

Legal Air Cover

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Background

Rapidly rising interest rates revive 'taper tantrum' memories

Daily cross-border portfolio flows, six-week moving average (\$bn)*



*Daily data not available for Chinese debt

Source: Institute of International Finance

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Official Response: DSSI (Apr. 2020) & Common Framework (Nov. 2020)

- *Rich Countries (including China) will grant some relief*
 - *For the Poorest 70 Nations*
 - *But most debt is owed by EMEs*
- *Only extensions of maturity (not reductions of principal)*
- *Will “ask” private creditors to contribute (and hope for the best?)*
 - *But most of the debt is private . . .*

Debt relief from markets: so far? Zero

- Private Creditors Say:

- We have complex contracts that call for individualized negotiation
- Plus, fiduciary duty

- Upshot

- Assuming we have twenty countries who go into default (we are at six)
- Thousands of individualized negotiations that will have to take place
- No mechanism to do this at one blow

Key questions

1. How to Put in a Single Shot Solution that Works For All?

- *Private Sector Says that Case-by-Case is the Only Way*

2. If we can figure out 1, how much will it cost?

- *Private Sectors Reps are saying it will increase the future cost of borrowing*
- *But no attempt to look at empirics*

Can We Design a Single Shot Procedure?

- Yes
- Using the facts that:
 - a) Jurisdiction for almost all the EM debt is NY & England
 - b) Attachable financial assets primarily flow through these two markets
 - c) US and UK decide the scope of immunity from litigation in their space

We did it For Iraq in 2003

- When Saddam was ousted in the spring of 2003, the total amount of unpaid claims against Iraq exceeded \$140 billion.
 - Most of the debts were owed to bilateral (governmental) creditors.
 - Approximately \$48 billion was due to members of the Paris Club
 - Another \$71 billion to more than 60 non-Paris Club bilateral lenders.
 - \$21 billion of the Saddam-era debt stock was owed to a widely mixed group of commercial creditors including commercial banks, insurance companies, hedge funds, trade creditors
- The Iraq debt restructuring was both harsh on the creditors and successful.
 - In NPV terms, Iraq inflicted an 89% loss on holders of Saddam-era claims
- Iraqi authorities had settled 13,164 separate claims tendered by 576 commercial creditors

How did we do it for Iraq in 2003?

- Iraq conducted its debt restructuring under the cover of a U.N. Security Council resolution -- Resolution 1483 of May 22, 2003 -- that effectively immunized Iraqi assets from seizure by Saddam-era creditors
 - Holders of Saddam-era claims against Iraq retained their legal *rights* under their respective contracts, their legal *remedies* had been significantly curtailed by the operation of Resolution 1483.
 - Creditors were free to stay out of the debt restructuring, but they could not count on their ability to seize Iraqi assets to satisfy any court judgments they might obtain until the Security Council resolution was either lifted or it expired
 - In November, 2004, President Bush added to the items covered by Security Council Resolution 1483 (Iraqi oil, the proceeds from the sale of that oil, and the bank account in New York into which Iraq's financial assets were deposited), any assets held in the United States by the Central Bank of Iraq ("CBI")
- The UN Security Council's Immunity strategy was initially set to expire in 2007, and received one extension until 2011.
- When the global shield expired in 2011, the US was still able to extend its effectiveness acting on its own
 - President Obama decided to renew President Bush's Executive Order immunizing Iraqi assets held in the United States until May 2014

Three options to provide air cover

1. A UN Security Council Immunity Shield similar to that used to restructure the Iraqi debt accumulated by Saddam Hussein
2. An executive order by the US President and a similar legislative action by the UK parliament (most international debt is issued under either New York law or English law)
3. The doctrine of Necessity under Article 25 of the International Law Commission's Articles on Responsibility of States for Internationally Wrongful Acts

Yes, we can!

- The air cover they provide may facilitate negotiations with creditors and buy time for conducting debt sustainability analyses, without the fear of a rush to the courthouse
- These solutions that we propose can be useful to deal with both liquidity and solvency crises in a world that still lacks a statutory mechanism for dealing with sovereign defaults

But...will Such Action Raise the Cost of Capital?

- The two biggest retroactive changes to creditor rights in history
 - *United States (1933) – abrogation of the gold clauses*
 - *Greece (2012) – retrofit insertion of restructuring provisions in bonds*
- We know what happened as a result of the US abrogation
 - *Which was the model for Greece (2012)*

Abrogation of the Gold Clauses – How Did the Mkts React?

- Justice Mc Reynolds Predicted:
 - *Loss of reputation for honorable dealing will bring us unending humiliation; the impending legal and moral chaos is appalling*
- Kroszner (1998) analyzed the impact

**Asset Prices Changes upon the Supreme Court Announcement
Permitting Abrogation of the Gold Clause, February 18, 1935,
consistent with High Distress Costs and Debt-Deflation Costs**

Equity Prices	Higher*
Corporate Bond Prices	Higher*
Government Bonds with Gold Clause	Lower
Government Bonds without Gold Clause	Higher
Commodities Futures Prices	Higher
Foreign Exchange Value of the Dollar	Lower

* Firms that are closer to distress, that is, firms with lower debt ratings and higher leverage, experience a greater increase in their equity and bond prices than do other firms upon announcement of relief.

But that was a long time ago . . .

And one market (the US)

- 2012, Euro area retroactively changed contract terms in \$200 bn of Greek debt contracts
- David Kotok (Cumberland Investors):
 - *No sovereign debt contract is now immune from the same action. All sovereign debt contracts will carry a risk premium. Buyers of European sovereign debt now act at their own peril*

Greece is interesting because

- Large restructuring with retroactive changes in contract terms
 - *challenged in courts in several jurisdictions*
- Court decisions with uncertain outcomes
- Potential effect on other countries in the European periphery
- Perfect set-up for an event study

A new test of spillovers

- At first, let us focus on two events:
 - February 23, 2012: The Greek Bondholder Act
 - March 23, 2013: Greek Council of State affirms legality of the Act
- And on spillovers on bond spreads of the Euro periphery:
 - *Ireland, Italy, Portugal, and Spain*

Methodology

- Define the change in spreads as:

$$\Delta_t^d = S_t^d - S_{t-1}^d$$

- Estimate the following model for before the event:

$$\Delta_t^d = \alpha + \beta Market_t + \varepsilon_t$$

- Use the parameter estimates to obtain excess (“abnormal”) changes in spreads as out-of-sample forecast error (i.e., by subtracting the out-of-sample predicted values $\widehat{\Delta S_{t+i}^d}$ from the actual changes) during the event window
- Defining the abnormal change in spread as: $A\Delta_{t+i}^d = \Delta_{t+i}^d - \widehat{\Delta_{t+i}^d}$ and the length of the event window as W , the cumulated change in abnormal spreads is:

$$CA\Delta_W^d = \sum_{i=2}^{i=W+1} (A\Delta_{t+i}^d)$$

- The t statistics for the average cumulated excess spread is given by:

$$\frac{CA\Delta_W^d}{\sigma_{A\Delta S} \sqrt{W}}$$

What do we find?

Table 1: Average excess spreads

	Feb . 23, 2012	March 25, 2013
	Mean Model	
Ireland	1.22 (0.17)	5.82 (0.85)
Italy	5.11 (0.75)	7.46 (1.04)
Portugal	16.05 (0.45)	12.23 (1.5)
Spain	1.15 (0.14)	7.68 (1.43)
	Market Model	
Ireland	1.59 (0.42)	2.27 (1.01)
Italy	0.12 (0.04)	- 5.51* (1.92)
Portugal	- 10.29 (0.5)	0.07 (0.02)
Spain	- 2.24 (0.31)	0.19 (0.13)

Abnormal returns t
1% confidence level

- test in parenthesis, ** statistically significant at 5% confidence level, *** statistically significant at

**OK, but maybe
this was not so
unexpected**

Decisions by foreign courts

- I. **May 20, 2014.** Ruling by **Austrian Supreme Court** on case brought by holders of Greek sovereign bonds. Plaintiffs had alleged, that following the Greek Bondholder Act, they had not received their expected amount at the point of the debts' maturity. The Austrian Supreme Court ruled against plaintiffs on the ground that the Greek Bondholder Act was a piece of foreign legislation and thus had sovereign immunity from foreign court rulings. However also included in the decision was the caveat that in issuing its bonds, Greece could be considered a commercial actor in this instance and could potentially be ruled on by a court. All of this would be dependent on jurisdiction – the plaintiff would have to prove Austrian jurisdiction over this case. Plaintiff ended up failing in this regard, and thus was never rewarded damages.
- II. **April 9, 2015.** Date of the ruling of the tribunal formed by the **International Centre for the Settlement of Investment Disputes** (ICSID) on the arbitration cases brought by Postova banka and Istrokapital SE against Greece. The tribunal rejected claims by the claimants that the bonds issued by Greece were to be considered as investments under the definition of the Slovakia-Greece BIT, which would have granted the ICSID tribunal jurisdiction to rule on the case.

Decisions by foreign courts

- III. **July 30, 2015.** The **Austrian Supreme Court** rules on a second case regarding Greek bonds. The court sided with the plaintiffs' argument that the Greek Bond Act was not to be considered under sovereign immunity but rather a commercial act. Despite this, jurisdiction was once again the key issue and the court ruled that the plaintiffs could not establish jurisdiction for the court to rule on the matter.
- IV. **November 25, 2015.** The **Austrian Supreme Court** rules on a third case on Greek bonds. As in the ruling of July 30, the Supreme Court affirmed that while Greece could indeed be considered a commercial actor at the time of issuance, jurisdiction under the Brussels I Regulation would have to be proven, specifically regarding the "place of performance" for the Supreme Court to be able to render a ruling.
- V. **March 8, 2016.** In a case brought by several German bond holders against Greece, The **Federal Court of Justice of Germany** ruled against the plaintiffs, writing that as a sovereign actor and having utilized powers unique to one such position in its enactment of the Greek Bond Act, the court could not render and enforce its judgement on internal sovereign affairs of Greece.

Decisions by foreign courts

- VI. **April 15, 2016.** The **Oldenburg Court of Appeals** (Germany) rules that the commercial nature of bond issuance could not be annulled by virtue of retroactive legislation, but do not rule in favor of the plaintiffs, as they did not receive the bonds directly from the Greek government but rather through proxy.
- VII. **July 7, 2016.** The **Schleswig Court of Appeals** (Germany) sides with Greece by deciding that as a foreign court, the court could not rule in a case regarding legislation passed by another power.
- VIII. **July 21, 2016.** In the case of *Mamatras and others v. Greece*, the **European Court of Human Rights** rejects investors' challenges on expropriation grounds. The Court ruled that while the investors were right in that their expectations to a certain amount of reward were reduced because of the government altering conditions already agreed upon, such altercations could be permissible in certain circumstances in pursuit of the public good.
- IX. **May 6, 2020.** The **German Federal Constitutional Court** rejected a constitutional complaint by Greek bondholders that the German Federal Court of Justice had decided to drop a case on the grounds of sovereign immunity without consulting the Federal Constitutional Court

Event study with matched bonds

Event	Italy										Lithuania		Latvia		Slovak	Portugal		Spain
Date	IT1a	IT1b	IT2a	IT2b	IT3a	IT3b	IT4	IT5	IT6	IT7	LT1	LT2	LV1	LV2	Republic	PT1a	PT1b	ES2
5/20/2014	NS	NS	NA	NA	NS	NS	NA	NS	4.78	NA	-4.68	NS	-1.41	NA	-3.67	NA	NS	NS
									(0.31)		(1.78)		(0.17)		(0.97)			
4/9/2015	NS	NS	NA	NA	6.30	6.42	NA	NS	NS	NA	NS	-4.08	NS	NS	NS	NA	9.21	NS
					(3.30)	(5.45)						(0.29)					(1.99)	
7/30/2015	NS	NS	NA	NA	4.33	NS	NA	NS	NS	NA	-16.12	NS	-10.88	NS	-1.49	-4.95	11.78	NS
					(1.66)						(0.83)		(0.073)		(0.03)	(1.00)	(1.09)	
11/25/2015	NS	NS	NA	NA	NS	NS	NA	NS	NS	NA	NS	NS	10.74	NS	NS	NS	NS	NS
													(1.02)					
3/8/2016	NS	NS	NA	NA	-3.85	-4.65	NA	NS	NS	NA	-12.57	NS	NS	NS	-2.84	-0.99	4.23	NS
					(3.47)	(2.12)					(1.04)				(0.29)	(0.21)	(1.06)	
4/15/2016	NS	NS	NA	NA	NS	NS	NA	0.49	NS	NA	NS	NS	NS	NS	-6.17	-1.09	-0.78	NS
								(0.01)							(0.62)	(0.34)	(0.21)	
7/7/2016	NS	NS	NA	NA	1.83	1.04	NA	NA	NS	NA	-14.75	NS	-16.70	18.26	-8.84	2.79	-1.67	-0.14
					(0.46)	(0.20)					(1.23)		(1.58)	(0.96)	(1.08)	(1.03)	(0.44)	(0.01)
7/21/2016	3.22	0.70	NA	NA	3.35	2.56	NA	NA	NS	NA	0.80	NS	-2.96	6.01	2.42	-4.61	-5.15	NS
	(2.95)	(0.30)			(1.03)	(0.63)					(0.05)		(0.26)	(0.17)	(0.26)	(0.75)	(0.72)	
5/6/2020	29.62		12.55	11.58	17.21	7.69	12.19	NA	NA	2.07	NS	NA	NS	NA	NS	NS	NS	NA
	(4.25)		(0.65)	(0.70)	(0.88)	(0.29)	(0.46)			(1.29)								
All	16.42				4.86	2.61					-9.47		-8.53	12.13	-3.43	-1.75	3.50	
Episodes	(1.24)				(1.71)	(1.19)					(2.92)		(3.03)	(1.98)	(2.17)	(1.25)	(1.36)	

Summary of results

- Out of 50 bond-event pairs for which we have data on abnormal spreads, only 6 are positive and statistically significant, while two are statistically significant and negative.
 - For bond-event pairs with positive and statistically significant abnormal accumulated spreads, we find that the effects are small, ranging from 3 to 29 basis points and being below 10 basis points in 5 out of 6 cases.
- Considering the joint tests of the bottom row, we find 5 statistically significant abnormal returns (out of ten for which we have data).
 - In two cases (one for Italy and one for Latvia), our estimates indicate positive abnormal accumulated spreads and in three cases (one for Lithuania, one for Latvia, and one for the Slovak republic), they indicate negative abnormal accumulated spreads.
 - In all cases, the abnormal accumulated spreads are very small, ranging between -9 and 12 basis points.

Summing up

- A wave of defaults might be coming
- If it's just in Low Income Countries with mostly official debt, things will be difficult
- If some large emerging markets also need to restructure their debts, things will be **EXTREMELY** difficult
- Hopefully, it will not happen but if it does happen, we need to be ready

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