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Article

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George Pavlidis

Designing a Sovereign Debt Restructuring Mechanism for a European Monetary Fund

The establishment of a European Monetary Fund (EMF) enjoys increasing academic and political support, though its advocates do not necessarily agree on the purpose and functions of such an institution. This paper aims to examine the features of the EMF that are relevant to sovereign debt restructuring. We argue that a European sovereign debt restructuring mechanism would be a feasible and useful tool in a crisis. It would facilitate private sector involvement and convey all the advantages that pre-defined procedures offer compared to ad hoc solutions in dealing with a crisis.

This paper builds on previous works and proposals looking at the integration of a sovereign debt restructuring mechanism within the European framework for countries in financial distress.¹ The idea is worth examining in the context of the ongoing discussions on the establishment of a European Monetary Fund (EMF). A European legal and institutional framework for the restructuring of sovereign debt could be modelled on Krueger's 2001 proposal for a Sovereign Debt Restructuring Mechanism (SDRM). That proposal – the final form of which was tabled at the International Monetary Fund (IMF) in 2003 – failed to materialise into new rules and institutions, but it has spurred debate that continues today, especially following the sovereign debt crisis in the eurozone. In our view, it is worth revisiting the debate and going a step further with a proposal for a Europeanised SDRM, which could be integrated within the framework of a future EMF.

The establishment of an EMF enjoys increasing academic and political support, though its advocates do not necessarily agree on the purpose and functions of such an institution.

¹ F. Gianviti, A. Krueger, J. Pisani-Ferry, A. Sapir, J. von Hagen: A European Mechanism for Sovereign Debt Crisis Resolution: A proposal, Bruegel Blueprint Series No. 10, 2010; J. Matthes, T. Schuster: Zum Umgang der Europäischen Währungsunion mit reformunwilligen Eurostaaten, in: ifo Schnelldienst, Vol. 68, No. 4, 2015, pp. 13-18; J. Matthes: Risks and Opportunities of Establishing a European Monetary Fund Based on the European Stability Mechanism, IW policy paper No. 8, 2017, pp. 6-7.

tution.² Past proposals for an EMF typically entailed the following building blocks: a financial body to provide financing in case of crisis, a mechanism for restructuring sovereign debt, an independent dispute resolution to adjudicate disputes and a body to oversee the economic adjustment of the debtor.³ This paper aims to examine the features of the EMF that are relevant to sovereign debt restructuring, taking into consideration the discussion on the Krueger proposal as it was tabled 15 years ago.

Designing a Europeanised SDRM

An approach based on the use of collective action clauses (CACs) in euro area government securities cannot address all practical and legal issues associated with sovereign debt restructurings. Under the European Stability Mechanism (ESM) Treaty, the inclusion of standardised model CACs in new euro area government securities has been mandatory since 1 January 2013, with some minor exceptions (e.g. government securities with a maturity of less than one year). Nevertheless, the bulk of government bonds issued prior to that date in the eurozone are governed by the national law of the issuing member states.⁴ Hence, there are still outstanding sovereign bonds which may contain CACs of various types and which will mature

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² D. Gros, T. Mayer: A European Monetary Fund: Why and How?, CEPS Working Document No. 2017/11, 2017.

³ D. Gros, T. Mayer: How to Deal with Sovereign Default in Europe: Create the European Monetary Fund Now, CEPS Policy Brief No. 202, 2010; Y. Mersch: Reflections on the Feasibility of a Sovereign Debt Restructuring Mechanism in the Euro Area, in: European Central Bank: ESCB Legal Conference 2016 Proceedings, 2017, pp. 6-13.

⁴ Y. Mersch, op. cit.

in the next five to ten years or more. This diversity threatens to complicate the usage of bonds and the resolution of future sovereign debt crises in the eurozone.

On the other hand, if a debt restructuring mechanism is adopted by means of a new treaty or an amendment to existing legal instruments, all debt contracts entered into by a party to the treaty would be subject to the provisions of that treaty, any clause to the contrary notwithstanding. In practical terms, it would be “as if the contract included a collective action clause, the terms of which would be those defined by the treaty”.⁵ This would help address the slow implementation of CACs in bond contracts during the transition period when bonds with and without CACs will co-exist.⁶ This would also help address the lack of uniformity among CACs prior to 2013 and the need to introduce more comprehensive standardised CACs after 2013.⁷

Legal basis

A European SDRM could be established either through an amendment of the ESM Treaty or through adoption of a new intergovernmental agreement, such as a statute of a future EMF. In both cases, the intergovernmental approach would be followed and new treaty obligations established for member states; therefore, legislative authorisation for acceptance would be required in most countries, and in some cases, domestic legislation would need to be enacted. These are difficulties that were also discussed in the context of the Krueger proposal, according to which the SDRM could be established through an amendment of the IMF's Articles, which would require acceptance by three-fifths of the Fund's members (85% of the voting power).⁸ Admittedly, building consensus for new treaty obligations would be easier among the 19 eurozone members than among three-fifths of the IMF members, not only because of the number of states involved, but also because of the eurozone's shared vision and goals.

An alternative proposal on the establishment of an EMF was put forward by the European Commission in Decem-

ber 2017, but it did not deal with debt restructuring.⁹ The proposal attempted to communitise the ESM by anchoring it within the legal framework of the European Union. The Commission argued that such a change “would strengthen governance and decision-making”, avoiding “cumbersome national procedures” and ensuring timely crisis management.¹⁰ It was also argued that such a change would mean greater transparency, anchored in the EU accountability framework with judicial control. We agree with Ioannidis that the Commission's proposal is problematic for several reasons,¹¹ primarily due to the selection of Article 352 of the Treaty on the Functioning of the European Union as a legal basis. The necessity test under this article is clearly not satisfied, as a financial assistance mechanism (namely, the ESM) has already been established to safeguard eurozone stability. Thus, a rebranded version need not be created, nor can it be deemed necessary to integrate such a mechanism within the EU framework. Eurozone member states will have to opt for the intergovernmental approach, as in the case of the ESM, to establish an EMF.

Triggering of the SDRM

According to the principle of sovereignty, activation of the European SDRM could only be initiated by the sovereign debtor (i.e. the central government). The debtor's willingness to activate depends on the design of the mechanism – that is, whether the sovereign debtor would be convinced that activation would ensure rapid and orderly debt restructuring and limit economic dislocation.¹² Of course, member states participating in the European SDRM may consent to a debt restructuring even in the absence of any request on their part, but such a scenario seems politically unfeasible. Allowing for the unilateral activation of the mechanism, without any third-party confirmation, may be an option, but in this case, there should be robust features discouraging abuse of the mechanism by the debtor.

It is important to confirm the debtor's judgment that its debt is unsustainable. Clearly, the entity performing such a function should be independent from implicated parties to reduce the risk of a unilateral declaration of insolvency.¹³ If an EMF became part of the European financial architec-

5 F. Gianviti et al., *op. cit.*, p. 26.

6 G. Corsetti, M.P. Devereux, J. Hassler, G. Saint-Paul, H.-W. Sinn, J.-E. Sturm, X. Vives: A New Crisis Mechanism for the Euro Area, in: European Economic Advisory Group: The EEAG Report on the European Economy, Munich 2011, CESifo, pp. 71-96.

7 Deutsche Bundesbank: Approaches to Resolving Sovereign Debt Crises in the Euro Area, in: Deutsche Bundesbank: Monthly Report, Vol. 68, No. 7, 2016, pp. 41-62.

8 A.F. Lowenfeld: International Economic Law, Oxford 2008, Oxford University Press, p. 736; K. Chrysogonos, G. Pavlidis: The Greek Debt Crisis: Legal Aspects of the Support Mechanism for the Greek Economy by Eurozone Member States and the International Monetary Fund, in: A. Bitzenis, I. Papadopoulos, V. Vlachos (eds.): Reflections on the Greek Sovereign Debt Crisis, Newcastle upon Tyne 2013, Cambridge Scholars Publishing, pp. 275-303.

9 European Commission: Proposal for a Council Regulation on the establishment of the European Monetary Fund, COM(2017) 827 final, 2017.

10 *Ibid.*, p. 3.

11 M. Ioannidis: Towards a European Monetary Fund: Comments on the Commission's Proposal, EU Law Analysis, 31 January 2018.

12 International Monetary Fund: The Design of the Sovereign Debt Restructuring Mechanism – Further Considerations, 2002, p. 7.

13 H. Hirte: A Sovereign Debt Restructuring Mechanism for the Euro Area? No Bail-Out and the Monetary Financing Prohibition, in: European Central Bank: ESCB Legal Conference 2016 Proceedings, 2017, pp. 104-108.

ture, the debt sustainability analysis would be conveyed to this new institution by the parties currently carrying out the analysis (i.e. the European Central Bank, the European Commission and the IMF).

Lending by the EMF should be made conditional on debt restructuring only when a sovereign debtor is judged to be insolvent, while lending to a solvent sovereign debtor that faces temporary liquidity problems should be possible without debt restructuring.¹⁴ Resorting to the restructuring mechanism should not be a prerequisite of EMF lending, because as former Eurogroup President Jeroen Dijsselbloem has correctly pointed out, “if you say that if a country comes to the ESM for support there will always be sovereign debt restructuring, it will scare investors away from that country.”¹⁵

Scope of eligible claims

Orderly debt restructuring would imply an exchange of distressed sovereign debt for new debt (possibly backed by the EMF) with a haircut.¹⁶ Therefore, a European SDRM should identify the scope of eligible claims that are to be restructured. Negotiations between the debtor and its creditors could determine the subset claims to be restructured in a particular case.

Eligible claims held by international organisations should not be restructured under the European SDRM. The exclusion of such claims from restructuring is an international practice applied consistently and based on solid practical grounds (i.e. the need to not disrupt multilateral financing). The exclusion of multilateral claims could be in the form of a general exclusion, covering all public international financial institutions, or in the form of an enumeration of international organisations whose claims would be covered, with the possibility to amend this list in the future.

Claims held by official bilateral creditors should be restructured under the European SDRM as a separate class or in the framework of the Paris Club – the informal group of creditors who try to find solutions to the payment difficulties of debtor countries – in coordination with the restructuring of private debt under the European SDRM. The treatment of official bilateral claims was also discussed in the context of the Krueger proposal, but consideration of the

issue was deferred, with state creditors preferring to retain their treatment under the Paris Club.¹⁷

Encouraging creditor participation

It is important to encourage creditor participation both in the early stages of the restructuring process and in the final phase of the restructuring. In the first case, active creditor participation may take the form of representative creditors' committees. Such committees could negotiate the terms of a restructuring agreement with the sovereign debtor. An organised negotiating framework, in which the debtor may enter into good faith negotiations with a single counterpart, is important. Nevertheless, some issues must be taken into consideration: (i) the initiative to form such committees should belong to the creditor; (ii) creditors' committees should be sufficiently representative and take into account the creditor's exposure to the sovereign debtor; (iii) the sovereign debtor should be required to provide some level of information to creditors; (iv) though it would be appropriate for the debtor to bear the reasonable operational costs of such committees, this will be a tough sell; and (v) creditors holding a requisite percentage of registered claims could be given the right to terminate SDRM procedures.

Aggregation and majority restructuring

After the completion of the registration and verification process for eligible claims, as well as the negotiation process, the restructuring agreement should be approved by a qualified majority of creditors. The threshold could be fixed at 75%, as is the practice of many CACs. More importantly, the vote should take place on an aggregated basis (i.e. eligible claims should be aggregated for voting purposes). This option, indicated by new treaty obligations and subsequent national legislation, would be a key advantage of an SDRM compared to the CACs. Consolidating voting procedures into a single limb will help avoid holdouts created by investors acquiring a blocking minority in small bond issues.¹⁸ Moreover, following the standardised model of disenfranchisement clauses in the eurozone,¹⁹ there should be specific treaty provisions precluding creditors from voting if they are under the control of the sovereign debtor or if they have been unduly influenced by the sovereign debtor to vote in a particular manner.

14 A. Sapir, D. Schoenmaker: The Time is Right for a European Monetary Fund, Bruegel Policy Brief No. 4, 2017, p. 5.

15 J. Strupczewski: Europe needs market pressure to get economics right: Eurogroup head, Reuters, 14 October 2017.

16 D. Gros, T. Mayer: A European Monetary Fund..., op. cit.

17 International Monetary Fund: Proposed Features of a Sovereign Debt Restructuring Mechanism, 2003, p. 4.

18 J. Andritzky, D.I. Christofzik, L.P. Feld, U. Scheuering: A Mechanism to Regulate Sovereign Debt Restructuring in the Euro Area, German Council of Economic Experts Working Paper No. 04/2016, 2016.

19 C. Hofmann: Sovereign-Debt Restructuring in Europe Under the New Model Collective Action Clauses, in: Texas International Law Journal, Vol. 49, No. 2, 2014, pp. 385-443.

Stay on enforcement

A useful feature of a future European SDRM would be a stay on enforcement during the negotiation of a rescue programme. To reduce any moral hazards, this stay should not be a generalised one, but rather should apply in specific circumstances where enforcement could undermine the restructuring process (e.g. in instances of vulture litigation). A targeted stay on enforcement could be ordered by a dispute resolution forum, at the debtor's request and upon creditors' approval (or upon approval of a representative creditors' committee before the completion of the registration and verification process).²⁰ Alternative measures, such as the hotchpot rule used in the non-sovereign context, could deter disruptive litigation, without imposing a general stay on enforcement. Orders issued by a new international dispute resolution body that stay enforcement should be made binding on courts of the member states of a future EMF. A stay on enforcement could be complemented with an automatic extension of the debtor's securities, where the state in crisis faces liquidity problems, not solvency problems.

A forum for adjudicating disputes

A European Sovereign Debt Dispute Resolution Forum (SDDRF) could be established following the model in the Krueger proposal. Alternatively, an amendment of the EU Treaties could create a specialised chamber to deal with sovereign debt litigation in the EU's Court of Justice.²¹ The establishment of such a forum should ensure independence, competence and impartiality. A European SDDRF could have three primary functions: (i) administrative functions, such as the registration of claims and the administration of the voting process; (ii) exclusive jurisdiction over the resolution of disputes that will arise during the restructuring process, e.g. with regard to the validity and value of claims, the voting process, and the operation of creditors' committees; and (iii) the power to issue injunctive orders, such as an order that would stay a specific enforcement action or require a court in a member state to suspend legal proceedings.

Avoiding conflicts of interest

Providing financing in the case of a crisis – a function currently undertaken by the ESM – would be assumed by a future EMF. Inevitably, there would be conditionality for EMF financial assistance greater than the capital subscription,

as well as some mechanism for overseeing the economic adjustment. To avoid conflicts of interest, the EMF should not obtain new legal powers with regard to a European SDRM, but, in its role as a creditor or as part of the surveillance mechanism, the EMF should simply encourage an early and effective dialogue between the debtor and creditors. In our view, a European SDRM should be independent from existing organs of the ESM (or a future EMF), which could use its financial powers to create incentives for the appropriate use of the new mechanism.

Moving beyond the Commission proposal

Despite its flaws, the Commission proposal on the establishment of an EMF within the EU legal framework is a positive contribution to the discussion on Europe's future financial architecture. We argue that adding new innovative features to the European crisis resolution framework is more important than rebranding existing institutions, such as the ESM. More specifically, we argue that the integration of a formal European SDRM within a future EMF will provide greater predictability and timeliness to sovereign debt restructuring. Of course, such a reform will also likely lead to higher risk premiums for sovereign debt, particularly for countries that are less creditworthy; nevertheless, we agree with Matthes that the introduction of such a mechanism would be beneficial in the long run, as it would provide an incentive for more scrutiny and discipline in the markets.²² The fear that financial support might become conditional on restructuring in all cases led to the failure of the Krueger proposal, and this must not be left unaddressed within the European context. Furthermore, we believe that a European SDRM is more feasible than a global SDRM. First, contrary to the Krueger proposal, the proposal for a European SDRM would not face the same opposition from the United States or the US veto power at the IMF. Secondly, EU countries are fewer than IMF members and have a history of policy coordination, common rule-making and institution building as part of the European economic and political integration process. Therefore, a European SDRM, following the model of the Krueger proposal, would be a feasible and useful tool in the European crisis mechanism, facilitating private sector involvement in a crisis, with all the advantages that pre-defined procedures offer compared to ad hoc solutions.²³

20 International Monetary Fund: Proposed Features. . . , op. cit., p. 11.

21 R.M. Lastra: How to Fill the International Law Lacunae in Sovereign Insolvency in European Union Law?, in: European Central Bank: ESCB Legal Conference 2016 Proceedings, 2017, pp. 56-63.

22 J. Matthes: A European Monetary Fund - Considerations of Design, Politics and a Preliminary Evaluation, in: CESifo Forum, Vol. 18, No. 3, 2017, p. 17.

23 C. Fuest, F. Heinemann, C. Schröder: A Viable Insolvency Procedure for Sovereigns in the Euro Area, in: Journal of Common Market Studies, Vol. 54, No. 2, 2016, pp. 301-317.