famine or disaster zones."⁵¹

European readers are not used to such headlines, however that is the concrete evidence of the dramatic effects of crisis on the population, in any crisis, the story repeats. A more detailed analysis of the debt restructuring process of Greece will be carried out in the fourth chapter.

⁵⁰ *Greek unemployment soars to new record, more pain ahead*, in Financial Post, see at <http://business.financialpost.com/2012/08/09/greek-unemployment-rate-soars-to-new-record-more-pain-ahead/>. For an updated rate of unemployment in Greece see Eurostat statistics at http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&language=en&pcode=teilm020&tableS_election=1&plugin=1.

⁵¹ D.Kyvrikosaios, *Poverty-stricken Greek town hits new low*, at <http://www.reuters.com/article/2012/03/30/us-greece-poverty-idUSBRE82T11S20120330>.

CHAPTER TWO

SOVEREIGN EXTERNAL DEBT: SOURCES OF FINANCING FOR DEVELOPING COUNTRIES

1) PRIVATE AND PUBLIC DEBT

After the introduction on the growing relevance of the concept of sustainable development in the financial field in the first chapter, this second chapter will focus on the analysis of the main kind of financing available to developing countries in order to meet their financial needs for development.

Broadly speaking, the sources of external (i.e. from foreign third parties creditors) financings available to developing countries can be distinguished between “public” sources (i.e. funds which are made available by international organizations such as the World Bank and the IMF) and “private” sources, offered by private banks in their regular banking activity.

Such distinction is relevant also for the purposes of the third chapter and fourth chapter, which will focus on the restructuring process of sovereign debt, whereby the distinction between the interests at stake and negotiation patterns of public and private institutions will be analysed and the different attitudes and outcomes of the process will be highlighted.

Mention will be made of hybrid entities such as the Sovereign Wealth Funds (SWF) as well, given their growing importance in the international financial system. SWF are formally public entities (given that they are owned by the governments) which act as private investors and/or lenders.⁵²

SWF will also be analysed not only in their role of actors in the global financial markets, but also in relation to the rationale for creating such entities as a reaction to the risks connected with global financial instability and excessive volatility of the markets, in order to protect developing countries from sudden crises as it happened in the '90 in Asia.⁵³

⁵² The International Working Group of Sovereign Wealth Funds, established by the International Monetary Fund, defined the SWF as: “SWFs are special purpose public investment funds, or arrangements. These funds are owned or controlled by the government, and hold, manage or administer assets primarily for medium to long-term macroeconomic and financial objectives. The funds are commonly established out of financial foreign currency operations, the proceeds of privatisations, fiscal surpluses, and/or receipts resulting from commodity exports. These funds employ a set of investment strategies which include investments in a foreign financial assets.”, IMF, *Sovereign Wealth Funds - A Work Agenda*, 29 February 2008, p. 26.

⁵³ See next chapter in relation to the Asian crisis of the '90.

The following paragraphs will describe the characteristics of the kind of financing offered by public and private actors in the international financial markets: developing countries which will look to achieve a balanced and sustainable mix of long and short⁵⁴ term debt, concessional terms financings, bonds or loans and to select the right counterparty (public or private) to deal with. The results of all such choices will bring different results if and when the country faces financial difficulties and needs to start a dialogue with its creditors, as the following chapters will explain in more detail.

After the sovereign debt crisis developed in the '80ies (which will be analysed in the next chapter) the relevance of responsible lending and borrowing in the international financial system has been stressed. In order to set out a “responsible lending and borrowing” framework, it is necessary to consider the peculiar features of sovereign debt:⁵⁵

- **Intergenerational tensions:** due to the fact that the persons that borrow money are not always the ones that will have to repay the sums borrowed. The moral hazard of over borrowing is connected to this very reason and in particular in relation to money raised to cover budget deficits, wars or bailouts of commercial enterprises, as borrowing for long term infrastructure projects and similar long term investment do not cause this kind of intergenerational issue, given that future generations will benefit of those investments as well.
- **Government officials as agents:** the debate involves the idea of looking at government officials as agents of or trustees for present and future citizens. It could be envisaged a fiduciary duty that governmental officials owe to the population and they could, consequently, be held responsible for actions in breach of such duty.
- **Mixed motivations of certain lenders:** as already mentioned in the previous chapter, profit for the bankers involved will often drive the structuring of the loans to certain sovereign borrowers rather than an actual planning for the country financial need. In relation to bilateral loans between governments, other kind of motivations for lending come into play, such as stimulating exports of capital goods from the creditor country or acquiring geopolitical influence over

⁵⁴ Short term loans are commonly defined as those loans with one year maturity or less, while long term debt is the debt maturing later than one year after it is borrowed.

⁵⁵ L. B. Buchheit and G. Mitu Gulati correctly point out that the term “sovereign debt” sounds like an oxymoron: “A debt – at least of the financial kind, suggests an obligation whose performance is legally enforceable against the borrower. The word sovereign, however, connotes an entity that is not subject to external constraints, least of all the tiresome constraint of repaying borrowed money. Yet sovereigns borrow money all of the time and they pay it back most of the time.” See L. B. Buchheit and G. Mitu Gulati, *Responsible Sovereign Lending and Borrowing*, UNCTAD Discussion Papers, no. 198, April 2010, pag. 1.

the creditor. In both scenarios, however, the likely outcome will be a tendency to over-lending/over-borrowing.

- **The absence of a formal bankruptcy mechanism:** sovereign borrowers are not bound by the rules of national bankruptcy regimes, and this results in both positive and negative consequences from the perspective of the sovereign borrower. As positive aspect, the creditors know that the only options are either to negotiate or to litigate (subject to the uncertainties of being able to enforce such judgment). On the other hand, they do not have any moratorium or other kind of court-relief orders imposed in the context of a bankruptcy proceeding or so called “cram-down” procedures which allow the borrower to force minorities into a deal negotiated and approved by the majority of the creditors.
- **The sovereign debtor as a defendant:** as countries benefit from immunities set out in international treaties and agreements, the ability for creditors to satisfy their claims over the country’s asset are limited to basically assets located outside the country and used for commercial purposes (rules regarding sovereign immunities will be further analysed in the forth chapter).⁵⁶

Given the peculiarities of sovereign finance, just set out, lenders and borrowers will have an additional set of duties to comply with, in order to qualify as “responsible” lenders or borrowers.

Lenders will have to investigate rather than ignore or pretend not to be aware of the fiduciary duties that the government officials have vis-à-vis their citizens, in order not to favour corruption and the assumption by debtor countries of the so-called odious debts. Motivations to lend should be exclusively linked to commercial objectives rather than political ones and accurate due diligence on the borrower should be carried out before lending (in order to carefully assess the amount that the borrower will be able to repay) and after lending (in order to monitor what the borrower does with the money).

Furthermore, in order to avoid situations in which the lender’s officers push the borrower to request a bigger loan that it needs, due to the fact that their bonuses are based on the actual size of the loans, lending institutions should make sure that the interest of the officers are aligned with the institutions long-term interests.

On the other hand, borrowers will have to carefully consider the amounts to be borrowed on the basis of the financial needs of the country and taking into account the fact that servicing the debt will be a long-term burden on the country. In working out the correct figure, borrowers should also consider that their borrowing capacity (usually measured

⁵⁶ See L. B. Buchheit and G. Mitu Gulati, *Responsible Sovereign Lending and Borrowing*, UNCTAD Discussion Papers, no. 198, April 2010, pag. 5-7.

on the basis of the country GDP) should not reach the saturation point so that in the event of emergency which require additional funding, they will not face the choice of either printing additional money (with the inflation consequences linked to it) or requiring the official sector's help. There is also a reputational aspect linked to the responsible behaviour of sovereign borrowers: given that the market will not forget about debtors dishonouring their commitments, the consequences of irresponsible borrowing will be inherited by future generations which will find it harder and more expensive to find creditors willing to lend.

In light of the above, a responsible borrower should comply with the following duties: (i) to repay its debts, other than in extraordinary and unforeseeable circumstances such as natural cataclysm, wars etc.; (ii) to be transparent about amounts of money borrowed and guaranteed so that the borrowing capacity of a country can clearly be assessed; (iii) receive internal approvals for borrowing, in order to comply with their agency obligations vis-à-vis their citizens; (iv) appoint debt management officers to monitor the financial situation of the country at any moment.⁵⁷

⁵⁷ See L. B. Buchheit and G. Mitu Gulati, *Responsible Sovereign Lending and Borrowing*, UNCTAD Discussion Papers, no. 198, April 2010, pag. 8-17. And on the relationships between creditors and borrowers in sovereign finance see also J.D. Aronson, *International Lending and Debt*, The Washington Quarterly, 1983, pp. 62-76.

2) PUBLIC SECTOR CREDITORS

a. Multilateral creditors

i. International Monetary Fund

The International Monetary Fund (IMF) was originally conceived in July 1944, during the Bretton Woods meeting, as part of the framework for economic cooperation post World War II. The IMF was formally established in December 1945, when the first 29 member countries signed its articles of agreement.⁵⁸

Each member funds the IMF through the payment of a “quota”, based, broadly, on the country’s position in the global economy, which also determines the voting and other participative rights of each member.⁵⁹

The main function assigned to the IMF by its members is to guarantee international financial stability, through cooperation amongst the members.⁶⁰

In order to achieve such goal, one of the main activities of the IMF is to create and promote standards codes of conduct for the members of the international

⁵⁸ See the IMF Articles of Agreement at: <http://www.imf.org/external/pubs/ft/aa/index.htm>. The Articles of Agreement have now same legal value of an international treaty for those countries that signed up to them. The Articles entered into force in December 1945 and have been subsequently amended in 1969, 1978 and 1992.

⁵⁹ The quota system has been revised in 2010, for more information see: <http://www.imf.org/external/np/exr/facts/quotas.htm>. On the history and internal organization of the IMF see also D.K. Tarullo, *The role of the IMF in Sovereign Debt Restructuring*, Chicago Journal of International Law, 2005-2006, pp. 287-300.

⁶⁰ Article 1, which sets out the purpose of the IMF, states: “The purposes of the International Monetary Fund are:

(i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(v) To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The Fund shall be guided in all its policies and decisions by the purposes set forth in this Article.”

financial systems, the “rules of the games” for all the international “players”.⁶¹

The IMF oversees the creation of such standards in particular in respect of three most sensitive areas: (i) monetary policies; (ii) statistics data, and (iii) fiscal transparency. The IMF in carrying out such function cooperates with other international Standard Setting Bodies such as the World Bank, the Bank for International Settlements and the World Trade Organization.⁶²

Historically, the IMF covered several functions through the years: originally thought to control the exchange rate stability, once the Bretton Woods system of fixed exchange rates collapses in the 70ies, the IMF took a prominent role in dealing with financial crisis resulting from the oil shocks and in assisting east European countries upon the dissolution of the Soviet block.

The focus of this paragraph is the lending activity of the IMF and its role in sovereign debt crisis (which will also be analysed in the following chapter more in detail).

One of the main functions of the IMF is to lend to those countries which are facing actual or potential balance of payment issues. The facilities granted by the IMF are both at concessional (i.e. which carry zero interest rate) or non-concessional, depending on the financial situation of each borrower.

During the debt sovereign crisis in the ‘80ies, the IMF played the role of “lender of last resort”⁶³, which would bail out countries with an excessive debt burdens, facing the incapacity to repay debts coming due.⁶⁴

The role of the IMF in the context of sovereign debt crisis has been at the centre of many discussion and two main theories regarding such point developed: according to the first one, the fact that countries know they will be bailed out by the IMF, creates a moral hazard due to the fact that countries are conscious that notwithstanding wrong economical and financial choices

⁶¹ On this see R.M. Lastra, *The reform of the international Financial Architecture*, Kluwer, 2001 and F. Saccomanni, *A new architecture or new system? A survey of International Monetary reform in the 1990s*, in *Open Economics Review*, vol. 11, 2000, pp. 15 ss.

⁶² See the complete list of the Standards Setting Agencies at: <http://www.imf.org/external/standards/agency.htm>. The IMF is also member of the Financial Stability Board, as already discussed in the previous chapter. On the cooperation between the IMF and other Standards Setting Agencies, see S. Morettini, *Il fondo monetario internazionale e le reti globali di regolatori finanziari*, in *Rivista Trimestrale di Diritto Pubblico*, La regolamentazione globale dei mercati finanziari, S. Battini ed., Giuffrè, 2007, pag. 293 ss.

⁶³ The concept of Lender of Last Resort was originally created by the theoretical contributions of H. Thornton, in *An Enquiry into the Nature and Effects of the Paper Credit of Great Britain*, 1802, and later on by W. Bagehot in *Lombard Street: a description of the money market*, 1873.

⁶⁴ On the evolving role of the IMF see K. Alexander, *International Economic Law and the lender of last resort*, in *Liber Amicorum Guido Alpa – Private Law beyond the national systems*, M. Andenas, S.D. Alabart, Sir B. Markesinis, H. Micklitz, N. Pasquini eds., British Institute of International and Comparative Law, 2007, pp. 24 ss.

by investors and the government, they will still be rescued⁶⁵, consequently IMF intervention should be limited in size and frequency in order to reduce moral hazard distortion⁶⁶ and the IMF should have merely a facilitative role in the negotiations between the private sector lenders and the debtor countries,⁶⁷ the second one sees the international financial crisis as the consequence of sudden lack of liquidity and investors' panics, therefore a lender of last resort providing the necessary liquidity to avoid a shortfall in countries in difficulties is key to improve international financial stability.⁶⁸

A short overview of the IMF funding arrangements will now be introduced, starting from the more traditional ones and the moving on to the most recent financing agreements offered by the IMF.⁶⁹

- **Stand-by arrangements:** these are the main instruments through which the IMF makes available its funds to its members.⁷⁰In order to benefit from a stand-by arrangement, the Minister of Finance or the Governor of the Central Bank of the country requesting the stand-by line of credit must sign a letter of intent to be addressed to the

⁶⁵ "IMF loans, then, actually offered extraordinarily generous rebates of about 10% below market rates. On the \$117 billion lent to East Asia under IMF auspices thus far, the region is saving about \$12 billion a year in interest payment. Over three years, South Korea, Thailand and Indonesia will have received a direct wealth transfer of at least \$35 billion, mostly from US and Western European tax-payers. But this \$35 billion figure actually understates the true scale of the transfer. Investor priced South Korea's debt at a yield of 14.5 per cent only because there was a good chance the IMF would come in sooner or later and rescue them. Absent the market-distorting activities of the IMF, the risk premium on this sovereign debt would have been even greater. More specifically, much of the \$35 billion will amount to a wealth transfer from middle-class Westerners to East Asia Governments, banks and their rich equity owners and from there to wealthy Western and Japanese investors who risked capital in foolish ways (or perhaps not so foolish since there was a good chance they would be bailed out in the end). The whole series of transactions amounts to a remarkably regressive tax", D. Sacks and P. Thiel, *The IMF's big wealth transfer*, in I. McQuillan and P. Montgomery, *The International Monetary Fund*, Hoover Institution Press, 1999, at pag. 32.

⁶⁶ See Meltzer Commission, *Report of the International Financial Institutions Advisory Commission*, October 2001, Washington D.C.

⁶⁷ See M. Knight, L. Schembri and A. Powell, *Reforming the Global Financial Architecture: just tinkering around the Edges?*, in D. Vines and C. Gilbert, *The IMF and its critics*, Cambridge University Press, 2004, pp. 14 ss.

⁶⁸ See S. Fischer, *On the Need for an International Lender of Last Resort*, 1999, unpublished, available at: <http://www.imf.org/external/np/speeches/1999/010399.HTM> and G. Corsetti, B. Guimaraes, N. Roubini, *International lending of last resort and moral hazard: a model of IMF's catalytic finance*, National Bureau of Economic Research working paper series, 2003, available at: <http://www.nber.org/papers/w10125>.

⁶⁹ See K. Alexander, *International Economic Law and the lender of last resort*, in Liber Amicorum Guido Alpa – Private Law beyond the national systems, M. Andenas, S.D. Alabart, Sir B. Markesinis, H. Micklitz, N. Pasquini eds., British Institute of International and Comparative Law, 2007, pp. 30 ss and the IMF factsheet on lending, available at: <http://www.imf.org/external/np/exr/facts/howlend.htm>.

⁷⁰ Such arrangements started in practice and were then officially introduced in the Articles of Agreements which now make reference to stand-by arrangements in article V (3).

Managing Director of the IMF, which sets out the undertakings the Fund requires in order to grant the facilities.⁷¹ Under article XXX (b) of the Articles of Association, stand-by arrangements are defined as “a decision of the Fund by which a member is assured that it will be able to make purchases from the General Resource Account⁷² in accordance with the terms of the decision during a specified period and up to a certain amount.”⁷³ The non-compliance with the stand-by arrangements term by the borrower may lead the Fund to deny the renewal of the credit line or may impact on the borrower’s capacity to draw under such credit line.

- **Precautionary stand-by arrangements:** these are lines of credit granted by the IMF to States in order to prevent a capital account crisis. The States undertake to the IMF not to draw from such facilities unless its economic and financial conditions worsen. Such arrangements replace, to a certain extent, the IMG Contingent Credit Line, created in 1999 as a precautionary defence to those countries potentially vulnerable to financial market crisis. The Contingent Credit Line expired in November 2003, and was never actually used by any country. Therefore, the Precautionary arrangements represent a replacement for the purpose of promoting crisis prevention.⁷⁴

⁷¹ The legal value of the Letter of Intent is debated: according to the former IMF General Counsel Sir Joseph Gold argued that a stand-by is an “arrangement” and not an agreement creating legal obligations, while others argue that the Letter of Intent together with the Stand-by arrangements are legally binding agreements. See A. Lowenfeld, *International Economic Law*, Oxford University Press, 2003, pag. 516. In 1979 the Executive Board of the IMF itself expressed its position on the debate, stating that stand by arrangements have no contractual function. See Executive Board Decision no. 6056 (79/38) dated 2 May 1979.

⁷² “The GRA is the principal account of the IMF and handles by far the largest share of transactions between the IMF and its membership. The GRA can best be described as a pool of currencies and reserve assets built up from members’ fully paid capital subscriptions in the form of quotas. Quotas are the basic building blocks of the IMF. They broadly reflect each member’s relative economic size, taking into account the quotas of similar countries. Quotas determine the maximum amount of financial resources that a member is obligated to provide to the IMF, voting power in IMF decision making, and a member’s share of SDR allocations. The financial assistance a member may obtain from the IMF is also generally based on its quota. “, see *Financial Organization and Operation of the IMF*, Pamphlet series no. 45, 2001, pag. 19.

⁷³ See Articles of Association, available at: <http://www.imf.org/external/pubs/ft/aa/>.

⁷⁴ Amongst the Executive Directors of the IMF, it has been debated whether the expiry of the Contingent Credit Line left a gap in the instruments to prevent financial crisis offered by the IMF, as the Precautionary arrangements may not be enough to provide adequate financial support in the event of an exogenous shock. See IMF Discusses Status Report on Crisis Prevention and Precautionary Arrangements, Public Information Notice, no. 04/117: “[...] regular precautionary arrangements – while useful in cases where pressures are likely to emerge in the current account – are not an effective tool of crisis prevention for members that pursue sound policies but still remain exposed to exogenous shocks and contagion”, available at: <http://www.imf.org/external/np/sec/pn/2004/pn04117.htm>.

- **Extended arrangements:**⁷⁵ these arrangements offer a long-term support to developing countries, more flexible both in terms of time period and amount available. The Extended Fund Facility, in particular was established in 1974 in order to help those countries with longer-term balance of payment issues, which require overall economic reforms. The lines of credit granted under the terms of such arrangements have a 3 years term and their maturity is between four and ten years of the date of their execution. In addition to the Extended Fund Facility, the IMF established other six additional facilities, which all have as main purpose to deal with countries which suffered from a severe financial shock, impacting on the economic development perspectives of such country.⁷⁶
- **General Arrangements to Borrow (GABs):** created in 1962 as an additional founding source, due to the fact that at the time the IMF memberships was growing much faster than the increases in its membership quotas and it could not meet the financial needs of its members. The GABs were created as international agreements between the IMF and each government or central bank of the main industrialised countries at the time in order to establish bilateral lines of credit between the IMF and such entities.⁷⁷ Originally the scope of such credit lines was to grant to the IMF sufficient liquidity to act as lender to its members which were experiencing economic imbalances or temporary payment difficulties on a scale that would exceed the IMF resources.⁷⁸ Before calling on the GABs, however, the IMF had to receive majority approval of the Executive Board and special majority approval of GAB participants. Once the IMF borrows from

⁷⁵ On the Extended Fund Facilities see also the IMF factsheet, available at: <http://www.imf.org/external/np/exr/facts/eff.htm>.

⁷⁶ The six additional lines include, *inter alia*: (i) Comprehensive Development Framework (seeking to direct the development agenda of a country so that it can meet the United Nations' Millennium Development Goals); (ii) Country-Assistance Program; (iii) the Highly Indebted Poor Countries Debt Relief Strategies (see next chapter in this respect).

⁷⁷ The original parties to the GAB were: Belgium, Canada, the German Bundesbank, France, Italy, Japan, the Netherlands, Swedish Riksbank, United Kingdom and the United States.

⁷⁸ The General Arrangement to Borrow, the Preamble: "In order to enable the International Monetary Fund to fulfil more effectively its role in the international monetary system, the main industrial countries have agreed that they will, in a spirit of broad and willing cooperation, strengthen the Fund by general arrangements under which they will stand ready to make loans to the Fund up to specified amounts under Article VII, Section 1 of the Articles of Agreement when supplementary resources are needed to forestall or cope with an impairment of the international monetary system". See IMF, *Selected Decisions*, Thirtieth Issue, available at: <http://www.imf.org/external/pubs/ft/sd/index.asp?decision=1289-%2862/1%29>.

the GAB members, it has an obligation to repay the loan within five years and pro-rata to the commitments of each participant in the relevant loan. GABs were amended in 1978: one of the main amendments was to allow non IMF members to benefit from GAB, if certain criteria were met, namely: (i) the IMF has inadequate resources to meet expected or actual requests of financial assistance; (ii) a country's balance - of-payments problems that are of a size that could threaten not only such country's financial stability but the international monetary system stability. GABs have been criticized because too favourable *vis-à-vis* industrialised countries, which could easily receive the benefit of such loans and too difficult for non-GAB countries, which in order to receive financial support had to receive both special majority approval and prove that the crisis would have such far-reaching consequences that the international monetary stability would be jeopardised.⁷⁹

- **New Arrangements to Borrow (NAB) and supplemental reserve facility:** such new arrangements were introduced after the Mexican financial crisis in the '90ies, when it became clear that the IMF needed more resources to deal with financial crisis in developing and emerging market economies. The NAB includes the terms for bilateral credit arrangements between the IMF and 38 member countries and institutions, for an overall amount of SDR million 369,997.36.⁸⁰ Unlike GABs, non-NAB countries that are IMF members are entitled to have access to NAB on the same terms and conditions as NAB countries. As per the Stand-by arrangements, NAB requires the entry into a Letter of Intent and the compliance with the undertakings included therein. In 1997 the Supplemental Reserve Facility was also implemented, during the Asian crisis (see next chapter), which provides for short term financing at market rate to IMF members suffering from a financial crisis. In order to draw from

⁷⁹ Evidence that the requirements to be met were too difficult for non-GAB countries is that none of such countries ever received funds from GAB other than Russia in 1998, when there was a general consensus on the risks to the international stability that the financial crisis in Russia would result into. See more on GAB in K. Alexander, *International Economic Law and the lender of last resort*, in Liber Amicorum Guido Alpa - Private Law beyond the national systems, M. Andenas, S.D. Alabart, Sir B. Markesinis, H. Micklitz, N. Pasquini eds., British Institute of International and Comparative Law, 2007, pp. 34 ss.

⁸⁰ See the list of NAB countries on the IMF website at: <http://www.imf.org/external/np/exr/facts/gabnab.htm>.

such facility the members have to comply with a restructuring programme under the supervision of the IMF.⁸¹

Low-income countries are allowed to borrow certain facilities on concessional terms (i.e. the loans carry which carry zero interest rate), while non-concessional facilities bare the IMF's market-related interest rate which is based on the Special Drawing Rights⁸² interest rate, revised weekly to take into account the variations in the short-term interest rates in the main international money markets.⁸³ Generally the maximum amount that each country can borrow is a multiple of such country's IMF quota, but there are exceptions to deal with exceptional financial crisis.⁸⁴

The IMF has developed a set of financing instruments to deal with financial crisis and external crisis⁸⁵ of its members, which often involve a sudden reverse in the international capital flow in the country. The IMF provides credit facilities in reasonably quick timeframes in order to provide the relevant country which some "breathing space" to deal with the sudden financial imbalance.

The process to receive funds from the IMF involves the evaluation by the IMF of the overall financial and economical situation of the country and the determination of the conditions at which the IMF is willing to advance the facilities. This is the so-called "IMF conditionality", which attracted several criticisms and has been object of a lively debate between authors.

⁸¹ On NAB see K. Alexander, *International Economic Law and the lender of last resort*, in Liber Amicorum Guido Alpa – Private Law beyond the national systems, M. Andenas, S.D. Alabart, Sir B. Markesinis, H. Micklitz, N. Pasquini eds., British Institute of International and Comparative Law, 2007, pp. 40 ss.

⁸² The SDR is an international reserve account, supplemental to the quotas granted by each member, whose value is calculated on the basis of four key international currencies (US dollar, Euro, pound sterling and Japanese yen) and it is an exchangeable instrument, which can be swapped for usable currencies. For more information on SDR, see: <http://www.imf.org/external/np/exr/facts/sdr.htm>.

⁸³ The SDR interest rate is reset each Monday and can be checked at any time at: http://www.imf.org/external/np/fin/data/sdr_ir.aspx.

⁸⁴ In particular, Stand-by arrangements, the Flexible Credit Lines and the Extended Fund Facility have no pre-set cap.

⁸⁵ The IMF defines external crisis as crisis which: "can be characterized by severe balance of payment problems, which often lead to pressure on the currency, a large decline in consumer demand and investment by firms, higher unemployment, and lower incomes. Crises are often accompanied by heightened uncertainty in financial markets and declines in the prices of stocks, bonds and, quite frequently, the value of the domestic currency", while financial crisis are defined as crisis which: "can originate in or affect the financial sector, and can be caused by or accompanied by heightened uncertainty in financial markets, leading to declines in the prices of stocks and bonds. They can also be caused by or lead to difficulties in banks and the payments system, causing damage to the real sector and to economic activity more generally", see IMF Crisis Lending factsheet, available at: <http://www.imf.org/external/np/exr/facts/crislend.htm>.

The term “IMF Conditionality” refers commonly, to the conditions “attached” to the loans granted by the IMF to countries experiencing financial difficulties. The borrower undertakes to comply with certain economic and financial adjustments suggested by the IMF so that the IMF is sure that the borrower will be able to repay its debt. Loans are split in “tranches” which are advanced upon satisfaction of certain objectives. If the borrower does not reach the correspondent policy actions, it is not entitled to drawdown the additional tranche.

The objectives are included in the so-called Letter of Intent, (which sometimes has a memorandum of economic and financial policies attached to it) and they are general macro-policy goals to be met in order to restore the balance of payments of the country and facilitate the growth of the country.⁸⁶

The IMF conditionality has gradually evolved, both due to the different kind of financial crisis, which have widespread since its establishment and, also, as answer to the frequent criticism that the IMF conditionality raised.

The IMF guidelines on conditionality have been reviewed in 2002 in order to give more flexibility to each country and in order to allow a more tailored and less stringent approach to each crisis.⁸⁷

The IMF conditionality rose, in the course of the years, severe criticism.

The main factor of criticism was that it was not perceived as a tool to allow developing countries to deal with their internal financial issues, due to the lack of effectiveness of the reforms suggested, but as a mean to introduce liberalisation reforms against the will of the relevant country.

In the following chapter some specific cases will be analysed, in particular the Asian crisis and the Argentinian one, whereby the IMF intervention was proven to be not only not beneficial but the true reason for the situation getting worst.

Stiglitz pointed out, in relation to the financial policies driving the IMF actions: “The IMF is pursuing not just the objectives set out in its original mandate of enhancing global stability and ensuring that there are funds for countries facing a threat of recession to pursue expansionary policies. It is also pursuing the interest of the financial community...Simplistic free market ideology provided the curtain behind which the real business of the “new” mandate could be transacted. The change in mandate and objectives, while it

⁸⁶ On the IMF conditionality, see the IMF factsheet, available at: <http://www.imf.org/external/np/exr/facts/conditio.htm>.

⁸⁷ The updated version of the guidelines can be found at: <http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.htm>.

may have been quiet, was hardly subtle: from serving global economic interests to serving the interests of global finance. Capital markets liberalisation may not have contributed to global economic stability, but it did open up a vast new markets for Wall Street".⁸⁸

The allegation is that IMF acted as a mean to force liberalisation, in particular capital account liberalisation, in order to favour private international finance, in particular banks and private investors which benefitted from the new financial markets which opened upon the implementation of the financial reforms imposed by the IMF in exchange for financing.⁸⁹

The main negative outcome of liberalisation is volatility in the market, which exposes developing countries to risks of sudden capital outflows, such as in the Asian crisis.

The World Bank, agrees upon the bad outcomes due to the excessive volatility, however, they point out that liberalisation had positive effects too, namely; "they permit the financing of trade deficits allowing countries to invest more than they save and thus accumulate capital faster; (ii) they permit the import of technology which is essential to build a productive capacity; and (iii) they may improve the working of the financial sector".⁹⁰

After the Asian crisis, which is admittedly the most unsuccessful of the IMF rescue policies, Malaysia refused IMF assistance and advise and rather than liberalising its economy, imposed strict capital controls, which, in the end, prevented the economic crisis to widespread in Malaysia too.

A further source of criticism relates to the lack of accountability of the IMF to developing countries: given that developed countries supply the IMF with money to lend and they have the majority of voting rights, it seems the power they can exercise over the decisions the IMF has to take is unbalanced in respect of developing countries, which have a much smaller influence, voting

⁸⁸ See J. Stiglitz, *Globalisation and its Discontents*, Allen Lane, 2002, pp. 206-207.

⁸⁹ On the critics to the IMF conditionality see also: J. Dine, *The IMF and its Relation to Private banks: Risk Free Banking?*, in *Global Governance and the Quest for Justice*, vol. 2, ed. S. MacLeod, 2006, pp. 221-237. The author links the interaction between the IMF and the provision of private finance from the banks to an increase in the inequality in the borrower country, affecting especially the poorest layers of the society. In particular, the mechanics fro such result is: "(i) an insistence on capital account liberalisation by the IMF; (ii) a consequent increase in the provision of foreign finance often on a short-term basis and at rates poorly assessed for risk increased volatility due to "hot money" flowing freely in and out the country; (iii) the loss of control over fiscal policy by the states; (iv) crises caused by poor domestic policies, speculators and "herd" behaviour; (v) the IMF bailout response causing the repayment of the wealthy and poor risk assessment; (vi) the imposition of conditionality and the removal of many public services". Ibid. p. 223. See also, on the same subject, B. Herman, *The Players and the Game of Sovereign Debt*, International Affairs working paper, The New School, 2002.

⁹⁰ See World Bank, *Global Development Finance 2001*, World Bank, 2001.

wise and that rather than supplying the IMF with funds, require financing to support them. As consequence of such critics, the IMF Board of Governors voted in 2008 in order to change the IMF income model, so that some of the influence exercised by developed countries was mitigated.⁹¹

Furthermore, on 24 May 2009 the Executive Board approved changes to the IMF conditionality, in response to the criticism raised by its borrowers. The changes concern three main points: (i) structural performances criteria are replaced by assessments of the need to implement structural changes in the context of general program reviews, so that the default of the country upon failure to meet the performance criteria is not automatically triggered any longer; (ii) access to IMF funding is based on certain fixed qualification criteria and not on the acceptance by the borrower of the IMF conditionality; (iii) creation of new flexible facilities (as described above) to meet the needs of developing countries.⁹²

ii. World Bank

The World Bank (as the other multilateral development banks) was established to transfer financial resources to selected governments in amounts and on terms that the governments could not get without such assistance.

As the IMF, the World Bank was established at Bretton Woods in 1944. On 27 December 1945 the Articles of Agreement of the International Bank for Reconstruction and Development (which is the original name of the World Bank) were signed.⁹³

The original scope of the World Bank was to help with the reconstruction of Europe after World War II. Nowadays, the reconstruction (which still remains in connection with developing countries needs in case of natural catastrophes and humanitarian emergencies) as main scope of the World Bank has been replaced by the focus of poverty reduction.

⁹¹ On the IMF accountability issue see A. Bloom, *The Power of the Borrower: IMF responsiveness to Emerging Markets Economies*, New York University Journal of International Law and Politics, 2011, pp. 767-810.

⁹² See A. Bloom, *The Power of the Borrower: IMF responsiveness to emerging market economies*, New York University Journal of International Law and Politics, 2011, pp. 793-804.

⁹³ The updated version of the Articles of Association can be found on the World Bank website at: <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/0,contentMDK:20049557~menuPK:63000601~pagePK:34542~piPK:36600~theSitePK:29708,00.html>.

The World Bank is one of the main lenders to developing countries, but, differently from the IMF, it does not act as lender of last resort and does not have such an active involvement in debt crisis scenarios. The World Bank carries out its lending activities through the International Bank for Reconstruction and Development and through the International Development Association (IDA), which is basically the concessional finance arm of the World Bank.⁹⁴

In terms of lending activity, the World Bank under the terms of its constitutional documents, is allowed to provide funds (both as loans or as guarantees) to member states and commercial enterprises established within the member states only.⁹⁵ The Articles of Agreement specify that loans and guarantee should prioritise: (i) programs which involve more than one member state; and (ii) projects and programs which aim at integrating member states economies. The programs financed by the World Bank are of three kinds:⁹⁶

- **Investment operations:** in this category fall loans, grants and any kind of financial assistance linked to the constructions of infrastructures to reduce poverty and to support sustainable development. In terms of allocation of the World Bank resources, this kind of activities involve almost 80% of the World Bank portfolio. Historically the funds were lent in order to allow the country to develop engineering works and other hardware infrastructure, while

⁹⁴ The International Development Association (IDA) is the part of the World Bank that helps the world's poorest countries. IDA was established in 1960 with the aim to reduce poverty by providing loans (called "credits") and grants for programs that boost economic growth, reduce inequalities, and improve people's living conditions. IDA is one of the largest sources of assistance for the world's 82 poorest countries, 40 of which are in Africa. It is the single largest source of donor funds for basic social services in these countries. IDA-financed operations deliver positive change for 2.5 billion people, the majority of whom survive on less than \$2 a day. IDA lends money on concessional terms. This means that IDA charges little or no interest and repayments are stretched over 25 to 40 years, including a 5- to 10-year grace period. IDA also provides grants to countries at risk of debt distress. In addition to concessional loans and grants, IDA provides significant levels of debt relief through the Heavily Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative. More information on Ida on the IDA website at: <http://www.worldbank.org/ida/>.

⁹⁵ See section 4 of the Articles of Agreement of the IBRD: "The Bank may guarantee, participate in, or make loans to any member or any political sub-division thereof and any business, industrial, and agricultural enterprise in the territories of a member [...]", available on the World Bank website at: <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/0,contentMDK:20049598~menuPK:63000601~pagePK:34542~piPK:36600~theSitePK:29708~isCURL:Y,00.html>.

⁹⁶ On the lending activity of the World Bank see the World Bank website at: <http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS/0,contentMDK:20120732~menuPK:268725~pagePK:41367~piPK:51533~theSitePK:40941,00.html>.

recently the World Bank included social targets within the scope of such projects, such as social development and improving public policy infrastructure. Usually the loans are advanced in tranche, which can be drawn down upon completion of certain steps (the so-called milestone), so that the World Bank can monitor the effectiveness and the progresses of the project. Eligible borrowers are countries which are not in arrears with the World Bank group. The technical financing structure by means of which most of the investment operations are carried out is project finance. Project finance is a particular financing structure where, simplifying, lenders funds a certain project on the basis that the revenues produced by the project, once completed will be able to repay the initial debt. Project finance will be further analysed in the following paragraphs, from the private sector perspective: however the technical structure does not change. One of the main differences between commercial lending and project lending is that in the latter the aim is also to transfer expertise and know-how and to offer technical assistance. On 8 April 2012 a new Investment Financing Policy went into effect, in order to allow more flexibility in the policy framework of the World Bank and also to increase accountability and compliance and provide more adequate instruments to deal with small states and states affected by conflicts and with fragile economic and political situations.⁹⁷ The reform was also focused on the World Bank policies in respect of: (i) procurement,⁹⁸ in order to pursue open and competitive procurement procedures to avoid frauds and corruption and to introduce new innovative techniques; and (ii) social and environmental safeguard, required in connection with the confluence of internal and external factors like the growing importance of delivering environmentally and socially sustainable results, strengthening borrowers' country institutions and systems and addressing emerging challenges at the global, regional, and country level.⁹⁹

⁹⁷ On the new policy see also the World Bank Board Paper dated 1 November 2012, available at: <http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS/0,contentMDK:22262276~pagePK:41367~piPK:51533~theSitePK:40941,00.html>.

⁹⁸ On the reform involving the World Bank procurement policy, see the Board Approach Paper on the procurement policy dated 29 March 2012, available at: <http://documents.worldbank.org/curated/en/2012/03/16249953/world-banks-procurement-policies-procedures-policy-review-approach-paper>.

⁹⁹ On the reform involving the World Bank safeguard policies, see the Board Approach Paper on the safeguard policies, available at:

- **Development policy operations:** the aim of such operations is to provide rapid financial assistance to developing countries in order to deal with actual or future development financing requirements both of domestic or external sources. Usually such operations are established to support the achievement of a set of development results through a medium-term program of policy and institutional actions. They can be structured as a single operation or a in the context of a more comprehensive plan of action, involving medium-long term plan of actions, with tranches of the debt, again, available once certain objectives are met. In low-income countries which are eligible for International Development Association (IDA) assistance, such operations are also called Poverty Reduction Support Credits (PRSCs) and are granted on a concessional basis. As per the Investment Operations, eligible borrowers must not be in arrears with any member of the World Bank Group.
- **Program-for-results operations:** these operations differ from the previous two because the World Bank in this case acts as investor supporting a project created and promoted by the government of developing countries themselves rather than being projects proposed by the World Bank directly. The World Bank usually participates along with other public and private institutions and it contributes not only in terms of funds being provided to the countries but also by offering technical expertise and valuable know-how. Program-for-results include project to invest in expenditures and activities, which can be on going or new, sectorial or sub-sectorial, and national or sub-national programs, as well as community development programs. The new approach embodied in the Program-for-results operations allows the World Bank to strengthen partnerships with governments and development partners, which co-participate in the financing of the programs, and to effectively support larger programs thanks to the pooled funding arrangements.¹⁰⁰

<http://web.worldbank.org/WBSITE/EXTERNAL/PROJECTS/EXTPOLICIES/EXTSAFEPOL/0,,contentMDK:23275156~pagePK:64168445~piPK:64168309~theSitePK:584435,00.html>.

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On Program-for-results see also: World Bank. 2011. *A new instrument to advance development effectiveness: program-for-results financing*. Washington D.C. - The Worldbank. <http://documents.worldbank.org/curated/en/2011/12/15590386/new-instrument-advance-development-effectiveness-program-for-results-financing>.

It is also worth noting that the World Bank, since the '80ies started to grant so-called Structural Adjustment Loans as well, which are not linked to a specific project but due to the liquidity crisis which many developing countries were facing in those years. The structure of such loans is very similar to the IMF loans, and they are subject to the terms of "letter of development policies" which have basically the same aim as the letters of intent stipulated by the IMF and its borrowers. The letter includes the conditions upon which the loans are granted and often cross refer to the conditions set out by the IMF given that usually the World Bank would grant assistance after that the IMF had already agreed with the countries the terms according to which loans would have been advanced to the country suffering of liquidity crisis.

According to the Articles of Association, the following general conditions need to be met in order to receive financial support from the World Bank:

- i. When the member in whose territories the project is located is not itself the borrower, the member or the central bank or some comparable agency of the member which is acceptable to the Bank, fully guarantees the repayment of the principal and the payment of interest and other charges on the loan.
- ii. The Bank is satisfied that in the prevailing market conditions the borrower would be unable otherwise to obtain the loan under conditions which in the opinion of the Bank are reasonable for the borrower.
- iii. A competent committee, as provided for in Article V, Section 7, has submitted a written report recommending the project after a careful study of the merits of the proposal.
- iv. In the opinion of the Bank the rate of interest and other charges are reasonable and such rate, charges and the schedule for repayment of principal are appropriate to the project.
- v. In making or guaranteeing a loan, the Bank shall pay due regard to the prospects that the borrower, and, if the borrower is not a member, that the guarantor, will be in position to meet its obligations under the loan; and the Bank shall act prudently in the interests both of the particular member in whose territories the project is located and of the members as a whole.

- vi. In guaranteeing a loan made by other investors, the Bank receives suitable compensation for its risk.
- vii. Loans made or guaranteed by the Bank shall, except in special circumstances, be for the purpose of specific projects of reconstruction or development.¹⁰¹

It is clear from the conditions above that the World Bank does not conceive grants as general mean to support its members, given that in order to advance loans or guarantee, the World Bank has to carefully assess the capacity of the borrower to repay the debt and being able to service it throughout the life of the facility. The ratio for such approach is the need for the World Bank to be perceived in the international market as a credible player, which therefore has to assess the creditworthiness of its borrowers on the basis of what could be defined as commercial banks criteria.¹⁰²

The main difference between loans and guarantees entered into with member countries and agreements with non-member is the legal character of the respective agreements.¹⁰³ Loans and guarantees with member states are international agreements as both parties to it have international legal personality and therefore such agreements are treaties as a matter of international law and are registered with the United Nations as such. On the other hand, loans and guarantees entered into with non-state borrowers cannot be governed by international law, given that non-state entities do not have international law personality. The main topic of discussion in relation to such agreements is the governing law clause of the General Conditions applicable to Loan and Guarantee Agreements, which states the non-applicability of municipal law to such agreements.¹⁰⁴ The negative formulation of the sentence aims at excluding the applicability of any national law to the agreements, implicitly stating that international law is the law applicable to the loan and the guarantee agreement. However it has been

¹⁰¹ Section 4 of the IBRD Articles of association, available at: <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/0..contentMDK:20049598~menuPK:63000601~pagePK:34542~piPK:36600~theSitePK:29708~isCURL:Y,00.html>.

¹⁰² On the lending activity of the World Bank, F. Seatzu, *Il Panel di ispezione della Banca Mondiale*, Giappichelli, 2008, pp. 35- 47.

¹⁰³ J.W. Head, *Evolution of the governing law for loan agreements of the World Bank and other Multilateral Development Banks*, American Journal of International Law, 1996, pp. 214- 234.

¹⁰⁴ Section 10.01 of the General Conditions applicable to Loan and Guarantee Agreements reads: "The rights and obligations of the Bank, the Borrower and the Guarantor under the Loan Agreement and the Guarantee Agreement shall be valid and enforceable in accordance with their terms, notwithstanding the law of any State or political subdivision thereof to the contrary."

observed how stating more clearly that the governing law of the agreements is public international law would grant greater certainty in respect of the sets of standards and procedures in accordance with which disputes need to be resolved.¹⁰⁵

The World Bank has developed in time a sophisticated structure to overview and to assess the development of the programs financed, in order to make sure that the funds advanced to the relevant borrower are used in accordance with the terms of the loan agreement.

Furthermore, the World Bank can be held accountable for the projects that they finance by people that argue to be negatively affected or likely to be negatively affected by such projects. The Board of Executive Directors created the Inspection Panel in 1993 to ensure that people¹⁰⁶ have access to an independent body to express their concerns and seek recourse. The panel will have to assess if the World Bank in financing the project acted in violation of its internal policies and guidelines, the so-called Operating Policies and Procedures.¹⁰⁷

The Independent Panel represent a relevant step forwards in terms of accountability of international organizations generally, in particular because it gives a right to affected people to bring a claim directly to the World Bank, without the need to go through the government or any other entity.¹⁰⁸

The World Bank was the first organization to create an accountability mechanism in favour of affected people, but the other International Financial Institutions such as the IMF, International Finance Corporation and the

¹⁰⁵ See J.W. Head, *Evolution of the governing law for loan agreements of the World Bank and other Multilateral Development Banks*, American Journal of International Law, 1996, p. 230.

¹⁰⁶ People entitled to bring a claim are: "Any group of two or more peoples in the country where the Bank financed project is located who believe that, as a result of the Bank's violation of its policies and procedures, their rights or interests have been, or are likely to be adversely affected in a direct and material way. They may be an organization, association, society or other grouping of individuals and/or: (i) a duly appointed local representative acting on explicit instructions as the agent of adversely affected peoples; (ii) in exceptional cases, a foreign representative acting as agent of adversely affected peoples; and (iii) an Executive Director of the Bank in special cases of serious alleged violations of the Bank's policies and procedures." See the World Bank web site in relation to how to file a complain at <http://web.worldbank.org/WBSITE/EXTERNAL/EXTINSPECTIONPANEL/0,contentMDK:21911332~menuPK:566350~pagePK:64129751~piPK:64128378~theSitePK:380794.00.html>.

¹⁰⁷ For a detailed analysis of the operation of the Inspection Panel, see F. Seatzu, *Il Panel di ispezione della Banca Mondiale*, Giappichelli, 2008.

¹⁰⁸ Examples of the grounds for complaints are: inadequate compensation for forced resettlement; destruction of culturally significant or ecologically unique landscapes; loss of traditional user-rights to forest or other natural resources; loss of access to resources or livelihoods; environmental degradation; threats to community health or safety resulting from increased levels of air pollution or poor road design; loss of livelihood resulting from regulatory or policy reforms; and poor project implementation stemming from inadequate consultation, participation, or information-sharing.

regional development banks followed such trends shortly after. Each accountability mechanism varies in size, scope, and structure, however they all share a common intention: to provide recourse for citizens and communities adversely affected by IFI-funded projects, particularly in instances when IFIs are alleged to have failed to follow their own social and environmental safeguard policies, guidelines, standards, or procedures.

The accountability mechanisms of the International Financial Institutions are now reunited in the Independent Accountability Mechanisms Network, which allows members of different independent accountability mechanism to stay in touch with members of other institution having the same role, in order to share experiences, know-how and keep track of progresses in the principles of accountability.¹⁰⁹

An additional point of interest, in respect of the World Bank's guidelines and policies is the increasing relevance that such internal instruments reached, becoming basically *de facto* global rules setting generally acknowledged international standards, adopted by corporations as well as public and private financial institutions, governments and export credit agencies.¹¹⁰

This trend is linked to the pressure that corporations and financial institutions receive from NGO, consumers and stakeholders to comply with acceptable standards of corporate social responsibility. Some of the stories of social and environmental devastation connected with international projects, affected the public opinion and in the end influenced also the way in which funds are lent.¹¹¹ Lenders grew progressively more aware of the environmental and social "creditworthiness" of projects to be financed, realizing that being perceived as supporting environmentally reckless investment was, in short, "bad for business". In order to deal with the changed panorama and be perceived as environmental and social engaged, "Corporate and governmental actors alike defend themselves by wrapping

¹⁰⁹ On independent accountability mechanisms see the paper by K. Lewis, *Citizen-driven accountability for Sustainable Development*, available on the World Bank web site at: <http://web.worldbank.org/WBSITE/EXTERNAL/EXTINSPECTIONPANEL/0..menuPK:64129253~pagePK:64132081~piPK:64132054~theSitePK:380794,00.html>.

¹¹⁰ On this point see N. Affolder, *Cash not cash: another sort of World Bank group borrowing*, Michigan State Journal of International Law, 1996, pp. 141-165.

¹¹¹ For instance, in 1997 the International Finance Corporation threatened to call the debt in relation to the construction of the Pangu hydroelectric dam on the Bio Bio river in Chile due, because the project had failed to meet the environmental conditions set out in the loan agreement. See R. S. Frye, *The Role of Private Banks in Promoting Sustainable Development, from Outside Counsel's Perspective*, Law and Policy in International Business, 1997/1998, p. 484.

themselves in the cloak of environmental and social responsibility that the World Bank standards represent. Reputation becomes the battleground.”¹¹²

In such context, private financial institutions developed the so-called “Equator Principles”, which will be further analyzed in the following paragraphs, relating to commercial banks.

In the context of the lending activities of the World Bank, it is worth mentioning also the International Finance Corporation (IFC), an international organization part of the World Bank group established in 1956 in order to promote private investment in developing countries, which is seen as the way forward in terms of developing finance.¹¹³ Historically the IFC was only allowed to carry out debt kind of investment, only in 1961 the IFC shareholders allow the first equity investment to occur,¹¹⁴ drawing the main distinction between the IFC and the other multilateral organizations, such as the IBRD and the other multilateral development banks, which generally carry out lending activity only and not equity investment or anyway in a smaller scale.

In the '70ies the IFC adds to its offer to developing countries also advisory services, providing business and financial expertise and assistance to such countries. This is quite a relevant step for the purpose of “rebalancing” the equilibrium between industrialised countries and commercial banks and developing countries as borrowers in terms of knowledge and experience of the financial market, which, as mentioned in the previous chapter, was one of the main reasons for numerous debt crisis.

A further point of interest is that the IFC, since 1984 is financially autonomous, by means of the issuance of IFC bonds in the international financial markets, therefore it is not subject to pressure from its members in

¹¹² N. Affolder, *Cachet not cash: another sort of World Bank group borrowing*, Michigan State Journal of International Law, 1996, pag. 147.

¹¹³ See the IFC website at: http://www1.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/home.

¹¹⁴ As further step, the IFC then created several private equity funds focused on investments in emerging countries. The relevance of equity investment, structured through creation of dedicated investment funds, is explained by the IFC on its website: “IFC backs private equity funds in the emerging markets because funds, with their unique provision of both equity capital and expertise, have a significant impact on company growth and job creation. The majority of private equity in emerging markets is growth equity, using little leverage and depending on sustained growth of companies to generate returns. The private equity fund helps companies to improve focus and negotiate the transformations and risks of rapid growth. Rapidly growing companies create jobs: the average annual rate of job creation within companies backed by IFC-supported funds since 2000 has been 22%, well in advance of regional rates of job growth of 2-3%.” See ICF website at: http://www1.ifc.org/wps/wcm/connect/industry_ext_content/ifc_external_corporate_site/industries/home.

terms of sources of financing to carry out its activities. The IFC was the first international organisation to properly focus on the development of a capital markets for emerging economies: in 1971 the IFC created a specific department, the Capital Markets Department, to focus on the development of local banks, financial intermediaries and local stock markets. This is particularly important in light of the evolution of the sources of finance for developing countries: as it will be described in the following chapter, historically the trend for countries has been to move from bank loans to bonds, therefore the IFC support in such field played quite a relevant role.

iii. Multilateral development banks

Other institutions carrying out lending activities to developing countries are the so -called multilateral development banks, which are part of the World Bank group, and as the IBRD aim at provide financial support and professional advice for economic and social development activities in developing countries, but each of them focuses on a specific region of the world. The multilateral development banks are:

- **African Development Bank:** was founded in 1964 in order to promote sustainable development and poverty reduction in Africa. Its shareholders currently are 53 African countries and 24 non-African countries. As the World Bank, it offers loans both on concessional and non-concessional terms but, differently from the World Bank, eligible borrowers are only the countries located in the African region;¹¹⁵
- **Asian Development Bank:** was founded shortly after the African Development Bank, in 1966, to improve the development of countries in Asia and in the Pacific. The members of the bank are 67, of which 48 located in the Asian and Pacific region and 19 from different regions. The bank offers a variety of financial products both to sovereign and non-sovereign borrowers in the Asian and Pacific region;¹¹⁶

¹¹⁵ See the African Development Bank website at: <http://www.afdb.org/en/>.

¹¹⁶ See also the Asian Development Bank website at: <http://www.adb.org/>.

- **European Bank for Reconstruction and Development:** was established in 1991, after the end of the Soviet Union, in order to help ex-soviet countries to develop and integrate with the rest Europe and since then it became the largest financial investor in the region which stretches from central Europe to central Asia and the southern and eastern Mediterranean. The members of the bank are 64, both from the European region and from the rest of the world, plus the European Union and the European Investment Bank;¹¹⁷
- **Inter-American Development Bank Group:** was founded in 1959 in order to reduce poverty and inequality in the Latin American and Caribbean countries. The bank is the leading source of development financing for Latin America and the Caribbean and offers also technical advise and research support. The shareholders of the banks are currently 48, which include 26 countries located in the Latin American and Caribbean regions, which are also the main borrowers of the bank.¹¹⁸

One of the main differences between the IBRD and multilateral development banks is that latters have mandate to lend not exclusively to member states, but also to any other country in that region.¹¹⁹Each multilateral development bank has a "private lending arm", to deal specifically with loans to private sector borrowers in the relevant region, rather than to public entities.

For completeness, it is worth mentioning that there are also multilateral financial institutions which carry out lending activities in favour of developing countries. They have a narrower ownership/membership structure and focus on special sectors or activities and they are, namely: (i) the European Investment Bank; (ii) International Fund for Agricultural Development; (iii) Islamic Development Bank; (iv) Nordic Development Fund; (v) Nordic Investment Bank; (vi) OPEC Fund for International Development.

¹¹⁷ See the European Bank for Reconstruction and Development at: <http://www.ebrd.com/pages/homepage.shtml>.

¹¹⁸ See the Inter-American Development Bank Group at: http://www.iadb.org/en/inter-american-development-bank,2837.html#_UboWCL_3iRs.

¹¹⁹ On the operations and mandate of multilateral development banks see G. Handl, *The Legal Mandate of Multilateral Development Banks as Agents for Change toward Sustainable Development*, American Journal of International Law, 1998, pp. 642- 665.

Given that in the context of sovereign debt restructuring, both multilateral banks and multilateral financial institutions generally follow the same dynamic as the World Bank, for simplicity going forward reference to multilateral institutions will make reference to the World Bank Group as well as multilateral development banks and other multilateral financial institutions.

b. Bilateral creditors:

Bilateral loans are offered by certain governments directly to the governments or public entities of developing countries. We list such kind of loans for completeness, however as for the purposes of the restructuring of such debt, they are treated as the debt granted by multilateral and official creditors, no further analysis will be carried out in this chapter. The main point of interest has been anticipated in the introductory paragraph, in relation to the political and strategic reasons which are usually behind this kind of financings.

c. Sovereign Wealth Funds (SWF)

As anticipated in the introductory chapter, SWF are investment vehicles created by national governments in order to manage specific portions of their financial resources.¹²⁰

There are a variety of SWF, differentiated primarily on the basis of: (i) the financial resources used by the governments to set them up; and (ii) on the basis of the investment objective of each fund.

In relation to the first category, SWF can be established using the funds deriving from foreign-currency reserves, commodity export reserves¹²¹ and governmental budget or pensions surpluses.

As far as the second category is concerned, SWF are classified as:

- *Stabilization funds*: these are funds created by countries with relevant quantities of non-renewable sources, which manage these funds in order to

¹²⁰ The International Working Group of Sovereign Wealth Funds defines SWFs on the basis of three elements: (i) the ownership of SWFs by the general government (both central and subnational); (ii) investment strategies must involve foreign financial assets; (iii) their objectives and purposes, as they are established for macroeconomic purposes and to reach financial objectives. See Sovereign Wealth Funds, Generally accepted principles and practices, "Santiago Principles", October 2008, pag. 27, available at: <http://www.iwg-swf.org/pubs/gapplist.htm>.

¹²¹ Commodity funds manage 55% of the wealth managed by the aggregate of the SWF, and 54% of it relates to surplus from the sale of oil. CONSOB – Discussion Papers: *I Fondi Sovrani e la regolamentazione degli investimenti nei settori strategici*, S. Alvaro, P. Ciccaglioni, Discussion Paper n. 3, July 2012, p. 5.

avoid negative economic consequences in the event the prices of their non-renewable resources drop. They aim, therefore, at reducing the risks connected with the volatility of the prices of those commodities on which their economy is based;

- *Saving funds*: whose aim is creating a reserve of wealth for future generations;¹²²
- *Development funds*: which have as investment objective the development of social and economic targets such as key infrastructures;
- *Pension reserve funds*: which aim at strengthening the pension system of the countries;
- *Strategic funds*: established in order to invest in national enterprises in order to promote their competitiveness.¹²³

The development of SWF has been one of the most noteworthy features of the international financial system in the last decade¹²⁴: most of the SWF has been established after 2002 and between December 2001 and October 2007 the reserves managed by SWF rapidly increased from US 2.1 trillion to US 6.2 trillion. It is also important to note that, under the geographical point of view, the vast majority of the increase in the funds managed by SWF was located in developing countries. Main protagonists of such sudden development were Asian countries, in particular India and China, due to export related resources, and commodity-producing countries, in particular oil exporting countries in the Middle East.¹²⁵

Table: first 30 SWF in terms of assets managed¹²⁶

¹²² IMF, *Stabilization and Saving Funds for Non-renewable Resources: Experience and Fiscal Policy Implications*, Occasional Paper, 2009, p. 9.

¹²³ France and Italy have established strategic funds in the past decade, respectively: (i) the *Fonds Stratégique d'Investissement* (FSI), created in 2008 in order to grant stability to the national companies which are key to the development of the country; and (ii) the *Fondo Strategico Italiano*, created in 2011, whose aim is to make equity investments in companies which are strategic for the Italian economy.

¹²⁴ For completeness, SWF are not a new figure of the international financial system, in particular in relation to countries with great availability of natural resources, where SWF were established for the first time in the 1950s: in 1953 a SWF was established in Kuwait and in 1956 a SWF was created in the Pacific Island of Kiribati too, out of the resources generated by its guano mines. The Economist, *Asset-backed Insecurity*, 17 January 2008.

¹²⁵ S. Griffith-Jones and J. A. Ocampo, *Sovereign Wealth Funds: a developing countries perspective*, paper prepared for the workshop on Sovereign Wealth Funds organized by the Andean Development Corporation, London 18 February 2008, p. 2 and 3.

¹²⁶ Data at April 2011, table from CONSOB – Discussion Papers: *I Fondi Sovrani e la regolamentazione degli investimenti nei settori strategici*, S. Alvaro, P. Ciccaglioni, Discussion Paper n. 3, July 2012, p. 5.

	Country	Sovereign Wealth Fund	Assets managed (in US billion)	Percentage on the overall amount
1.	UAE - Abu Dhabi	Abu Dhabi Investment Authority	625	15,7
2.	Norway	Government Pension Fund	530	29,0
3.	China	SAFE Investment Company	347	37,7
4.	China	China Investment Corporation	332	46,0
5.	Singapore	Government of Singapore Investment Corporation	315	53,9
6.	China - Hong Kong	Hong Kong Monetary Authority Investment Portfolio	293	61,4
7.	Kuwait	Kuwait Investment Authority	202	66,4
8.	Singapore	Temasek Holdings	140	69,9
9.	China	National Social Security Fund	120	72,9
10.	UAE	Dubai World	100	75,4
11.	Russia	National Welfare Fund	88	77,6
12.	Qatar	Qatar Investment Authority	80	79,6
13.	Australia	Australian Future Fund	71	81,4
14.	Libya	Libyan Investment Authority	70	83,1
15.	Algeria	Revenue Regulation Fund	61	84,7
16.	Brunei	Brunei Investment Agency	39	85,7
17.	US - Alaska	Alaska Permanent Fund	39	86,7
18.	South Korea	Korea Investment Corporation	37	87,5
19.	Malaysia	Khazanah Nasional	36	88,5
20.	Kazakistan	Kazakhstan National Fund	30	89,2
21.	Kazakistan	Samruk Kayna National Welfare Fund	29	89,9
22.	Venezuela	National Development Fund	27	90,6
23.	France	Strategic Investment Fund	91,2	91,2
24.	Russia	Reserve Fund	25	91,8
25.	Azerbaijan	State Oil Fund	24	92,4

26.	UAE - Abu Dhabi	Mubadala Development Company	23	93,0
27.	Ireland	National Pensions Reserve Fund	22	93,6
28.	UAE - Abu Dhabi	International Petroleum Investment Company	21	94,1
29.	Canada	Alberta's Heritage Fund	15	94,4
30.	US -New Mexico	Mexico New Mexico State Investment Council	15	94,7
Total			3,767	94.7%

Some authors¹²⁷ tried to investigate the rationale behind the decision to set up a SWF, in particular for developing countries, and the following main theories have been analysed:

- “Wealth substitution motive”: the rationale for countries to create a fund is to switch from natural resources asset into foreign exchange assets in case there is a current account surplus (i.e. if the sale of the resources would not just entirely consumed or transformed into domestic investment). In this case the key element to be evaluated is whether the resource if left under ground would be more valuable in the long term rather than being covered in other kind of assets. To the extent that (i) the funds deriving by the sale of the natural resource are invested in capital assets that aim at reaching a sustainable long-term growth, as an inter-generational equity; and (ii) the profits deriving out of such investments are higher than the expected increase in the value of the natural resource, the right balance it is undoubtedly struck. On the other hand, if the extraction of natural resources results simply in an overconsumption or over investment in infrastructure and other activities which may have little social impact, resources may be better left under ground and transformed into other assets at a later stage;
- “Resilient surplus motive”: such rational belongs to countries which do not have economies based on natural resources. It is the result of either an “over-competitiveness” in the production of tradable goods and services or voluntary exchange rate undervaluation, out of which they receive the

¹²⁷ S. Griffith-Jones and J. A. Ocampo, *Sovereign Wealth Funds: a developing countries perspective*, paper prepared for the workshop on Sovereign Wealth Funds organized by the Andean Development Corporation, London 18 February 2008.

resources necessary to set up the fund resilient to growth and exchange rates, as protective measure;

- “Counter-cyclical motive”: linked to two different set of circumstances: (i) the cyclical swings in exportation volumes and prices; and (ii) cyclical swings in the commodity prices. In “good” times, resources are accumulated and directed to the constitution of SWF which, once the prices will decrease will help the national economy out of the returns of investment made;
- “Self-insurance motive”: this rationale is linked to excess of flow of cash into the country out of investments generally rather than due to the commodity prices or trade trends, but the aim the SWF is the same as per the previous point: to protect the financial stability of the country. As the capital flow in developing countries is strongly pro-cyclical, SWF represent a self-insurance for the country in order to be protected from risks of capital flow reversibility, to avoid replicating what happened in Asia in the 1970s, where the crisis quickly spread from a country to the other resulting into a massive outflow of capital from economies rather sound.¹²⁸

We will now analyse what are the main investment targets for SWF, in order to reach the objectives in their constitutional documents.

Recent studies show that the appetite of SWF is mainly focused on equity investments, bonds and some real estate investments.

In relation to equity investments, the industries which seem more attractive for SWF are: (i) natural resources; (ii) industries connected to natural resources such as processing industries and transportation; (iii) financial services.¹²⁹

A positive aspect of the investments carried out by SWF is that they tend to hold “long” term participation, which has a stabilising effect against the risk of volatility of

¹²⁸ See next chapter for a more detailed analysis.

¹²⁹ In recent years SWF have invested in participations in banks (generally welcomed as it is usually for small portions of equity which does not involve sitting in bank boards): in 2007 Temasek Holdings invested 2 USD billions in Barclays, In 2007 and 2008 China Investment Corporation invested 5 USD billion in Morgan Stanley together with Kuwait Investment Authority and Korea Investment Authority, respectively 2 USD billion each. More recently (2010 and 2011 respectively) Qatar Investment Authority invested in Agricultural Bank of China, Banco Santander, Barclays and Credit Suisse. More recently SWF invested in equity participation in hedge funds and private equity funds. Abu Dhabi Investment Authority bought a 7.5% stake in the private equity funds Carlyle Group and a 9% stake in Apollo Management and China Investment Corporation bought a 10% stake in the private equity fund Blackstone. See CONSOB – Discussion Papers: *I Fondi Sovrani e la regolamentazione degli investimenti nei settori strategici*, S. Alvaro, P. Ciccaglioni, Discussion Paper n. 3, July 2012, p. 11 and S. Griffith-Jones and J. A. Ocampo, *Sovereign Wealth Funds: a developing countries perspective*, paper prepared for the workshop on Sovereign Wealth Funds organized by the Andean Development Corporation, London 18 February 2008, p. 30.

the markets.¹³⁰ As SWF look for long-term revenues rather than very volatile assets, some SWF have also approached the mezzanine lending market, which typically provides for higher returns (more risky investment) and longer investment.¹³¹

On the other hand, SWF raised some concern in the context of the debates for transparency and more accountability in the international financial markets, as anticipated in the previous chapter.

Three main topics have been discussed in connection with the investment strategy of SWF: (i) the lack of transparency in relation to the size of the assets managed and their investment objectives; (ii) the risk connected to potential market abuse behaviours on their part; (iii) the risk of having investments carried out for strategic/political reasons.

In order to address the first concern, in 2008 the International Working Group of Sovereign Funds¹³² (IWG) was founded with the objective to agree upon a set of principles for SWF to guarantee the transparency and stability of the international financial system.

The main achievement of the International Working Group was the preparation of the so-called "Santiago Principles".

The IWG in preparing the basic principles to guide the conduct of SWFs were driven by the following four objectives:

- to help maintain a stable global financial system and free flow of capital and investment;
- to comply with all applicable regulatory and disclosure requirements in the countries in which they invest;
- to invest on the basis of economic and financial risk and return related considerations; and

¹³⁰ As the International Working Group of Sovereign Wealth Funds points out: "SWFs also bring substantial benefits to the global markets. Their ability in many circumstances to take a long-term view in their investments and ride out business cycles brings important diversity to the global financial markets, which can be extremely beneficial, particularly during periods of financial turmoil or macroeconomic stress." See Sovereign Wealth Funds, Generally accepted principles and practices, "Santiago Principles", October 2008, available at: <http://www.iwg-swf.org/pubs/gaplist.htm>.

¹³¹ Mezzanine financing are usually repaid bullet at their maturity date.

¹³² The International Working Group was originally created by 25 countries: Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, South Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad & Tobago, the United Arab Emirates, the United States, and Vietnam. Saudi Arabia, the OECD, and the World Bank were permanent observers. See original web site of the International Working Group at: <http://www.iwg-swf.org/>.

- to have in place a transparent and sound governance structure that provides for adequate operational controls, risk management and accountability.¹³³

The preparation of the Santiago Principles was based on the analysis of the practices used by the majority of SWFs and by the review of principles already applied in other international *fora*.

The IWG in putting together such principles was also aiming at promoting a better knowledge of what SWFs are and what their *modus operandi* is both in the countries where such funds invest¹³⁴ and generally in the international financial markets.

The IWG presents the Santiago Principles (or GAPP, generally accepted principles and practices) as “...a voluntary set of principles and practices that the members of the IWF support and either have implemented or aspire to implement. The GAPP denotes general practices and principles, which are potentially achievable by countries at all levels of economic development.”¹³⁵

The Santiago Principles are 24, and each principle has a set of sub-principles, further clarifying the scope of each principle. The principles cover a variety of areas, starting from the legal framework in which SWFs operate, their policy, the need for cooperation with domestic fiscal and monetary authorities of the countries in which they invest, the way in which SWFs are funded, their governance, the need for having a defined accountability framework in the constitutive documents of each SWF, the duty to comply with disclosure requirements of the countries in which they operate, general principles to guide their investment policy and risk management.¹³⁶

¹³³ See Sovereign Wealth Funds, Generally accepted principles and practices, “Santiago Principles”, October 2008, pag. 4, available at: <http://www.iwg-swf.org/pubs/gapplist.htm>.

¹³⁴ In relation to recipient countries, in June 2008 the OECD Investment Committee adopted a report on recipient countries policies in relation to SWFs: “The OECD will continue its work on how governments can maintain their commitment to open international investment policies – including for SWFs – while also protecting essential security interests. The resulting framework will foster mutually-beneficial situations where SWFs enjoy fair treatment in the markets of recipient countries and these countries can confidently resist protectionism pressures”. See OECD Investment Committee Report, 4 April 2008, available at: <http://www.oecd.org/daf/inv/investment-policy/oecddeclarationonsovereignwealthfundsandrecipientcountrypolicies.htm>.

¹³⁵ See Sovereign Wealth Funds, Generally accepted principles and practices, “Santiago Principles”, October 2008, pag. 5, available at: <http://www.iwg-swf.org/pubs/gapplist.htm>.

¹³⁶ The Santiago Principles are: (1) The legal framework for the SWF should be sound and support its effective operation and the achievement of its stated objective(s); (2) The policy purpose of the SWF should be clearly defined and publicly disclosed; (3) Where the SWF's activities have significant direct domestic macroeconomic implications, those activities should be closely coordinated with the domestic fiscal and monetary authorities, so as to ensure consistency with the overall macroeconomic policies; (4) There should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal, and spending operations; (5) The relevant statistical data pertaining to the SWF should be reported on a timely basis to the owner, or as otherwise required, for inclusion where appropriate in macroeconomic data sets; (6) The governance framework for the SWF should be sound and establish a clear and effective division of roles and responsibilities in order to facilitate

In 2009, the International Working Group of Sovereign Funds reached the consensus for turning the working group in a more structured and permanent forum: the International Forum of Sovereign Wealth Funds (IFSFW) was created between the same members which had originally founded the International Working Group.¹³⁷

The IFSWF has a voluntary nature and its goal is to promote the exchange of views and discussions amongst its members and to facilitate the understanding and application of the Santiago Principles.

In 2010 a survey on the implementation of the Santiago Principles amongst the members of the IFSWSF was launched in order to assess the impact of such principles on its members.¹³⁸

accountability and operational independence in the management of the SWF to pursue its objectives; (7) The owner should set the objectives of the SWF, appoint the members of its governing body(ies) in accordance with clearly defined procedures, and exercise oversight over the SWF's operations; (8) The governing body(ies) should act in the best interests of the SWF, and have a clear mandate and adequate authority and competency to carry out its functions; (9) The operational management of the SWF should implement the SWF's strategies in an independent manner and in accordance with clearly defined responsibilities; (10) The accountability framework for the SWF's operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or management agreement; (11) An annual report and accompanying financial statements on the SWF's operations and performance should be prepared in a timely fashion and in accordance with recognized international or national accounting standards in a consistent manner; (12) The SWF's operations and financial statements should be audited annually in accordance with recognized international or national auditing standards in a consistent manner; (13) Professional and ethical standards should be clearly defined and made known to the members of the SWF's governing body(ies), management, and staff; (14) Dealing with third parties for the purpose of the SWF's operational management should be based on economic and financial grounds, and follow clear rules and procedures; (15) SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate; (16) The governance framework and objectives, as well as the manner in which the SWF's management is operationally independent from the owner, should be publicly disclosed; (17) Relevant financial information regarding the SWF should be publicly disclosed to demonstrate its economic and financial orientation, so as to contribute to stability in international financial markets and enhance trust in recipient countries; (18) The SWF's investment policy should be clear and consistent with its defined objectives, risk tolerance, and investment strategy, as set by the owner or the governing body(ies), and be based on sound portfolio management principles; (19) The SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds; (20) The SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities; (21) SWFs view shareholder ownership rights as a fundamental element of their equity investments' value. If an SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments. The SWF should publicly disclose its general approach to voting securities of listed entities, including the key factors guiding its exercise of ownership rights; (22) The SWF should have a framework that identifies, assesses, and manages the risks of its operations; (23) The assets and investment performance (absolute and relative to benchmarks, if any) of the SWF should be measured and reported to the owner according to clearly defined principles or standards; (24) A process of regular review of the implementation of the GAPP should be engaged in by or on behalf of the SWF.

¹³⁷ The IWG reached a consensus on 6 April 2009 in Kuwait City (known as the Kuwait Declaration) to establish the International Forum of Sovereign Wealth Funds. The first meeting of the IFSWF was held in Baku (Azerbaijan) in October 2009, followed by meetings in Sydney in May 2010 and in Beijing in May 2011.

¹³⁸ See International Forum of Sovereign Wealth Funds, *IFSFW Members' Experiences in the Application of the Santiago Principles*, 7 July 2011, available at www.ifswwf.org/pst/stp070711.pdf.

The survey showed that 95% of the member's practices were fully or partially consistent with the Santiago Principles. In relation to the four main areas on which the Santiago Principles, the main findings were:

- Legal framework, Objectives and Coordination with Macro Policies: all members disclose their legal basis and often their policy objective too, the rules for their funding and withdrawal are generally set out in the national legislation, therefore publicly available;
- Institutional Framework and Governance Structure: most of the members have sound governance framework, are accountable to their legislature and have to prepare audited financial statements and annual reports which are publicly available. Most members have also a defined code of ethics and policies to deal with third parties;
- Investment and Risk Management Framework: all members try to maximize long-term risk adjusted return and seek for responsible investments in accordance with long-term macroeconomic concerns, most of them discloses information on investments and internal policies and objectives and try to implement a dynamic approach to risk management;
- Value of transparency: most of the member see transparency as a value and state to get practical benefits from being open with other players in the global market.¹³⁹

The final balance in relation to the implementation of the Santiago Principles seems therefore quite positive and gives the chance to SWFs to let the public know about their operations and being compliant with such principles gives to the participating members a "title" to spend on international markets and in the recipient countries.

However, it must be noted that the survey on the implementation of the Santiago Principles is limited to the IFSWF members, therefore in relation to other SFWs the concerns relating to the lack of transparency and accountability and the political reasons behind their investments still remain.

A further note of interest is a recent development in the role of SWFs: the financial support of developing countries.¹⁴⁰ In 2010 the World Bank launched a new program,

¹³⁹ See International Forum of Sovereign Wealth Funds, *IFSWF Members' Experiences in the Application of the Santiago Principles*, 7 July 2011, pag. 6-10, available at www.ifswf.org/pst/stp070711.pdf.

¹⁴⁰ On SWFs and human rights generally and the implications on development see P.J. Keenan and C. Ochoa, *The human rights potential of Sovereign Wealth Funds*, in *Georgetown Journal of International Law*, 2009, pp. 1151- 1179 and R. Sarkar, *Sovereign Wealth Funds: furthering development or impeding it?*, in *Georgetown Journal of International Law*, 2009, pp. 1181- 1207.

based on the constitution of a 600 million USD fund for less developed countries, financed by SWFs owned by South Korea, The Netherlands, Saudi Arabia and Azerbaijan.¹⁴¹ However, given that SWFs for their very nature (i.e. sources of profitable investment for their government) are not aid or charity vehicles, reliance on them to deliver development goals may be misguided.¹⁴²

d. Public creditors in sovereign debt restructuring

The distinction between public sector creditors and private sector creditors is meaningful in the context of debt restructuring proceedings, as it will be better analysed in the following chapter.

In a nutshell, public creditors negotiate the terms of the restructurings with the relevant borrower in the context of the Paris Club and they are strictly connected and mainly follow the activities and decisions taken by the IMF, given that usually multilateral creditors agreed upon a deal with the borrower once the IMF has already set the conditions according to which it will agree to assist and usually provide additional finance to the country experiencing financial distress.

Private creditors rely equally on the IMF intervention and leading role, however they have a separate forum to negotiate with the borrower in the context of debt restructuring.

¹⁴¹ See The Washington Post, *World Bank gets help from sovereign wealth funds to invest in developing nations*, 18 April 2010, available at: <http://www.washingtonpost.com/wp-dyn/content/article/2010/04/17/AR2010041702921.html>.

¹⁴² On the concerns raised by the operation of SWFs see also E. F. Greene and B.A. Yeager, *Sovereign wealth funds – a measured assessment*, *Capital Markets Law Journal*, 2008, vol. 3 no. 3 pp. 247-274 and Y.C.L. Lee, *A reversal of neo-colonialism: the pitfalls and prospects of sovereign wealth funds*, *Georgetown Journal of International Law*, 2009, pp. 1109-1149.

3) PRIVATE SECTOR CREDITORS

The second main category of players in the context of entities financing developing countries are private entities, mainly commercial banks lending to government and corporations and investors which subscribe bonds issued by the developing countries. Historically, bank loans used to be the main source of capital for emerging economies, however after the sovereign debt crisis of the '80ies (as better described in the following chapter), the issuance of bonds was used to refinance such loans, so that now the main source of financing is bonds. A short overview of the kind and percentage of indebtedness of some developing countries will be presented in the final paragraph below.

a. Commercial banks financing

Historically, developing economies represented key clients for commercial banks in the '80ies, when European and American banks were overloaded by petrodollars coming from OPEC countries which were benefitting from a raise in the cost of oil. As bonuses of bankers were proportionate to the amount of financing arranged, during that period massive loans were advanced to developing countries, with little or no analysis of how much debt was beneficial or at least capable of being repaid by the borrower. A deeper analysis of this phenomenon and its consequences is carried out in the following chapter.

For the purposes of this paragraph, is enough to highlight the kind of financing offered to sovereign borrowers: the loans were advanced to deal with the general needs of the country, and they were not linked to a specific project to be developed or milestone to be met in order to receive additional tranches of the loan.

The quantum of the loan was usually based on the GDP of a country, (sometimes exceeding it) without keeping some "headroom" to deal with sudden need of supplemental financing in connection with natural or human disasters. The borrowing capacity would be saturated, leaving such countries exposed to the risks connected to sudden and unexpected risks.

The two main common form of financing from developing countries will now be shortly analysed: (i) general corporate loans, to finance budget deficit; and (ii) project finance structures.

- i. **Loans:** loans are usually advanced by commercial banks operating in pools, the so-called syndicated loans, in order to raise more capital

due the fact that each bank has to advance a smaller amount, which is easier in terms of risk and exposures that banks are willing to accept. Historically, the birth of syndicated loans is linked to the need to advance high amounts of debt and the unwillingness and/or impossibility for single banks to deal with such requests, as better described in the next chapter. Syndicated loans consists of an investor group, opposed to a single creditor, which the borrower has to deal with throughout the life of the facility. They create the issue of how to deal with the relationships between the creditors themselves, which requires some sort on inter-creditors arrangement, to regulate procedural issues such as voting requirement and majorities, particularly important on the context of restructuring. In connection with loans generally, it is worth mentioning that the trend has been to get the main players to agree upon certain prevailing standards, which have originally developed in industrialised countries but which have recently involved emerging markets as well. In Europe, the most authoritative voice in such respect is the Loan Market Association (LMA)¹⁴³, which was founded in 1996 by banks operating in the market. The LMA's aim is to "encourage liquidity in both the primary and secondary loan market by promoting efficiency and transparency, as well as developing standards of documentation and codes of market practice, which are widely used and adopted".¹⁴⁴ Similar organizations developed in other regions of the world, such as the Loan Syndications and Trading Association (LSTA)¹⁴⁵ in the USA and the Asia Pacific Loan Market Association.¹⁴⁶

Although during the crisis the general trend for commercial banks was to reduce or withdraw completely loans advanced to developing countries, the African region was a notable exception to such trend. This has been explained by a combination of three factors: (i) the African region was not directly touched by the crisis; (ii) international lenders recognised the potential growth opportunities in Africa; (iii) the volumes of loans started from a very low base,

¹⁴³ The members of the LMA are currently 470 and consists of banks, non-banks investors, law firms, rating agencies and service providers.

¹⁴⁴ See *The Loan Book*, Loan Market Association, eds. N. Voisey and A. Slocombe, 2011, p. 3.

¹⁴⁵ More info available on their website, at: <http://www.lsta.org/>.

¹⁴⁶ More info available on their website, at: <http://www.aplma.com/>.

representing a small proportion of all emerging markets loans (between approximately 3% and 5%). The availability of funds for African borrowers was also due to the expansion of Chinese banks' operations in that region, which supported the demand of new financing together with European and domestic and regional banks.¹⁴⁷

A significant development in the approach of the LMA has been the introduction of a specific set of standard documentation for loans to be advanced to borrowers located in development countries jurisdictions.¹⁴⁸ Upon request from the main commercial players in the market, the LMA prepared a standard form loan agreement to be used as starting point for the negotiations with developing countries borrowers. This is a clear sign of the relevance of this kind of transactions in the market.

The assumptions included in the documentation are that the borrower is a corporate borrower (i.e. such documents do not purport to deal with loans to governments or public entities) incorporated in a development market jurisdictions and that the loans are either secured or unsecured (separate sets of documents have been prepared in such respect) and the loans are advanced in one or more currencies (again, separate set of documents are contemplated for such options).

The LMA acknowledges that the nature of developing market transactions is such that producing a common standard for all of them is an ambitious goal, given that each standard form will need to be adapted in respect of the specific structure and the peculiar jurisdictional and credit related risks connected to each transaction. However, as the LMA states: "...it was still felt that it would be a step forward in promoting the efficiency of the market if a document was produced which was a good starting point for the draftsman; which provided a common framework and language for those involved in these transactions[...]"¹⁴⁹

¹⁴⁷ See *The Loan Book*, Loan Market Association, eds. N. Voisey and A. Slocombe, 2011, pp. 79-81.

¹⁴⁸ The standard documents are available for download to all LMA registered users at: <http://www.lma.eu.com/>.

¹⁴⁹ See LMA, *Users guide to the recommended form of facility agreement for use in developing market jurisdictions*, p. 2, available to LMA registered users at <http://www.lma.eu.com/>.

Content wise, it is worth noting that the standard forms documents deal with the environment and in particular "Environmental Claims" and "Environmental Law", due to the growing relevance of environmental issues for lenders in the market.

The relevance for the lenders of clauses which deal with environmental issues is linked to many factors, mainly: (i) environmental claims may impair the ability of the borrower to repay the debt; (ii) the lenders themselves could be held liable for ongoing violations or environmental remediation; (iii) from a pure asset perspective, environmental contaminations could result in the impairment of the value of the collateral; (iv) the lenders could be held liable for cleanup costs; and (v) the stigma effect on the lenders. On this final point, it is worth noting that the financial institutions realised that the mere association of their names with major environmental problems could seriously affect the institution's image.

Summing up, either due to the willingness of the lenders to minimize losses and maximising returns or due to the lenders' environmental policy objectives, the final outcome is that, in the recent years, lenders have made an important contributions on environmental protection and sustainable development as a necessary consequence of their efforts to minimise their risks.¹⁵⁰

ii. Project Finance

Project finance is a specific financing structure developed in order to fund in an effective way the constructions and operation of projects in both developed and developing countries. The essence of project finance is that repayment of the loan is limited to the assets of the project (and the equity contribution of the sponsors). Project finance is also called "limited recourse" financing (i.e the lenders' recourse is limited to an identifiable pool of assets, the project assets and not generically to the entirety of the assets of the borrower and guarantors). Lenders in a project financing look to the future cash flow projected to be generated by the project and any payment in respect of the residual value of the project assets at the end of project

¹⁵⁰ On the environmental issues in connection with private source of financing, see R. S. Frye, *The role of private banks in promoting sustainable development, from outside counsel's perspective*, Law and Policy in International Business, 1997-1998, pp. 481- 499.

life for repayment of the loan and interest, rather than the analysing the credit worthiness of the borrower itself (as in the context of regular corporate financings), which is a special purpose vehicle which has no assets other than the project itself.

As already discussed in the previous paragraphs, project financing is the financing tool by means of which all the main projects in developing countries have been funded. Lenders in respect of such financing vary, as it could be just a number of commercial banks pooling together or it could involve official creditors as well, such as the World Bank or other multilateral development banks and export agencies. As anticipated, the advantage from the commercial banks' perspective, to have the official creditors "on board" is that official creditors will carry out the monitoring of the projects, as part of their internal procedures, on which private financiers will rely upon.

A further point of interest in respect of this kind of structure, is the development of a specific set of environmental and social principles, the so-called Equator Principles, which the borrowers have to comply with in order to be eligible for the financing.

On 4 June 2003 several of the world's largest banks announced their adoption of the Equator Principles, a set of voluntary guidelines developed for managing social and environmental issues relating to projects, particularly in the emerging markets. Following major redrafts in 2006 and 2013, 79 financial institutions in 35 countries have now officially adopted the Principles, covering over 70 per cent of international project finance debt in emerging markets.¹⁵¹

The Equator Principles are based on, and expressly incorporate, a number of the policies and guidelines of the International Finance Corporation. ¹⁵²In adopting the Equator Principles, each financial institution undertakes to develop individual internal practices and policies consistent with the framework established by the Equator Principles. Each financial institution is then expected to provide direct loans and project finance advisory services only to projects whose sponsors demonstrate the ability and willingness to comply with the Equator Principles' processes, and meet their substantive

¹⁵¹ Statistics from the Equator Principles Association's website: <http://www.equator-principles.com/index.php/about-ep/about-ep>.

¹⁵² The full version of the Equator Principles is available on the Equator Principles Association's website at: http://www.equator-principles.com/resources/equator_principles_III.pdf.

standards, similar to those which apply in the case of loans from the IFC.¹⁵³

In the context of sovereign debt restructuring, commercial banks group together in the so-called London Club, in order to deal with the negotiation with the borrower as a unite front. The activity of the London Club is analysed in the following chapter.

The main common feature in relation to private debt in the context of debt restructuring is the so-called “socialization” of private sector debt.¹⁵⁴ What usually happens as a result of the negotiations with public and private creditors during a financial crisis, is that the government represent all debtors located in its territory vis-à-vis the creditors. Corporate borrowers are protected by the government and do not have to face separate negotiations. However, as supplemental step, the government guarantees for all the debt granted to such national private borrowers, so that on one hand their credit risk is enhanced (for the benefit of the creditors, mainly private creditors) but on the other hand this results in a heavy charge put on the common people of such country, given that such loans will be ultimately serviced higher taxes and lower social services.¹⁵⁵

b. Bonds

The main structural difference between bonds and loans, from the borrower perspective, is that bonds create a single relationship between the bond issuer and each bondholder, rather than a sole relationship between a group of banks and the borrower.

In the '80ies, the creditors' class was overwhelmingly composed by commercial banks, in the '90ies, bank loans were replaced in vast majority by bonds issuances. Hence why the final chapter focuses on the restructuring of sovereign debt in the "bondholders era", analysing the main differences in the negotiation process between banks and bondholders and the developments in the contractual arrangements between the issuers and the holders of the bonds. For the purposes of this paragraph, few main features of sovereign bonds will be set out.¹⁵⁶

¹⁵³ On the Equator Principles see M. Marco, *Accountability in international project finance: the Equator Principles and the creation of third-party-beneficiary status for project affected communities*, Fordham International Law Journal, 2010-2011, pp. 452- 503.

¹⁵⁴ On the issue of socialization of private sector debt see R.P. Buckley, *International Financial System – Policy and Regulation*, Kluwer Law International, 2008, pp. 156-159.

¹⁵⁵ On this topic see also R.P. Buckley, *The Fatal Flaw in International Finance: The Rich Borrow and the Poor Repay*, World Policy Journal, 2002/2003, pp. 59-64.

¹⁵⁶ On sovereign bonds see M. Megliani, *Debitori sovrani e obbligazionisti esteri*, Giuffre' Editore, 2009.

What makes bonds attractive from a borrower perspective, it a combination of factors, amongst which, the most relevant ones are: (i) bigger quantum of funds potentially available, given that the international financial market is a much bigger source of funds than commercial banks; (ii) their term is usually longer than bank debt (and given that long term debt gives more stability to the borrower, this is quite a relevant aspect); and (iii) covenants and undertaking required by creditors are overall less stringent than for bank loans. The downsides of bonds are that they usually bear a higher interest rate than bank loans and that bonds have a very liquid market which allows investors to sell them rapidly, causing a destabilising effect for the sovereign borrower, which upon a consistent sale of its bonds on the market, is perceived by the international market, as affected by a reduced creditworthiness, which will eventually result in a further outflow of money from the country (as in the Asian crisis, see next chapter).

Sovereign can issue bonds by means of two procedure: (i) through a issuance on the market without using a investment banks as intermediary; or (ii) using investment banks as their intermediary vis-à-vis the market.

The first procedure is cheaper, given that no fees for the intermediary are required, however the sovereign country has to take the risk that a some (or all) of the bonds will not be underwritten by investors, therefore only countries with a high international rating (which are therefore sure to offer to the market an attractive product) can allow themselves to use such procedure.

The second procedure, on the other hand, gives the issuer the certainty that all the bonds will be subscribed, given that the investment banks will take responsibility to look for a group of banks willing to underwrite the whole amount of the issuance (the so-called underwriters). Banks will not underwrite the bonds in order to hold them, but with a view to place them on the market.¹⁵⁷

The main contractual provisions of the bond issuance are:

- i. Monetary clauses: which include clauses dealing with the conditions of the issuance (i.e. whether the issuance is at par or below the face value of the bonds) and the pricing of the bonds (i.e. if the interest rate is fixed or floating). Currency wise, sovereign bonds, in particular bonds issued by developing countries, are issued in a currency which is not the national currency of the issuer. This is due to the fact that otherwise bonds would not be attractive for the

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For more information on the steps and procedure for the issuance of sovereign bonds, see M. Megliani, *Debitori sovrani e obbligazionisti esteri*, Giuffrè Editore, 2009, pp. 15-60.

market, due to the devaluation risk and the overall control of the debtor on its own currency. In this category also falls the clauses dealing with repayment of the principal amount of the bonds, which can either be a repayment in full at the end of the life of the bond or it can amortise throughout the term of the bonds (but the first option is the more common).

- ii. Non monetary clauses: amongst the clauses which do not deal with the economics of the issuance, the most relevant clauses are the covenants granted by the issuer, in particular the *pari passu* covenant and the negative pledge covenant, and the events of default. The *pari passu* covenant aims at granting that all creditors are treated equally, so that they all receive the same treatments in respect of repayment of interest and principal (this specific clause will be further analysed in the final chapter, as it became a quite relevant clause in the context of debt restructuring). The negative pledge clause, on the other hand, aims at prohibiting the issuer to grant security and any kind of liens to other creditors, in prejudice of the bondholders. In the event the issuer is in breach of such clause, it will have to grant the same security offered to third party creditors to the bondholders as well. Events of default are key terms of the bonds as well, given that they regulate the situation in which the bondholders are entitled to get an exit and be repaid, due to a breach of the contractual terms by the issuer or certain changes in the factual situation. The cross default, in particular, is a standard event of default, which allows the bondholders to declare their debt due in the event the issuer keep to make regular payments in respect of its bonds obligations, but defaults under other debt instruments, showing a situation of financial distress. As final boilerplates clauses, the governing law clause is included (governing law is almost invariably either New York law or English law), the jurisdiction clause and the waiver of sovereign immunity (which will be analysed in the final chapter).¹⁵⁸
- iii. IMF clause: the IMF clause was introduced in the offering memorandum of bonds between 1978 and 1985, which was a period of several sovereign debt restructurings. Under the terms of such clause, the issuer undertakes to maintain its membership in and

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On the contractual terms of the bonds, see M. Megliani, *Debitori sovrani e obbligazionisti esteri*, Giuffrè Editore, 2009, pp. 30-37.

eligibility to use the resources of the IMF. Unless cured within a certain time period, the loss of membership causes the occurrence of an event of default, which triggers the acceleration of the maturity of the debt. This clause is included for issuances by developing countries which are not established issuers, seen as too big to be abandoned, such as Brazil, Mexico or India.¹⁵⁹ Some writers suggested that the clause was a "seal of approval" proving to the international community that the issuer was creditworthy.¹⁶⁰ Historically, however, notwithstanding the several sovereign financial crises, no sovereign lost its eligibility to use IMF funds. Interestingly enough, in fact, the IMF criteria for eligibility are unlikely to be of any comfort to the lenders, which was proven by the fact that not even Argentina, during the worst years of its financial crisis, was anywhere close to lose its eligibility.¹⁶¹ The most plausible explanation for the introduction of such clause is the fact that it obliges the IMF to be part of the relationships between the issuer and the bondholders: "The private lenders were anxious to secure the IMF's involvement because they were finding it remarkably hard to directly control sovereign debtors in the same way that they might control corporate debtors. The IMF clause, we contend, emerged as an ex-ante mechanism to draw the IMF into the relationship and, indeed, to give it notice of this fact."¹⁶²

¹⁵⁹ As some authors point out, such clause: "The IMF clause raises the stakes if the IMF should withdraw membership or eligibility: by doing so, it would trigger the acceleration of the sovereign's debt. The IMF is a political body and it does not wish to be blamed for such a financial calamity, either to individual sovereigns or to the global economy. In this sense, the parties to sovereign debt contracts use IMF clauses to co-opt the IMF, by exploiting its responsibility to preserve international financial stability. The clause cements the IMF's commitment to monitor the borrower, and to be a leading force in any debt restructuring, by providing emergency financing and intervening in the economic management of the sovereign." M. Gulati and G. Triantis, *Contracts without law: sovereign versus corporate debt*, University of Cincinnati Law Review, 2006-2007, p. 999.

¹⁶⁰ D. D. Bradlow, *International borrowing: negotiating and structuring international debt transactions*, International Law Institute, 1986.

¹⁶¹ See M. Gulati and G. Triantis, *Contracts without law: sovereign versus corporate debt*, University of Cincinnati Law Review, 2006-2007, p. 1001.

¹⁶² See M. Gulati and G. Triantis, *Contracts without law: sovereign versus corporate debt*, University of Cincinnati Law Review, 2006-2007, p. 1001.

4) EXTERNAL DEBT TRENDS FOR DEVELOPING COUNTRIES

In order to complete the overview on the sources of financing available for developing countries, it is worth briefly considering some recent trends in respect of international debt.¹⁶³

In respect of trends for official and private flows to developing countries, it has been noted that in 2008, as consequence of the financial crisis, the level of private financing dropped dramatically, requiring the IMF and the World Bank to step in and offer emergency financing. Consequently, in 2009 the data shows that the inflow from official creditors exceeded the level of private funds advanced, and historically that had not happened since 2002.

However, in 2010 the previous trend was back, showing a strong resumption of inflows from private creditors, with the parallel reduction of financing from official creditors. In terms of figure, in 2011 USD 30 billions were advanced by official creditors (of which USD 2.4 billion on concessional terms), against the USD 81 billion advanced in 2009.

In respect of destination of funds granted by private lenders, the beneficiary of the recover in such inflows were mainly private sector borrowers, which received funds from banks and other financial institutions mainly for projects and in connection with their export activities. Number wise, the inflows tripled in 2011, being equal to USD 110 billion. Geographically speaking, 80% of such figure was directed to Latin America and the Caribbean, Europe and Central Asia.

A further point of interest, in terms of sources of financing, is that the bond issuance in international capital markets raised, showing a 49% increase against 2010. The main driver of such raise was issuance by corporate borrowers.

Finally, in terms of the entities requesting financing within developing countries, we note that the general trend has been a shift from debt owed by private sector borrowers rather than public sectors debts. In 2011 the amount owed by private sector borrowers was equal to USD 2,616 billion, which is almost double the figure for 2000.

In respect of capacity to repay debts, calculated as a ration of the external debt service to export earnings, developing countries have seen a significant improvement, due to the increased export earnings but also as outcome of successful debt restructuring processes and debt relief both from official and private creditors in the context of the Highly Indebted Poor Countries (see next chapter) and Multilateral Debt Relief Initiative (see next chapter).

¹⁶³ Data are taken from the World Bank report issued in 2013, *International Debt Statistics*, available at <http://data.worldbank.org/sites/default/files/ids-2013.pdf>.

In order to complete the overview, the split between official and private debt and between bonds and commercial banks loans in respect of some developing countries will be reported below.¹⁶⁴

Country	Overall amount of long term external debt (in million)	Official creditors debt ¹⁶⁵ (in million)	Private creditors debt (bonds ¹⁶⁶) (in million)	Private creditors dent (commercial banks loans) (in million)
Brazil	USD 357,738	USD 36,517	USD 77,239	USD 11,759
Cameroon	USD 2,562	USD 2,078	0	USD 23
Chile	USD 77,826	USD 933	USD 18,699	USD 3,825
China	USD 197,776	USD 66,840	USD 41,570	USD 2,456
Colombia	USD 64,968	USD 16,580	USD 25,929	USD 1,800
Cote D'Ivoire	USD 10,108	USD 9,670	0	USD 80
Guatemala	USD 13,712	USD 4,728	USD 785	0
Guinea Bissau	USD 219	USD 219	0	0
India	USD 250,171	USD 75,711	USD 27,378	USD 15,375
Indonesia	USD 172,327	USD 66,481	USD 43,556	USD 4,800
Jordan	USD 7,496	USD 5,294	USD 895	USD 23
Liberia	USD 187.2	USD 187.2	0	0
Malaysia	USD 48,697	USD 3,263	USD 24,753	USD 4,350
Mexico	USD 231,325	USD 28,399	USD 159,102	USD 17,926
Peru'	USD 37,751	USD 10,721	USD 18,302	USD 121
South Africa	USD 91,909	USD 1,449	USD 45,152	USD 6,423

The figures above confirms that countries which are able (due to their economic and financial situation) to have access to the international capital markets, tend to use bonds as main source of private financings (most of them still having official sector support). On the other hand, countries which do not have access to such pool of resources, still rely heavily on official sector help, getting to the extreme situation of the poorest countries such as Guinea Bissau and Liberia, which rely exclusively on official creditors' support.

¹⁶⁴ Data referring to statistics for 2011 and taken from World Bank report issued in 2013, *International Debt Statistics*, available at <http://data.worldbank.org/sites/default/files/ids-2013.pdf>.

¹⁶⁵ Which includes also publicly guaranteed debt.

¹⁶⁶ Both guaranteed and not guaranteed.

CHAPTER THREE

THE RESTRUCTURING PROCESS OF SOVEREIGN DEBT OF DEVELOPING COUNTRIES

1) HISTORICAL BACKGROUND

Sovereign defaults are nothing new to the history of countries.

Throughout the sixteenth and eighteen centuries European countries such as England, Spain and France repeatedly went through debt crises due, *inter alia*, to the excessive costs of wars that they had undertaken.

Historically, defaults on the repayment of debt would be dealt by means of a combination of rescheduling and debt relief.¹⁶⁷ Military intervention was also considered as means for recovery of the unpaid sums. It was not until the beginning of the 19th century that the Argentinian Secretary of State at the time, Luis Drago, established the modern doctrine according to which public debts do not represent a justification for the violation of the territorial integrity of a sovereign state.¹⁶⁸

And it was in the nineteenth century that debt crises, defaults, and debt restructurings began to dramatically increase, both in terms of incidence and in terms of geographical spread. This was the result of increasing cross-border debt flows, newly independent governments and the development of modern financial markets and of the modern international financial architecture.

We will now focus on some examples of recent sovereign debt crises of developing countries, namely the Latin American crises of the 1980s and the Asian one.

a) The Latin American debt crisis in the 1980s - the over indebtedness issue

There are three primary causes of the Latin American crises in the 1980s: (i) the banking policies of developed countries; (ii) a change in the global economy in the late 1980s; and (iii) the economic policies and conditions in the borrower countries themselves.¹⁶⁹

¹⁶⁷ H. James, *Deep Red - The International debt crises and its historical precedents*, the American Scholar, 1987, pp. 334-336.

¹⁶⁸ See the 1907 Drago Porter Convention. Article 1.1 reads: "The contracting powers agree not to have recourse to armed forces for the recovery of contract debts claimed from the government of one country by the government of another country as being due to its nationals". Such principle is now generally acknowledged and covered by the general prohibition on use of force contained in article 2.4 of the Charter of the United Nations.

¹⁶⁹ A.G. Santos, *Beyond Baker and Brady: deeper debt reduction for Latin American sovereign debtors*, New York University Law Review, 1991, pp. 66-111.

In the 1970s US and European banks experienced a period of high liquidity due to the “petrodollars” that members of the Organization of Petroleum-Exporting Countries (OPEC) deposited with them. OPEC quadrupled oil prices in 1973-1974, which resulted in a flow of USD 13.8 billion from OPEC to the six largest US banks by the end of 1975.¹⁷⁰

Banks granted loans to Latin American countries on the basis of an overly optimistic assessment of their economies and on the assumption that sovereign borrowers were immune from bankruptcy risks and would have not defaulted.¹⁷¹

Together with the increased liquidity, there were two technical innovations in the loan markets that made possible the structuring of transactions in amounts previously unheard of: (i) the development of syndicated lending; and (ii) the introduction of floating interest rates. By means of syndicated lending¹⁷² massive loans were advanced, loans that would have otherwise been beyond the capacity of any single bank.¹⁷³

The introduction of floating interest rates allowed banks to meet the demand from borrowers for five to seven year term loans in circumstances in which banks were themselves only able to borrow from the Euromarkets to fund such loans for periods up to six months. The solution to such mismatch was for a bank to set the interest rate on the loans as a floating rate that resets periodically (every six months or less) upon each consecutive expiry and reborrowing of the bank's short term funding from the Euromarkets at a margin over the bank's cost of funding as it borrowed and reborrowed in the Euromarkets.¹⁷⁴ This mechanic enabled the bank to transfer the interest rate risk to the debtor.¹⁷⁵ Summing up, that the high liquidity, ability to share risk with other banks and transfer risk to borrowers together with the optimistic assessment on the countries credit risk resulted in high volumes of lending into Latin America in the 1970s and in the 1980s.

¹⁷⁰ P.A. Wellons, *World Money and Credit – the crisis and its causes*, in Boston, Division of Research, 1983, p. 23.

¹⁷¹ On sovereign risk assessment see A. Haynes, *The law relating to international banking*, Bloomsbury Professional 2011, pp. 55-75.

¹⁷² A syndication occurs when few principal organizers work on a loan package in which participations are sold to other lenders which do not come into direct contact with the borrower.

¹⁷³ J.N. Brooks, *Participation and syndicated loans: intercreditor fiduciary duties for lead and agent banks under US law*, Butterworths Journal of International Banking and Financial Law, 1995, p. 275.

¹⁷⁴ J. Levison, *the International Financial System: a flawed architecture*, in Fletcher Forum World Affairs, 1999.

¹⁷⁵ The effects of fixed and floating interest rates for sovereign borrowers are analysed by Buckley, see R.P. Buckley, *International capital flows, economic sovereignty and developing countries*, Yearbook of International Financial and Economic Law 1999, pp. 21-24.

The second main cause of the crises, and related to the first, was the change in the economic climate in developed countries at the end of the 1980s, during which time there was a period of recession which resulted in a sharp rise in interest rates. Following the development and proliferation of floating rate loans to Latin American countries referred to above, as the rate of interest charged on such loans followed the market, the cost of servicing the debt correspondingly increased.

The other main cause of the crises was the monetary and fiscal policy of the Latin American countries during the previous decade, each of which relied almost exclusively on loans for its economic growth. A considerable portion of such loans was advanced to inefficient public sector spending, which did not generate the necessary earnings to service the debt.¹⁷⁶

In 1982 Mexico declared its inability to service its debt and Brazil, Argentina, Bolivia and Venezuela followed shortly after.

The US Government did not take any action in respect of these country defaults initially, preferring to allow commercial banks and the International Monetary Fund to deal with it.¹⁷⁷

In the following years commercial banks reduced their exposure to Latin American countries, although pursuant to so-called "involuntary lending"¹⁷⁸ they were still required to continue lending to the extent the debtors did not fall into arrears. It was crucial for American commercial banks that their debtors did not default on interest payments since at that time regulatory rules required that banks declared any loans from which interest payments had not been received within ninety days of their due date to be non-performing. If a debt was declared non-performing, the bank had to maintain adequate loss-reserves for such loan. If loans advanced to Latin America

¹⁷⁶ See P. Kuczynski, *Latin American Debt*, 1988.

¹⁷⁷ See A.G. Santos, A.G. Santos, *Beyond Baker and Brady: deeper debt reduction for Latin American sovereign debtors*, *New York University Law Review*, 1991, pp. 66-111.

¹⁷⁸ Traditionally, debt renegotiations with public and private creditors had been conditioned upon the implementation of an IMF program. The banks' reliance on the IMF strengthened its power in negotiations with countries needing financial assistance. Initially, at the beginning of the crises, the IMF would also provide the relevant countries with new money to solve what it had originally been interpreted as simply a liquidity issue for the countries. However when it became clear that was not the case and that they were dealing with real sovereign insolvency, the IMF decided to take a different approach: since it was not any longer willing and able to give the debtor countries the financial assistance they needed to service their external debt, it started to condition its loans upon further lending by the existing commercial lenders. This was intended to create a close tie between the IMF and the private creditors. Since the banks were unwilling to risk further loans to a debtor country without IMF assurance of the country's improved creditworthiness, a reciprocal requirement emerged. The IMF could reliably assure the creditworthiness of a debtor only if the country agreed to implement an IMF adjustment program, but the IMF would approve a program only if it included new commercial lending, and the commercial banks would fund such loans only if the IMF approved the program. As a result, private creditors and the IMF started to draft joint renegotiations packages. See. R. MacMillan, *The next sovereign crisis*, *Stanford Journal of International Law*, 1995, p. 317-321.

countries had been declared non-performing in 1982, most of the lenders would not have had sufficient capital to maintain the required reserves.¹⁷⁹

The burden of such new financing was shared amongst the lenders: each bank contributed pro rata to the amount of outstanding loans as of a specified date.¹⁸⁰

With a view to avoiding defaults and the regulatory consequences, the approach that banks followed in the following years was to search for contingent solutions by means of rescheduling repayment of principal due and extending new loans to enable the debtors to make the interest payments as scheduled.

The IMF, hoping to find a quick solution to the liquidity issue, instituted a practice of conditioning the granting of new finance upon acceptance by the debtor country of the implementation of austerity measures, which would include efforts to balance current accounts by restricting imports, devaluing local currency in order to move towards more "realistic" exchange rates and balancing domestic budgets.¹⁸¹

In 1985, after several rounds of rescheduling of sovereign debt, it became clear that the policy that had been pursued by banks and the IMF did not represent a long-term solution to the debt crises.¹⁸² Such policy had the merit of preventing the collapse of the American banking system as a result of all the loans advanced to Latin American countries being declared non-performing, but did not address the necessity of ensuring that the debt burden of such countries became sustainable.

(i) The Baker Plan

On 9 October 1985, at the annual meeting of the World Bank and of the IMF, the US Secretary to the Treasury, James A. Baker, announced a plan to solve the debt crises.¹⁸³

¹⁷⁹ See P.J. Power, *Sovereign Debt and the Secondary Market*, Fordham Law Review, p. 2709-2710.

¹⁸⁰ See L. Buchheit, *the Capitalization of Sovereign Debt: an Introduction*, University of Illinois Law Review, 1988, pp. 401 ff.

¹⁸¹ See B. Orr, *After a decade bankers say "adios" to Latin debt crisis*, A.B.A. Banking Journal, 1992, p. 36 ff.

¹⁸² In 1983 a regular pattern for rescheduling had developed. As first step a steering committee would be established to act as an advisory group and liaise with the all bank creditors. Usually the members of such committee would be the major money-centre banks. The steering committee would require then the debtor to undertake a rescheduling of its official debts (i.e. debts towards other countries or international institutions). As further step the steering committee would request the country to implement an economic program designed by the IMF (a "structural adjustment"). Following these preliminary steps, the rescheduling would be implemented by means of: (i) new commercial bank loan, usually with a grace period on interest repayments of between two and four years; (ii) new 3 year term loans from the IMF; and (iii) the rescheduling of existing commercial bank loans over longer maturities and with substantial grace periods on capital repayments. See R. P. Buckley, *Rescheduling as the groundwork for secondary markets in sovereign debt*, in Devon Journal of International Law and Policy, 1998, pp. 300-301.

¹⁸³ See statement by J.A. Baker before the Joint Annual Meeting of the IMF and World Bank, October 1985, Seoul South Korea.

The Baker plan required the implementation of the following actions: (i) new three year term loans for an amount equal to USD 29 billion¹⁸⁴ being advanced by commercial banks and by the IMF to the fifteen most indebted countries (which at the time included not only Latin American countries but some African countries also)¹⁸⁵ to allow interest payments to remain current; (ii) continued payment of interest to commercial banks at market rates; (iii) rescheduling of principal payments on both official and commercial debt; (iv) IMF conditionality; and (v) voluntary debt reduction through new financing arrangements.

The new finance was conditional upon the debtors putting in place "market-oriented" reform policies such as deregulation, privatization and liberalization of trade in order to encourage further private-sector initiatives ("structural adjustment").¹⁸⁶

By the late 1980s, it became clear that the Baker Plan did not achieve its objectives: sovereign debtors had simply continued to grow progressively more leveraged due to the new loans and due to the fact that creditors had granted no debt forgiveness.

As the principal amounts of the rescheduled loans began to mature and the debtors were once again in the position of not being able to repay their debts, there was a general understanding that a different approach would be required to reduce the debts of the defaulting countries to sustainable levels.

(ii) The growth of the secondary market¹⁸⁷ for sovereign debt

Trades of discounted debt of Lesser Developed Countries (LDCs) and the corporations of LDCs had existed in a very small scale since the 1970s and they largely represented a way by which banks and other creditors could manage their developing country portfolios.

¹⁸⁴ Baker proposal called upon new loans from commercial bank for an amount equal to USD 20 billion and from the IMF for an amount equal to USD 9 billion. Id.

¹⁸⁵ The so-called Baker Fifteen, namely, Argentina, Bolivia, Brazil, Chile, Colombia, Cote D'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela and Yugoslavia.

¹⁸⁶ The concept of structural adjustment introduced by the IMF has already been analysed in chapter 2.

¹⁸⁷ Secondary market means the market whereby investors trade between themselves, rather than with the borrower of a loan or the issuer of securities.

The development of this immature market into the modern sovereign debt secondary market took place at the beginning of the 1980s and was a result of the following main reasons:

- The desire of banks to sell their outstanding loan positions to willing buyers at a substantial discount to face value;
- The desire of some banks to adjust their LDC loan portfolios by means of loan swaps;
- The development of a debt conversions schemes (see following paragraph on debt-to-equity swaps).¹⁸⁸

From a technical banking perspective, the rescheduling process had a direct impact on the growth of the sovereign debt secondary market for the following three reasons¹⁸⁹:

- **Single debtor:** the documentation required to reschedule the relevant debt would provide for the replacement of the hundreds of different entities as borrowers with the relevant state itself as a single borrower of all the distressed loans (or the nation's central banks would act as borrowers and the state would act as guarantor). Consequently, all the loans would thereafter be traded at one price, based on the state's creditworthiness. This simplified the secondary trading process considerably providing for an increased volume of trading- there was no need to evaluate the creditworthiness of multiple borrowers; all loans carried the same credit risk and were effectively fungible.
- **Single agreement:** the restructuring documentation required for the rescheduling process allowed the provisions relating to the transferability of all of the distressed loans to be recorded in a single contract establishing whether and how the debt could be transferred to other investors. Prior to the rescheduling process there were thousands of lengthy loan agreements, each with differently negotiated transfer provisions/restrictions. Therefore

¹⁸⁸ R. P. Buckley, *The transformative potential of a secondary market: emerging markets debt trading from 1983 to 1989*, Fordham International Law Journal, 1998, pp. 1152-1238.

¹⁸⁹ R.P. Buckley, *Rescheduling as the groundwork for secondary markets in sovereign debt*, Denver Journal of International Law and Policy, 1998, pp. 305-309. See also R.P. Buckley, *The practice of emerging markets loan sales*, Journal of International Banking Law, 1999, pp. 151-154.

trading the debt would have required have access to and knowledge of such agreements, increasing legal costs and slowing the trades.

- **Standardization of the transfer provisions:** rescheduling resulted relatively quickly in the transfer/assignment clauses¹⁹⁰ becoming standardized for large portions of a country's indebtedness. Many restructuring agreements of that period shared the same clauses regarding assignment and transfers.¹⁹¹

Originally trading consisted of sovereign debt swaps between banks, in which the seller granted no assurances as of the recoverability of the debt. The purchaser would therefore represent that it had conducted its own analysis as to the creditworthiness and financial status of the borrower, acknowledging that it had no recourse to the seller. The purchaser of the loan instrument was also required to undertake to provide any new funding that the relevant debtor country may request from its lenders in connection with any rescheduling of the loan.¹⁹²

Notwithstanding the risk of non-payment of the loan, the sovereign debt secondary market became highly attractive to those investors looking to make equity investments in the relevant country and who were in need of local currency to purchase plant and equipment, since they could buy it at a discounted price the debt and then ask the country to convert the foreign currency debt into local currency. Such request would meet the country's needs to exchange their dollar denominated debt obligations for an equivalent amount of local currency and the exchange would be

¹⁹⁰ On the nature of transfers of sovereign loans see R.P. Buckley, *The law of emerging markets loan sales*, Journal of International Banking Law, 1999, pp. 110-114.

¹⁹¹ For instance, the transfer provision was in substance identical in each of: (i) the \$3,700,000,000 Term Credit Agreement dated as of 1 August 1985 among the Banco Central de la Republica Argentina as borrower, the Republic of Argentina as guarantor, Citibank N.A. as agent and other lenders; (ii) the New Restructure Agreement dated 29 August 1985 among the United Mexican States as obligor, Banco de Mexico as the central bank of the United Mexican States and the lenders listed therein. The same provisions were also inserted by way of addendum in (i) the Restructuring Agreement dated 16 December 1986 among the Republic of Chile as Obligor, Companies Luxembourgeoise A.G., Dresdner Bank International as Servicing Bank and others; and (ii) the \$925,000,000 Credit Agreement dated 20 May 1985 among the Central Bank of the Philippines as borrower, the Republic of the Philippines as guarantor, Manufacturers Hanover Trust Company as Agent, and others. See R.P. Buckley, *Rescheduling as the groundwork for secondary markets in sovereign debts*, Denver Journal of International Law and Policy, 1998, footnote no. 53.

¹⁹² R.P. Buckley, *Rescheduling as the groundwork for secondary markets in sovereign debts*, Denver Journal of International Law and Policy, 1998, pp. 305-320.

implemented by means of debt-for-equity swaps (see below paragraph on debt-for-equity swaps).¹⁹³

The secondary market also gave debtors the opportunity to benefit from debt buy-backs¹⁹⁴, pursuant to which they could purchase their own debt at a discount to face value, representing one of the most efficient ways to reduce their debt.¹⁹⁵

As soon as banks started to sell their sovereign loan portfolio on the secondary market, offering significant discounts to the face value of the loans, investors began to purchase sovereign debt with the intention of speculating on short-term appreciation in the value of the country's debt as its economy improved. The discounts allowed investors to profit materially even where the relevant countries were only able to repay a small percentage of the face amount of the debt.¹⁹⁶

The growth of the sovereign loan secondary market has historical relevance in the context of the structuring of a new plan proposed by the American government to deal with the Latin American crises: the securitization of sovereign loans under the Brady Plan.

(iii) The Brady Plan

On 10 March 1989, the US Treasury Secretary, Nicholas Brady, proposed a new set of principles to be applied in the context of the Latin American debt crisis, which took the name of Brady Plan.

The original version of the Brady Plan included the following major features:

¹⁹³ Id.

¹⁹⁴ A debt buy-back involves the acquisition of the debt by or on behalf of the debtor either directly from the creditors or through secondary market.

¹⁹⁵ Debtors would usually request consent or at least communicate to their lenders their intention to buy back debt: the lenders were aware that the monies used to repurchase the debt were in fact the same monies that they had been forced to advance by means of interim financing and attempts to buy back debt by debtors inevitably added to tensions in the lender/borrower relationship. Lenders were also worried about the moral hazard of the buy back mechanic: given that secondary market prices of sovereign debt would inevitably decrease following a default, a country contemplating a buy-back of its debt would have an incentive to default in order to benefit from the lower purchase price. See P. Power, *Sovereign Debt: the rise of the secondary market and its implications for future restructurings*, Fordham Law Review, 1996, pp. 2717-2718.

¹⁹⁶ R. MacMillan, *The next sovereign debt crisis*, Stanford Journal of International Law, 1995, pp. 305 ff.

- Commercial banks would either reduce the outstanding principal of their sovereign loans portfolios or reduce the amount of interest payable on such loans;
- In return for the concessions described above, commercial banks would be offered an improved debt instruments from the credit risk perspective (i.e. guaranteed or collateralized) for the remaining principal (and maybe a portion of the interest) due on their loans;
- Such credit improvement would be the result of new funds granted by the IMF, the World Bank and some bilateral official lenders, such as Japan.
- Debtor countries would be entitled to benefit from these measures only upon acceptance of structural adjustment as proposed by the IMF.¹⁹⁷

According to Secretary Brady's view, the Plan was to be implemented by means of individual market-based transactions, whereby: (i) creditors would be invited to partake on a voluntary basis (ii) debt relief would be linked to conversion of loans into collateralised bonds;¹⁹⁸ (iii) debtor countries would be entitled to buy back their debt; and (iv) debt-equity schemes would be promoted.¹⁹⁹

In practice, the implementation of the Brady Plan by the various debtor countries was somewhat different.

Debtor countries imposed the Plan on their creditors by providing them with a set of options, a "menu", among which they could choose in the context of a one off transaction by means of which the debtor would obtain debt reduction and new money.

We will now review a few examples of how the Brady Plan was implemented in the context of the restructuring of the sovereign debt at the end of the 1980s and in the 1990s.

¹⁹⁷ See L. C. Buchheit, *The background to Brady's initiative*, in the *International Financial Law Review*, 1990, pp. 29-30.

¹⁹⁸ A first version of this mechanism was applied in the context of the issuance of the so-called Aztec bonds, issued by Mexico in 1987, by means of which almost USD 20 million were converted in bonds. See R.P. Buckley, *The transformative potential of a secondary market: emerging markets debt trading in 1983-1989*, *Fordham International Law Journal*, 1997-1998, pp. 1198-1202.

¹⁹⁹ See R. P. Buckley, *International Financial System, policy and regulation*, Kluwer Law International, 2008, p.41.

MEXICO

Negotiations on the restructuring of Mexican debt began in May 1989. In September 1989 a term sheet was distributed to the banks, in February 1990 a debt restructuring agreement was signed, and in March 1990 the first Brady bonds were issued.²⁰⁰

Banks were offered the following options:

- **Discounted bonds:** the original loans could be converted into newly issued 30-year bonds paying Libor plus 13/16%. The principal was discounted by an amount equal to 35% of face value. Zero-coupon²⁰¹ US Treasury bonds of matching maturity purchased by Mexico collateralized the principal component of the bonds. Such collateral, however, was not available to bondholders prior to the maturity of the bonds (i.e. only after 30 years).²⁰² Interest was collateralized by a guarantee granted by the Mexico government and rolling over every eighteen months.²⁰³
- **Par bonds:** loans could be converted into bonds with the same face value as the loans, with interest discounted from the original ones at a fixed rate of 6.25%. The same collateral as per discounted bonds applied.
- **New loans:** banks could elect to participate in new loans in the following four years for an amount equal to 25% of their medium-long term exposure to Mexico.²⁰⁴

²⁰⁰ Id.

²⁰¹ Zero-coupon bonds are bonds on which the issuer makes no periodic interest payments: the bonds are issued at a discount from their face value which represents the issuer's interest cost for the borrowing. See Black's Law Dictionary.

²⁰² See Prospectus of Prudential Distressed Securities Fund, Inc. 16 January 1996: "In the event of a default with respect to collateralized Brady Bonds as a result of which the payment obligations of the issuer are accelerated, the U.S. Treasury zero coupon obligations held as collateral for payment of principal will not be distributed to investors, nor will such obligations be sold and the proceeds distributed. The collateral will be held by the collateral agent to the scheduled maturity of the defaulted Brady Bonds, which will continue to be outstanding, at which time the face amount of the collateral will equal the principal payments which would have then been due on the Brady Bonds in the normal course".

²⁰³ The purchase of the US treasury bonds was funded by means of USD 20 billion granted by the IMF and the World Bank and USD 4.5 billion granted by Japan. S.G. Santos, *Latin American Debt*, New York University Law Review, 1991, p. 79.

²⁰⁴ The new money option contained a paradox: new monies were crucial to purchase the collateral for the Brady bonds to be issued, to make coupon payments on the Brady bonds and, more generally, to guarantee the economic growth of Mexico. However, in the event that too many banks elected to advance new monies, the resulting net increase would jeopardise the debt-reduction effect that the proposal was trying to achieve. See R.P. Buckley, *International Financial System, policy and regulation*, Kluwer Law International, 2008, p. 42. This option was

The outcome of the implementation to Mexico of the Brady Plan has been criticized for the inadequateness of the proposed debt reduction, which did not achieve the goal of releasing the country from its excessive debt burden.²⁰⁵

However some authors point out some positive consequences resulting from the Plan.²⁰⁶ In *primis*, Mexico regained access to capital markets since international confidence had been restored, capital flows had recovered and Mexico was able to retire an aggregate amount of USD 7.2 billion from the market on favourable terms by means of debt buy-backs.²⁰⁷ Furthermore, the Brady restructuring modified two material features of the lending boom which had occurred in the 1970s: (i) a relevant amount of borrowing on floating interest rates was replaced by borrowing on fixed interest rates, so that Mexico was better protected against interest rate rises²⁰⁸; (ii) the nature of a material amount of its borrowing shift from loans to bonds.²⁰⁹

PHILIPPINES²¹⁰

complementary to the other previous ones, since the creditor would still have to exchange the original debt for new bonds.

²⁰⁵ The nominal debt reduction was equal to USD 14 billion. However, when this is combined with the amount of new financing, the amount of borrowing by Mexico did not change materially. See M. Monteagudo, *The debt problem: the Baker Plan and the Brady Initiative: a Latin American perspective*, the International Lawyer, 1994, p. 80. See also A.G. Santos, *Beyond Baker and Brady: deeper debt reduction for Latin American sovereign debtors*, New York University Law Review, 1991, p. 80.

²⁰⁶ See M.A. Walker, *Mexico, more than a debt crisis*, International Financial Review, 1992, p. 33; R.P. Buckley, *International Financial System, policy and regulation*, Kluwer Law International, 2008, p. 46.

²⁰⁷ A more detailed analysis of such mechanism is carried out in the following paragraphs.

²⁰⁸ On the effects of fixed and floating interest rates see R.P. Buckley, *International capital flows, economic sovereignty and developing countries*, Yearbook of International Financial and Economic Law 1999, pp. 21-24.

²⁰⁹ See R.P. Buckley, *The facilitation of the Brady Plan: emerging markets debt trading from 1989 to 1993*, Fordham International Law Journal, 1998, p. 1812. See also J. Clark, *Debt Reduction and Market Reentry under the Brady Plan*, Federal Reserve Bank of New York Quarterly Review, 1994, p. 62: "The Brady restructurings did not achieve significantly more near-term cash flow relief for debtors than the previous approach. But they did provide a more stable long-run financial framework that, in combination with structural reforms by debtors and a favourable environment of lower global interest rates, helped to restore market access".

²¹⁰ The Philippine restructuring which took place in the early 1990s will be analysed here notwithstanding the fact that geographically it would not be appropriate, because chronologically it belongs to the Brady era and the financial instruments that have been used reflect this. The Philippines will be considered also in next paragraph in the context of the later crisis which widespread in the late 1990s in Asia.

The Philippines were the second country to start negotiations with its creditors following the proposal of Secretary Brady. Such restructuring represents a more anomalous case of sovereign debt restructuring, since it was structured as a two steps transaction, whereby only the second step fell within the classical Brady restructuring scheme.

In early 1990 the Philippines proposed to their commercial banks creditors to either advance new money purchasing transferable bonds issued by the country or selling their exposure back discounted 50% of face value. This offer came together with the undertaking of the Philippines to grant their creditors options to exchange their loans for new collateralised loan instruments, on the basis of a voluntary and market based transactions, in the following couple of years.²¹¹

Using the proceeds of such new loans, the Philippines were able to repurchase more than USD 1.3 billion of its existing indebtedness at a 50% discount through one single cash buyback transaction. In 1992 a second buyback transaction was carried out, by means of which further 1.26 billion of commercial bank debt was purchased by the Philippines.²¹²

When the second part of the restructuring was presented to the creditors, it was in the shape of a one-off transaction based on the Mexican implementation of the Brady Plan.

The menu offered to creditors by the Philippines was as follows:

- **25-year bonds:** bonds with a 25 years maturity fully collateralised for principal and a rollover guarantee covering 14 months of interest, with a fixed coupon of 4.25%, which would rise to 6.5% starting from year six.
- **15-year bonds:** bonds with 15 years maturity, not collateralised for principal, with a rollover guarantee covering 12 months interest for the first six years. Interest rates were fixed, commencing at 4% rising to 6% in year six, turning into a floating interest rate equal to Libor plus 13/16th% starting from year seven.

²¹¹ See L. Buchheit, *The Background to Brady's initiative*, International Financial Law Review, 1990, p. 31 and R.P. Buckley, *International Financial System, policy and regulation*, Kluwer Law International, 2008, p. 47.

²¹² See L. Buchheit, *Philippines takes two bites from Brady apple*, International Financial Law Review, 1992, p. 35.

- **New money:** banks could advance new money up to 25% of their respective exposure. New money would have been advanced purchasing newly issued bonds with 17 years maturity bearing interest of Libor plus 13/16th%.²¹³

A comparison between the Mexican approach and the Philippine formulation highlights one main difference: in Mexico, the package offered to creditors would focus on debt and debt service reduction, while new money would play an ancillary role. Mexico offered an integrated approach whereby new money is considered as alternative to debt reduction. The way in which Philippine implemented the Brady Plan was more focused on receiving new finance in order to carry out a buyback transaction which served two purposes: debt reduction at significant discount and as exit vehicle from the new finance. The second part of the debt restructuring granted further debt relief in the context of an already improved economic situation.²¹⁴

VENEZUELA

The restructuring of the Venezuelan debt involved a contextual restructuring of the public and private sector. In 1990 the Brady Plan for Venezuela was agreed with the commercial debtors of the country. The table below sets out the main features of such financing plan, showing, *inter alia*, the amount of debt allocated to each option.²¹⁵

²¹³ R.P. Buckley, *International Financial System, policy and regulation*, Kluwer Law International, 2008, p. 47.

²¹⁴ See L. Buchheit, *The Background to Brady's initiative*, *International Financial Law Review*, 1990, p. 31.

²¹⁵ Table taken from M. H. Stumpf, *Venezuela: separating public and private debt*, *International Financial Law Review*, 1992, p. 36.

1990 Financing Plan							
<i>Option</i>	<i>Interest Rate</i>		<i>Tenor</i>	<i>Collateral</i>	<i>Discount</i>	<i>Debt Allocated</i>	
						(\$ million and as Percentage of Eligible Debt)	
Short-Term Notes	13 week US Treasury Bill Rate		91 Days ⁽¹⁾	100% face value of notes, collateralised with US Treasury Bill	55%	\$1,411	7.2%
Discount Bonds ⁽²⁾	LIBOR + 13/16%		30 years	Principal – zero coupon bond; interest – 14 months coverage	30%	\$1,810	9.2%
Par Bonds ⁽²⁾	6.75%		30 years	Principal – zero coupon bond; interest – 14 months coverage	None	\$7,457	37.8%
Front-Loaded ⁽²⁾ Interest Reduction Bonds	<i>Years</i>	<i>Rate</i>					
	1 & 2	5%	17 years	12 months interest coverage	None	\$3,028	15.3%
	3 & 4	6%	7 years grace	(for 5 years)			
	5	7%					
	6-17	LIBOR + 7/8%					
New Money							
Series A:	LIBOR + 1%		15 years		None	\$480	n.a.
Series B:	LIBOR + 7/8%		7 years grace		None	\$720	n.a.
Debt Conversion Bonds	LIBOR + 7/8%		17 years 7 years grace		None	\$6,022	30.5%
Notes:							
(1) Matured on 17th January, 1991.							
(2) Interest rates and interest collateral for the Par and Discount Bonds are with respect to US dollar denominated Bonds. Interest rates for Front-Loaded Interest Reduction Bonds with respect to US dollar denominated bonds.							
n.a.: not applicable							
Sources: Ministry of Finance and Banco Central.							

The Venezuelan restructuring had several features in common with the Mexican one, with few differences represented by the options of temporary interest reduction bonds and the option of debt buyback at the secondary market price.²¹⁶

No Paris Club debt was restructured;²¹⁷ the debt owned to commercial banks only was restructured in the context of the 1990 Financing Plan.

A peculiarity of this restructuring was that in parallel with the rescheduling of the debt owned by the public sector to external creditors, a plan to restructure the debt owned by the private sector was put in place as well.

In 1990 the Venezuelan Government adopted Decree No 1,307, which provided the delivery of foreign exchange for payment of external private sector debt to be covered by exchange rate guarantees issued by the government. Pursuant to the same Decree, the Central Bank of Venezuela

²¹⁶ R.P. Buckley, *International Financial System, policy and regulation*, Kluwer Law International, 2008, p. 47.

²¹⁷ An analysis of the Paris Club activities and the definition of Paris Club debt will follow in the next paragraphs.

was authorised to: (i) in relation to debts not exceeding the overall amount of USD 10 million, deliver foreign exchange for an amount equal to 35% of the net unpaid amount of such debt; (ii) in relation to debts exceeding USD 10 million, deliver foreign currency denominated 20 year-bonds for up to 70% of the unpaid balance and delivering same kind of bonds for overdue interest on such debt, covered by exchange rate guarantees. As a result of such plan, USD 479 million in foreign exchange was delivered to the debtors.²¹⁸

ARGENTINIA

As final example, we will shortly described the terms of the Argentinian restructurings, which occurred in 1992 and in 2003-2005.

The first restructuring followed the Mexican model and offered to commercial creditors the following options:

- **Par bonds:** 30-year fixed interest rate par bonds. The interest rate was fixed at 4% at year one and then increasing at 6% in year seven. Such bonds were fully collateralised for principal and had a 12-months rollover interest guarantee;
- **Discount bonds:** they had a 35% discount of principal on the original face value of the loans, interest equal to Libor plus 13/16th% and they would benefit from the same collateral as per the par bonds;
- **New Money.**²¹⁹

In the 1990s, Argentina also implemented a major economical reform in compliance with the structural adjustment program requested by the IMF. Examples of such reforms are the liberalization of its capital account by relaxing capital control and pegging the peso to the US Dollar. Notwithstanding the implementation of the reforms suggested by the IMF, in 2001 Argentinian economy collapsed turning what many thought as one of the main success of structural adjustment IMF policy into the

²¹⁸ M. H. Stumpf, *Venezuela: separating public and private debt*, International Financial Law Review, 1992, p. 36.

²¹⁹ R.P. Buckley, *International Financial System, policy and regulation*, Kluwer Law International, 2008, p. 50-51.

biggest sovereign default in modern history.²²⁰ The role of the IMF and criticisms moved to it will be analysed in the following paragraphs.

The starting point of negotiations was the aggressive proposal of the Argentinian Government requesting a 75% nominal haircut and no recognition of past-due interest. At the end of three years of negotiation on 25 February 2005 the USD 102.6 billion debt swap closed. The menu consisted of:

- **Par bonds:** old Brady bonds would be exchanged for a new bond with 3.2% coupon and 35 years maturity;
- **Discount bonds:** old Brady bonds would be exchanged at a nominal discount of 66% with an 8.28% coupon and 30 years maturity;
- **Quasi-par bonds:** old Brady bonds would be exchanged for consumer price indexed Argentine peso denominated bonds, implying a 31% nominal cut due to pesoization, with a 3.31% coupon and 42 years maturity.²²¹

The terms and the conditions of the offering memorandum, quite innovative in respect of the terms of previous offering memorandum of sovereign bonds will be analysed in the following chapter.

The outcome of the restructuring process was a reduction by 30% of Argentinian public debt, accounting for 72% of its GDP.²²²

A more detailed analysis of the debt instruments used in the context of the restructurings briefly reviewed herein will now follow.

b) The Asian Crisis in the 1990s - a liquidity issue

A short overview of the Asian crisis will now follow, mainly in order to highlight some different features of it, since it was defined as a liquidity crisis, versus the over indebtedness crisis of the Latin American countries.

The first symptoms of the crisis manifested in 1997 in Thailand, namely the depreciation of its currency, the baht, and in October a currency crisis²²³ exploded, which shortly after moved to Malaysia and the Philippines too.²²⁴

²²⁰ Id. See also G. Gomez-Giglio, *A new chapter in the Argentine saga: the restructuring of the Argentine sovereign debt*, Journal of International Banking Law and Regulation, 2005, pp. 345-349.

²²¹ See J. Diaz-Cassou, A. Erce Dominguez and J. Vazquez-Zamora, *Recent episodes of sovereign debt restructurings. A case-study approach*, 2008, Documentos Ocasionales Banco de España.

²²² G. Gomez-Giglio, *A new chapter in the Argentine saga: the restructuring of the Argentine sovereign debt*, Journal of International Banking Law and Regulation, 2005, p. 346.

Buckley traces back the origin of crisis to five main causes: (i) the kind of indebtedness incurred by the Asian countries; (ii) excess of liquidity; (iii) the weakness of the financial sector of such countries; (iv) fixed exchanged rates; and (v) loss of confidence in the market.²²⁵

Hagan judged this crisis as a result of the globalization of financial markets.²²⁶ Wade defines it as “panic triggering debt deflation in a basically sound but under-regulated system”.²²⁷ Sachs commented on it saying: “There is no ‘fundamental’ reason for Asia’s financial calamity except financial panic itself. Asia’s need for significant financial sector reform is real, but not a sufficient cause for the panic, and not a justification for harsh macroeconomic policy adjustments. [...] Asia is reeling not from a crisis of fundamentals but a self-fulfilling withdrawal of short-term loans, one that is fuelled by each investor’s recognition that all other investors are withdrawing their claims. Since short-term debts exceed foreign exchange reserves, it is ‘rational’ for each investor to join in the panic”.²²⁸

As noted above, the Brady plan facilitated the development of a secondary market for the sovereign loans, granting access to developing countries to capital markets. At such point in time the source of the majority of the sovereign debt was the issuance of sovereign bonds.²²⁹ The lost of confidence of the market in the Asian economies brought to an outflow of capitals, causing a currency depreciation which had the effect of deepening the crisis.²³⁰ The IMF package prepared to deal with the crisis was ineffective for two reasons: (i) US and Japan did not contribute enough to the bail out, so that the funds available were not enough to address the crisis; (ii) the conditionality imposed by the IMF as condition to the loans required a structural

²²³ Buckley defines the Asian crisis as a “[...] currency crisis developed into a more generalized economic crisis, at least for Indonesia, Thailand and Korea [...]”. R.P. Buckley, *International Financial System, policy and regulation*, Kluwer Law International, 2008, p. 56.

²²⁴ On the history and causes of the crisis see R. Wade, *The Asian debt-and-development crisis of 1997-?: causes and consequences*, World Development, 1998, pp. 1538-1545. For a study of the connection between hedge funds and the Asian crisis, see S.J. Brown, W. N. Goetzmann, J. M. Park, *Hedge funds and the Asian currency crisis of 1997*, Department of Finance, working paper series 1998, 13 January 1998, available at <http://archive.nyu.edu/bitstream/2451/26859/2/wpa98014.pdf>.

²²⁵ Id. p. 56-66.

²²⁶ S. Hagan, *Sovereign debtors, private creditors and the IMF*, Law and Business Review of Americas, 2002, p. 53-54.

²²⁷ R. Wade, *The Asian debt-and-development crisis of 1997-?: causes and consequences*, World Development, 1998, pp. 1538.

²²⁸ J. Sachs, *The IMF and the Asian flu*, The American Prospect, March-April 1998, p.17.

²²⁹ As already observed above, the Philippines were one of the first countries to issue bonds according to the implementation of a Brady plan.

²³⁰ On the relevance of management of capital flows in emerging markets see R.P. Buckley, *International capital flows, economic sovereignty and developing countries*, Yearbook of International Financial and Economic Law, 1999, pp. 17-46.

reform of the economy of the Asian country involved, which was interpreted by the market as a sign of the unsoundness of the economy of such countries, pushing investors to withdraw from them.²³¹

The IMF has been criticized for how it dealt with the Asian crisis, arguing that it was not able to understand the real causes of the crisis, delivering consequently the wrong diagnosis and imposing measures which were judged as too harsh, and which did not keep into account social consequences.²³²

Trying to draw a conclusion, the Asian crisis could be defined as one of the first modern crisis, whereby over indebtedness is one of the components of the crisis, but not the main reason, contrary to what happened in the Latin American countries. The access of developing countries to capital markets exposed them to new risks and changed the rules of how to deal with the crisis, as it will be analysed in the fourth chapter.

²³¹ Wade commented that the IMF intervention during the Asian crisis “amounted to screaming fire in the theatre”. R. Wade, *The Asian debt-and-development crisis of 1997-?: causes and consequences*, World Development, 1998, pp. 1543.

²³² For a critique of the IMF work in the context of the Asian crisis see R.P. Buckley, *International financial system, policy and regulation*, Kluwer Law International, 2008, pp. 66-73.

2) FINANCIAL STRUCTURES USED IN THE CONTEXT OF SOVEREIGN RESTRUCTURINGS

The following pages mechanics used in sovereign workout since the Brady era will be analysed, trying to highlight pros and cons of each instrument.

a) Brady bonds, securitization and secondary market

The innovative idea of the Brady Plan, as it has been observed above, was to securitize sovereign loans, by converting syndicated loans into bonds (the so-called Brady Bonds). The classical Brady Plan would set forth the steps to pool together all the loans which a single country owed to its commercial creditors, repackage them as bonds which were then offered to the public or exchanged for existing loans owned by the creditors. The proceeds of the bonds are used to refinance the loans (or portions of the loans) either by means of new money received by the public or by means of set off against outstanding loans in case of exchanges with existing loans, so that the country's obligations under the various loan agreements are extinguished at the end of the process, either because the debts have been repaid in full or because they have been partially repaid and partially waived by the creditors.²³³

The securitization of loans was beneficial both for the banks, which were provided with an exit option, so that they could put an end to the cycle of debt rescheduling and could take off their books the distressed sovereign loans²³⁴, and for the sovereign country for the following reasons:

- Brady bonds were issued at a discount either in principal or interest from the loans from which they were converted (as noted in the review of the implementation of Brady Plans in the restructuring of sovereign debts in the previous paragraphs), reducing the sovereign's debt service obligations;
- Most Brady bonds had a 30-years maturity date, which was a maturity considerably longer than the maturity of the loans from which they were converted;

²³³ P.J. Power, *Sovereign Debt: the rise of the secondary market and its implications for future restructurings*, Fordham Law Review, 1996, p. 2720, 2721. See also R.P. Buckley, *Lessons from the globalisation of the emerging debt market*, Journal International Banking Law, 2000, p. 103-108.

²³⁴ Securitization gave the banks liquid bonds, rather than relatively illiquid loans. It also triggered a turnaround in secondary market prices that improved the values of the banks' portfolio. It also opened the door for the debtors to return to the voluntary capital markets by bond issuance from which the banks, as underwriter, profited. The Brady Plan, permitting broader ownership of the debt, signalled the end of the 1982 crisis as a threat to the stability of the international financial system. Securitization permitted banks to sell the debt to a broad cross-section of investors and not simply to each other. Banks could liquidate their entire portfolio of less developed countries sovereign loans, if they wished. See R.P. Buckley, *The facilitation of the Brady Plan: emerging markets debt trading from 1989 to 1993*, Fordham International Law Journal, 1998, p. 1887.

- Brady bonds were collateralised, as seen above, for principal by zero-coupon US Treasury bonds of matching maturities and for interest, usually 12-18 months, by a rollover guarantee, making remote the possibility of a default, at least in respect of the principal amount.²³⁵

The effect of the securitization of the bank loans was also to create a new creditor class, the bondholders. The restructurings pre-Brady had been characterised by a small and homogeneous class of commercial bank creditors. Future restructurings had to deal with a diverse class of creditors made up by pension and mutual funds, insurance companies, investment firms and sophisticated individual investors which are not subject to the same external institutional pressures to participate in sovereign debt restructurings as commercial banks were.²³⁶ The consequences of this transformation of the class of creditors will be further analysed in the following chapter.

As anticipated in the previous paragraphs, the success of the Brady Plan was connected with the development of the secondary market, which facilitated the acceptance by creditors of the innovative features of sovereign restructurings.²³⁷

Such facilitation was due to four main factors:

- The secondary market provided for a prototype: the relevant parties could see their loans being traded each day and that made it easy for them to conceive the securitization of such loans into bonds;
- The existing secondary market could have been a market for bonds: the existing market could readily adapt to the trade of bonds, making the banks comfortable of the possibility to trade such new debt instruments;
- The market had already foreseen appetite for such bonds: the active trading of loans on the secondary market was as strong indication that investors would have been interested in purchasing distressed sovereign loans converted into bonds;²³⁸

²³⁵ P.J. Power, *Sovereign Debt: the rise of the secondary market and its implications for future restructurings*, Fordham Law Review, 1996, p. 2720, 2721.

²³⁶ Id. pag. 2763-2764. See also R.M. Auerback, *Sovereign Debt – Default and restructuring of debts owed to private creditors*, Journal of International Banking Law and Regulation, 2003, pp. 444-445.

²³⁷ See also L. C. Buchheit, *The capitalization of the sovereign debt: an introduction*, University of Illinois Law Review, 1988, pp. 401 ff. and M. Monteagudo, *The debt problem: the Baker Plan and the Brady Initiative: a Latin American perspective*, The International Lawyer, spring 1994, p. 68-69 and 71-72.

²³⁸ On the criteria to establish secondary market price see W. Elali, *Debt-Equity swaps and the alleviation of the LDCs debt problem*, International Journal of Commerce & Management, 1995, p. 68, footnote 10.

- The discount offered on the secondary market was a strong argument for debt relief: it was difficult for banks to oppose to debt relief in the securitization process when most banks were already selling their loans at steep discounts in the secondary market.²³⁹

On the other hand, the conversion of an always increasing amount of loans into bonds resulted into the transformation of the secondary market itself, which had now to meet the needs of new investors: the market which used to be a small and heavily negotiated one turned into something more similar to a standard securities market.²⁴⁰ Bond trades became cheaper and quicker, the number of investors raised, since many prohibitions preventing them from investing in loans were not applicable to bonds and since a Brady restructuring was seen as a stamp of approval for a nation's economic policies so that Brady bond would benefit from the perceived improvement in the creditworthiness of the country. As a result, in 1992 it was estimated that more than USD 500 billion face value of less developed countries debt was traded.²⁴¹

b) Debt buy-backs

As anticipated in the previous paragraphs, debt buy-backs consist in the acquisition of debt by the debtor itself either directly from its creditors or in the secondary market.

From a creditors' perspective, debt buy-backs were not particularly welcome for the following three reasons²⁴²:

- Lenders interpreted the buy-backs mechanic as a mere transfer of the debtors' foreign exchange reserves to the selling banks. Truth is that such transfer would have only occurred in case the buy-back price had overvalued the debt, in other words if the real value of the debt was less than the price paid in the context of the buy-back. Supporting the not sharable theory that secondary market undervalued the real value of

²³⁹ R. P. Buckley, *The facilitation of the Brady Plan: emerging markets debt trading from 1989 to 1993*, Fordham International Law Journal, 1998, p. 1886-1887.

²⁴⁰ See R.P. Buckley, *The Facilitation of the Brady Plan*, Fordham International Law Journal, 1998, pp. 1875 ff.

²⁴¹ Id. pag. 1876.

²⁴² See R.P. Buckley, *Debt exchanges revisited: lessons from Latin America for Eastern Europe*, Northwestern Journal of International Law & Business, 1998, pp. 676-681.

debts, major commercial banks involved in the LDC loan market were able to create a strong impediment for the growth of buy-backs.

- Buy-backs had an obvious debt forgiveness component. Debtors were able to discharge their debts at discount prices. Many lenders of the time would consider buy-backs as an excessive gift to sovereign debtors.
- Buy-backs as moral hazard, already mentioned in the previous paragraphs. Moral hazard was any situation in which the sovereign debtor is rewarded for its financial misbehaviour.²⁴³ Being the secondary market acutely sensitive to the actions of the debtor country, the debtors had a direct tool to operate on the prices of its own debt, to facilitate buy-backs transactions.

The only pros for creditors were that this was an efficient way to get distressed loans out of the banks books and to avoid to be forced into the practice of involuntary lending, as noted in the previous paragraphs.

From the sovereign borrowers' perspective, debt buy-backs had only two downsides: (i) they would not represent a replacement for foreign direct investment (as equity swaps, as we will highlight in the following paragraph); (ii) some argue they would produce a negative effect for the return of the debtor country to financial markets, since the stigma of having bought its own debt at a high discount would label the debtor country as one to which prospective lending business would not be acceptable.²⁴⁴

The positive aspects for the borrower, beyond the debt relief component, which was obviously the most important one, were: (i) debt buy-backs had not inflationary effects, since they were made in foreign currency and funded from foreign exchange reserves, not involving therefore printing money nor issuing local currency bonds; (ii) the debtor nation retained its productive national assets; and (iii) they did not favour foreign investors over local ones.²⁴⁵

Under the banking technical point of view, debt buy-backs would require amendments in the underlying loan documentation.²⁴⁶ Amendments were

²⁴³ See. R.P. Buckley, *Moral hazards and other delights*, International Financial Law Review, 1991.

²⁴⁴ See. M. Monteagudo, *The Debt Problem: the Baker Plan and the Brady Initiative: a Latin American perspective*, The International Lawyer, spring 1994, p. 71.

²⁴⁵ R.P. Buckley, *Debt Exchanges Revisited: lessons from Latin America for Eastern Europe*, Northwestern Journal of International Law & Business, 1998, p. 681.

²⁴⁶ No amendments were required in case the purchase of sovereign debt was carried out not directly by the debtor but by state-owned companies or in case the debtor appoints a third party

necessary because loan agreements would usually include the following clauses²⁴⁷:

- **Sharing clause:** according to which payments received by any creditor through exercise of any right of counterclaim, set-off or otherwise, which exceed what has been received by any other creditor should be shared with the other creditors so that all creditors benefit equally for any recovery;
- **Prepayment clause:** according to which any prepayments by the debtor should be on certain dates and in multiples of a certain amount;
- **Mandatory prepayment clause:** which typically confers remedies to the lenders in case the debtor services comparable indebtedness in a manner preferential to its servicing the lenders under the loan agreement.²⁴⁸

Debt buy-backs could trigger such provisions since it could be interpreted as a payment received by the selling bank only and as a prepayment from the borrower. In order to proceed with the purchase of its own debt, therefore, the debtor had to receive the lenders' consent to a waiver of the terms of the loan agreement or to agree with the lenders an amendment to the loan agreement.²⁴⁹

Examples of debt buy-backs arrangements are the 1988 Bolivian agreement and the Chilean agreement of the same year, which implement different approaches.

The Bolivian agreement provided for the acquisition by Bolivia of USD 253 million paying USD 28 million, which had been funded by means of donations received by several countries and managed by the IMF. Bolivia had offered the banks two options: (i) being paid in cash; (ii) being paid by

to but the debts and acquires beneficial ownership of the debts through participation share. See R.P. Buckley, *Moral hazard and other delights*, International Financial Law Review, 1991.

²⁴⁷ R.P. Buckley, *The transformative potential of a secondary market: emerging markets debt trading from 1983 to 1989*, Fordham International Law Journal, 1998, p. 1220.

²⁴⁸ Furthermore, other technicalities would need to be amended in order not to put the borrower into a technical default, such as: (i) breakage costs provisions, which protect lenders against any loss due by a repayment by the debtor on a date which breaks into the lenders' matched funding of the loan; (ii) certain provisions regarding the maintenance of foreign currency accounts with the debtor nation's central bank; (iii) certain events of default. Id.

²⁴⁹ On the difficulties connected to amend the terms of a loan agreement due to unanimity requirement inserted in amendment clauses of restructuring agreements see R.P. Buckley, *Making amends for amendments*, International Financial Law Review, 1991, pp. 11-12.

exchange of zero coupon bonds collateralised by triple-A rated bonds held in trust by the IMF.²⁵⁰

Chile was able to repay in full its USD 439 million for USD 248 million. Chile arguments to convince banks to accept this agreement was its good record of timely service and its current availability of foreign exchange due to the rise in world copper price in the previous years.²⁵¹

c) Debt-for-equity swaps

Debt-equity conversion is the “process through which any debt instrument issued by or on behalf of any development country borrower, public or private, is converted into an equity investment in that country”²⁵². The debt can be usually swapped for (i) equity in local business; or (ii) used for capital investments in the debtor nation.²⁵³

Such conversion programs require the debtor country to establish its debt-to-equity policies and procedures, such as industries in which swaps are allowed, the sources of local currency to be utilised, the administrative process to review and approve the swaps and the conversion rate.²⁵⁴ The

²⁵⁰ The transaction brought to the cancellation of about 50% of Bolivian external debt with banks. M. Monteaugudo, *The debt problem: the Baker plan and the Brady initiative: a Latin American perspective*, The International Law, spring 1994, p. 71.

²⁵¹ Id.

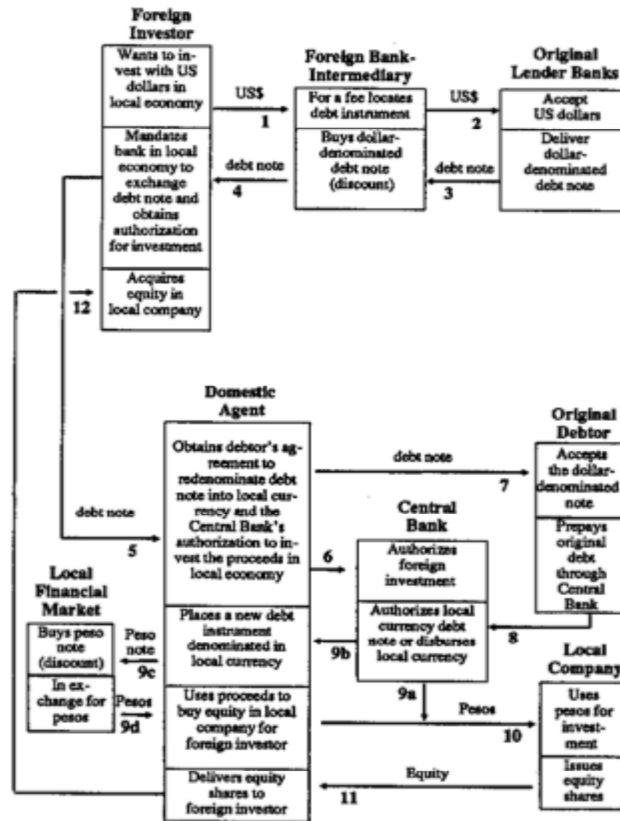
²⁵² A. Hilton, Debt-Equity swaps: costs, benefits and prospects, Financial Times Business Information, 1988. A proposal coming from two economists of the Massachusetts Institute of Technology was to structure debt-to-equity swaps in the context of a sovereign debt restructuring in the following way: the debtor country should have been allowed to pay interests on its loans or bonds in local currency, and then the creditors would have been allowed to invest such local currency in the country itself. Dividends and other proceeds deriving from such investments should have been then paid in local currency to such investors/creditors and after a certain period such payments in local currency would have been eligible for conversion into foreign exchange. See F. Modigliani and R. Dornbusch, *Easing the Mexican interest burden*, Wall Street Journal, 3 January 1989.

²⁵³ On the mechanics of debt-to-equity swaps see W. Elali, Debt-equity swaps and the alleviation of the LDCs debt problem, *International Journal of Commerce & Management*, 1995, pp. 60-62 and D. Asiedu-Akrofi, *A comparative analysis of debt equity swap programs in five major debtor country*, *Hastings International and Comparative Law Review*, 1988-1989, pp. 540-541.

²⁵⁴ The exchange rate can either be fixed by the central banks or the rate can be established through an auction so that investors bid for their right to covert their debt into equity. See M. Schubert, *Trading debt for Equity*, the Banker, 1987, p. 18. The attraction of such schemes is that investor who has receive, for example, 88 cents worth of pesos for one dollar of debt, may have paid only 50 or 60 cents on the dollar. R.P. Buckley, *The transformative potential of a secondary market: emerging markets debt trading from 1983 to 1989*, *Fordham International Law Review*, 1997-1998, p. 1179. On regulation aspects for the debtor country see L. Maktouf, *Some reflections on debt-for-equity conversions*, *The International Lawyer*, winter 1989, p. 915-916. On the implementation of conversion programs in developing countries see D. Asiedu-Akrofi, *A comparative analysis of debt equity swap programs in five major debtor country*, *Hastings International and Comparative Law Review*, 1988-1989, pp. 541-565 and the *Guide to Debt Equity Conversions*, pp. 68-110.

table below summarizes the key steps and shows the key actors of the conversion process:²⁵⁵

Table 1. Principal elements involved in debt equity conversion procedures



Source: UNCTC/ECLAC Joint Unit, based on World Bank, *World Development Report 1987*, Washington, D.C., 1988.

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From the debtor's perspective, the advantages that debt-equity swaps highlighted by literature are the following²⁵⁶:

- It is a strong incentive for foreign direct investment, due to the favourable exchange rates offered by such programs;²⁵⁷

²⁵⁵ Table taken from United Nations Centre on Transnational Corporations, *Debt equity conversions, a guide for decision-makers*, 1990, p. 7.

²⁵⁶ R.P. Buckley, *Debt exchanges revisited: lessons from Latin America for Eastern Europe*, *Northwestern Journal of International Law & Business*, 1998, pp. 660-662, L. Maktouf, *Some reflections on debt-to-equity conversions*, *The International Lawyer*, winter 1989, pp. 909-919 and D. Asiedu-Akrofi, *Comparative analysis of debt equity swap programs in five major debtor countries*, *Hastings International and Comparative Law Review*, 1988-1999, pp. 537-573.

- Transfer of resources: this program represented a channel through which technology, patents, new management skills etc. could be introduced in developing countries;²⁵⁸
- Replacement of debt with equity: the conversion of the debt into equity implies the reduction of the outstanding external debt of the debtor and the related debt service obligations;²⁵⁹
- Repatriation of flight capital: the favourable exchange rate would make attractive the repatriation of flight capital by local investors;²⁶⁰
- “De-dollarization”: since in the short term these programs convert an obligation to be serviced in foreign exchange into a local currency obligation.²⁶¹
- Encourages private sector initiative and can support privatization programmes: in cases it facilitated the privatization of not profitable state-owned companies which represented a burden for the debtor country’s economy.²⁶²

However, debt for equity swaps have drawbacks too,²⁶³ some of them quite relevant, reason for which debt buy-backs have been generally considered as

²⁵⁷ See United Nations Centre on Transnational Corporations, *Debt Equity Conversions: a guide for Decision-makers*, United Nations, 1990 (hereinafter the Guide to Debt Equity Conversions), p. 36, L. Maktouf, *Some reflections on debt-for-equity conversions*, Journal of International Law, 1989 and W. Elali, *Debt-equity swaps and the alleviation of the LDCs debt problem*, International Journal of Commerce & Management, 1995, p. 64.

²⁵⁸ Elali id.

²⁵⁹ Chile is a successful example of the good outcome of debt-to-equity swaps since in the first three years of implementation of such programs was able to reduce its external debt by USD 3.8 billion. However, generally speaking, the benefit of this kind of debt relief can be set-off by the burden of repaying a portion of the debt in local currency and having to deal with the capital repatriation on equity investment. To address such concern, many debt-equity schemes would include restrictions on capital repatriation and profit remittances. R.P. Buckley, *Debt exchanges revisited: lessons from Latin America for Eastern Europe*, Northwestern Journal of International Law & Business, 1998, pp. 661 and the Guide to Debt Equity Conversions p. 37-38.

²⁶⁰ W. Elali, *Debt-equity swaps and the alleviation of the LDCs debt problem*, International Journal of Commerce & Management, 1995, p. 64.

²⁶¹ The Guide to Debt Equity Conversions, p. 39 and W. Elali, *Debt-equity swaps and the alleviation of the LDCs debt problem*, International Journal of Commerce & Management, 1995, p. 64. However, as Blackwell and Nocera pointed out, in case the project financed was successful, the conversion would actually results into a long term foreign exchange obligation, therefore in case no restrictions are imposed to this kind of investments, the overall effect on the balance of payments would be negative, since payments abroad deriving from the initial equity investment would exceed the payment of interests on the converted external debt. See M. Blackwell and S. Nocera, *The impact of debt to equity conversion*, Finance & Development, 1988, p. 15-17

²⁶² The Guide to Debt Equity Conversions, p. 38

²⁶³ See L. Buchheit, *The capitalization of sovereign debt: an introduction*, University of Illinois Law Review, 1988, pp. 401-414 and the Guide to Debt Equity Conversions p. 39-43.

a better option to improve the sustainability of the debt of sovereigns. The main disadvantages of such programs are as follows:

- Political concerns: foreign investors taking part to these transactions would raise worries in respect of the sovereign control over natural resources;²⁶⁴
- Inflationary consequences: since the debtor country in order to implement this kind of program has to print cash (or issue short-term bonds in local currency), to fund the conversions;²⁶⁵
- Substitute for fresh investment (additionality): the conversion of the external debt of a country does not represent extra foreign exchange and capital for the country. In case the program facilitates only investment which would have been implemented anyway (therefore are not additional to what had already been planned), that negatively impacts on the country's economy since in absence of the debt-equity swaps, the same investments would have been carried out at more favourable exchanges rates for the country and would have implied an injection of foreign currency in the country which instead did not occurred.²⁶⁶
- Round tripping transactions: debt to equity conversions represent a way for foreign exchange value of the local currency exceeds the value of the local currency by another conversion back into foreign currency and then back into local currency by a further conversion. In this way, external debt is converted into local currency in such a way that the foreign exchange value of the local currency exceeds the value of the local currency exceeds the value of the converted external debt. This will result in a higher local indebtedness for the sovereign debtor. Ways to prevent round tripping are: (i) introducing restrictions on the use of proceeds of the conversion, so that such proceeds will be invested in approved projects; and (ii) prohibitions on

²⁶⁴ W. Elali, *Debt-equity swaps and the alleviation of the LDCs debt problem*, International Journal of Commerce & Management, 1995, p. 65.

²⁶⁵ R.P. Buckley, *Debt exchanges revisited: lessons from Latin America for Eastern Europe*, Northwestern Journal of International Law & Business, 1998, pp. 662 and E. Burton, *Debt for Development*, Harvard International Law Journal, 1990, p. 236-237, pointing out the social consequences of debt-equity swaps for the country.

²⁶⁶ M. Blackwell and S. Nocera, *The impact of debt to equity conversion*, Finance & Development, 1988, p. 17 and the Guide to Equity Debt Conversions. W. Elali, *Debt-equity swaps and the alleviation of the LDCs debt problem*, International Journal of Commerce & Management, 1995, p. 65.

repatriation of principal or payment of dividends for a number of years post conversion.²⁶⁷

- Disparity for local investors: since debt to equity schemes granted to investors preferential exchange rates but local investors in most countries were prohibited to partake to such schemes. This would result in local resentment towards the government policies;²⁶⁸
- Misallocation of resources: resulting from inefficiencies in increased investments, as those going into sectors of the economy sheltered by tariffs and quotas.²⁶⁹ Investments if not correctly controlled, could actually worsen the structural imbalances of the country's economy.²⁷⁰

Buckley, drawing his conclusion on this mechanism, expresses an overall negative judgment of it from the perspective of the debtor's country.²⁷¹ The theoretical advantages in concrete turned out to be not as positive as required in order to set off the number of disadvantages listed above. Blackwell and Nocera comment on the balance between pros and cons stating that such programs can improve the overall debt position of a country but that: "It must be acknowledged, however, that the limitations imposed by monetary,

²⁶⁷ L. Buchheit, *Debt equity conversions programmes from the debtor country's perspective*, in Guide to Debt Equity Swaps, special report 1104, ed. S.M. Rubin, 1987 and Elali id. In Chile round-tripping transactions were described with the name of "bicicletas". Buckley, however, highlights how no literature could be found on this aspect of the market, giving the following reasons for the lack of discussions on the point: "(i) most bicicletas involved exploiting the inability of the local central banks to control the loopholes in their complex debt-equity and currency control regulations – the transactions would typically be within the letter but not the spirit of the regulations, and thus were likely to invoke the displeasure of the central bank if they came to light; (ii) at times bicicletas involved transactions of dubious legality in terms of exchange control regulations; (iii) and the trading desks earning handsome returns from the bicicletas knew that the profitability would be squeezed from these transactions if too many traders learned of, and participated in them. See R.P. Buckley, *The transformative potential of a secondary market: emerging markets debt trading from 1983 to 1989*, Fordham International Law Journal, 1998, pp. 1221-1225.

²⁶⁸ L. Buchheit Id.

²⁶⁹ M. Blackwell and S. Nocera, *The impact of debt to equity conversion*, Finance & Development, 1988, pp. 15-17.

²⁷⁰ In order to prevent such negative effect most countries would try to force investors to channel the proceeds of the conversions in priority sectors of the economy, as those that generated exports and foreign exchange, or into depressed geographical regions of the country. See L. Maktouf, *Some reflections on debt-for-equity conversions*, Journal of International Law, 1989, p. – and R.P. Buckley, *Debt exchanges revisited: lessons from Latin America for Eastern Europe*, Northwestern Journal of International Law & Business, 1998, p. 664.

²⁷¹ R.P. Buckley id pp. 667-669.

fiscal and other economic considerations mean that the amount of debt-equity swaps that can be financed has to remain somewhat limited".²⁷²

From the lenders' perspective, debt-for-equity swaps have the same advantages and disadvantages as per the debt buy-backs transactions.²⁷³

d) Debt for nature swaps

The concept of debt for nature was created as variation from the concept of debt for equity swaps. As general observation, in fact, the debt burden of developing countries and the incapacity of developing countries to protect its own natural resources were deeply interconnected. As result of the poor status of their public finance, developing countries had no funds to take care of the environment and poverty would also push such countries to overexploit their own natural resources.²⁷⁴ Debt-for-nature swaps tried to address both problems using a single transaction.

The debt for nature conversion process consist in the purchase by a "green" investor of a portion of the sovereign debt on the secondary market or by the selling bank which is then converted in local currency (or a long term bonds denominated in local currency) and donated to the debtor country upon agreement that it will contribute such amount into a project for the conservation of its own territory or it will be used directly by the environmental groups to implement a specific project.²⁷⁵

The first two countries to implement such schemes were Bolivia and Costa Rica in the late 1980s, the so-called "first generation" debt-for-nature swaps. In Bolivia, the swap was structured as follows: the environmental group Conservation International purchased from on of Bolivia commercial creditor a portion of Bolivian debt with a face value equal to USD 650,000 for a

²⁷² M. Blackwell and S. Nocera, *The impact of debt to equity conversion*, Finance & Development, 1988, p. 17.

²⁷³ On creditors constrains on debt equity transactions, see the Guide to Debt Equity conversions, pp. 51-61.

²⁷⁴ See J.E. Gibson and W.J. Schrenk, *The enterprise for the Americas initiative: a second generation of debt-for-nature exchanges - with an overview of other recent exchange initiative*, George Washington Journal of International Law and Economy, 1992, pp. 1-70. On the machanics of this kind of swap see also N.M. Dillon, *The feasibility of debt-for-nature swaps*, North Carolina Journal of International Law and Commercial Regulation, 1991, pp. 127-140.

²⁷⁵ Environmental group have structured such transactions in various ways: (i) some would donate the purchased debt to affiliate member which operate in the debtor country and then such affiliates would start a relationship with the government; (ii) some would convert the debt into local currency and then they would dedicate such amount to support a specific project. Id. On the transactional aspects of the negotiation of debt-for-nature swaps see M. Lachmann, *Debt-for-nature swaps: a case study in transactional negotiation*, Journal of Contemporary Legal Issues, 1989, p 139-171.

purchase price equal to USD 100,000. Conservation International then converted such amount on the basis that in exchange the Bolivia government would have set up a 4 million acres Amazon rain forest natural reserve.²⁷⁶

Costa Rica developed a more sophisticated arrangement, according to which the Government undertook to pay to any person willing to donate its sovereign debt for conservation project 75% of the face value of its debt, not taking into account the price at which the debt was traded on the secondary market. However, the government, in order to have a strict control over the funds, would not pay the purchasers of the debt, but it would transfer the money directly to a special fund (the Natural Resources Conservation Fund), dedicated specifically to environmental projects. An upside of this program was its capacity to pool funds coming from multiple small environmental organizations, which otherwise would have not been able to implement such project on their own. The appreciation by the public and the effectiveness of this structure was such that Costa Rica was able, as of late 1989 Costa Rica, to reduce its debt up to USD 75 million by means of it.²⁷⁷

Other developing countries follow such approach in the following years, such as Brazil, Ecuador, the Philippines, Madagascar and Zambia.²⁷⁸

From the country's perspective, this process had raised some concerns in respect of the claimed lost of sovereignty over the portion of territory that was object of the "eco-swaps". In some cases local people would accuse the environmental group managing the territory pursuant to such debt-for-nature swaps to interfere with the government right to govern its lands.²⁷⁹

The impact of this kind of swaps on the debt reduction process of the countries was relatively small, however using as criteria for the assessment the effects on the preservation of the nature that they were able to produce,

²⁷⁶ See the Guide to Equity Debt Conversions p.15-16. See also M. Chamberlin, M. Gruson and P. Weltchek, *Sovereign debt exchanges*, University of Illinois Law Review, 1988, p. 441-443 and J.E.Gibson and W.J. Schrenk, *The enterprise for the Americas initiative: a second generation of debt-for-nature exchanges – with an overview of other recent exchanges initiatives*, George Washington Journal of International Law and Economics, 1991, pp. 7-9.

²⁷⁷ Id. p. 16. See also M. Chamberlin, M. Gruson and P. Weltchek, *Sovereign debt exchanges*, University of Illinois Law Review, 1988, p. 445 footnote 115 and M. Lachmann, *Debt-for-nature swaps: a case study in transactional negotiation*, Journal of Contemporary Legal Issues, 1989, p 144-145.

²⁷⁸ For an overview of the programs implemented in such countries see J.E. Gibson and W.J. Schrenk, *The enterprise for the Americas initiative: a second generation of debt-for-nature exchanges – with an overview of other recent exchanges initiatives*, George Washington Journal of International Law and Economics, 1991, pp. 12-15 and D. Asiedu-Akrofi, *Debt-for-nature swaps: extending the frontiers of innovative financing in support of the Global Environment*, The International Lawyer, 1991, pp. 565-571.

²⁷⁹ See R.P. Buckley, *Debt exchanges revisited: lessons from Latin America for Eastern Europe*, Northwest Journal of International Law & Business, 1998, p. 241-243.

the final judgment was definitely positive.²⁸⁰ Some authors defined them as “one of the few types of Latin American debt transactions in which all participants can rightfully claim benefits”.²⁸¹ Costa Rica, for instance, received a considerable amount of funds dedicated to its nature, which would have never been able to channel to such purpose otherwise, since its agreement with the IMF would prevent it from raising its budget for maintenance of national parks.²⁸²

In the late 1980s and early 1990s a second kind of debt-for-nature swaps were introduced: the so-called “second generation” debt-for-nature exchanges.²⁸³ The innovative element of such transactions was that the debt to be swapped was the external debt that developing countries owed to governments, the Paris debt.²⁸⁴ The relevance of this kind of government-to-government swaps was that larger amounts of debt could be actually invested in environmental oriented projects. Debt exchange programs to convert debt deriving from Official Development Assistance were introduced as well.

Second generation debt-for-nature exchanges were implemented in 1989 in Costa Rica, in 1991 in Poland and in 1995 in Bulgaria.²⁸⁵

An innovative aspect of such agreements was the insertion of enforcement measures which enabled the donor countries to maintain control over the projects financed by means of: (i) control over the selection process of projects to be financed; (ii) inspectional powers, which entitled the donor country to interrupt the financing in case the debtor country was not compliant with the terms of the exchange agreement.²⁸⁶

²⁸⁰ See M. Lachmann, *Debt-for-nature swaps: a case study in transactional negotiation*, Journal of Contemporary Legal Issues, 1989, p 141-142 and on the domestic awareness effect that swap-for-nature have see also D. Asiedu-Akrofi, *Debt-for-nature swaps: extending the frontiers of innovative financing in support of the Global Environment*, The International Lawyer, 1991, pp. 577-578.

²⁸¹ M. Chamberlin, M. Gruson and P. Weltchek, *Sovereign debt exchanges*, University of Illinois Law Review, 1988, p. 441.

²⁸² C. Jochnick and F. A. Preston, *Sovereign debt at the crossroads*, Oxford, 2006. For a costs and benefits analysis see also id. p. 445-446. On the possible application of debt-for-nature swaps in the sub-Saharan Africa see P. M. Nichols, *Swapping debt for development: a theoretical application of swaps to the creation of microenterprise lending institutions in sub-Saharan Africa*, International Law and Politics, 1994, pp. 43-102.

²⁸³ C. Jochnick and F. A. Preston, *Sovereign debt at the crossroads*, Oxford, 2006.

²⁸⁴ See S. Freeland and R.P. Buckley, *Debt-for-development exchanges: using external debt to mitigate environmental damage in developing countries*, West Northwest Journal of Environmental Law and Policy, 2010, pp. 84-91.

²⁸⁵ Id. pp. 85-89.

²⁸⁶ Id. p. 85. As interesting further development on the point, see the description of the potential synergies between debt-for-nature exchanges and Clean Development Mechanism set forth by the Kyoto Protocol in Indonesia, id. pp. 97-100.

This mechanism, however, suffers from the lack of a secondary market for official bilateral debt, which does not allow the potential private donors to benefit from the steep discounts that a market may offer. Investors in fact would have to pay the debt at the discount granted to the debtor country in accordance with the terms of the Paris Club agreement (which will be analysed in the following paragraphs). The investor therefore may find cheaper to buy local currency in the secondary market, creating a disincentive to the implementation of this kind of transactions by private actors.²⁸⁷

e) Debt for development swaps

Debt-for-development swaps were introduced shortly after the implementation of the first debt-for-nature exchanges. Their structure is exactly the same as the “eco-swaps” but their target is different: debt conversion is used in this context to fight hunger and disease and to promote more generally the development of the country. A further version of this kind of exchanges is represented by the debt-for-education swaps, whereby the final aim is not generically development but improving the education system of developing countries.²⁸⁸

From a results point of view, the value of debt-for-development exchanges had much more success than debt-for-nature swaps. It has been calculated that in the period between 1987-1994, the face value of developing countries debt cancelled because of “eco-swaps” was equal to USD 750 million, while debt-for-development swaps reached the significant result of USD 1 billion of debt cancellation.²⁸⁹

The advantage of this kind of transactions in comparison with the debt-for-nature swaps is that they do not raise criticism in respect of sovereignty issues.²⁹⁰

²⁸⁷ See J. Kaiser and Lambert, *Debt swaps for sustainable development-a practical guide for NGO's*, IUCN, 1996 (hereinafter the Debt Swaps for Sustainable Development Guide).

²⁸⁸ See R.P. Buckley, *Debt exchanges revisited, lessons from Latin America for Eastern Europe*, *Northwestern Journal of International Law & Business*, 1998, pp. 673-674.

²⁸⁹ Debt Swaps for Sustainable Development Guide.

²⁹⁰ On the transactional aspects of a debt-for development agreement, see E. Burton, *Debt for development: a new opportunity for non-profits, commercial banks and developing states*, *Harvard International Law Journal*, winter 1990, pp. 233-256.

Concluding on both nature and development for debt exchanges, a couple of observations on the effects on the constituents of these structures, applicable to both debt and development kind of transaction, will follow.

From the perspective of the debtor country, this represent a way to get relief from the debt servicing of the portion of debt purchased by the private party. It will also achieve the improvement of the overall living conditions of the population, channelling funds directly to specific projects set up for such purpose. Since the amounts to be converted are not excessively big, they do not trigger the risk of inflationary results, as per the debt for equity swaps.

From the perspective of the private party (NGO's or other entity), this is an effective way to strengthen their spending power in respect of their project, offering local currency at discounted prices. A moral dilemma was raised by the non-profits since they feel that such programs is for the benefit of commercial banks too, which to the contrary, in their opinion, should not request the repayment of the debt from such poor countries.²⁹¹

Finally, private creditors of developing countries take the view that being repaid in part is anyway better than not being repaid at all. The only issue they may encounter is if non-profits request them to sell their loans at prices which are more favourable than secondary market prices, on the grounds that a higher level of debt relief is necessary.²⁹²

Overall, therefore, it can be shared the view that the great potential of such transactions is their capacity to address the needs of all the parties involved, resulting into what could be judged as a win-win situation for all.

f) Debt relief, the HIPC initiative and odious debt

Debt relief represents obviously the most favourable approach to unsustainable debts burdens from the debtor countries' perspective. This paragraph will first do a short introduction on debt relief in general and then will focus on a specific initiative set up for highly indebted countries and finally it will take into account the doctrine of the odious debt.

(i) Debt relief

²⁹¹ Id. p. 254.

²⁹² Id. p. 255.

The idea of debt relief is based on two general observations: (i) some countries are too poor to repay their debts without inflicting unbearable suffering to their population; and (ii) some debts were not legitimate. We will focus on the second point in the paragraph related to the odious debt doctrine.

Debt relief has an ethical component in those cases in which the burden of debt is so heavy that the governments cannot serve the basic functions of a state in a civilized society. An ethical approach to finance would impose lenders not to profit at the expenses of the poorest, requiring debt forgiveness any time servicing the debt makes a country unable to provide its population with basic social services.

From the lenders' perspective, creditors are generally against debt relief on the basis that it creates a moral hazard, rewarding the debtor who has not repaid its debt and that it makes it harder for the debtor to have access again to capital markets in the future. Debt relief obviously implies great losses for the creditors and in the past was able to put at risk the stability of the credit institutions lending to developing countries, in cases in which their exposure in respect of the country requesting the write off is very high, as for American banks at the beginning of the Latin American crisis in the 1980s, as already observed.

However, in extreme circumstances, when all parties involved consider the debt of a country as clearly unsustainable, debt relief is the only remaining option. Creditors agree upon writing off portion of their debt in the hope that by improving the economical conditions of the debtors they will eventually be repaid at least partially.

Historically, in order to proceed with cancellation of debt, creditors would evaluate whether in absence of such relief the country would default on its external debt, in other words if the country was in a situation of imminent default.²⁹³ In case such test was passed, debt relief was usually granted both by multilateral creditors and private creditors. Such approach has been mitigated with a view to find long-term solutions to the debt sustainability issue of developing

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On the principle of imminent default see A. Fieffel, *The Paris Club, 1978-1983*, Columbia Journal of Transnational Law, 1984, pp. 83-85.

countries to be implemented prior to having a country on the verge of default.²⁹⁴

In the context of the implementation of the Brady-menu in Latin America in the late 1980s, for instance, debt relief, in the form of debt-to-debt swaps, played a key role in the process of recovery of the economical situation of such countries.

Three examples of debt relief can be examined: bilateral debt relief (i.e. debt relief implemented or facilitated by a single country by means of its internal legislation), Paris Club debt relief (which will be separately analysed in paragraph 4) and multilateral debt relief.

A bilateral debt relief implies the political will of a country to support the reduction of the debt burden of developing countries and it is usually translated into reforms of the legislation in order to facilitate the write off.

In 1990 the US, for instance, passed the Federal Credit Reform Act whose purpose was to change the way in which governmental loans and guarantees could be forgiven, in order to facilitate such process.²⁹⁵ Prior to such reform in order to write off one dollar of debt, the US Congress had to appropriate one dollar. According to the new legislation, rather than taking into account the face value of the debt for the purpose of the appropriation by the US Congress, introduced the concept of “net present value” of the debt. In order to establish such value factors such as likelihood of default, interest rate and maturity period are taken into account, reducing the amount to be appropriated and making less burdensome for US taxpayers. In this way, for example, seven dollars debt could be relieved against one dollar’s worth of US public funds.²⁹⁶

Moving to multilateral debt relief, a short overview of the most relevant initiatives carried out by the World Bank and the IMF will follow.²⁹⁷

²⁹⁴ See references to the Evian approach implemented by the Paris Club in the following paragraph, for instance.

²⁹⁵ R. Sakar, *International development law- rule of law, human rights and global finance*, Oxford Press, 2009, p. 321-322 and J. Sanford, *Debt owed to the United States by foreign countries: recent rescheduling and forgiveness*, CRS Report for Congress, the Library of Congress, 19 November 1993.

²⁹⁶ Id and J. Sanford, *Foreign Debts to the US Government: recent rescheduling and forgiveness*, George Washington Journal of International Law and Economics, 1995.

²⁹⁷ R. Sakar, *International development law- rule of law, human rights and global finance*, Oxford Press, 2009, p. 324-326.

In 1960 the World Bank created the International Development Association (IDA), which had the scope of advance loans to the poorest countries at concessional terms. However, the funds made available to such organization were insufficient to deal with the needs of the most indebted countries, therefore in 1987 the Special Programme of Assistance (SPA) was set up by the World Bank and by the IMF. The SPA was designed as a complement to existing aid coordination mechanisms and as a response to the economic crises of the debt-distressed countries in Sub-Saharan Africa and intended to support the countries' structural adjustment programs with the International Development Association and the IMF.²⁹⁸

In 1985 the World Bank established the Special Facility for Africa, shortly followed by the Debt Reduction Facility in 1989.

The Debt Reduction Facility (DRF) provides grant funding to eligible Governments to buy back -- at a deep discount -- the debts owed to external, commercial creditors. Since its inception, the DRF has played a significant role in extinguishing commercial external debt from the books of the public sector of low-income countries. It has supported 25 completed buy-back operations in 22 IDA-only countries, extinguishing about US\$10.3 billion of external commercial debt principal and more than US\$3.5 billion of associated interest arrears and penalties.

In conclusion, the analysis of the debt issue in the poorest countries made clear that some kind of debt relief is necessary in order to bring the debt of such countries to sustainable levels.

(ii) HIPC initiative

In 1996 the World Bank and the IMF proposed the Heavily Indebted Poor Countries (HIPC) Initiative in acknowledgment of the fact that traditional measures to deal with the sovereign debt such as structural adjustment programs, Paris Club reschedulings and

²⁹⁸ For an evaluation of the SPA results see the evaluation by the Independent Evaluation Group available on the World Bank Group website: <http://lnweb90.worldbank.org/oed/oeddoelib.nsf/DocUNIDViewForJavaSearch/B9308361A99ACB5F852568150051D59F> (last visited on 23 March 2012).

bilateral donor forgiveness had been proved to be not effective in respect of the poorest countries.²⁹⁹

The aim of the HIPC Initiative is to offer a faster and more comprehensive way to address the debt issue and achieve poverty reduction.

In order to be eligible for the HIPC Initiative a country has to: (i) have an unsustainable level of indebtedness³⁰⁰ after the application of the traditional Paris Club debt relief mechanism; (ii) be eligible for the concessional terms of financial assistance granted by the IDA and the IMF's Poverty Reduction Strategy Facility (PRGF); and (iii) have a track record of reform and develop a Poverty Reduction Strategy Paper (PRSP) which includes civil society participation.³⁰¹

Under the HIPC Initiative, the IMF and the World Bank boards first determine (at the "decision point") whether a country is eligible for debt relief. If an affirmative decision is reached, all creditors (multilateral, bilateral and commercial) is requested, on a voluntary basis, to commit to provide debt relief once the country has satisfactorily carried out certain prescribed policy reforms (the "completion point"). Of the 39 countries eligible or potentially eligible for HIPC Initiative assistance, 32 are receiving full debt relief from the IMF and other creditors after reaching their completion points. Four countries have reached their decision points and some of them are receiving interim debt relief. Three countries, which have been identified as potentially eligible for HIPC Initiative assistance, have not yet reached their decision points.³⁰²

²⁹⁹ See IMF fact sheet on <http://www.imf.org/external/np/exr/facts/pdf/hipc.pdf> (last visited on 23 March 2012) and for a comment on the initiative see V.K. Aggarwal and B. Granville, *Sovereign Debt, origins, crises and restructuring*, The Royal Institute of International Affairs, 2003, p. 29-30.

³⁰⁰ The debt is defined as unsustainable if the ratio of debt-to-export is above 150% and if the ratio debt-to-government revenues is 250%. For a critic of such ratio, see M.A. Walker and B. Faye, *Sovereign debt renegotiation: restructuring the commercial debt of HIPC debtor countries*, *Law and Contemporary Problems*, fall 2010, pp. 321-324.

³⁰¹ R. Sakar, *International development law- rule of law, human rights and global finance*, Oxford Press, 2009, p. 325. In 2006 the World Bank, the International Monetary Fund (IMF), and the African Development Bank (AfDB) implemented a further initiative for the debt reduction for poor countries. The plan, known as the Multilateral Debt Relief Initiative (MDRI), was first agreed by the G8 in June 2005 and has since been approved by the boards of the international financial institutions. The MDRI has promised it will erase 'as much as 100 percent' of the debts owed by qualifying countries, the vast majority of which are in sub-Saharan Africa. See <http://www.imf.org/external/np/exr/facts/mdri.htm> (last visited on 23 March 2012) and <http://www.imf.org/external/np/pp/eng/2009/091509.pdf> (last visited on 23 March 2012) on the status of HIPC Initiative and MDRI.

³⁰² See IMF fact sheet above.

(iii) Odious debt

Alexander Sack, a Russian scholar of international law, presented the first formal theorization of the doctrine of the odious debt in 1927.³⁰³ An odious debt is the debt incurred by a dictatorial regime for the personal benefit of such regime, which is not approved by the citizens and whose proceeds are not used for their benefit. Sack establishes two elements to be proven to an international tribunal by a Government that wants to repudiate the debts incurred by the previous regime: “(a) that the needs which the former Government claimed in order to contract the debt in question, were odious and clearly in contradiction to the interests of the people of the entirety of the former State or a part thereof, and (b) that the creditors, at the moment of paying out the loan, were aware of its odious purpose. Upon establishment of these two points, the creditors must then prove that the funds for this loan were not utilized for odious purposes-harming the people of the entire State or part of it-but for general or specific purposes which do not have the character of being odious.”³⁰⁴

Such theory represents an exception to the general rule of international law according to which successor governments inherit the obligations incurred by previous governments and must honor them. According to such theory, some debts should not fall within the category of obligations which can be passed on to the successor government, due to their odious nature. Sack suggests to apply a debt-by-debt approach for the evaluation of the odious nature of the obligations, requesting international courts to review each single

³⁰³ A. N. Sack, *Les effets des transformations des Etats sur leurs dette publiques et autres obligations financières*, 1927.

³⁰⁴ Sack establishes two elements to be proven by the Government that wants to repudiate the debts incurred by the previous regime to an international tribunal: “(a) that the needs which the former Government claimed in order to contract the debt in question, were odious and clearly in contradiction to the interests of the people of the entirety of the former State or a part thereof, and (b) that the creditors, at the moment of paying out the loan, were aware of its odious purpose. Upon establishment of these two points, the creditors must then prove that the funds for this loan were not utilized for odious purposes-harming the people of the entire State or part of it-but for general or specific purposes which do not have the character of being odious.” *Id.*, translated in R. Howse, *The concept of odious debt in public international law*, U.N. conference on Trade and Development, discussion paper no. 185, 2007.

loan documentation and how such loan was used in order to establish whether such debt can be considered as odious or not.³⁰⁵

The doctrine of the odious debt has been consequently developed as a mean to constrain creditors to advance loans to dictators, on that basis that odious debt are illegitimate and therefore cannot be transferred to the new government. The risk of having the debt declared unenforceable was a powerful disincentive for creditors to extend loans to regimes.³⁰⁶

The debate on odious debts developed again in the 1980s, in respect of the debt crisis of the Latin American countries and in 2003, upon the fall of the Saddam Hussein regime in Iraq.

In the late 1980s, some authors would question the nature of the loans advanced to Latin American countries by private creditors in the late 1970s and 1980s, which were the result of reckless policies of international banks dealing with an excess of liquidity deriving from the petrodollars (as already observed in the first part of this chapter).³⁰⁷ However, the carelessness of banks in advancing loans is not a reason for debt cancellation under the odious debt doctrine. Borrowers, anyway, did not try to support this theory and unilaterally repudiate their debts because of the fear of scaring international lenders and not being able to access to credit in the

³⁰⁵ In structuring such theory Sack's aim was to avoid creating a disincentive to creditors to advance money to a regime in case such money were used to finance projects for the benefit of the population. However some authors have pointed out the weakness of such approach: since money is a fungible good, establishing how the proceeds of a specific loan have been used is a hard task. The same authors suggest focusing on the odiousness of the regime instead, defining an odious regime as "a regime is odious if it engages in either systematic suppression or systematic looting". Once an odious regime has been identified, the obligations of such regime can be declared unenforceable. The authors suggest that the IMF and the United Nations should share responsibility for identifying odious regimes. See P. P. Bolton and D. Skeel, *Odious debts or odious regimes?*, Law and Contemporary Problems, Autumn 2007, pp. 83-107.

³⁰⁶ Historically such theory had already been implemented, prior to Sack's formulation of it, at the end of the 1910s by U.S. Supreme Court Chief Justice William Howard Taft, in his decision on the unenforceability of a loan advanced by the Royal Bank of Canada to the Tinoco regime, which was governing Costa Rica at the time. The new government of Costa Rica, elected once the Tinoco regime was over, refused to repay such loan, which had been used for personal expenses by the Tinoco family. Chief Justice Taft ruled that Costa Rica was legitimately entitled to refuse to repay such loans on the basis that. "The whole transaction was full of irregularities...The case of the Royal Bank depends not on the mere form of the transaction but upon the good faith of the bank in the payment of money for the real use of the Costa Rican Government under the Tinoco Regime. It must make out its case of actual furnishing of money to the government for its legitimate use. It has not done so. The bank knew that this money was to be used by the retiring president...for his personal support after he had taken refuge in a foreign country...". See C.M. Gentile, *The market for odious debt*, Law and Contemporary problems, fall 2010, p. 155-156. On this point see also P. Bolton and D. Skeel, *Odious debts or odious regimes?*, Law and Contemporary Problems, Autumn 2007, pp. 83-107.

³⁰⁷ See J. V. Feinerman, *Odious debt, old and new: the legal intellectual history of an idea*, Law and Contemporary Problems, autumn 2007, pp. 202-209.

future.³⁰⁸ Furthermore, even if Latin American countries had tried to argue the odiousness of the loans, it would have been difficult to tell which were bad loans and which were good loans used to build hospitals and bridges. Once the Brady Plan was implemented in the single countries, moreover, the whole amount of loans would be consolidated into one single loan and converted into bonds,³⁰⁹ making impossible to distinguish from that moment on the good or bad nature of debts.³¹⁰

Moving to the Iraq situation, by 2003 the overall debt burden of the country, taking into account all claims related to the Hussein Regime, was equal to USD 120 billion.³¹¹ Because of the size of debt and the brutality of the regime many authors, politicians and members of the civil society argued for the cancellation of odious debts. Political concerns were involved as well, since it was feared that more financial distress would have jeopardize the just born democracy. The doctrine of odious debt would have provided a legal way to cancel a portion of the debt and condemning the regime at the same time. However, eventually Iraq was granted debt relief (80% of Paris Club debt was written off) but on the basis of the distressed economic situation of the country avoiding explicitly references to the odious debt doctrine.³¹² Such generous write-off, however, raised concerns in respect of the sustainability of such policy for the IMF and the World Bank, which are the main creditors of the poorest countries. Granting such high level of debt relief on a regular basis, in fact, would be in prejudice of the capacity of such institutions to carry out their own functions, since they do not have enough funds to put up with such losses.³¹³

³⁰⁸ Perù was the only country which in 1984 repudiated a substantial portion of its debts, not because they were judged odious but rather unaffordable. Authors are not convinced that the economical problems Perù went through in the following year was due to such decision. See T. Lothian, *The criticism of the Third-World debt and the revision of legal doctrine*, Wisconsin International Law Journal, 1995, pp. 421 ff.

³⁰⁹ On odious debts and bondholders see A. Chander, *Odious Securitization*, Emory Law Journal, 2004, pp. 923-927.

³¹⁰ Id.

³¹¹ M.A. Weiss, Cong. Research Serv., *Iraq: Debt Relief 1*, 2005, available at <http://fpc.state.gov/documents/organization/44019.pdf>.

³¹² R. K. Rasmussen, *Sovereign debt restructuring, odious debt and the politics of debt relief*, Law and Contemporary Problems, autumn 2007, p. 252.

³¹³ On the Iraq case in general and for a comment on the USA behaviour see. R.P. Buckley, *International Financial System, policy and regulation*, Kluwer Law International, 2008, 83-93.

In conclusion, although the doctrine of odious debts cannot be considered to be part of customary international law, the concept of odious debt acquired growing importance and some authors have suggested ways to translate such concept into something more institutionally structured in order to create a “more usable odious debt doctrine”.³¹⁴

³¹⁴ Id. p. 251. Stiglitz’s proposal is that the United Nations should prepare a set of principles on the basis of which courts can assess whether a loan can be defined an odious debt and therefore not enforceable. See J. Stiglitz, *Odious rules, odious debts*, Atlantic monthly, 2003, pp. 35-45. Kremer and Jayachandran suggested to create an institution ad hoc to establish whether a loan granted to a regime is odious, so that the successor government would be legitimately entitled not to repay such debt, without fearing for consequences and countermeasures from the international financial community. See M. Kremer and S. Jayachandran, *Odious debt*, National Bureau of Economical Research, Working Paper no. 8953, 2002.

3) THE ROLE OF THE IMF IN SOVEREIGN DEBT RESTRUCTURINGS

The role of the IMF as lender of the last resort has already been analyzed in the previous chapter together with the concept of conditionality connected to the loans advanced by the IMF. This paragraph will focus on the role played by the IMF in the context of the restructuring process and the proposal advanced by the IMF in relation to the creation of an international insolvency regime.

a) IMF and sovereign workouts

The IMF plays a central role in the context of restructuring of sovereign debt: starting from the Latin American crisis and was maintained in most of the following restructurings, exception made for some cases whereby the countries decided not to involve the IMF since they did not want to implement any structural adjustment, as discussed in the previous chapter.

The IMF is usually involved in sovereign workouts for the following reasons:

- As lender of the last resort: as already analysed in the previous chapter, a country which has difficulties in servicing its debt may request the IMF to provide it with the necessary amount of new money in order to avoid a payment default and the exclusion from international capital markets. However the IMF approach in respect of lending to countries in economical distress changed after the first phase of the Latin American crisis, as already commented in the first paragraph. Initially the IMF was the only lender to advance new finance in order to allow the service of the country's debt. However the IMF then requested private creditors to share the burden of advancing new finance to the borrower (the involuntary lending), since having the IMF as only entity to advance funds was not sustainable from the borrower's perspective. Since the IMF loans do not suffer haircuts and have priority in respect of all other debts of the country (that is due to the fact that the IMF is the only lender to fund in arrears- this point will be further analysed in the following chapter), such policy resulted in having the commercial debt being serviced by money which would create a debt burden not object of debt relief, and which could have been repaid only at the population's expenses, creating a lucrative but unethical vicious circle;³¹⁵

³¹⁵ Palley commented on this at a Conference on the Sovereign Debt Restructuring Mechanism held at IMF Headquarters, on 22 January 2003: "Under the existing system, costs of default are large

- As catalyst of financial assistance: the IMF provides a country in financial distress with a limited amount of funds in respect of the financial needs of that country. However, the fact that the IMF judged such country as eligible in order to receive its loans, since the implementation of the adjustment plan has been correctly carried out, catalyses financial assistance from other sources. The intervention of the IMF allows the country also to regain access to financial markets, which is crucial in order to work out a path out if the crisis;³¹⁶
- As coordinator: the IMF assists negotiations with the Paris Club and the London Club, facilitating the process by coordinating it and playing the role of the “honest broker”;³¹⁷
- As advisor: since the IMF will advance money only if the State follows its technical prescriptions, implementing a plan which will secure the short-medium term sustainability of the debt (a structural adjustment), which was analysed in the previous chapter as well, in relation to the policy of conditionality of the IMF. The IMF is equipped with a large highly trained technical staff, that monitors, in general, trends in the global economy, and specifically, the countries which are implementing its programs, feeding this information into discussion with other governments;³¹⁸
- As gatekeeper: since the IMF will be involved in monitoring the implementation of the plan, the other parties involved in the restructuring

for countries, and they are also potentially large for the global economy owing to contagion effects. To avoid these costs, countries have an incentive to “gamble for redemption,” taking on additional high interest rate loans in the hope of escaping default. Side-by-side, the IMF also has an incentive to extend additional loans, so that solvency crises get treated as if they were liquidity crises. The net result of this policy treatment is that private sector lenders get bailed-out and moral hazard is created in international credit markets”. T. I. Palley, *Sovereign debt restructuring, what is the problem?*, available at <http://www.imf.org/external/np/exr/seminars/2003/sdrm/pdf/palley.pdf>. On the role of the IMF as lender of last resort see also G. Corsetti, B. Guimaraes and N. Roubini, *International lending of last resort and moral hazard: a model of IMF's catalytic finance*, National Bureau of Economic Research, working paper no. 10125, available on <http://www.nber.org/papers/w10125>. On the role of the IMF in the Latin American crisis see S. Hagan, *Sovereign debtors, private creditors and the IMF*, Law and Business Review of the Americas, pp. 50-53. On bridge financing in the context of a sovereign debt restructuring see also K. Hudes, *Coordination of Paris and London Club reschedulings*, New York University Journal of International Law and Politics, 1984-1985, p. 565-567.

³¹⁶ S. Hagan, *Sovereign debtors, private creditors and the IMF*, Law and Business Review of the Americas, p. 51.

³¹⁷ Hudes defines the role of the IMF in the context of the Paris and London Club reschedulings as an honest broker that would mediate and balance the opposite demands of the parties involved: on one hand the request of the creditors of intrusive and harsh adjustment measures to be implemented by the debtor country and on the other hand the request of the debtor country for new finance. See K. Hudes, *Coordination of Paris and London Club reschedulings*, New York University Journal of International Law and Politics, 1984-1985, p. 563.

³¹⁸ See D. Lombardi and N. Woods, *The politics of influence, an analysis of IMF surveillance*, in International Economic Law, A.H. Qreshi and X. Gao editors, Routledge Edition, 2011, pp. 167-175.

will trust the role of supervisor played by the IMF³¹⁹ and will rely on the information passed on by the IMF on the economical status of the State;³²⁰

The critics to the IMF have already analysed in the previous chapter and are applicable in this context as well. The statutory approach proposed by the IMF in order to create an international bankruptcy regime will be now set out.

b) The Sovereign Debt Restructuring Mechanism

One of the main issues of the restructuring process of sovereign debt is the lack of a consistent and orderly framework for crisis prevention and resolution.³²¹ Implementing such a framework would ultimately reduce the future cost of sovereign borrowing, which have been proven to be too long and too expensive, because creditors would receive a higher recovery under such a system and this would result into a decrease of the cost of sovereign lending and would minimizing

³¹⁹ In the 1980s, the surveillance activity of the IMF was instrumental in promoting the debt restructuring agreements with the other creditors (both commercial and bilateral): the IMF would monitor the performance of the debtor and set clear benchmarks against which the IMF and the other creditors could evaluate the performances of the debtor. D. Lombardi and N. Woods, *The politics of influence, an analysis of IMF surveillance*, in *International Economic Law*, A.H. Qreshi and X. Gao editors, Routledge Edition, 2011, pp. 164-186.

³²⁰ The relevance of the role of the IMF as gatekeeper brought borrowers and creditors of low-income countries to develop a new instrument, in collaboration with the IMF: the Policy Support Instrument (PSI). The PSI was designed for countries which do not have a financial arrangement with the IMF (either because they are not in financial distress or because they preferred not to rely on the IMF) but which still need assistance from donors. Such program requires the entry into an unfunded arrangement based on a quantitative macroeconomic framework. Under the PSI, member countries agree to implement a set of policies designed to maintain macroeconomic and financial stability, and accelerate growth, with sustainable domestic and external debt. These commitments, including specific conditions, are described in the country's letter of intent - a document that spells out a country's commitments under the PSI. The IMF checks on the progress made by the country in the implementation of such framework and in case the expectations set out in the arrangement are met, the country receives the IMF's approval. Nigeria was the first country to implement such program and the restructuring of its Paris club debt was conditional upon receipt of the IMF's approval. D. Lombardi and N. Woods, *The politics of influence, an analysis of IMF surveillance*, in *International Economic Law*, A.H. Qreshi and X. Gao editors, Routledge Edition, 2011, pp. 164-186. See also the IMF fact sheet, available on <http://www.imf.org/external/np/exr/facts/psi.htm> (last checked on 27 March 2012).

³²¹ Palley sums up the main issues related to sovereign debt restructuring as follows: "First, restructuring negotiations under both the Paris and London club arrangements are long and uncertain, giving rise to economic dislocation during the negotiating period. Second, there is inadequate protection for new lending during the negotiation period, and this discourages the flow of needed new financing. Third, there is an absence of uniformity of treatment across creditor classes. Fourth, there is the collective action problem associated with getting creditors to agree. This collective action problem obtains within a specific creditor class (the hold-out or vulture fund problem) and across creditor classes (the aggregation problem). Finally, all of these problems are worsening owing to the shift away from bank loan financing to more diversified sources of funding", see T. I. Palley, *Sovereign debt restructuring, what is the problem?*, available at <http://www.imf.org/external/np/exr/seminars/2003/sdrm/pdf/palley.pdf>.

social costs for the population which ultimately suffers the most from the lack of effectiveness of the current restructuring process.³²²

In order to address such issue, two main proposals were formulated by the academic world and by the institutions involved in this field: (i) a statutory approach promoted by the IMF, so-called Sovereign Debt Restructuring Mechanism (SDRM);³²³ and (ii) a contractual, market-based approach, based on the insertion of specific clauses in the agreements governing sovereign bonds and loans. The second approach will be analysed in the following chapter while a summary of the IMF proposal will follow.

In 2001, the First Deputy Managing Director of the IMF, Anne Krueger, presented the proposal for a treaty based international bankruptcy regime, setting up an entity close to an international bankruptcy court.³²⁴

Even if other proposal for a reform had been advanced at earlier stages, the IMF initiative would distinguish from them for the level of support received by the official sector. Such support, according to Hagan's opinion, was due to three main reasons: (i) frustration for the lack of implementation of contractual, market-based solutions, which the public sector had encouraged since 1996; (ii) the tragedy unfolding in Argentina, which would have lead to a restructuring and which made clear the need to establish a restructuring framework aiming at encouraging the sovereign debtor and the creditors to start negotiating at an early stage of the crisis so that collateral damages could have been limited; (iii) concerns in respect of the role of the IMF, which in absence of a structured framework for the restructuring able to give confidence to the debtor in respect of the outcome of the process, countries in financial distress would continue to ask the IMF to provide them with new finance in order not to default and in order to avoid the pain of going through a restructuring.³²⁵

The original proposal formulate by the IMF was criticised because of the relevance given to the role of the IMF in overseeing the restructuring process, resulting into a lack of independence, therefore the original proposal was remodelled, and a revised

³²² See S. L. Schwarcz, *Sovereign Debt Restructuring: A Bankruptcy Reorganization Approach*, Cornell Law Review, 2000, pp. 956-1032; and A. M. Dickerson, *A Politically Viable Approach to Sovereign Debt Restructuring*, Emory Law Journal, 2004, pp. 998 - 1041.

³²³ On SDRM see A.O. Krueger and S. Hagan, *Sovereign workouts: an IMF perspective*, Chicago Journal of International Law, summer 2005, pp. 203-218 and J. Sedlak, *Sovereign debt restructuring: statutory reform or contractual solution?*, University of Pennsylvania Law Review, 2003-2004, pp. 1491-1497.

³²⁴ Anne Krueger's speech is available at <http://www.imf.org/external/np/speeches/2001/112601.HTM>.

³²⁵ See S. Hagan, *Designing a legal framework to restructure sovereign debt*, Georgetown Journal of International Law, 2005, pp. 302-303.

version, structured as Proposed Features, was presented in 2003.³²⁶ Key elements of the Proposed Features are:

- Dispute Resolution Forum (DRF): an independent body should be set up in order to carry out the following main activities (i) administrative functions during the restructuring process, (ii) resolve upon the disputes arising out of the restructuring process, having exclusive jurisdiction in such respect; and (iii) Issuance of orders of suspension of enforcement proceedings, in cases such proceeding could undermine the restructuring process;³²⁷
- Principles guiding the restructuring mechanism: such principles are, *inter alia*: (i) the scope of SDRM, which should just be used to restructure unsustainable debt³²⁸ only and should not result into an encouragement for increasing the number of defaults or likelihood of future restructurings; (ii) it should catalyse a quick restructuring process; (iii) limited interference with contractual relationships; (iv) promoting transparency in the restructuring process; (v) the mechanism should not interfere with the sovereignty of debtors; (vi) the role of the IMF should be limited;³²⁹
- Eligible claims: identifying the scope of the claims to be included in the restructuring. The proposal to include official bilateral claims too had been object of lengthy discussions;³³⁰
- Activation: the sovereign debtor only can activate the proceeding;³³¹
- Information: the debtor shall provide all information about its indebtedness and the indebtedness of other included entities, including debt which will be restructured and debt which will not be affected by the restructuring to the Dispute Resolution Forum (DRF);³³²
- Limits on creditor enforcement: creditor claims are aggregated across instruments, hotchpot rule³³³ would apply and upon request of the sovereign

³²⁶ The text of the Proposed Features is available online at <http://www.imf.org/external/np/pdr/sdrm/2003/021203.pdf>.

³²⁷ See art. 14 the sets of principles included as attachment to the paper presented by the IMF on 13 February 2003, available at <http://www.imf.org/external/np/pdr/sdrm/2003/021203.pdf>.

³²⁸ On the concept of unsustainable debt see A. O. Krueger and S. Hagan, Sovereign Workouts: an IMF perspective, Chicago Journal of International Law, summer 2005, pp. 205-207.

³²⁹ Id. Art. 2.

³³⁰ Id. Art. 3.

³³¹ Id. Art. 4.

³³² Id. Art. 5.

³³³ The hotchpot rule is a legal rule in international insolvency law which says that any funds collected by an individual creditor enforcement action in another jurisdiction shall be netted out of the share due that creditor in the jurisdiction where the bankruptcy case is being heard. It is

and approval of the holders of 75% of the verified claims,³³⁴ a stay of all enforcement proceedings would be applied;³³⁵

- Creditors committees: according to the IMF proposal, creditors committees should be set up in order to facilitate the restructuring process. The costs of such committees should be borne by the debtor country;³³⁶
- Priority financing: upon consent of holders of 75% of the registered claims, new finance, ranking ahead of any other indebtedness of the debtor, would be advanced to the debtor;³³⁷
- Approval of the restructuring agreement: the restructuring agreement should be approved by 75% of the outstanding principal of each class of verified claims (as defined above) and would be binding on dissenting minority.³³⁸

In order to implement the SDRM, an amendment to the Articles of Agreement of the IMF was necessary; therefore the consent of IMF members holding 85% of the total voting power was essential for the good outcome of the proposal.³³⁹ In particular, the approval by the United States was key, since the United States holds 17,14% of the voting power. However the United States ultimately did not support the initiative, which was then dismissed.³⁴⁰

The origin of the framework proposed by the IMF can be traced down to US Bankruptcy Code, in particular Chapter 11 and Chapter 9, the latter dealing with the

therefore a disincentive to individual creditor enforcement actions, since any amount recovered at the end of the judicial proceeding will be affected by the application of the hotchpot rule.

³³⁴ The verified claims are the claims registered with the Dispute Resolution Forum and verified on objective basis by it, as set forth in art. 6 of the Proposed Features. Id.

³³⁵ Id. Art. 7. However no automatic cessation of payments upon activation has been included in the Proposed Features. The IMF suggests that a moratorium on payments would represent an incentive for creditors to rush for the exit. On the other hand the risks that the cessation of payments due to the distressed conditions of the borrower, such as the loss of the access to capital markets, has not been addressed. Id. p. 5.

³³⁶ Id. Art. 8.

³³⁷ Id. Art. 10.

³³⁸ Id. Art. 9.

³³⁹ Articles of Agreement of the International Monetary Fund, as amended, art. XXVIII(a), available at <http://www.imf.org/external/pubs/ft/aa/pdf/aa.pdf>.

³⁴⁰ On 12 April 2003, at the Meeting of the International Monetary and Financial Committee (IMFC), Secretary John W. Snow, Treasury of the United States, stated: "The IMF's exploration of a sovereign debt restructuring mechanism has raised important issues. But clearly, given the reactions of markets and emerging market countries, we should move forward with collective action clauses. These clauses, and not a centralized mechanism, are the vehicle to resolve the issues connected with sovereign debt restructuring. There can at times be "collective action" problems that prevent a prompt, orderly resolution of a sovereign debt crisis. The source of these problems lies in the relationships and agreements of debtors and their creditors. It is these parties, not an international organization, that must assume responsibility for the solution. Therefore, it is neither necessary nor feasible to continue working on SDRM". Full text available at <http://www.imf.org/external/spring/2003/imfc/state/eng/usa.htm>.

bankruptcy of municipality, which share with sovereign debtors the main characteristic of not being able to convert the restructuring process into a liquidation process.³⁴¹

The IMF approach has been acknowledged for its role in developing the discussion on the subject, but several authors have highlighted the limitations of such proposal. Bolton and Skeel set forth three main aspects of the SDRM to be improved: (i) it does not pay enough attention to *ex ante* effects of the SDRM, in particular the need of the debtor country to service the debt so that its access to capital markets is facilitated; (ii) the bridge financing proposal is not effective, since it is too cumbersome and it does not deal with the concerns in respect of the role of the IMF in such context; and (iii) the fact that the SDRM is created within the IMF raises independence and conflict of interest concerns.³⁴²

A comparative analysis of pros and cons of the statutory approach versus the contractual approach will be carried out in the next chapter.

³⁴¹ For an analysis of the SDRM in light of the US Bankruptcy code see H. Schier, *Towards a reorganisation system for sovereign debt, an international perspective*, Martinus Nijhoff Publishers, 2007, pp. 37-46.

³⁴² See P. Bolton and D. A. Skeel, *Redesigning the international lender of last resort*, Chicago Journal of International Law, summer 2005, p. 177-201. For a critique of the IMF statutory approach see T. I. Palley, *Sovereign debt restructuring, what is the problem?*, available at <http://www.imf.org/external/np/exr/seminars/2003/sdrm/pdf/palley.pdf>.

4) THE ROLE OF CREDITORS CLUBS IN SOVEREIGN DEBT RESTRUCTURINGS

a) The Paris Club

The Paris Club of Sovereign Creditors is an informal forum composed of the largest sovereign creditors³⁴³ which was created with the aim of coordinating sovereign creditors' contribution to the resolution of external payment problems of sovereign debtors. It gathered for the first time in 1956 to deal with Argentina's financial crisis by the French Treasury, which remained the place where Paris Club meetings are held.

The Paris Club plays a coordinating role in the sovereign debt restructuring process, representing a homogeneous group of sovereign creditors. From a practical point of view, the process starts once the debtor country addresses the Paris Club seeking for a rescheduling or reorganization of its bilateral debt and it usually ends upon issuance of the so-called Agreed Minutes, which represent the final agreed text between creditors and the debtor.³⁴⁴ Agreed Minutes however, are just a framework agreement agreed by the parties on the basis of unanimous consent (no cramdown procedure is contemplated): in order to give binding effect to the content of such

³⁴³ The Paris Club is composed by 19 permanent members (US, Canada, France, UK, Germany, Italy, Japan, Russia, Spain, Switzerland, Belgium, the Netherlands, Ireland, Norway, Sweden, Finland, Denmark, Austria, Australia) and 13 associated countries (Portugal, Israel, New Zealand, Brazil, Turkey, Korea, Argentina, South Africa, Abu Dhabi, Koweit; Morocco; Trinidad & Tobago) and observers. Permanent members fix the principles to be applied in negotiations by the Paris Club. Associated members are creditors countries which may participate to negotiations with a debtor country and sign the final agreement, subject to the permanent members and the debtor country allowing them to do so, and which agree upon implementing the Paris Club principles. Observers are divided in three categories: (i) representative of international institutions (IMF, World Bank, OECD, UNCTAD, European Commission, African Bank of Development, Asian Bank of Development, European Bank for Reconstruction and Development and Inter-American Bank of Development); (ii) representatives of permanent members which do not have any claim against a specific debtor, but which are willing to partake to the Paris Club meeting; and (iii) representatives of countries which have claims against the specific country but which are not neither permanent member nor associated members, which may assist upon consent of permanent members and of the debtor.

³⁴⁴ The definition of Agreed Minutes taken from the official Paris Club web site is as follows: "Participating creditor countries and the debtor country sign Agreed Minutes at the end of a negotiation session. This document states the commonly agreed debt treatment in writing. This is not a legally binding document but a recommendation by the heads of delegations of Participating creditor countries and of the debtor country to their governments to sign a bilateral agreement implementing the debt treatment". Available at <http://www.clubdeparis.org/sections/services/glossaire/definitions/proces-verbal-agree>. See also E. Cosio-Pascal, *The emerging of a multilateral forum for debt restructuring: the Paris Club*, United Nations Conference on Trade and Development November 2008, Discussion Paper no. 192, pp. 12-13. On the Paris Club process see A. Rieffel, *The Paris Club 1987-1983*, Columbia Journal of Transnational Law, 1984, pp. 90-98, K. Hudes, *Coordination of Paris and London Club reschedulings*, New York University Journal of International Law and Politics, 1984-1985, pp. 555-556 and the Paris Club Annual Report, 2010, p. 46, available at [http://www.clubdeparis.org/sections/communication/rapport-annuel-d/2010-rapport-annuel/downloadFile/file/Rapport annuel-Annual Report 2010.pdf](http://www.clubdeparis.org/sections/communication/rapport-annuel-d/2010-rapport-annuel/downloadFile/file/Rapport%20annuel-Annual%20Report%202010.pdf).

framework, single bilateral agreement have to be executed between the debtor and the single creditor.³⁴⁵

The functioning of the Paris Club is based on a set of fixed principles:³⁴⁶

- **Case by case:** the decisions are taken on a case-by-case basis in order to tailor its action to each debtor country's individual situation.³⁴⁷
- **Consensus:** decisions cannot be taken without a consensus among the creditor countries involved in the restructuring process.
- **Conditionality:** debt restructurings negotiations are limited to the debtor countries that meet the following three requirements: (i) the burden of debt is such that debt relief is necessary as viable option. In this respect debtor countries have to provide detailed descriptions of their economic and financial situation in order to evaluate the compelling necessity of the debtor country to benefit of debt relief policies; (ii) have or are in the process of implementing reforms to restore their economic and financial situation; and (iii) they have a track record of implementing reforms under an IMF program.³⁴⁸ □
- **Solidarity:** in the sense the all members of the Paris Club agree, albeit informally, to act as a group in their negotiations with a debtor country and take into account the impact that their own claim may have on other Paris Club creditors.
- **Comparability of treatment:** by signing an agreement with its Paris Club creditors the debtor country agrees upon seeking to receive from its non-Paris Club creditors terms of treatment of its debt that are comparable to those agreed with the Paris Club.

The principle of comparability of treatment is particularly relevant in the context of the restructuring process. Pursuant to such principle, in fact, the borrower undertakes to seek to obtain from non-multilateral creditors, in particular other official bilateral creditor countries that are not members of the Paris Club and private creditors a treatment on comparable terms to those granted by Paris Club members.

³⁴⁵ Id. pp. 106-107.

³⁴⁶ See the Paris Club website at <http://www.clubdeparis.org/sections/composition/principes/cinq-grands-principes>.

³⁴⁷ Such principle was consolidated by the Evian Approach, which is described below.

³⁴⁸ This means in practice that the country must have a current program supported by an appropriate arrangement with the IMF. The level of the debt treatment is based on the financing gap identified in the IMF program.

The terms of the arrangements with other creditors have to be “comparable” and not identical to the terms of the Paris Club’s agreement, in order to take into account the diverse nature of creditors and to give some flexibility to the negotiation process.

Paris Club creditors will evaluate the comparability of treatment requirement on the basis of: (i) the maturity of the debt; (ii) applicable interest; (iii) the face value of the debt. The implementation of this principle has been facilitated by the work of the London Club (see next paragraph), which makes easier to coordinate the progresses in negotiations with the bilateral creditors and private creditors of a specific debtor country.

The conditionality principle is translated in practice into a close cooperation with the IMF and it is based on two main grounds: (i) the Paris Club accepts to negotiate with a debtor only if such debtor has already agreed with the IMF a program to restore its economic status, so that Paris Club creditors get more comfortable in negotiating with the debtor, knowing that the implementation of an economic program will reduce the likelihood of future defaults; (ii) the Paris Club creditors rely on the IMF supervision during the implementation of the program and on the information delivered to them by the IMF. The role of observers which representatives of the IMF have during the negotiations with the debtor, facilitates such coordination.

Further relevant concepts elaborated and applied in the context of negotiations with the Paris Club are: (i) the definition of eligible credits (i.e. the process of establishing which credits will not be taken into account in the Paris Club restructuring);³⁴⁹ (ii) the cut-off date (i.e. the date starting from which new money advanced to the debtor country will benefit of priority towards other debts of the country, based on the principle that advancing loans to a distressed debtor is risky but important, also from the other creditors’ perspective, in order to avoid the default of the country); and (iii) the consolidation period (i.e. the period of time in which eligible credits will be affected by the restructuring).³⁵⁰

³⁴⁹ Usually short-term debt is excluded, due to their rollover nature, which would create difficulties in the context of restructuring, together with loans advanced to private entities within the country which are not guaranteed by the government and further ad hoc categories negotiated on a case-by-case basis. See A. Rieffel, *The Paris Club 1987-1983*, Columbia Journal of Transnational Law, 1984, pp. 99-100.

³⁵⁰ Bilateral creditors do not reschedule the aggregate amount of indebtedness that the debtor owes them for two reasons, connected to the nature of bilateral loans: (i) the term of public loans can be much longer than private ones, as much as 50 years, therefore deferring payments due in 40 years time do not make sense; (ii) since their actions are judged by the official creditors’ taxpayers, the representatives of the official creditors prefer to offer debt relief for a limited amount of time, from one to three years. See A. Rieffel, *The Paris Club 1987-1983*, Columbia Journal of Transnational Law, 1984, pp. 101-102.

The Paris Club offers two main kind of debt treatments: (i) rescheduling mixed with a debt relief component; and (ii) prepayments. Within the first kind of treatment are included the following financial structures/approaches:³⁵¹

- Standard terms: debt treatments are determined on a case-by-case approach but the practice created some standard terms that are used a starting point for the negotiations. Such terms derive from the practice matured in years of negotiations and they have been updated and amended in order to reflect the borrowers' needs. They differentiate among themselves because of the different level of concessionality granted to the debtor pursuant to such terms. There are currently four standard terms, namely: (i) the Classic Terms (which represent the standard treatment); (ii) the Houston terms (for highly indebted lower-middle-income countries); (iii) the Naples terms (for highly indebted low-income countries); and (iv) the Cologne terms (for countries eligible for the HIPC initiative);³⁵²
- Evian approach: this is a new comprehensive approach promoted by the Paris Club and offered to no HIPC countries and middle-low-income countries with debt sustainability issues. It is a framework for actions to be implemented aiming at assuring long-term debt sustainability;³⁵³
- HIPC initiative: in order to support the HIPC initiative Paris Club creditors agreed upon granting debt relief to eligible countries;³⁵⁴
- Cases of crisis: specific treatments are granted to countries which suffered from natural catastrophes, internal political conflicts and economical difficulties due to food and petroleum prices;
- Debt swap: countries may benefit from debt-for-equity swaps, debt-for-nature swaps and debt-for-development swaps. Pros and cons of such financial structures have been already analyzed in the previous paragraphs.

The second kind of approach includes either prepayment at par value or debt buy-backs on the secondary market, which have already been analysed as well.

³⁵¹ See the Paris club official website: <http://www.clubdeparis.org/sections/types-traitement/rechelonnement/termes-de-traitements>.

³⁵² On the evolution of the terms of the Paris Club rescheduling see T. M. Callaghy, *Innovation in the sovereign debt regime: from the Paris Club to enhanced HIPC and beyond*, OED Working Paper, 9 July 2002, pp. 15-18.

³⁵³ See E. Cosio-Pascal, *The emerging of a multilateral forum for debt restructuring: the Paris Club*, United Nations Conference on Trade and Development November 2008, Discussion Paper no. 192, pp. 21-26

³⁵⁴ Id. pp. 18-21.

The Paris Club played a fundamental role in the Latin American crisis of the late 1980s³⁵⁵ and in the successive sovereign debt crisis throughout the 1990.³⁵⁶ The implementation of the HIPC initiative in the late 1990s was another important moment in terms of relevance of the Paris Club in the sovereign debt panorama.³⁵⁷ Query is what the future will be for the Paris Club in the modern time, whereby bonds represent the vast majority of sovereign debt, and therefore capital markets and not bilateral lenders are the key actors of the play.³⁵⁸ Such question will be addressed in the next chapter.³⁵⁹

b) The London Club

The London Club is an informal forum which gathers private creditors in the process of restructuring the debt owed to them by sovereign countries.³⁶⁰ The work of the London Club and of the Paris Club usually is coordinated, in order to offer a joint solution to the sovereign debt crisis. This coordinated approach facilitates also achieving a comparable treatment satisfactory for both Paris Club creditors and London Club creditors, making easier for the borrower to reach a comprehensive agreement.

Since the group of creditors to be represented is far more widespread than in respect of Paris Club creditors, usually commercial creditors are represented by a committee composed by 10-15 banks which will negotiate with the debtor on behalf of the group of creditors.

³⁵⁵ Hudes reports that between 1978 and 1983 twenty-three countries rescheduled USD 22 billion of debt. See K. Hudes, *Coordination of Paris and London Club reschedulings*, New York University Journal of International Law and Politics, 1984-1985, pp. 557.

³⁵⁶ T. M. Callaghy, *Innovation in the sovereign debt regime: from the Paris Club to enhanced HIPC and beyond*, OED Working Paper, 9 July 2002, pp. 13-15.

³⁵⁷ On the history of the Paris Club see E. Cosio-Pascal, *The emerging of a multilateral forum for debt restructuring: the Paris Club*, United Nations Conference on Trade and Development November 2008, Discussion Paper no. 192, pp. 2-26.

³⁵⁸ On the Paris Club and its role in the international economic governance, see T. M. Callaghy, *The Paris Club and international economic governance: double crisis and debt*, in *Sovereign Debt, origins, crises and restructuring*, V. K. Aggarwal and B. Granville eds., Royal Institute of International Affairs, 2003, pp. 201-227.

³⁵⁹ In 2010 9 agreements have been signed in the Paris Club framework, in the context of the HIPC initiative (8) and pursuant to the Evian approach (1) and similar figures have been registered in the previous years, giving evidence of the different scenario whereby the IMF is now operating. See the Paris Club Annual Report, 2010, p. 6, available at [http://www.clubdeparis.org/sections/communication/rapport-annuel-d/2010-rapport-annuel/downloadFile/file/Rapport annuel-Annual Report 2010.pdf](http://www.clubdeparis.org/sections/communication/rapport-annuel-d/2010-rapport-annuel/downloadFile/file/Rapport%20annuel-Annual%20Report%202010.pdf).

³⁶⁰ See S. Radelet, *Orderly Workouts for cross-border private debt*, International Monetary and Financial Issues for the 1990s, Vol. XI, 1999, available at <http://r0.unctad.org/p166/modules2001/mod4/Radelet.pdf> and B. Eichengreen and R. Portes, *Crisis? What crisis? Orderly workouts for sovereign debtors*, Center for Economic Policy Research London, 1995.

A similarity with the Paris Club is the role played by the IMF, both as information supplier and because the implementation of an economic plan agreed with the IMF is a condition to the beginning of the negotiations with the London Club.

Differently from the Paris Club creditors: (i) commercial banks are often requested to provide bridge finance to the debtors (as already observed in the context of the Latin American crisis); and (ii) the final agreement has to be approved by banks holding around 90-95% of the outstanding debt, in order to avoid impasses due to the unanimous consent rule.³⁶¹

Negotiation with the London Club is generally much more time consuming than negotiations with the Paris Club, due to the number of creditors (sometimes over four hundred) involved. At the beginning the process would terminate with the drafting of a final agreement to be signed by all parties. Such practice was later replaced by an approach based on the Paris Club model: a framework agreement would be agreed by the parties and then creditors would enter in separate agreements with the sovereign debtor.³⁶²

The London club will be further analysed in next chapter, in the context of its potential role in a reform of the sovereign restructuring process based on a contractual approach.³⁶³

³⁶¹ However, small minority can still interfere with an orderly restructuring process and it is because of this that sometimes negotiations with the London Club can take a very long time.

³⁶² K. Hudes, *Coordination of Paris and London Club reschedulings*, New York University Journal of International Law and Politics, 1984-1985, pp. 560-561.

³⁶³ See also D. McGovern, *Different market windows on sovereign debt: private-sector credit from the 1980s to the present*, in *Sovereign Debt, origins, crises and restructuring*, V. K. Aggarwal and B. Granville eds., Royal Institute of International Affairs, 2003, pp. 82-84.

CHAPTER FOUR

THE SOVEREIGN DEBT RESTRUCTURING PROCESS IN THE BONDHOLDERS ERA

1. NEW PLAYERS AND NEW MARKET

a) The old game

As anticipated in the previous chapter, the debt restructuring dynamics went through two main phases. The debt restructuring procedures in the 1980'ies, as described in the previous chapter, were characterised, in terms of identity of the country's private creditors, by a majority of commercial banks, lending in pools to the borrower in order to meet the vast economical needs of developing countries.³⁶⁴

Loan agreements, at the time (as now) were drafted so that all lenders were treated equally amongst themselves: banks would group together in order to advance money to a specific borrower under the same terms, set out in the agreement. Although the obligation to advance funds was an independent obligation undertaken by each bank (i.e. each bank was responsible for the advance of its portion of commitments only and would not be held responsible in the event of default by an other member of the syndicate) the loan agreement would then create a single and centralised management of the loan itself. Provisions in order to deal with day-by-day management of the loan, decision making and undertakings and representations by the borrower to all the lenders were introduced in order to discipline unitarily the relationship between the borrower and the banks of the pool. One of the banks of the syndicate is normally designated as agent of the pool and carries out administrative functions and facilitates the operations throughout the life of the loan, dealing with communications, collecting and transferring funds etc.

Loan agreements generally include a share losses provision according to which recoveries from the borrowers are shared pro rata across the lenders, which

³⁶⁴ On syndicated lending and intercreditor relationships see L. Buchheit and R. Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-creditor relationships*, University of Illinois Law Review, 1988, pp. 495-517.

weakened the position of hold out creditors in such context.³⁶⁵ Furthermore, individual enforcement actions were usually prohibited

In case of financial distress of the borrower, the banks would group together creating an “advisory” or “steering” committee, which would represent the group of banks throughout the restructuring and represented the spokesperson to which the debtor could address its proposals and with whom the negotiations would be carried out, avoiding the almost impossible exercise of getting in touch with every single lender.³⁶⁶

Steering committees are formally appointed by the borrower and negotiate de facto the business and legal terms of the debt restructuring arrangements on behalf of the other lenders. Members of such committees are generally the largest commercial banks which have an exposure in respect of such borrower, which have a moral strength to convince the other members of the syndicate to agree upon the deal reached with the borrower.³⁶⁷

Furthermore, main international banks are institutional players, which care about their international image, are bound by internal social rules of conduct and they care about their commercial relationship with the borrower. And given the size of the debts, the stability of the banking systems of the creditors’ countries were at stake as well, reason why governments did not hesitate to get involved in the negotiations as such as they felt it was necessary in order to take care of the stability of their financial system.³⁶⁸

In order to further reduce the risk of single lenders taking enforcement actions, the borrower at the outset of the crisis would communicate to the international banking community that the intention is to treat all creditors equally, highlighting therefore that there would be no benefit in commencing individual actions. Such communication would usually also attach confirmations from the main commercial banks that they agree upon the moratorium of any enforcement action to the extent the banking community as a whole takes the same approach. The moral and

³⁶⁵ On sharing clauses in syndicated loan agreements in such period and on the structure of such agreements generally, see P. R. Wood, *Essay: Sovereign Syndicated Bank Credits in the 1970's*, Law & Contemporary Problems, 2010, pp. 7-28.

³⁶⁶ On this first phase of debt restructurings, see also R.M. Auerback, *Sovereign Debt – Default and Restructuring of Debts Owed to Private Creditors*, Journal of International Banking and Regulation, 2003, pp. 440-452.

³⁶⁷ L. C. Buchheit and R. Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-creditor relationships*, University of Illinois Law Review, 1988, pp. 505-506.

³⁶⁸ L. C. Buchheit, *A Change of Hat*, International Financial Law Review, 1990, p. 12.

reputational strength of the main players of the banking system became, again, relevant.³⁶⁹

b) The new players

In the 1990's, as well as today, the main source of funds for developing countries switched from loans from commercial banks to bonds. Commercial banks were not willing to expose themselves as much as before, after the haircuts suffered throughout the 1980's and contextually, the appetite for investors for bonds issued by emerging markets developed, due to the fact that they would generally bear higher interest rates than US corporate bonds. Such appetite was also fuelled by the idea that bonds were "safer" than loans. Investors noted that in the 1980's debt crises, bonds were usually left untouched and not rescheduled, differently from what had happened to the loans from commercial banks. Investors got this false sense of security without appreciating that at the time, publicly issued bonds were few and the most likely reason why they had not been included in the debt restructuring agreements was that their value was so little that it was not worthy going through the process of negotiating a rescheduling.³⁷⁰

Main differences between bondholders and commercial banks as creditors can be summed up as follows:³⁷¹

- **Identity of the creditors:** in the 1980's, borrowers would always know which were the lenders of the record advancing loans or taking a participation in the loans already advanced to them under the terms of the loan agreements. The borrower would mainly deal with the agent appointed by the syndicate but the names of the banks of the syndicate were known, and in the event of a financial crisis the borrower was in a position to communicate to the banks directly. Bonds are usually very liquid and are transferred heavily throughout their lives and are held by a multitude of investors, which makes the relationship between the issuer of the bonds and its bondholder a relationship based on

³⁶⁹ L. C. Buchheit and R. Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-creditor relationships*, University of Illinois Law Review, 1988, p. 504.

³⁷⁰ L. C. Buchheit, *Cross-Border Lending: What's Different This Time?*, Northwest Journal of International Law & Business, 1995, pp. 44-56.

³⁷¹ On the differences between banks and bondholders as creditors of sovereign borrowers see also R.M. Auerback, *Sovereign Debt – Default and Restructuring of Debts Owed to Private Creditors*, Journal of International Banking and Regulation, 2003, pp. 440-452.

anonymity, which makes it very difficult for the issuer to start a proper dialogue with the creditors in a moment of crisis;³⁷²

- **Nature of the creditors:** bondholders are less approachable than commercial banks given that they do not receive any peer or moral pressure nor pressure from governments and they do not suffer from the geopolitical consequences of their actions. Certain purchasers of bonds, the so called vulture funds, as better explained in the following paragraph, actually actively research bonds which are about to be restructured in order to make profits at the expenses of the borrower;
- **Size of the debts:** bondholders would generally lend much smaller amounts, differently from the quantum of debt advanced by commercial banks, and consequently have better chances for recovery, given that the sovereign borrowers would likely have assets to attach outside their national territory whose value would have covered the creditor's claims;³⁷³
- **Free riders:** individual bondholders have a right to seek repayment through individual legal actions brought in the US or English courts. Even if bondholders committees are created, and although such entities would have a strong aura of political legitimacy to the eyes of both the borrowers and the bondholders, they would have no moral strength or peer pressure to impose a rescheduling on all the bondholders, keeping the option for litigation open for single investors. Such individual power was granted by the terms of the indenture agreement under which the bonds were issued: originally, in fact, amendments to the economic terms of the bonds required unanimous consent from the bondholders, empowering single creditors to hold out the entire restructuring process (free riders are also called "hold-out" creditors).³⁷⁴

³⁷² As C. G Paulus notes, "As a rule of thumb, the anonymity which is inevitable companion of this modern development in credit markets bears the threat of inhumanity. This interrelation is evidenced by long-lasting historical experience." In *Global Insolvency Law and the Role of Multinational Institutions*, Brooklyn Journal of International Law, 2006-2007, p. 763.

³⁷³ S. Goldman, *Mavericks in the Market: the Emerging Problem of Hold-outs in Sovereign Debt Restructuring*, UCLA Journal of International Law & Foreign Affairs, 2000, pp. 169-171.

³⁷⁴ R. MacMillan, *The Next Sovereign Debt Crisis*, Stanford Journal of International Law, 1995, pp. 346-349. MacMillan in his article urged the relevant stakeholder to find a system to unify private creditors in the event of a sovereign financial crisis in the bondholders era, highlighting the issues that such new source of funding would have brought to the table: "We urgently need a system which will unify commercial creditors when a sovereign debtor needs debt relief. In the 1980's, a number of people made suggestions for an international bankruptcy system of sovereign debtors. Due to the relationship of the banks and the IMF, the homogeneity of the banking community, and the syndicated contractual nature of the debt, the parties involved in the debt crisis of the 1980s scraped by without ever needing such a system. In a bond crisis, however, those factors will not be present, and the need for some such system will be more compelling. That system must

c) Vulture funds

The reason why individual bondholders have great incentives to free-ride during the bond restructuring process is that they can buy bond obligations on the secondary market³⁷⁵ at a fraction of the full cost of the debt and then sue the sovereign in order to enforce the entire debt. Emerging-market sovereign bonds are usually bought at a substantial discount on the secondary market (this is due to the fact that bonds are priced at steep discounts to reflect the bonds' credit risk, a defaulted bond can be priced as low as 20% of the original face value or less). A default gives the secondary-market investor in bonds issued by countries in financial difficulties the opportunity to use litigation as a means to achieving repayment: after a default, in fact, the investors gain the right to accelerate the debt and to act against the sovereign's assets in the United States (or other international courts) through litigation.³⁷⁶ These investors of bond debt on the secondary market are more likely to pursue their claims by attaching the sovereign's limited assets located outside their territory following a default and, as already mentioned, they are also generally not subject to the political pressures that commercial banks face to participate in a restructuring and they may thus have great incentives to pursue litigation.

The most important cases fought in court will be analysed in the following paragraph.³⁷⁷

A specific category of hold out creditors are the so called "vulture funds", which are hedge funds and mutual funds specialised in investing in distressed assets. Such kind of funds are not primary lenders, as they generally purchase sovereign debt on the secondary market with the specific aim to make a profit out of the difference

provide for a collective bondholder decision-making process and for representational unity. It must prevent bondholders, either individually or in groups, from bringing suits that would disrupt the development of a solution to a debt crisis."

³⁷⁵ The secondary market was created during the Brady Plan era, as better explained in the previous chapter.

³⁷⁶ See J. Nolan, *Emerging Market Debt & Vulture Hedge Funds: Free-Ridership, Legal & Market Remedies*, Derivatives Study Center, Special Policy Report 3, 2001 available at <http://www.financialpolicy.org/DSCNolan.htm>.

³⁷⁷ As it will be better analysed in the following paragraphs, the free-riding by individual creditors undermines the debt restructuring process and it is economically inefficient because it can potentially delay, preclude or increase the costs of a debt restructuring between a sovereign debtor and its private creditors. For even if a debt restructuring is reached in the midst of this free-riding, the participants in the restructuring (both creditors and debtor alike) are forced to bear the cost of those recalcitrant creditors who do not participate and the social consequences for the people of the issuer country have also to be borne in mind.

between the discounted value paid on the secondary market and the face value of the instrument purchased which they attempt to recover through litigation.

The difference between vulture funds and general hold-out creditors is as follows: holdout creditors are the creditors that in the context of a debt restructuring whereby the sovereign country offers to its creditors to exchange old debt with new debt (debt exchanges will be analysed in more detail in the following paragraphs) decide not to accept such offer and to hold on to their old debt. As the exchange offer is made on a voluntary basis and given that the new debt as generally a lower face value, certain investor may decide to reject the exchange and sit and wait to be repaid. Vulture funds, on the other hand, purchase the debt only when the financial difficulties of the debtor country make the secondary market pricing such debt at a very high discount and they then bring the debtor to court in order to try to collect the entire face value of the debt.³⁷⁸ This lucrative business is possible mainly because of one legal technical reason: there is no sovereign countries bankruptcy regime, which protects defaulting countries from private debtors suing them, and there are no tribunal which can impose a “haircut” on the claims of the creditors.³⁷⁹

“Vulture funds” is the pejorative name for such kind of investors, due to the moral reproach that their behaviour has attracted, given that their business model is based on getting a profit out of the poorest countries in the world. Some courts, in answer to such developed business model, have tried to argue that when sovereign debt is traded at such large discount, trading such debt is immoral.³⁸⁰

An example of the activity carried out by vulture funds is the Donegal International case. In the 1990'ies Zambia owned \$30 million to Romania, however due to the widespread poverty, Zambia was not able to service its debt any longer and started a process of restructuring of its indebtedness. Before an official agreement was reached, the fund Donegal International³⁸¹ purchased the \$30 million debt at a discount from Romania, for an overall amount of \$4 million, and started a litigation procedure in London to recover the full face value of the debt, plus accrued interests,

³⁷⁸ See J. Fish, C. Gentile, *Vulture or vanguards? The Role of Litigation in Sovereign Debt Restructuring*, Emory Law Journal, 2004, p. 1043.

³⁷⁹ J. I. Blackman, R. Mukhi, *The Evolution of Modern Sovereign Litigation: Vultures, Alter Egos, and Other Legal Fauna*, Law and Contemporary Problems, 2010, p. 47-61.

³⁸⁰ See L.J. Hooper in *Barbados Trust Co v Bank of Zambia*, 2007.

³⁸¹ Donegal International, as generally vulture funds do, set up an SPV (i.e. an empty shell company created only with one specific purpose, in this case to hold the Zambian debt), so that the debt becomes a portable asset given that rather than selling the debt it is possible to sell the SPV itself and transfer a direct claim vis-à-vis the debtor, going around the issues related to contractual limits to assignability of the debt. On the issues related to assignability, see S. Brodie, *Assignment: problems and pitfalls*, Journal of International Banking and Financial Law, 2013.

which, at the time, was equal to \$55 million.³⁸² To put such figure into perspective, Zambia had received \$42 million in debt relief the year before. Donegal International was demanding more than that.

Vulture funds are a threat to the orderly management of a debt restructuring for the following reasons:

- Delay in the debt restructuring process: the vulture funds' claims delay the process of restructuring and result into an increase in the costs of the restructuring and they overall worsen the burden carried by the citizens of economies facing challenging situations;³⁸³
- Interaction with other creditors: debt restructurings happen mainly due to the indulgence shown by the majority of the creditors which accepts to suffer certain reductions of the value of the debt held and the fact that vulture funds gain while all the other creditors are losing creates a strong resentment and may both dissuade creditors to participate in future debt restructuring and encourage other creditors to follow the same path (i.e. litigation).³⁸⁴

Some authors have also tried to focus on the positive aspects connected to the activity of vulture funds, namely: (i) they represent a check in terms of reasonableness and genuine debt defaults versus opportunistic defaults due to unwillingness to pay rather than inability to pay, because the sovereign debtors know that they will be exposed to the vulture funds threat once their inability to pay debts is declared;³⁸⁵ (ii) several cases of corruption in developing countries were

³⁸² See *Donegal International Limited v. Republic of Zambia* and Anr, 15 February 2007, case no. 2005-190, available at: news.bbc.co.uk/1/16_02_07_zambiajudge.pdf. The judge introduces the case as follows: "The proceedings arouse strong feelings. Zambia is a poor country and sees itself as being vulnerable to "vulture funds". They say that this claim for more than \$55 million is an improper attempt by Donegal to exploit their vulnerability, Donegal having originally become their creditors by buy debt from the Government of Romania in 1999 for some \$3.2 million. Donegal respond that their proper profit is to make a profit, that it is legitimate to pursue their claim through these proceedings against Zambia and that they are justified in doing so, Zambia having rejected their reasonable proposal for settling the indebtedness and having sought to evade their responsibilities. I am concerned, of course, with the legal questions that are raised by the applications before me and not with questions of morality or inhumanity."

³⁸³ S.E. Goldman, *Mavericks in the market: the Emerging Problem of Hold-outs in Sovereign Debt Restructuring*, *UCLA Journal of International Law and Foreign Affairs*, 2000, pp. 159-197.

³⁸⁴ See J. Fish, C. Gentile, *Vulture or vanguards? The Role of Litigation in Sovereign Debt Restructuring*, *Emory Law Journal*, 2004, p. 1043.

³⁸⁵ N. Roubini, *Do we need a new bankruptcy regime?*, *Brookings Papers on Economic Activity*, 2002.

exposed;³⁸⁶ (iii) the liquidity in the secondary market, given that they increase the demand of defaulted loans and offer an exit to investors.³⁸⁷

It seems however, that the negative consequences of the business carried out by the vulture funds are not matched by the positive ones, hence why several campaigns against the vulture funds were started and in the United Kingdom, legislation was passed (the 2010 Debt Relief (Developing Countries) Act)³⁸⁸ so that the ability of vulture funds to litigate in the United Kingdom has been considerably restricted, limiting the amount which can be recovered through litigation to the amount initially paid for the debt, plus interest or charges.³⁸⁹ Ian Pearson, MP, which supported the introduction of the Bill, stated: “we need to change the law to prevent creditors from taking this path. Commercial finance can help – not hinder-development in low-income countries. The Private Member’s Bill seeks to prevent creditors from recovering an amount in excess of the debt relief expected. The Government, which consulted on legislation last year, will support the Bill when it is debated on 26 February. Parliament has a chance to make sure that million of the world’s poorest people gain maximum benefit from the debt relief that we provide.³⁹⁰

In 2008 the Belgian Parliament introduces a bill to deal with the issue of vulture funds litigation as well (the Act of 6 April 2008). The main concern was that creditors seized loans, granted by the Belgian government for humanitarian and development

³⁸⁶ E. Broomfield, *Subduing the Vultures: assessing government caps on recovery in sovereign debt litigation*, Columbus Business Law Review, 2010, p. 437.

³⁸⁷ See J. Fish, C. Gentile, *Vulture or vanguards? The Role of Litigation in Sovereign Debt Restructuring*, Emory Law Journal, 2004, p. 1043.

³⁸⁸ The 2010 Debt Relief (Developing Countries) Act is available at: <http://www.legislation.gov.uk/ukpga/2010/22/contents>.

³⁸⁹ In 2007 in France a bill was introduced in Parliament in order to fight against the vulture funds: the proposal consisted in granting the judge the discretionary power to order or refuse to order payment of a debt in the event the debtor was a foreign sovereign. The judge could have justified its refusal to order the payment on the basis that the foreign sovereign had been helped by public sources, the behaviour of the other creditors and the financial situation of the debtor. The bill would go even further, stating that no debt could have been enforced if such debt was purchased by a party with the intention to speculate on possible litigation rather than due to the low price of the debt on the secondary market. However the bill was never passed by the Parliament. In 2009 a proposal to introduce a legislation to limit the activities of vulture funds was also presented to the United States Congress (the so called Stop Vulture Funds-Bill”). This bill was never introduced either, but it aimed at making unlawful for all US citizen and corporations established in the US to take part into “sovereign debt profiteering”. (which was defined as the attempt to recover payment of a sovereign debt for an amount which exceeds the purchase price pad for such debt. US courts were also prevented from issuing any judgment which would result into sovereign debt profiteering. P. Wautelet, *Vulture Funds, creditors and sovereign debtors: how to find a balance?* in *Insolvabilité des États et dettes souveraines*, M. Audit, LGDJ, 2011, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1994425.

³⁹⁰ See D. Sookun, *Stop Vulture Funds Lawsuits: A Handbook*, Commonwealth Secretariat, 2010, p.p. 89-90.

purposes, so that the humanitarian goals assigned to such loans were never fulfilled. The provision included in the Act is as follows: “the funds and assets which are earmarked for international cooperation as well as the funds and assets earmarked for public development aid, other than those of the international cooperation, cannot be attached nor assigned”.³⁹¹ A similar provision deals also with loans made by Belgium to foreign countries and organizations. However, it is arguably required a more widespread action in order to discipline vulture funds litigation and in particular the international community should take a united approach. Until now, the only initiatives undertaken are non binding resolutions, such as the resolution adopted by the Paris Club in 2007 whereby the Club expresses its concern in respect of the vulture funds issue, which takes resources away from poverty reduction and investments in developing countries.³⁹²

The main litigation cases started by vulture funds will be analysed in the following paragraphs together with the main legal arguments raised by developing countries to resist the claims raised by such funds.

d) The market

The integration of the international financial markets is the main innovation which has deeply affected the world of cross border lending to emerging economies, as anticipated in the first chapter.

Money can now flow in and out of a country at an incredible speed, with far reaching consequences for developing country, as it happened during the Asian crisis.

When markets perceive that a government is likely not to be able to repay its debts, borrowing costs generally rise rapidly and as a consequence, it will be more difficult for the government to find cheap resources to refinance its debts, increasing the likelihood of default. Indicators of the deteriorated financial condition of a government are: (i) the price at which sovereign bonds are sold in the secondary

³⁹¹ J. Fish, C. Gentile, *Vulture or vanguards? The Role of Litigation in Sovereign Debt Restructuring*, Emory Law Journal, 2004, p. 1043.

³⁹² Paris Club creditors have furthermore confirmed that they are committed to avoid selling their claims on countries which qualify for the HIPC initiative to other creditors who do not intend to provide debt relief under the HIPC initiative. See <http://www.clubdeparis.org/sections/themes-strategiques/2009-8217-action-du-club>.

market; (ii) the spread of sovereign credit default swaps³⁹³, and (iii) the rating given to the government by rating agencies.

The role of sovereign credit default swaps has recently been under scrutiny of the International Monetary Fund upon the round of restructurings that hit the European Union in recent years. In particular, the potential abuse of such credit protection instruments has been discussed and the IMF has launched a study on the subject: "With the growing influence of SCDS, questions have arisen about whether speculative use of SCDS contracts could be destabilizing. Such concerns have led European authorities to ban uncovered, or "naked," purchases of SCDS protection referencing European Economic Area sovereign debt obligations, that is, banning purchases in which there is no off setting position in the underlying debt. The prohibition is based on the view that, in extreme market conditions, such short selling could push sovereign bond prices into a downward spiral, which would lead to disorderly markets and systemic risks, and hence sharply raise the issuance costs of the underlying sovereigns".³⁹⁴

Furthermore, crisis can easily widespread from one emerging country to the others, as it happened during the Mexican crisis in the early 1990's, which caused the so-called Tequila Effect, which affected the rest of the Latin American financial community.³⁹⁵

Nowadays, the interest rates, the exchange rates, prices of commodities, trades, political factors are analysed almost on an hourly basis and affect the investors' decisions. The mood of the investors can change very quickly on the basis of information received and cause a massive outflow of money from a country in a very short timeframe, upon receipt of worrying news.³⁹⁶ Hence why the need for transparency and a constant flow of official information from international organisation and from the governments themselves and more careful regulation are key in order to avoid mass panic attacks, as set out in the first chapter.

³⁹³ Sovereign credit default swaps are agreements that aim at protecting investors against losses on sovereign debt arising from so-called credit events such as the default of the government or debt restructuring. The seller of credit default swaps undertakes to the buyer to provide protection against losses in connection with so called credit events in exchange for a fee paid by the buyer. Credits events generally include failure to pay interest or principal on, and restructuring of, one or more obligations issued by the sovereign.

³⁹⁴ International Monetary Fund, *Global Financial Stability Report 2013*, p. 57, available at: www.imf.org/external/pubs/ft/gfsr/2013/.../c2.pdf.

³⁹⁵ *Tequila Hangover: The Mexican Pesos Crisis and Its Aftermath*, IMF publication, 2012, available at www.imf.org/external/pubs/ft/history/2012/pdf/c10.pdf.

³⁹⁶ L. C. Buchheit, *Cross-Border Lending: What's Different This Time?*, Northwest Journal of International Law & Business, 1995, pp. 54-56.

The Emerging Markets Traders Association (EMTA), an association created after the Brady Bonds era, once the secondary market for sovereign bonds started to develop (see previous chapter in such respect), plays an important role in the market of sovereign debt of developing countries. The EMTA defines its mission as: “promoting the orderly development of fair, efficient and transparent trading markets for Emerging Markets instruments and to helping integrate the Emerging Markets into the global capital markets. Above all, EMTA provides a forum that enables EM market participants to identify issues of importance to the trading and investment community and, when necessary, to review alternatives and develop consensus approaches to addressing industry problems and opportunities.”³⁹⁷ EMTA's Members include leading investment banks, commercial banks, merchant banks, investment management firms and other organizations with a strong interest in the emerging markets.

e) New rules?

Debates around the need for new regulations are a common feature of sovereign debt restructuring. In the past chapters and paragraphs the main areas whereby it has been felt that new rules should be applicable have been outlined and can be summed up as follows:

- **SDRM (Sovereign Debt Restructuring Mechanism):** i.e. the discussions around the need for a specific forum to deal with insolvency procedure for sovereign states, so that corporate insolvency procedures could be replicated in the context of sovereign states (such as the US chapter 11, for instance) to grant the sovereign state and its creditors the same protections, *inter alia*, in terms, respectively, of moratorium for enforcement and the court supervision in the process of repaying or rescheduling the creditors. As described in chapter 3 (*Sovereign Debt Restructuring*), the IMF suggested the creation of an international entity, which would have broadly covered the role played by national courts in corporate restructuring. Opposed to this approach are the authors and practitioners which believe that there is no need for an international entity to be established because history teaches that debt restructuring have existed since a long time and there is now a common know how and common understanding of how sovereign crisis

³⁹⁷

See EMTA website at: <http://www.emta.org/template.aspx?id=32>.

develop and are resolved which does not require any “external” intervention. Such authors and practitioners believe that the introduction of collective action clauses and other similar contractual mechanics are the way forward to deal with sovereign debt restructuring. Collective action clauses will be analysed in more detail in the following paragraphs;

- **Odious debt:** as described in chapter 3 (*Sovereign Debt Restructuring*), there is an on-going debate in relation to what can be defined as “odious debt” and the legal consequences of classifying a debt as odious. The doctrine of odious debt was at the centre of discussions quite recently due to the use of such definition in the context of the Greek financial crisis, whereby many commentators queried the use of such term in relation to the debt incurred by a legitimate government, democratically elected.³⁹⁸The issues around the burden of proof, determining when a debt becomes odious and who is entitled to have the final say on whether a debt is odious or not have already been analysed in the previous chapter. An interesting approach is suggested by certain authors that look at the governing law of the debt as instrument to resolve the disputes around the qualification of the debt, noting how national private law can be an answer to the issue, rather than looking at international public principles such as international customary law, which would be difficult to be applied (given the arguably such principle is part of general and consistent practice of states and followed by them from a sense of legal obligations);³⁹⁹
- **Transparency:** as mentioned in the first chapter (and as further noted in the previous paragraphs), the need for more transparency in the financial markets and for the unregulated players of the market has been recently discussed, particular due to the impact that financial transactions have on the stability of weak economies across the world;

³⁹⁸ Alexis Tsipras, leader of radical left-wing Greek party SYRIZA, during one of his press conferences, declared that an international committee should have reviewed the Greek debt in order to assess whether such debt could be classified as odious. See *Does Greece has “odious” debt?*, by A. Hern, published on NewStatesman on 9 May 2012, available at: <http://www.newstatesman.com/blogs/interest-rates/2012/05/does-greece-have-odious-debt>.

³⁹⁹ See L. C. Buchheit and M. G. Gulati and R.B. Thompson, *The Dilemma of Odious Debts*, Duke Law Journal, 2006. Available at SSRN: <http://ssrn.com/abstract=932916>. Also interesting the suggested approach in respect of “piercing the corporate veil”, to be replicated in relation to governments incurring odious debts, so that the debt itself can be re-qualified as a loan to the members of the government directly rather than a loan to the state.

- **Litigation:** i.e. the treatment of the so-called vulture funds, as mentioned in the previous paragraph. The aspects related to the litigation carried out by vulture funds and the theories presented by governments in order to protect themselves from vulture funds will be further analyzed below.

Separately, as final paragraph, the initiatives implemented by the European Union will be set out, being one of the most recent example of answers to a financial crisis and also due to the peculiarity of the European Union as international organization and the relationship amongst its member states.

2. SOVEREIGN DEBT LITIGATION

The aim of this chapter is to explore some of the most relevant sovereign debt litigation and to trace which are the main arguments brought in court by vulture funds enforcing their claims in respect of sovereign debt and the main defenses used by states.

Historically, bonds were excluded from the restructuring process and the government would continue to service such debt, notwithstanding the rescheduling and haircuts applied to other form of indebtedness. The reasons for such approach were multiple: (i) mainly because the quantum of the debt was *de minimis* (as mentioned previously, in the 1970ies and 1980ies the vast majority of debt was structured as syndicated loans); (ii) to avoid markets to negatively judge the credit worthiness of the country, making access to the market for such country particularly hard (especially in terms of interest to be paid) and to protect individual investors; (iii) due to the fragmentation of the creditors (opposed to the banks' committees) which would have made the restructuring process more complex.⁴⁰⁰

As mentioned at the beginning of this chapter, following the debt crisis in the 1980ies, countries switched from bank loans to bonds so that the debt crisis that followed involved mainly restructuring of bond issuances.

The origin of any restructuring (and related litigation) is the default of the borrower. The default can consists of failure of meeting a payment which falls due or a breach of the other terms of the contract which regulates the bonds.⁴⁰¹ The governing law of the bonds will dictate the general contractual rules applicable to the default and the remedies available to the creditors. As mentioned in chapter two, the law applicable to sovereign bonds is generally English law or New York law, both "neutral" law and commonly used in international transactions. The risk of having a sovereign bond governed by the national law of the issuer is that the issuer itself would then

⁴⁰⁰ See M. Megliani, *Debitori sovrani e obbligazionisti esteri*, Giuffr  editore, 2009, pp. 61 ss.

⁴⁰¹ Standard events of default in a bond issuance are: (i) non payment (i.e. non payment of principal or interest for a consecutive period of 30 days); (ii) breach of other obligations under the contract regulating the issuance (upon expiry of the relevant grace period); (iii) cross default; (iv) moratorium; (v) contestation of the validity of the debt securities; (vi) failure of authorisations required to perform the obligations by the issuer; (vii) monetary judgement (i.e. a monetary judgment exceeding a pre-agreed amount in the prospectus, not adequately satisfied or contested in good faith); (viii) illegality (i.e. the adoption by the issuer of any applicable law, rule or regulation which would make it unlawful to comply with the obligations agreed); (ix) IMF membership cessation. See R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, p. 389.

be able to unilaterally amend the terms of the contract, by passing a law or decree, which could, for instance, mandatorily declare the deferral of certain payments.

A default would trigger two main consequences for a government: (i) it would be source of international responsibility and would expose the government to litigation; (ii) it would result into a loss of reputation, which would affect the government credibility in the markets.⁴⁰²

Another relevant feature of international bonds is the jurisdiction clause. All contracts regulating international bonds include, together with an applicable law clause, a jurisdiction clause, regulating the forum which the parties acknowledge to be the relevant forum for an dispute arising in connection with the issuance of the bonds. Generally the forum selected reflects the applicable law of the bonds, being either the courts of New York or the courts of England and Wales. By submitting the jurisdiction of the disputes to a certain court, the relevant government implicitly waives to its sovereign immunity⁴⁰³ and accepts that its contractual counterpart may bring a claim against it before the relevant court.⁴⁰⁴

a) The main issues related to litigation aspects of sovereign debt

Prior to discussing certain litigation and the main arguments supported by the creditors (plaintiffs) and by the governments (defendants), it is helpful to picture the choices that a bondholder faces once the government (issuer of the bonds) is in financial difficulties.⁴⁰⁵

⁴⁰² On this point there are opposed theories: (i) one supporting the idea that a default would negatively impact on the capacity of the country to raise additional indebtedness on the market, due to the loss of reputation; (ii) one arguing that the market “forgets” quite easily and the appetite of investors changes quickly so that it is not predictable the success or lack of success of future bond issuances by a defaulted country. See M. Tomz, *Reputation and International Cooperation: Sovereign Debt across Three Centuries*, Princeton University Press, 2007 and B. Eichengreen, *Historical Research on International Lending and Debt*, *The Journal of Economic Perspectives*, 1991, pp. 149-169.

⁴⁰³ H. Schier, *Towards a Reorganisation System for Sovereign Debt*, Martinus Nijhoff Publishers, 2007, pp. 6-7.

⁴⁰⁴ Until the 1950ies, the general principle of sovereign equality of states was predominant under English and American law, so that no state should have had jurisdiction in relation to another state. From this starting point, the doctrine of absolute immunity of sovereign states was slowly eroded to the present distinction between *acta iure imperio* (i.e. sovereign acts per se) and *acta iure gestionis* (i.e. commercial activities which the government carries out but which are dealt with in the same way as activities of corporations or natural persons). See M. N. Shaw, *International Law*, Cambridge, 2003, p. 628.

⁴⁰⁵ On sovereign debt litigation by vulture funds generally see C.C. Wheeler and A. Attarant, *Declawing the Vulture Funds: Rehabilitation of a Comity Defence in Sovereign Debt Litigation*, *Stanford Journal of International Law*, 2003, pp. 253-284, P. Wautelet, *Vulture funds, creditors and*

As preliminary step, a creditor whose sovereign debtor is going through financial difficulties has to decide whether it will partake in the restructuring process and accept the offer made by the creditor (which, as already mentioned in the previous chapter) usually consists of a rescheduling of the debt and remodeling of the economics of the bond (in terms of interest), implemented through the exchange of the existing bonds with newly issued bonds, which can be exchanged at par or below par (which implies a haircut on the amount of principal to be repaid) or whether it will start a legal proceeding against the government demanding repayment of the amounts due.⁴⁰⁶

If the creditor decides to litigate, as briefly mentioned above, the first issue to deal with is state immunity or sovereign immunity, as referred to under English law and New York law respectively.⁴⁰⁷ A bondholder has to prove that the relevant court has personal jurisdiction over the sovereign and that the sovereign has waived to its immunity or, alternatively, there is an exception applicable so that the sovereign is not protected by the immunity. Usually, the instrument governing the bonds includes a submission to jurisdiction clause, together with the appointment of a process agent and an express waiver to immunity from suit, therefore this preliminary step is quite straightforward and the creditor are generally able to obtain a court judgment for the payment of money.

Once the money judgment is obtained, the creditor has to decide whether executing property within the territory of the debtor (by means of recognition of foreign court decision) or whether executing property abroad.

The risk connected to the first option is that the sovereign state would probably refuse to recognize the judgment due to public policy restrains or, to the extent the judgment is recognized, that the government rather than allowing the creditor to execute property, would repay *in specie*, offering debt instruments with very

sovereign debtors: how to find a balance?, available at: <http://orbi.ulg.ac.be/bitstream/2268/87549/1/Vulture%20funds%20and%20sovereign%20debtors%20Wautelet.pdf>.

⁴⁰⁶ As mentioned in the previous chapters, there is no insolvency procedure for states (opposed to procedures such as chapter 11 for corporates) which can insure protection for the governments from enforcement actions during a restructuring process. Therefore governments are exposed throughout the process to the legal actions carried out by hold out creditors, which are against the restructuring process. Furthermore, during the Allied Bank II case, the Federal Court of Appeal of the Second Circuit stated that pending the restructuring process, the payment obligations of the sovereign debtor remain valid and binding and that the creditors which decide not to support the restructuring are entitled to start a legal proceeding against the sovereign debtor, otherwise the rights of the creditors would be unjustly limited, given that in practice there would be no option between being part of the restructuring process or enforcing its rights, due to the fact that the creditor would not be allowed to commence a legal action prior to the restructuring having completed. M. Megliani, *Debitori sovrani e obbligazionisti esteri*, Giuffrè editore, 2009, pp. 132-133.

⁴⁰⁷ R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, p. 390-391.

unattractive economical terms. In addition, the execution process itself would be quite uncertain and ultimately in the hands of the sovereign debtor itself.⁴⁰⁸

The second option is more reliable in terms of process and outcome, both easily predictable; however, the downside is that it could be very difficult to find assets of the sovereign state abroad to attach.⁴⁰⁹ Furthermore, assets designated for sovereign or official functions enjoy immunity, such as diplomatic missions, central bank reserves, payments to and from international financial institutions (for instance the IMF).

A further point to be considered, is the structure chosen for the issuance of the bonds, which can either be based on a fiscal agent agreement or on a trust structure. In the first case, a fiscal agent is appointed to deal with monetary matters in the context of the issuance, such as redeeming bonds at maturity and payment of the coupons. The second structure requires the appointment of a trustee which will act as fiduciary and overview all matters connected to the issuance to ensure that the issuer complies with all the terms of the instrument governing the issuance.

There is one main difference, of relevance in the context of a restructuring: a fiscal agent acts as representative of the issuer, while the trustee is a fiduciary representing the bondholders.⁴¹⁰

In an enforcement scenario, this makes a great difference, given that payments made to the trustee are not attachable as soon as they are received by the trustee, which holds the money on trust for the bondholders (consequently as soon as the moneys reach the trustee's bank account, the ownership of such amount is transferred to the trustee). On the other hand, payments made to the fiscal agent and held on the bank account of the fiscal agent can be attached given that such funds belong to the sovereign until they are transferred from the bank account of the fiscal agent to the account of the bondholders. To the extent the bank account of the fiscal agent is held outside the jurisdiction of the sovereign debtor, such funds represent an attractive

⁴⁰⁸ R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, p. 392-393.

⁴⁰⁹ Argentina, for instance, even prior to its default, was doing everything it could to avoid having assets abroad: Central Bank reserves deposited in New York were withdrawn, funds of the *Banco Nacion* (the national bank) that were in their New York branch were repatriated, salaries of government employees abroad were paid into deposit accounts in Argentina or the money was sent via the so-called diplomatic pouch (which enjoys immunity), the presidential airplane and frigate avoided certain airports and ports in countries where bondholders had asked for garnishments. See A. Rebossio, *El gobierno se protege de los embargos*, La Nacion, 5 February 2004.

⁴¹⁰ Historically, the fiscal agent structure has been prevailing in international bond issuances, however in recent years, there has been an opposite trend, where the trust structure is the preferred option. Argentina, Belize, Dominica, Ecuador, Grenada and Uruguay have all opted for a trust structure in their recent issuances. See L. C. Buchheit, *Supermajority control wins out*, *International Financial Law Review*, April 2007.

option for creditors, while accounts held in the territory of the sovereign debtor can always be protected by means of passing emergency laws or decrees.⁴¹¹

b) The champerty defence

The Law of Champerty is a common law doctrine which aims at preventing the instrumental use of justice, to avoid people starting legal proceedings for private ends.⁴¹²

The Law of Champerty is a common defence of sovereign debtors, which argue that vulture funds purchase sovereign debt with the mere intention to sue the sovereign debtor for repayment, against the common law principle of champerty.

In *CIBC Bank versus Banco Central do Brasil*⁴¹³, the New York court admitted that the simultaneous acquisition of the debt and the commencement of the legal proceeding to obtain repayment had a champertuous aim, however that fact that other legitimate purposes could also be attributed to the purchase of the debt, would prevent the judge from applying the Law of Champerty to such case.

In *Elliot Associates versus the Republic of Peru*⁴¹⁴, the federal court of appeal overruled the judgment issued by the district court of New York in favour of the Republic of Peru. The district court of New York argued that Elliot purchased the Peruvian debt with the purpose of commencing a legal proceeding to recover the full amount of the bonds, and such intention was further confirmed by the fact that Elliot did not partake together with the other creditors in the negotiations during the restructuring process, but decided to follow a separate course of action, suing the Brazilian government to obtain the repayment in full of the debt.

The judgement was however overruled by the federal court of appeal, in line with previous jurisprudence, stating that the primary intention of Eliot in purchasing the debt was the recovery of the amounts due, and the commencement of a legal action

⁴¹¹ R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, p. 395-396.

⁴¹² The underlying ratio, which justifies the moral reproach connected to the private use of justice, is due to the fact that “the psychological background is the medieval and Christian one in which litigation is at best a necessary evil, and litigiousness is a vice”. M. Radin, *Maintenance by Champerty*, in *California Law Review*, 1935-36, pp. 48 ss.

⁴¹³ *CIBC Bank and Trust Company LTD v. Banco Central do Brasil*, 886 F. Supp. 1105 (S.D.N.Y. 1995). CIBC Bank was an investment fund specialised in the purchase of debt of developing countries, which rejected the restructuring plan put forward by the Brazilian government and commenced a legal action against Banco Central do Brasil before the New York Court. M. Megliani, *Debitori sovrani e obbligazionisti esteri*, Giuffr  editor, 2009, pp. 136- 137.

⁴¹⁴ *Elliot Associates L.P. v. Republic of Peru*, 12 F. Supp. 2d 328, 332 (S.D.N.Y. 1998).

was a secondary aim, subordinated to the lack of voluntary payment by the sovereign debtor.⁴¹⁵

The Argentinian government in 2003 further invoked the champerty defence, however the New York courts rejected such argument adopting the position held by the US courts in the previous judgments mentioned above.⁴¹⁶

Another case worth mentioning is the *Pravin Banker Associates v. Banco Popular del Peru*,⁴¹⁷ whereby Pravin refused to participate in Peru's restructuring process and sued Peru to obtain repayment of the full amount of the debt.

Peru argued that Pravin had bought the debt at a substantial discount and that a recovery in full of the amounts due would have resulted into an unjust enrichment at the expenses of the Peruvian population. The New York court involved in such case had to balance two opposite principles: (i) the success of the public debt restructuring of Peru; and (ii) the respect of contract law principles (and protection of the investors), which required the repayment of the debt. Finally, the court held that Pravin was not obliged to partake into the restructuring given that a restructuring process is based on a voluntary basis and consequently to the extent a creditor was not willing to support the restructuring its right to demand repayment (also through a court proceeding) should remain unfettered.⁴¹⁸ The decision was also affected by the role that New York plays in international financial transaction and the fear that a judgment against the rights of the investor could have negatively impacted on the role of New York as centre of the financial markets.⁴¹⁹

c) The *pari passu* mystery

⁴¹⁵ M. Megliani, *Debitori sovrani e obbligazionisti esteri*, Giuffr  editore, 2009, pp. 138-139 and S. E. Goldman, *Mavericks in the market: the emerging problem of hold-outs in sovereign debt restructuring*, *UCLA Journal of International Law and Foreign Affairs*, 2000, pp. 192-196.

⁴¹⁶ M. Megliani, *Debitori sovrani e obbligazionisti esteri*, Giuffr  editore, 2009, pp. 139-140.

⁴¹⁷ *Pravin Banker Associates v. Banco Popular del Peru*, 109 F 3d 850, 2nd Circuit, 1997, in R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, p. 396.

⁴¹⁸ R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, p. 396-397.

⁴¹⁹ On Champerty Defense see also J. I. Blackman and R. Mukhi, *The Evolution of modern Sovereign Debt Litigation: Vultures, alter egos and other legal fauna*, in *Law and Contemporary problems*, 2010, pp. 52-55.

A famous case in the sovereign debt litigation involves the interpretation of a boilerplate clause included in any instrument governing sovereign bonds, the so-called *pari passu* clause.⁴²⁰

The case (already mentioned above, although in relation to a separate aspect) is Elliot and Associates v. Republic of Peru and Banco de la Nacion de Peru. Elliot purchased Peruvian debt at a high discount and sued the Peruvian government to recover the full amount of the debt before the courts of New York, refusing to accept an exchange offer under which the existing bonds would have been exchanged with bonds issued under the Brady Plan (see chapter three). The court ruled in their favour and Elliot sought to enforce the monetary judgment, however there were not Peruvian assets outside the Peruvian territory to be attached.

Elliot tried to attach payments made by the Peruvian government under the newly issued Brady bonds through the fiscal agent (Chase Manhattan) and after an unsuccessful attempt they were able to obtain a restraining order from the Belgian court of appeal⁴²¹ prohibiting the fiscal agent and the clearing house (Euroclear) to pay interest due on the Brady bonds.

The court of appeal stated: “it...appears from the basic agreement that governs the repayment of the foreign debt of Peru that the various creditors benefit from a *pari passu* clause that in effect provides that the debt must be repaid pro rata among all creditors”.⁴²²

Given that the judgment of the court of appeal prevented the Peruvian Government to make payments through the fiscal agent and through the clearing house located in Brussels (Euroclear), the only option to avoid the default under the newly issued Brady bonds was to make payments through the other clearing house, Clearstream, located in Luxembourg. However, this would have required all bondholders to open an account with Clearstream and it was a matter of time before Elliot obtained a restraining order from the courts in Luxembourg, making any payment impossible.

The Government of Peru eventually decided to settle with Elliot in order to avoid a default under the Brady bonds, which would have re-opened the restructuring process just concluded. The settlement agreement required payment by the Peruvian

⁴²⁰ A famous practitioner defined the *pari passu* clause as: “short, obscure, and sports a bit of Latin; all characteristics that lawyers find endearing”, L. Buchheit, *How to negotiate Eurocurrency loan agreements*, International Financial Law Review, 2000, pp. 82-83.

⁴²¹ Elliot Associates, LP; General Docket No 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, 26 September 2000, in R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, p. 398.

⁴²² Elliot Associates, LP; General Docket No 2000/QR/92 (Court of Appeals of Brussels, 8th Chamber, 26 September 2000, in R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, p. 398.

Government of \$58,45 million, which meant a gain worth 400 per cent of the defaulted bonds for Elliot.⁴²³

The judgment of the Belgian court was based on the affidavit prepared by professor Andreas Lowenfeld, which opined that the meaning of the *pari passu* clause⁴²⁴ in any debt instrument was that the debtor has to treat all creditors equally, so that when the debtor makes a payment, the payment must be pro rata across all the creditors, stating: "I have no difficulties in understanding what the *pari passu* clause means: it means what it says – a given debt will rank equally with other debt of the borrower, whether that borrower is an individual, a company, a sovereign state. A borrower from Tom, Dick and Harry can't say "I will pay Tom and Dick in full, and if there is anything left over I'll pay Harry." If there is not enough money to go around, the borrower faced with a *pari passu* provision must pay all three of them on the same basis...".⁴²⁵

Many authors and practitioners argued against the "rateable" interpretation of the *pari passu* clause, in contrast with the usual interpretation of such clause, according to which the *pari passu* covenant imposes an obligation on the borrower not to subordinate⁴²⁶ the claims of the creditors under the relevant debt instrument, dealing therefore with raking of the creditors rather than with pro rata payments.⁴²⁷

⁴²³ R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, p. 399.

⁴²⁴ A standard formulation of the *pari passu* clause in modern cross border credit instruments is: "the Notes rank, and will rank, *pari passu* in right of payment with all other present and future unsecured and unsubordinated External Indebtedness of the Issuer". L. C. Buchheit and J. S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, Emory Law Journal, 2004, p. 871.

⁴²⁵ L. C. Buchheit and J. S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, Emory Law Journal, 2004, p. 878.

⁴²⁶ Generally, the claims of all unsecured creditors against a borrower are on a parity, . . . The creditors, however, may contractually alter this relationship through a subordination agreement. Debt subordination involves the agreement of one creditor (the junior creditor) to allow payment of indebtedness due to another creditor (the senior creditor) prior to the payment of indebtedness' owed to it. A subordination agreement is a type of intercreditor agreement between or among the affected creditors, that describes the nature and the mechanics of an agreed legal subordination. D. J. Schnebel, *Intercreditor and Subordination Agreements-A Practical Guide*, Banking Law Journal, January 2001, pp. 48-62.

⁴²⁷ "Over the years, a few commentators (including one of the authors) have offered possible explanations for the appearance of *pari passu* covenants in sovereign credit instruments. These explanations have ranged from a suggestion that drafters may have wanted to prevent an informal "earmarking" of a sovereign's assets or revenues to service a particular debt, to the more cynical explanation that this type of clause had a tendency to migrate-through the ignorance or inattention of contract drafters-from cross-border corporate debt instruments to sovereign debt instruments. The common theme among these commentators was a degree of agnosticism about the precise denotation of the *pari passu* clause in a sovereign context". L. C. Buchheit and J. S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, Emory Law Journal, 2004, pp. 875 and G. M. Gulati and K. N. Klee, *Sovereign Piracy*, the Business Lawyer, 2001, pp. 635-655.

The effects of the judgment issued by the court in Brussels had far reaching consequences and other vulture funds obtained judgment in their favour using the same argument.⁴²⁸

It has been discussed amongst academics and banking practitioners whether the drafting of the *pari passu* clause should have been changed in order to clarify that a rateable interpretation should have been excluded, however, in practice the wording did not change.

The fact that the clause remained the same after the judgment of the court of Brussels posed the question whether the continued use of the same clause meant the acceptance of the pro rata interpretation or whether the refusal of the interpretation suggested by the court was deemed so far from the actual meaning of the clause that lawyers and experts of the sovereign debt market did not considered necessary to amend the clause.

The *pari passu* clause migrated from corporate bonds into sovereign bonds, however the meaning and implications in the sovereign context are different. In both cases the aim of the clause is to prevent the borrower from incurring obligations to other creditors that rank legally senior to the debt instrument containing the clause. In the corporate scenario, however, the implications are different, given that creditors enjoying a senior treatment under the terms of the relevant debt instrument receive a preferred treatment during insolvency procedure in the USA (i.e. chapter 11). However, given that there are no insolvency procedures for sovereign states, it has been argued that the rationale for such clause is to prevent “earmarking” of the assets to certain creditors.⁴²⁹

In practice, as noted by certain authors, the relevance of *pari passu* clauses has been reduced by the widespread use of collective action clauses in debt instruments, which

⁴²⁸ U. Varotttil, *Sovereign Debt Documentation: unraveling the pari passu mystery*, DePaul Business&Commercial Law Journal, 2008, p. 124, L. C. Buchheit and J. S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, Emory Law Journal, 2004, pp. 880-884 and R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, pp. 401-402.

⁴²⁹ The Financial Markets Law Committee in the United Kingdom stated: “The only purpose of the clause was believed to be to prevent sovereigns from “earmarking” revenues of the government or allocating foreign currency reserves to a single creditor or, more generally, to prevent the sovereign from adopting legal measures which have the effect of preferring one set of creditors against the others”. Financial Markets Law Committee, Issue 79 –*Pari Passu clauses: analysis of the role, use and meaning of pari passu clauses in sovereign debt obligations as a matter of English law*, 2005, available at: ftalphaville.ft.com/files/2012/11/fmlc79mar_2005.pdf, L. C. Buchheit and J. S. Pam, *The Pari Passu Clause in Sovereign Debt Instruments*, Emory Law Journal, 2004, pp. 872-873 and U. Varotttil, *Sovereign Debt Documentation: unraveling the pari passu mystery*, DePaul Business&Commercial Law Journal, 2008, p. 119-120.

reduced the bargaining power of hold out creditors and which could be in part the reason why the terms of the *pari passu* clause did not change.⁴³⁰

As further point of interest, a broad interpretation of the *pari passu* clause in accordance with the principle set out by the court of Brussels would prevent countries restructuring their private debt from making payments to multilateral institutions such as the IMF and the World Bank, payments which, as general and uncontested understanding, have always had a *de facto* priority⁴³¹ which has never been challenged (and violation of the *pari passu* clause due to such *de facto* priority has never been contemplated).⁴³²

d) Recent developments

The *pari passu* clause was back in the spotlight following a recent ruling of the Federal District Court of New York (which was upheld by the Court of Appeal) which condemned the Argentinian Government to the payment in full of certain hold out creditors, arguing on the basis of the *pari passu* clauses included in the debt instruments.

The judge of the lower court ruled in favour of a group of vulture funds (including Elliot Management) which rejected the Argentinian restructuring proposal and sued the Argentinian government for repayment in full of the bonds, for an amount equal, approximately, to \$1,3 billion. The judgment included two relevant features. First, it has been imposed on Argentina an obligation to pay the vulture funds on their defaulted bonds whenever it next made payments on the restructured bonds. And an innovative approach is also suggested to potentially enforce this decision if Argentina chose to ignore it, focusing on the financial firms that pass the payments

⁴³⁰ U. Varottil, *Sovereign Debt Documentation: unraveling the pari passu mystery*, DePaul Business&Commercial Law Journal, 2008, p. 139-140.

⁴³¹ The priority granted to the IMF is due to many reasons, the main one being that the IMF is the only institution acting as lender of last resort and willing to advance money in distressed situations whereby other creditors would not be able to lend. The role of lender of last resort benefits also other private creditors (due to the improved liquidity situation of the borrower), hence why it has never been contested. R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, pp. 404-405.

⁴³² On the *pari passu* clause and the Elliot vs. Argentina case see also: C.D. Schmerler, *Restructuring Sovereign Debt*, in the Law of International Insolvencies and Debt Restructuring, editors J.R. Silkenta, C.D. Schmerler, Oceana Publications, 2006, pp.452-456, W. W. Bratton, *Pari Passu and a Distressed Sovereign's Rational Choices*, Emory Law Journal, 2004, pp. 823- 868, M. Monteagudo, *Peru's experience in sovereign debt management and litigation: some lessons for the legal approach to sovereign indebtedness*, Law and Contemporary Problems, 2010, pp. 201-2015, P. Wood, *Pari Passu Clauses – what do they mean?*, Journal of International Banking and Financial Law, 2003, pp. 371-376 and on equal treatment of creditors and *pari passu* clause see C. T. Ebenroth and R. Woggon, *The development of the equal treatment principle in the international debt crisis*, Michigan Journal of International Law, 1991, pp. 690-742

on the restructured bonds from the Argentine government to their holders. The final effect of the judgment is that if these firms handle the payments, they could effectively find themselves in contempt of the court's ruling.⁴³³ By threatening trustees and fiscal agents to breach the law by making payments to bonds in violation of the court's decision, the New York court found a powerful mean to enforce its decisions, which had never been explored in previous litigations involving the *pari passu* clause. Argentina appealed, however the Court of Appeal upheld the decision of the lower court ruling unanimously. The judgment is supportive of the lower court decision however in a vague and ambiguous way, welcoming the intervention of the Supreme Court on the point and stating, in relation to the most delicate point raised in the decision of the lower court (i.e. the potential liability for payment agents): "The amended injunctions simply provide notice to payment system participants that they could become liable through Rule 65 if they assist Argentina in violating the district court's orders. Since the amended injunctions do not directly enjoin payment system participants, it is irrelevant whether the district court has personal jurisdiction over them. And of course, there will be no adjudication of liability against a [non-party] without affording it a full opportunity at a hearing, after adequate notice, to present evidence. In such a hearing, before any finding of liability or sanction against a non-party, questions of personal jurisdiction may be properly raised. But, at this point, they are premature. Similarly, payment system participants have not been deprived of due process because, if and when they are summoned to answer for assisting in a violation of the district court's injunctions, they will be entitled to notice and the right to be heard."⁴³⁴

Furthermore, the Court of Appeal tries to deny the relevance and the far reaching consequences in the world of sovereign debt, of this ruling, by stating: "This case is an exceptional one with little apparent bearing on transactions that can be expected in the future. Our decision here does not control the interpretation of all *pari passu* clauses or the obligations of other sovereign debtors under *pari passu* clauses in other debt instruments. As we explicitly stated in our last opinion, we have not held that a sovereign debtor breaches its *pari passu* clause every time it pays one creditor and not another, or even every time it enacts a law disparately affecting a creditor's rights."⁴³⁵

⁴³³ P. Eavis, *Hedge funds win ruling in Argentinian bond case*, The New York Times, 24 August 2013 and The Economist, *An illusory haven*, 20 April 2013, available on line at: <http://www.economist.com/NEWS/FINANCE-AND-ECONOMICS/21576391-WHAT-LESSONS-SHOULD-INVESTORS-LEARN-ARGENTINE-AND-GREEK-RESTRUCTURINGS>.

⁴³⁴ F. Salmon, *Elliott vs. Argentina: it's not over yet*, published on line on Reuters, available at: <http://blogs.reuters.com/felix-salmon/2013/08/23/elliott-vs-argentina-its-not-over-yet/>.

⁴³⁵ F. Salmon, *Elliott vs. Argentina: it's not over yet*, published on line on Reuters, available at: <http://blogs.reuters.com/felix-salmon/2013/08/23/elliott-vs-argentina-its-not-over-yet/>.

The Supreme Court is now due to decide whether it will take the case and express its opinion or whether it will deny a further review of this case. It is noted that generally the Supreme Court does not rule over cases whereby the lower courts have been in agreement, and as of today the court has not yet accepted to take the case. Query if in the future the Supreme Court will accept to express a final judgement, given the relevance and the potential implications of this ruling.

It is also worth mentioning the recent development in relation to the applicability of class actions in the sovereign debt context: after couple of attempts of classes of bondholders in the late 1980ies and 1990ies, the US courts accepted jurisdiction over a class action of bondholders against the Argentinian government, on the basis of an “opt-in” mechanics (i.e. bondholders had to actively select to be part of the lawsuit). The positive aspect of class actions is that they are quite effective in terms of organising bondholders and engage the sovereign in a meaningful dialogue with creditors.⁴³⁶

⁴³⁶ R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, pp. 453-454.

3. COLLECTIVE ACTION CLAUSES (CACs) AND EXIT CONSENT

In this chapter transactional aspects of sovereign debt restructuring will be explored. The contractual aspects of sovereign debt restructuring in the bondholders era will be analysed, in particular the mechanics of exchange offers and the development of the so-called collective action clauses in English law and New York law bonds will be presented. Contractual technics have been supported by the authors and practitioners who did not support the proposal put forward by the IMF about a statutory mechanism to regulate sovereign debt restructuring (SDRM, see chapter 3)⁴³⁷, as a more flexible alternative, already used in practice.

a) Exchange offers

Exchange offers are an effective technique used to reprofile the debt of a country, which has become unsustainable. To the extent the exchange offer is performed prior to the default of the borrower, they avoid going through a proper debt restructuring and it is an effective tool to reduce the economic pressure of debt servicing when a country is facing financial issues.

In practice, exchange offers consist in the offer by the issuer to exchange the existing bonds with newly issued bonds with different economics in terms of final maturity and interest payable. To the extent the exchange offer is put in place prior to a default, and to the extent the burden of the debt is not unsustainable, the old bonds are exchanged at par with the new bonds (i.e. the principal amount is the same, so that there is no economic loss for the investors). As mentioned in the previous chapter, exchange offers below par have been a frequent feature of debt restructuring in the 1980ies and 1990ies (i.e. exchange of old bonds for new bonds with a face value

⁴³⁷ In short, the SDRM was not considered a viable option due to the burdensome process of amending the Articles of Agreement of the IMF and the fact that the SDRM upon amendment of the articles would have been binding on all members of the IMF, and in respect of any sovereign debt (opposed to Collective Action Clauses which can be tailored on a debt instrument by debt instrument basis). Furthermore, many sovereign issuers and investment banks were opposed to it because they believed that the introduction of such mechanism would have driven many investors away and it would have also made the cost of issuance for the sovereign debtors increase. As general idea, there was a general dislike of the idea of granting an excessive influence to the IMF in the context of debt restructuring in particular in relation to decisions affecting private creditors (in fact the SDRM would not have applied to debt owned to governments or to multilateral financial institutions such as the World Bank). See B. Metzger and M. J. Hagan, *Collective Action Clauses in International Sovereign Bonds*, *Journal of Banking and Finance Law and Practice*, 2003, p.223 and R. Gray, *Collective action clauses: theory and practice*, *Georgetown Journal of International Law*, 2004, p. 694-697.

below the face value of the old bonds, which represent an haircut in the amount of principal to be repaid).⁴³⁸

Given the widespread nature of investors in bonds, it is often the case that not all the existing bondholders enter into the exchange offer, either due to lack of knowledge that the exchange offer is in place or due to the willingness to reject the offer (i.e. the holdout creditors). Therefore, upon completion of the exchange offer, the government, issuer of the old and new bonds has to deal with two sets of creditors, the holder of the new debt and holders of the old debt, with the complexities that may arise in respect of the old creditors which transfer their debt to investment funds specialised in distressed debt, which purchase the debt at a discount and then commence litigation proceedings in order to recover the full amount of the debt (as set out in the previous paragraph).⁴³⁹

b) Collective Action Clauses

Collective action clauses are contractual provisions included in the debt instrument regulating bonds which prescribe a certain majority of bondholders in order to amend certain terms of the debt instrument itself or to take certain decisions.

The inclusion of majority provisions is a relatively recent feature in sovereign bonds: historically each bond was a “standalone” piece of debt and the consent of each bondholder was required in order to make any amendments. The right of the individual to recover the amount due was considered “untouchable” and the concept that a majority of bondholders could bound a minority of creditors was not contemplated.⁴⁴⁰

The downside of such approach is that a single bondholder acquires a position of strength given that any restructuring proposal will require the consent of every single bondholder and holdout creditors represented a material risk to the success of the restructuring.

In the second half of the nineteenth century, the first majority provisions were included in English law corporate bonds: it became in fact clear that unanimous decisions were against the interest of the bondholders themselves, as in practice they

⁴³⁸ R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, pp. 415-416.

⁴³⁹ R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, pp. 415-416.

⁴⁴⁰ L. C. Buchheit and G. M. Gulati, *Sovereign bonds and the collective will*, Emory Law Journal, 2002, p. 51 ss.

testified corporation being liquidated due to the lack of consent of all bondholders, when a simple deferment or reduction of the creditors' claims would have allowed the relevant corporation to continue to operate.⁴⁴¹

The position was different in the United States, whereby some technical issues⁴⁴² prevented majority provisions to be widespread and until very recently the standard approach for New York law bonds was to allow amendments to the terms of the bonds with the consent of 51% of the bondholders, however, to the extent any amendment to the payments dates or amounts to be repaid was required, the unanimous decision of the bondholders was necessary.

Quite recently, after the sovereign debt restructuring in the late 1990ies (such as Pakistan, Ukraine and Ecuador), the official sector began to encourage a broader use of collective action clauses to favour more orderly restructurings and avoid the issues created by holdout creditors in previous restructurings. As mitigant for the rights of the minority bondholders, the majority in taking any decisions had to act in the best interest of all the bondholders, creating a sort of fiduciary duty of the majority vis-à-vis the minority.⁴⁴³

The event that marked the switch to CACs was the Mexico bonds issuance⁴⁴⁴ that included CACs and which was positively welcomed by the market: after such issuance, the number of New York law bonds including CACs raised rapidly and

⁴⁴¹ The paternity of majority action clause has been claimed by Francis Beaufort Palmer, an English barrister which in 1881 published his "Company Precedents" (a book of English law corporate precedents), whereby the first form of majority clause was included, with the following explanation: " it is by no means uncommon now to insert [majority action] provisions...in a debenture trust deed, enabling the majority to bind the minority in respect of various matters...Now it sometimes happens that a company which has raised a large sum on debentures falls into temporary difficulties, and, though a large majority of its debenture holders may be willing to give time or make some reasonable arrangement, a minority decline to concur, and, in the result, the company is forced into liquidation. The Insertion of [majority action] provisions...meets this inconvenience, and may save the majority from the tyranny of the minority". F. B. Palmer, *Company Precedents*, 1881, p. 122.

⁴⁴² Under the Uniform Negotiable Instruments Law (1896), a provision which allows the amendment to payment terms post issuance may have affected the status of negotiable instrument of the bond. The Uniform Negotiable Instruments Law, in fact, required a negotiable instrument to contain "an unconditional promise...to pay a sum certain money...[and] be payable on demand, or at a fixed or determinable future time". L. C. Buchheit and G. M. Gulati, *Sovereign bonds and the collective will*, Emory Law Journal, 2002, p. 57. Furthermore, sovereign bonds followed the corporate bonds model, and under the Trust Indenture Act of 1939, amendments to the amounts due under a publicly issued corporate bond cannot be implemented without the consent of all the bondholders (provided that deferral to up to three years can be effected with 75% majority). The Trust Indenture Act is not applicable to sovereign bonds, however the drafting of sovereign bonds did not change to reflect this technical point. See R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, p. 435.

⁴⁴³ L. C. Buchheit and G. M. Gulati, *Sovereign bonds and the collective will*, Emory Law Journal, 2002, p. 66.

⁴⁴⁴ The excerpt of the CACs include in the Mexican bonds can be found in A. Gelpert, M. Gulati, *Innovation after the revolution: foreign sovereign bond contracts since 2003*, Capital Markets Law Journal, 2009, pp. 88-89.

recent issuance now have invariably majority provisions. The reason why issuer were reluctant to include such provisions was the fear that the market would have demanded a higher spread for bonds diverging from the traditional New York law approach (which did not include CACs), given that the individual rights were limited in favour of the majority.⁴⁴⁵

Some authors also highlighted certain disadvantages linked to the use of CACs, namely, the fact that not including these clauses could have sent a strong message to the market (i.e. that there was no possibility to restructure), that governments were expecting to receive an official sector bailout therefore there was little need to have a mechanics that would allow debtors to resolve the distressed situation without a bailout, provisions that facilitate restructuring may have brought to more “casual” restructurings and, finally, that CACs may have raised the cost of borrowing (as counterbalance for the flexibility granted to the debtor), which however was proven wrong.⁴⁴⁶

The public sector was also supporting the introduction of CACs in New York law bonds: in particular the Group of Ten (a committee of the IMF)⁴⁴⁷ elaborated a proposal for a set of model clauses to be used in sovereign bonds.⁴⁴⁸

The two main typologies of CACs are: (i) the majority restructuring provisions; and (ii) the majority enforcement provisions.⁴⁴⁹

- **Majority restructuring provisions:** these are provisions which empower a supermajority to bind all bondholders to certain amendments to the terms of the bonds, including the final maturity, the amount of interest to be paid and other related changes.⁴⁵⁰ When negotiation the original terms of the bonds,

⁴⁴⁵ R. Gray, *Collective action clauses: theory and practice*, Georgetown Journal of International Law, 2004, p. 698.

⁴⁴⁶ L. C. Buchheit and G. M. Gulati, *Sovereign bonds and the collective will*, Emory Law Journal, 2002, pp. 51 ss.

⁴⁴⁷ For more information see the IMF factsheet on the IMF committees available at: <http://www.imf.org/external/np/exr/facts/groups.htm#G10>.

⁴⁴⁸ The report prepared by the Group of Ten on CACs is available at: www.bis.org/publ/gten08.pdf.

⁴⁴⁹ See a summary of the main provisions in recent bonds issues in J. Dey, *Collective Action Clauses, Sovereign Bondholders cornered?*, Law and Business Review of the Americas, 2009, pp. 505-507.

⁴⁵⁰ A sample clause to deal with majority restructuring provisions is the following:

“Reserve Matters. Any modification, amendment, supplement or waiver of the Trust Indenture or the terms and conditions of the Bonds that would:

- (i) change the date for payment of principal of, or any installment of interest on, the Bonds;
- (ii) reduce the principal amount or redemption price or premium, if any, payable under the Bonds;
- (iii) reduce the portion of the principal amount which is payable in the event of an acceleration of the maturity of the Bonds;

there is always a tension between the issuer and the creditors in relation to the threshold to be included as supermajority: the issuer would rather have a lower figure, in order to facilitate the process of reaching the required majority and having a certain degree of predictability and flexibility, whilst the creditors would prefer to have a higher number so that they are not outvoted by dissenting bondholders, seeking therefore an adequate protection.⁴⁵¹In New York law bonds, the percentage is generally between 75% and 85% (calculated as the percentage of outstanding principal amount of bonds at the relevant time), including sometimes the right for 10% of the outstanding principal amount at the time to block any amendments to the key economics terms of the bond. In English law bonds, the percentage is broadly the same but calculated differently: the percentage refers to the amount of cast votes at a duly convened meeting (whereby a certain percentage of the principal amount of outstanding bonds shall be gathered).⁴⁵²

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- (iv) reduce the interest rate on the Bonds;
 - (v) change the currency or place of payment of any amount payable under the Bonds;
 - (vi) change the obligation of the Issuer to pay Additional Amounts in accordance with the Trust Indenture,
 - (vii) change the definition of Outstanding or reduce the quorum requirements or the percentage of votes required for the taking of any action pursuant to this Section ___;
 - (viii) authorize the Trustee, on behalf of all Holders, to exchange or substitute the Bonds for, or convert the Bonds into, other obligations or securities of the Issuer or any other person;
 - (ix) instruct the Trustee, on behalf of all Holders, to settle or compromise any proceeding or claim asserted by the Trustee pursuant to Section ___;
 - (x) give to any person or group of persons, other than the Trustee, the exclusive right to enforce any provision of the Trust Indenture or the Bonds on behalf of all Holders; or
 - (xi) appoint any person or group of persons to represent the interests of the Holders in any discussions with the Issuer or any other creditors of the Issuer in connection with any proposed restructuring of the Bonds or other indebtedness of the Issuer,

may be made with the consent of the Holders of more than 75% (or in the case of paragraph (x) or (xi), 66-2/3%) in aggregate principal amount of the Bonds at the time outstanding pursuant to a written action of the Holders; provided that modifications, amendments, supplements or waivers pursuant to paragraph (xi) of this subsection may also be made with the consent of the Holders of more than 66-2/3% in aggregate principal amount of the Bonds at the time Outstanding entitled to vote at a meeting of Holders convened and conducted in accordance with Section ___; provided further that modifications, amendments, supplements or waivers pursuant to paragraphs (i) through (vii) of this subsection also shall require the consent of the Issuer." Model clause prepared by the Group of Ten, available at: www.bis.org/publ/gten08.pdf.

⁴⁵¹ See H.S. Scott, *A bankruptcy procedure for sovereign debtors?*, *The International Lawyer*, 2003, p. 118 and B. Metzger and M. J. Hagan, *Collective Action Clauses in International Sovereign Bonds*, *Journal of Banking and Finance Law and Practice*, 2003, p.225.

⁴⁵² B. Metzger and M. J. Hagan, *Collective Action Clauses in International Sovereign Bonds*, *Journal of Banking and Finance Law and Practice*, 2003, p.225 and see R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, p. 438-439 for some recent examples of thresholds included in CACs of recent bond issuances.

- **Majority enforcement provisions:** these provisions deal with the capacity of the single bondholder to enforce its claims under the bonds following a default.⁴⁵³ It is generally required a certain majority in order to be able to accelerate the debt (i.e. to declare the debt due and payable) and, following acceleration, to enforce the debtor's claims. Usually, in English law and New York law bonds the required majority is 25% or more of the outstanding bonds. To the extent the required majority has not been reached, the bondholders will only be entitled to the payment of interest and principal when falling due however they will not be entitled to demand repayment of the entire debt outstanding.⁴⁵⁴ In New York law bonds it also common to

⁴⁵³ A sample enforcement clause is as follows:

“(a) Control by Holders

The Holders of a majority in principal amount of the Outstanding Bonds shall have the right to direct the time, method and place of conducting any proceeding for any remedy available to the Trustee or exercising any trust or power conferred on the Trustee; provided that

- (i) such direction shall not be in conflict with any rule of law or this Indenture;
- (ii) the Trustee shall not determine that the action so directed would be unjustly prejudicial to the Holders not taking part in such direction, and
- (iii) the Trustee may take any other action deemed proper by the Trustee that is not inconsistent with such direction.

(b) Limitation on Suits

No Holder of any Bond or coupon shall have any right to institute any proceeding, judicial or otherwise, with respect to the Bonds or this Indenture, or for the appointment of a receiver or trustee, or for any other remedy hereunder, unless:

- (i) such Holder has previously given written notice to the Trustee of a continuing Event of Default;
- (ii) the Holders of not less than 25% in aggregate principal amount of the Bonds Outstanding at that time shall have made written request to the Trustee to institute proceedings in respect of such Event of Default in its own name as Trustee hereunder;
- (iii) such Holder or Holders shall have offered to the Trustee reasonable indemnity against the costs, expenses and liabilities to be incurred in compliance with such request;
- (iv) the Trustee for 90 days after its receipt of such notice, request and offer of indemnity shall have failed to institute such a proceeding; and
- (v) no direction inconsistent with such written request has been given to the Trustee during such 90 day period by the Holders of a majority in principal amount of the Bonds Outstanding at that time;

it being understood and intended that no one or more Holders of Bonds or coupons shall have any right in any manner whatever by virtue of, or by availing of, any provisions of this Indenture to affect, disturb or prejudice the rights of any other Holders of Bonds or coupons, or to obtain or seek to obtain priority or preference over any other Holders or to enforce any right under this Indenture, except in the manner herein provided and for the equal and rateable benefit of all the Holders of Bonds and coupons.” Model clause prepared by the Group of Ten, available at: www.bis.org/publ/gten08.pdf.

⁴⁵⁴ A sample acceleration clause is as follows:

“Acceleration. If an Event of Default occurs and is continuing, then, and in every such case, the Trustee may, or shall upon the instruction of the Holders of not less than 25% in aggregate principal amount of the Bonds Outstanding at that time, declare the principal of, and any interest accrued on, all the Bonds to be due and payable immediately by a notice in writing to the Issuer, and upon any such declaration such principal and interest shall become immediately due and payable.” Model clause prepared by the Group of Ten, available at: www.bis.org/publ/gten08.pdf.

include a de-acceleration provision according to which upon cure or waiver the outstanding defaults by the borrower a certain majority (usually between 50% and 75%) is entitled to de-accelerate the debt,⁴⁵⁵ so that it is not due and payable and the pre-established repayment dates apply.⁴⁵⁶ Majority enforcement provisions may also deal with the right of the bondholders to initiate a legal proceeding, which is generally restricted so that only a qualifying majority of bondholders are entitled to proceed. English law bonds are issued under trust deeds, and under a trust deed the trustee is the only entity entitled to start a legal proceeding in respect of the claims arising from the bonds (upon instructions of a certain majority of bondholders, usually 20-25%), therefore prohibiting single bondholder to commence individual actions. A trust deed, furthermore, requires the proceeds of any litigation to be applied pro rata across all bondholders, making less attractive the litigation option for holdout creditors. On the other hand, New York law bonds may also adopt the fiscal agent structure, whereby there is no trustee acting on behalf of the bondholders, and hence the relevance of clauses dealing with majorities for initiating legal proceedings.⁴⁵⁷

A common feature for both types of clauses is that the bonds held by the borrower (upon debt buy backs) are disenfranchised for the purposes of calculating the relevant majorities, so that the relevant debtor cannot influence the voting process.⁴⁵⁸

Further examples of CACs, not yet very developed, are the representation clauses and the aggregation clauses.

⁴⁵⁵ A sample de-acceleration clause is as follows:

“Rescission of Acceleration. If any and all existing Events of Default hereunder, other than the non-payment of the principal of the Bonds which shall have become due solely by acceleration, shall have been cured, waived or otherwise remedied as provided herein, then, and in every such case, the Holders of 66-2/3% in aggregate principal amount of the Bonds Outstanding at that time, by written notice to the Issuer and to the Trustee as set forth in the Trust Indenture, may, on behalf of all the Holders, rescind and annul any prior declaration of the acceleration of the principal of and interest accrued on the Bonds and its consequences, but no such rescission and annulment shall extend to or affect any subsequent default, or shall impair any right consequent thereon. Actions by Holders pursuant to this Section ___ may be taken by written action of the Holders.” Model clause prepared by the Group of Ten, available at: www.bis.org/publ/gten08.pdf.

⁴⁵⁶ B. Metzger and M. J. Hagan, *Collective Action Clauses in International Sovereign Bonds*, Journal of Banking and Finance Law and Practice, 2003, p.225-226.

⁴⁵⁷ B. Metzger and M. J. Hagan, *Collective Action Clauses in International Sovereign Bonds*, Journal of Banking and Finance Law and Practice, 2003, p.226.

⁴⁵⁸ For recent examples of CACs introduced in sovereign bonds see R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, p. 442- 448 and M. Gugiatti and A. Richards, *The use of collective action clauses in New York law bonds of sovereign borrowers*, Georgetown Journal of International Law, 2004, pp. 815-835.

Representation clauses deal with the procedure for negotiations between the debtor and the classes of creditors. These clauses can be more or less detailed and provide a framework for negotiation, from the process to be followed to convene the borrower and creditors for negotiations, the method for representing the creditors and the necessary details and information to be provided by the borrower in the context of a restructuring. It could deal also, for instance, with the appointment of a bondholders' representative that would then be entitled to represent and voice the collective interests of the bondholders.⁴⁵⁹

Aggregation clauses amplifies the effect of majority restructuring clauses and majority enforcement provisions by providing such clause to apply not only to the specific debt instrument in which they have been included, but also to all further bond issuances, so that the creditors' claims in separate bond issuances are aggregated. They generally require a double majority: an overall majority in respect of all the series involved and a majority in respect of each single issue of bonds.⁴⁶⁰

These clauses allow the debtor to engage in a comprehensive restructuring with all bonds issuances covered by such aggregation clause and avoid hold outs issues in respect of creditors controlling a single bond issue amongst many and trying to block the entire restructuring process.⁴⁶¹

A very recent and interesting development is the requirement for all bonds with maturity more than one year issued in the European market (both national and international securities) to include CACs starting from 1 January 2013, as a measure against the occurrence of situations as the Greek restructuring (see next chapter) to happen again in the Eurozone and facilitate orderly and voluntary restructurings and reduce the issue of holdout creditors. The CACs to be included in the Eurobonds will also have an aggregation clause so that the majority provisions will apply across multiple issuances of bonds, making it more difficult for vulture funds to acquire a blocking position and stop the restructuring process.⁴⁶²

⁴⁵⁹ B. Metzger and M. J. Hagan, *Collective Action Clauses in International Sovereign Bonds*, Journal of Banking and Finance Law and Practice, 2003, p.226.

⁴⁶⁰ Uruguay introduced an aggregation clause in its bonds issued in 2003, which required a double majority as follows: (i) 85% of the aggregate principal amount of all affected series; and (ii) 66 2/3% of each specific series. See R. Olivares-Caminal, *Is there a need for an International Insolvency Regime in the Context of Sovereign Debt? A case for the Use of Corporate Debt Restructuring Techniques*, Journal of International Banking Law and Regulation, 2009, pp. 21-34.

⁴⁶¹ B. Metzger and M. J. Hagan, *Collective Action Clauses in International Sovereign Bonds*, Journal of Banking and Finance Law and Practice, 2003, p.226.

⁴⁶² C. de Vrieze, *New sovereign CAC provision a step forward, but unlikely to resolve future debt restructurings*, published online on Debtwire on 12 December 2012.

In practice, it must be noted that CACs are a partial solution, due to the fact that the vast majority of sovereign debt was issued several years ago (in particular the Brady bonds – see chapter three), will mature in many years to come (most of them will mature in 2025) and do not include CACs. Therefore the holdout issue may still be relevant and is not resolved.⁴⁶³

CACs are surely an effective tool to improve certain aspects of sovereign debt restructuring, in particular to avoid lengthy litigation with vulture funds which exacerbate the delicate position of a country going through a financial crisis, and they help creating an orderly framework to operate, setting out procedures ahead of the critical time, making the process quicker and more efficient.

The other useful effect is that the widespread use of these clauses “educates” the market and the investors, so that they are familiar with the process and they know what to expect if a distressed event occurs, avoiding panic attacks in the market, which a

It is worth noting that similar clauses are now generally included in private sector financing both in the form of loans and bonds. During the recent financial crisis the private sector had to face several restructuring process due to the incapacity of several companies to maintain the service of their debts as prior to the financial crisis. Most the debt documents did not include majority voting provisions so that unanimous decisions were often required, making the process a lengthy one and offering chances to holdout creditors to create issues in the negotiations.

Following such experiences, many practitioners included in the documentation clauses to deal with restructuring situations whereby a supermajority (generally between 75% and 85%) is entitled to change the economic terms of the loan agreement or bond instrument.

It has been argued that CACs do not deal with certain key issues of sovereign debt restructuring, in particular there is still the need to grant a “stay” to enforcement actions during the negotiations in order to avoid disruptive legal proceeding during the delicate phase of the restructuring and there is still no mechanics to provide rescue financing to the borrower in a distressed situation.⁴⁶⁴

It is certainly true that no statutory provisions as per national insolvency procedures are currently in place and CACs cannot offer such protections. It is however correct to say that CACs can be worded so that they empower the majority to enter into a

⁴⁶³ S. Hoger, *Towards a Reorganisation System for Sovereign Debt: an International Law perspective*, Brill Academic Publishers, 2007, pp. 33-35 and on CACs generally, A. Gelper, M. Gulati, *Innovation after the revolution: foreign sovereign bond contracts since 2003*, Capital Markets Law Journal, 2009, pp. 85-103 and J. Dey, *Collective Action Clauses, Sovereign Bondholders cornered?*, Law and Business Review of the Americas, 2009, pp. 485-530.

⁴⁶⁴ D.A. Jr. Skeel, *Can Majority Voting Provisions do it all?*, Emory Law Journal, 2003, pp. 417- 426.

contractual standstill which bounds all the bondholders and prevents any bondholder from commencing a legal proceeding, granting effectively the same level of protection to the debtor. In the same way, a CAC can be worded so that the majority is entitled to vote in favour of the introduction of an additional layer of debt ranking super senior, permitting the borrower to receive additional financing which would have priority over the existing debt, and being therefore more attractive for potential lenders.

In conclusion, CACs are not the answer to all the outstanding issues in the context of sovereign debt restructuring, however, they are a flexible instrument which has improved the debt restructuring process, creating an orderly framework for it, and which can further improve it, with innovative wordings which can be introduced in the future.⁴⁶⁵

c) Exit consents

Exit consents are a technique used in the context of sovereign debt restructuring in the event that the debt documentation to be restructured does not include majority voting provisions, requiring unanimous consent for amendments to its economic terms.⁴⁶⁶

According to such technique, the holders of the bonds in default, which have accepted an exchange offer, at the time when they accept the exchange offer are also requested to give their consent for certain amendments of the existing bond documentation. To the extent the majority required to amend the terms of the documentation is not reached, the exchange offer does not go through (i.e. the exchange offer is conditional upon the amendment of the terms of the existing documentation). The amendments concern those provisions which are not related to the economic terms of the bonds (which would require a unanimous consent to be amended), such as covenants and events of default.

The final result of the exit consent is that bondholders which do not accept the exchange offer are left with the old bonds, amended however in a way which make them very unattractive in legal and financial terms (so called covenant stripping,

⁴⁶⁵ On CACs see also N. Ishikawa, *Towards the Holy Grail of orderly sovereign debt restructuring Pt I: the use of CACs in sovereign debt financing*, Journal of International Banking and Financial Law, 2007, pp. 333-338 and N. Ishikawa, *Towards the Holy Grail of orderly sovereign debt restructuring Pt II: optimum architecture of collective action clauses*, Journal of International Banking and Financial Law, 2007, pp. 404-412.

⁴⁶⁶ Exit consent techniques can also be used if majority voting provisions have been included but the relevant majority has not been reached, so that payment terms cannot be amended.

which leaves the bondholder with very few of the original contractual protections included in the debt instrument).⁴⁶⁷

Ecuador was the first government to use exit consent techniques, in 2000, requiring the existing bonds to be amended as follows:

- all payment defaults had to be cured, so that the debt could be de-accelerated (i.e. not due and payable);
- deletion of the provisions prohibiting Ecuador to buy back the existing bonds while a payment default is continuing;
- deletion of the covenant according to which Ecuador undertook not to seek a further restructuring of the bonds;
- deletion of the cross default event of default (so that a default under the newly issued bonds would have not triggered an event of default under the old bonds);
- deletion of the negative pledge covenant (so that the borrower could grant additional security to other creditors);
- deletion of the covenant according to which the old bonds had to be listed on the Luxembourg Stock Exchange (turning effectively the old bonds in not tradable instruments).⁴⁶⁸

Uruguay, in 2003, also used exit techniques, but in a slightly different way in respect of the Ecuador exit consent. Uruguay, in fact, rather than making the exchange offer conditional upon the implementation of the required amendments in the old bonds, included a “check the box” exit consent, whereby bondholders could voluntarily choose to give their consent to the amendments, but the exchange offer was not conditional upon the required majority for the amendment being reached.⁴⁶⁹

As it has been noted by certain commentators, the downside of exit consent is that this technique has an element of coercion, which could go beyond the squeezing of the holdout creditors and there therefore a certain risk of abusing the minority. This

⁴⁶⁷ R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, p. 442-448.

⁴⁶⁸ R. Olivares-Caminal, *Is there a need for an International Insolvency Regime in the Context of Sovereign Debt? A case for the Use of Corporate Debt Restructuring Techniques*, *Journal of International Banking Law and Regulation*, 2009, pp. 31-32.

⁴⁶⁹ R. Olivares-Caminal, *Is there a need for an International Insolvency Regime in the Context of Sovereign Debt? A case for the Use of Corporate Debt Restructuring Techniques*, *Journal of International Banking Law and Regulation*, 2009, pp. 32 and R. Olivares-Caminal, J. Douglas, R. Guynn, A. Kornbeig, S. Paterson, D. Singh, H. Stonefrost, *Debt Restructuring*, Oxford University Press, 2011, p. 445-446.

is not the case in the event the exit consent is on a voluntary basis, as per the Paraguay example.⁴⁷⁰

On the other hand, the advantages of exit consents are as follows:

- they require no change to existing laws or standard form of bond documentation;
- they can be implemented only at a time when the debtor has found a restricting proposal deemed acceptable by the majority of its creditors;
- they ensure that the majority of creditors and the debtor itself are not exploited by a dissident minority of creditors, protecting them from opportunistic free riders of the market;
- the opportunity of implementing an exit consent will induce the debtor to propose an exchange offer good enough to attract a super majority support, indirectly strengthening the negotiation position of the bondholders.⁴⁷¹

⁴⁷⁰ L. C. Buchheit and G. M. Gulati, *Exit consents in sovereign bond exchanges*, UCLA Law Review, 2000, pp. 60-84.

⁴⁷¹ L. C. Buchheit and G. M. Gulati, *Exit consents in sovereign bond exchanges*, UCLA Law Review, 2000, pp. 82-83.

4. THE GREEK RESTRUCTURING

In this chapter the Greek case will be analysed. The main peculiarity of this restructuring is that it deals with government member of the European Union: historically, no European country had defaulted since the World War II⁴⁷² and this restructuring challenged the idea that sovereign defaults are for developing countries only and unthinkable for UE countries.

a) Background

The Greek drama commenced in October 2009, when the government revealed the deficit figures, making clear that the external indebtedness of the government was unsustainable and a restructuring of the debt would have been necessary.

The situation continued to deteriorate and became so critical that Greek sovereign bond yields rose up to 900 basis points over German bunds, making practically impossible for Greece to have access to the bond markets. The Greek government was then forced to turn to the European institutions and the international financial organisations for help.

A rescue package was put in place, consisting of Euro 80 billion in EU loans and additional Euro 30 billion granted by the IMF, conditional upon implantation of certain fiscal measures and structural reforms to restore competitiveness and growth. Shortly after, the leaders of the European Union agreed to implement additional rescue measures, in particular the creation of the European Financial Stability Facility (EFSF)⁴⁷³ with a lending budget equal to Euro 440 billion and destined to sovereign in financial distress and a secondary market purchase program (SMP) by the European Central Bank,⁴⁷⁴ according to which the European Central Bank had a mandate to purchase on the secondary market sovereign debt for the purposes of stabilising the spread of the relevant bonds.⁴⁷⁵

⁴⁷² Germany restructured its war debt in 1953, but the proper default dates back a decade earlier.

⁴⁷³ The mission of the EFSF is: "The EFSF's mandate is to safeguard financial stability in Europe by providing financial assistance to euro area Member States within the framework of a macro-economic adjustment programme. To fulfil its mission, EFSF issues bonds or other debt instruments on the capital markets. The proceeds of these issues are then lent to countries under a programme. The EFSF may also intervene in the primary and secondary bond markets, act on the basis of a precautionary programme and finance recapitalisations of financial institutions through loans to governments." See EFSF website on: <http://www.efs.europa.eu/about/index.htm>.

⁴⁷⁴ For more information on the program (now terminated) see the ECB website on: http://www.ecb.europa.eu/ecb/educational/facts/monpol/html/mp_013.en.html.

⁴⁷⁵ J. Zettelmeyer, C. Trebesch, M. Gulati, *The Greek Debt Restructuring: An Autopsy*, CESifo Working Paper Series, number 4333, 2013.

Notwithstanding the rescue plan, in 2011 it became clear that the improvements required to manage the Greek debt burdens were not sufficiently advanced (with a continuing negative GDP ratio) and that the debt would have soon become unsustainable.⁴⁷⁶

The involvement of the private sector in a second round of restructuring was inevitable and additional official financing would also be required. Before analysing the technical structure of the second restructuring, it will be helpful to set out the structure of the Greek private debt which needed to be reprofiled.

It is also relevant to recall that the Greek restructuring from a social point of view borne heavy consequences and endless public manifestations against the austerity measures, which added further complexity due to the political instability that such opposition created.⁴⁷⁷

b) Structure of the Greek indebtedness

The vast majority of the Greek private debt was in the form of bonds, held mainly by institutional investors (mainly French and German banks, together with hedge funds, mutual and pensions funds) and very few retail investors.

Almost all the debt was denominated in Euro and, quite surprisingly for international Eurobonds, the governing law of the large majority (approximately 90%) of the bonds was Greek law. English law was the governing law of the majority of the remaining bonds.⁴⁷⁸

In terms of CACs, the Greek law governed bonds did not include any majority voting provisions, whilst English law governed bonds included majority provisions allowing amendments to the payment terms with, respectively, a 66% majority in bonds issued prior to 2004 and a 75% majority for bonds issued thereafter.⁴⁷⁹

The peculiar characteristics of the Greek debt posed certain issues in terms of structure of the restructuring to be implemented, including certain advantages and certain disadvantages.

The main advantages are:

⁴⁷⁶ J. Zettelmeyer, C. Trebesch, M. Gulati, *The Greek Debt Restructuring: An Autopsy*, CESifo Working Paper Series, number 4333, 2013.

⁴⁷⁷ See, amongst many, H. Smith, *Anger in Athens as Greek austerity measures passed*, The Guardian, November 2012, available at: <http://www.theguardian.com/world/2012/nov/07/greece-austerity-protests-violence>.

⁴⁷⁸ L. C. Buchheit, G. M. Gulati, *How to Restructure the Greek Debt*, 2010, p. 1-2, available at Available at SSRN: <http://ssrn.com/abstract=1603304> or <http://dx.doi.org/10.2139/ssrn.1603304>.

⁴⁷⁹ L. C. Buchheit, G. M. Gulati, *How to Restructure the Greek Debt*, 2010, p. 2-3, available at Available at SSRN: <http://ssrn.com/abstract=1603304> or <http://dx.doi.org/10.2139/ssrn.1603304>.

- almost all the private debt was in the form of bonds, so that there were no sophisticated intercreditor issues between bank debt and bonds and negotiation generally could be carried out with a single category of creditors;
- financial support from multilateral and bilateral sources was available, so the newly issued bonds may have been made more attractive using some form of “credit enhancement” using as model the Brady bonds;
- very few bonds were held by retail investors, so that the Greek government was not in the uncomfortable situation of dealing with thousands of single investors;
- most the bonds were governed by the national law, which gave the government the option of passing ad hoc laws to deal with the amendment of the terms of the bonds.⁴⁸⁰

On the other hand, the same features presented some disadvantages, as follows:

- a relevant percentage of the bonds was held by Greek institutional investors, which implied that any relevant haircut of the debt would have negatively impacted on the Greek domestic financial sector itself;
- another category of holders of Greek debt (in a relevant proportion) were European banks, whose stability was also relevant for the general well being of the European financial framework (in this respect the Greek crisis resembled the Latin American crisis of the 1980ies, whereby the deep involvement of the international banks requested additional rescue financing for years in order to allow such banks to create appropriate loss reserves to allow them to deal with a right off of the sovereign debt without risking the bankruptcy of the commercial banks themselves);
- Euro was the currency of most of the debt, and being a currency shared with the other members of the European Union, any measure negatively affecting such currency would have been reflected on the Euro zone and any loss of confidence in the currency would also be propagated to all other EU countries.⁴⁸¹

⁴⁸⁰ L. C. Buchheit, G. M. Gulati, *How to Restructure the Greek Debt*, 2010, p. 4-5, available at Available at SSRN: <http://ssrn.com/abstract=1603304> or <http://dx.doi.org/10.2139/ssrn.1603304>.

⁴⁸¹ L. C. Buchheit, G. M. Gulati, *How to Restructure the Greek Debt*, 2010, p. 5-6, available at Available at SSRN: <http://ssrn.com/abstract=1603304> or <http://dx.doi.org/10.2139/ssrn.1603304>.

Next paragraphs will outline the terms of the deal struck for the Greek restructuring and some general observations in terms of consequences for the future.

c) The Greek deal(s)

At the end of 2011, negotiation with the private sector commenced, in order to reach an agreement on the terms of an exchange offer, which was due to considerably reduce the private debt burden hanging on Greece.

The negotiation were conducted on behalf of the private creditors by creditors's committee (which, again, reminds of the bank steering committees in the 1980ies (see chapter three)) composed by 12 banks, insurers and asset managers holding in aggregate about 30-40% of the outstanding debt.

In February 2012, the Greek Government and the committee announced that a deal had been found and in March the following exchange offer was presented to the investors, so that for every old bond, each investor would receive:

- 15% of the face value exchanged with EFEF notes, issued in two separate series, one maturing in March 2013 and bearing a 0.4% coupon and the other maturing in March 2014 with coupon of 1%;
- 31.5% of the face value exchanged with new English law bonds, with maturity of up to 30 years;
- a set of detachable GDP-linked securities, which offered an increase in the coupon of the principal amount of the new bonds of up to 1%, on the basis that the real growth and nominal GDP exceed certain figures starting from 2015.

Bondholders, as final outcome, suffered a haircut of more than 50%, however, 97% of the creditors supported the exchange offer. Main reason for such a successful exchange is that institutional investors held the vast majority of the debt, and such kind of investors are sensitive to official sector and public opinion pressure and could not ignore the European governments and regulators' recommendations.

Bonds purchased in 2010 by the European Central Bank, the bonds held by the Greek central bank and by the European Investment Bank were excluded by the exchange

offer and exchanged into new bonds with identical economics prior to the launch of the exchange offer on the market.⁴⁸²

A peculiarity of the restructuring was the inclusion, by means of law, of “retroactive” CACs in the bonds governed by Greek law, so that a majority of bondholders could vote in order to accept the amendments to the existing Greek bonds required to implement the exchange offer. The Greek Bondholder Act permitted to impose new payment terms on the dissenting minority with the consent of two thirds of face value votes. The CAC would also include an aggregation clause, so that it would apply to all series of bonds, with a participation quorum for each series of bonds of 50% of the face value of the debt. The aggregation clause was fundamental to achieve the restructuring of 100% of the Greek law governed bonds.⁴⁸³

The Greek tragedy however was not yet completed.

In November 2012 a further rescue package was required, involving the official sector, which agreed to: (i) extend the maturity of the loans advanced by the EFSF (with no face value discount); (ii) the European Central Bank’s commitment to return to Greece any profit made in respect of the bonds issued prior to the March 2012 exchange offer; (iii) the EFSF would have advanced further loans to finance the buy back of the newly issued bonds (which were trading at a large discount on the secondary market); (iv) a commitment by the Eurogroup to “consider further measures and assistance, including inter alia lower co-financing in structural funds and/or further interest rate reduction of the Greek Loan Facility (i.e. the loan advanced by the EFSF to Greece), if necessary, for achieving a further credible and sustainable reduction of Greek debt-to-GDP ratio, when Greece reaches an annual primary surplus, as envisaged in the current MoU, conditional on full implementation of all conditions contained in the programme”.⁴⁸⁴

In conclusion, the Greek restructuring was an example of a quick and orderly restructuring implemented mainly using contractual techniques (i.e. CACs) and introducing innovative expressions of such clauses, in particular in relation to the use of aggregation clauses in the Greek law bonds. A technical success in a timing and size failure: it is unfortunately clear that the magnitude of the crisis would have required a much earlier intervention and a more effective reduction of the debt and that the efficient technical approach could not compensate such delay.

⁴⁸² J. Zettelmeyer, C. Trebesch, M. Gulati, *The Greek Debt Restructuring: An Autopsy*, CESifo Working Paper Series, number 4333, 2013, pp. 10-11.

⁴⁸³ J. Zettelmeyer, C. Trebesch, M. Gulati, *The Greek Debt Restructuring: An Autopsy*, CESifo Working Paper Series, number 4333, 2013, p. 26.

⁴⁸⁴ Eurogroup statement on Greece, 27 November 2012.

d) The future

The Greek restructuring had several peculiar elements so that it will be difficult to use the “Greek model” for future European restructurings.

Surely one main consequence of the Greek meltdown was the introduction of CACs (preferably including an aggregation clause), mandatorily, in each Eurobond issuance starting from 1 January 2013 (as mentioned above), which testify the success of such contractual instrument in sovereign debt restructurings.

Furthermore, it has also been suggested that the treaty establishing the European Stability Mechanism⁴⁸⁵ (which replaced the EFSF) is amended so that it states that assets and revenues of Eurozone members will be immune from attachments during the restructuring process, creating a statutory “stay” which would protect European countries from opportunistic litigation commenced by holdout creditors, so that the financial support provided by the European institutions is not used to repay existing payment obligations of creditors which declined to support the restructuring.⁴⁸⁶

This kind of amendment would substantially replicate one of the key features of national insolvency procedure and become, together with the other ad hoc innovation such as the establishment of the ESM itself, the closest international representation of a statutory mechanism for sovereign debt restructuring.⁴⁸⁷

⁴⁸⁵ The European Stability Mechanism is an intergovernmental institutions under public international law, with a lending capacity of up to Euro 500 billion, which provides financial assistance by way of: (i) loan disbursement; (ii) precautionary facilities; (iii) facilities to finance the recapitalisation of financial institutions through loans, including non-program countries; (iv) facilities for the purchase of bonds in the primary and secondary markets. See the ESM website at: www.esm.europa.eu/.

⁴⁸⁶ J. Zettelmeyer, C. Trebesch, M. Gulati, *The Greek Debt Restructuring: An Autopsy*, CESifo Working Paper Series, number 4333, 2013, p. 42.

⁴⁸⁷ L.C. Buchheit, G. M. Gulati, I. Tirado, *The problem of holdout creditors in Eurozone Sovereign Debt restructuring*, *Butterworths Journal of International Banking and Financial Law*, April 2013, pp. 191- 194.

CONCLUSIONS

The world of sovereign debt restructuring has been characterised for many decades (centuries!) by a high level of unpredictability and disorder.

Throughout the several past restructuring episodes, practitioners, multilateral institutions and governments have been continuously looking for improvements in the way restructurings develop and for solutions to the main technical issues around debt workouts.

The need for an orderly sovereign restructuring mechanism is particularly felt due to the social consequences on the population that lengthy and inefficient restructurings have, limiting the development possibilities of emerging economies and causing social unrest and political instabilities in the defaulted countries.

This thesis starts from the acknowledgment of debt sustainability as a key issue for development. The main *fora* whereby international organizations and key influential actors of the financial world meet to debate contemporary issues discussed the way forward for developing countries in terms of management of their debt burdens. As mentioned in the first chapter, a first step to avoid main financial crisis is helping emerging economies with the incurrence and maintenance of their external debts, supporting them in terms of technical advice to be provided and transparency of the market.

In the 1970ies the disparity between the knowledge of experienced bankers offering financial products and members of governments of developing countries was such that easy mistakes were made and to some extent the unbalance of know how favoured the exploitation of such countries.

Nowadays, recent cases of debt restructuring prove that notwithstanding the presence of highly educated members of the government and being part of a sophisticated international organization as the European Union, still government can face economic crises due to the unsustainability of an external debt not sufficiently monitored.

In order to describe the background whereby sovereign debt restructurings take place, the second chapter sets out the various categories of debt that sovereigns generally incur, distinguishing between public and private debt. This distinction is particularly relevant give the different treatment, in terms of negotiation, that public and private debt receive and the *fora* whereby such negotiations take place. A relevant feature of sovereign debt restructuring, however, is the equal treatment between public and private creditors,

which requires both sets of creditors to agree upon the same level of reduction of the debt, in order not to advantage one class of creditors at the expenses of the other class, which would jeopardise the good outcome of the negotiations. In practice the debtors negotiate with public creditors a certain debt reduction or rescheduling and then undertake to achieve the same level of debt forgiveness from private creditors.

The focus of the thesis is mainly the rescheduling of private debt and the techniques adopted throughout the several cases of sovereign debt restructuring which occurred in the past decades and the developments and improvements of such instruments.

Each restructuring has its peculiar characteristics therefore it is difficult to trace a model for sovereign debt restructurings, as the factual circumstances vary greatly in each case.

Although for years the need for a statutory mechanism that replicated national insolvency procedures has been advocated, this thesis focused on the developments that the market itself introduced in the sovereign debt panorama and the positive effects that such innovations produced. As mentioned in the forth chapter, Collective Action Clauses are flexible instruments which can deal with the main issues affecting sovereign debt restructuring, with the advantage that such instruments are negotiated by the debtor and the creditors at the time of the issuance, so that they are not felt as an imposition by both parties and can be tailored to each specific case.

The introduction of this kind of clauses in sovereign bonds was supported by the US Treasury, which was relevant due to the fact that English law bonds already generally included CACs, whilst the New York law bonds still resisted to such trend and the blessing by the US government was a strong message to the market players which eventually accepted to amend the terms of the documentation.

Their flexibility also allows such instruments to be included in any kind of debt instrument, so that in the event the market switched back to bank loans (or to the extent certain countries still have a majority of bank loans outstanding) rather than bonds, CACs can be included also in such documentation, at their issuance or by way of pre-emptive amendment in respect of bonds already issued.

The Greek restructuring proved that exchange offers based on bond instruments including CACs can be effective and can be implemented in a very short timeframe. However, it is worth noting that the Greek debt had the peculiarity of being held mainly by institutional investors rather than retail investors, so that communicating and negotiating with them was more practical and less time consuming. In Argentina, where the bonds were mainly in the hands of retail investors, retrieving the names of each investor, locating each of them and then negotiating the terms of the offer was an

incredibly time consuming exercise. Therefore it is true that although technically they provide a useful tool for restructuring the debt, the circumstances of each specific case will impact on the level of effectiveness that such clauses can provide.

As general point, however, the relevance of the CACs is in respect of holdout creditors: the vote of a single creditor, in fact, loses its individual weight and in order to obstacle the restructuring it is required a so called “blocking” position, equal to the full amount of the bonds minus the amount necessary to vote in favour of the amendments plus one.

Acquiring such percentage of bonds is not impossible for specialised investment funds which purchase distressed debt on the secondary market. However, this can be avoided by the inclusion of aggregation clauses that require a double majority, in the single series of bond and across all the series of bonds to which the aggregation clause applies in order to vote in favour of the amendments. Acquiring a majority across all series of bonds can be challenging (and beyond the capacity) of such investment funds, providing a proper protection to the borrowers in distress.

The most recent update in terms of CACs is the decision by the European Union to require the mandatory inclusion of CACs in long term European bond issuances, sending a strong message to the market. And the development of CACs can solve further issues, such as providing for a standstill from enforcement actions and the provision of rescue financing to alleviate liquidity issue for distressed borrowers. The question to be answered in the following years is whether and to what extent the market will accept the inclusion of more sophisticated clauses and more “invasive” in terms of restructuring process, so that the price of the bonds remains untouched and the players in the sovereign bond panorama accept such further developments, limiting the power of single investors in favour of predictability and orderly terms of future restructurings.

There is something cyclical in the financial downturns in history: the recurrent theme being that situations of high liquidity bring a high level of confidence that everything is and will be fine, encouraging substantial incurrence of debt which is offered at low prices on the market. As the boom at the beginning of the XX century was followed by the dramatic economic downturn in the 1920ies, in the same way the economic peak at the beginning of the XXI century was followed by a financial crisis which challenged the strongest economies in the world.

Hence the query whether beyond improving and developing new frameworks to deal with sovereign debt restructurings, there is the need to learn from history.

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