The Argentine Debt Saga

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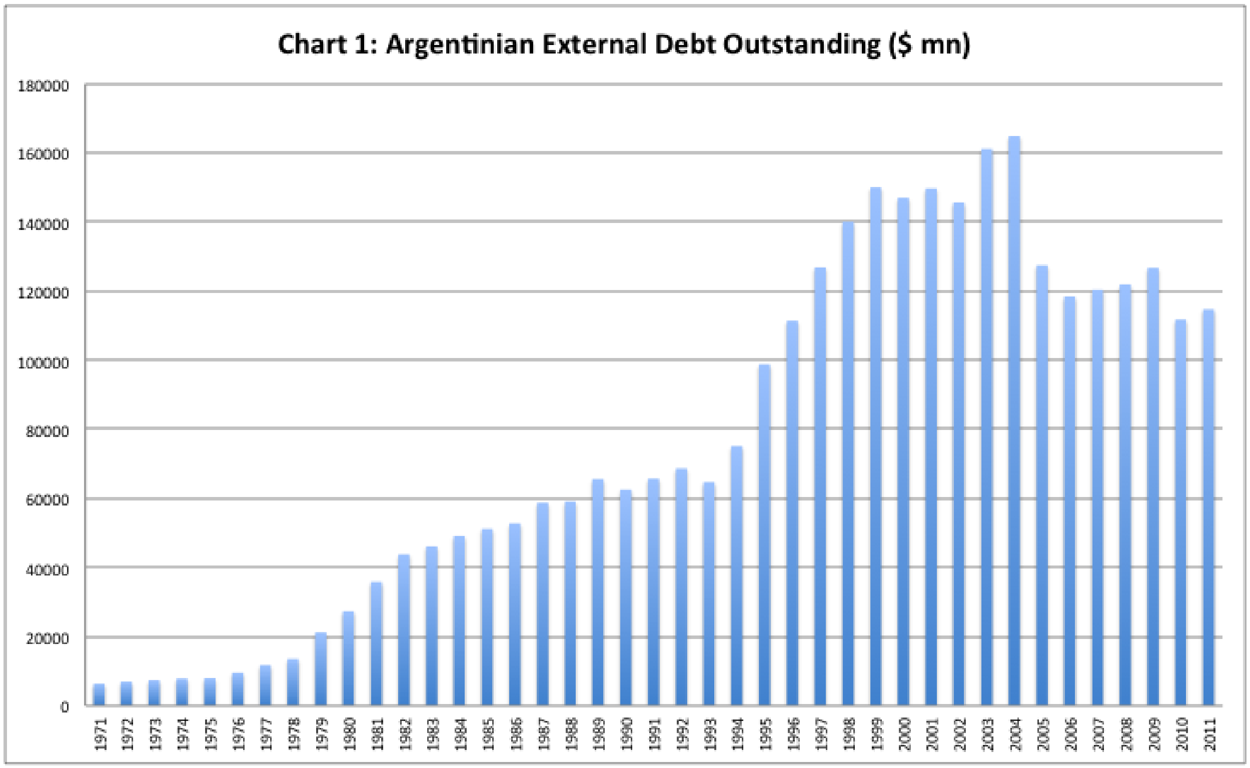
The effort by sections of global finance to force Argentina to retract on its more-than-ten-years old debt restructuring deal has not received the attention it deserves. In a ruling that marks a major departure from existing practice, the International Centre for Settlement of Investment Disputes (ICSID, established by a multilateral treaty under the World Bank) has ruled that it has the jurisdiction to arbitrate in a dispute between the Argentine government and a bunch of Italian “holdouts” accounting for around 7 per cent of the debt restructured in 2005 and 2010. The holdouts, who refused to participate in the debt-exchange offer are demanding full payment of sums owed to them based on the provisions of a bilateral investment treaty (BIT) between the Argentine and Italian governments. The treaty, needless to say, had little to do with the contractual obligations directly associated with the debt,

When the actual arbitration proceedings do begin they could lead to an award that requires Argentina to pay these bondholders in full. This would raise the issue of what the Argentine government would do about the remaining 93 per cent who took a significant “haircut” or reduction in the value of the debt they were originally owed. In the circumstances it may chose to default on payments to all holders of the original debt. If it does not, the case has larger ramifications and could set a precedent that traps countries into debt repayment even if that results in immense economic, social and political damage.

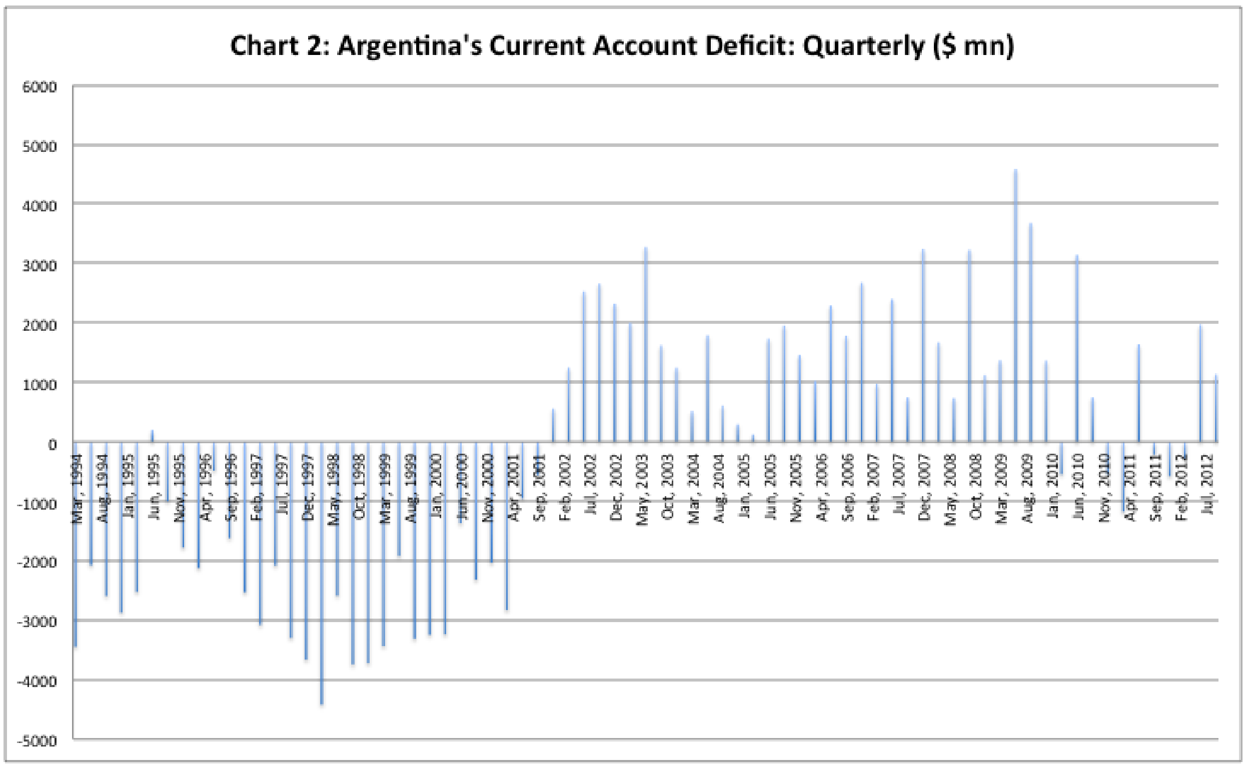
This story has a long history. Argentina’s sovereign external debt was accumulated in a process that began under the military dictatorship in the late 1970s and early 1980s (Chart 1). The shift to a neoliberal growth strategy in the 1980s and after only aggravated the Argentine debt problem, while growth remained low and the economy experienced bouts of hyperinflation. The shift to a currency board regime that involved fixing the value of the Argentine peso on a 1:1 basis vis-à-vis the dollar implied a highly overvalued exchange rate, a large current account deficit (Chart 2) and rising external debt to finance that deficit. That trajectory led up to the late 1990s crisis, which in turn finally precipitated the largest debt default in history in 2001, when Argentina defaulted on more than $80 billion dollars of external debt.



In 2005, the Argentine government managed to arrive at a deal with debtors accounting for around 75 per cent of its defaulted debt and interest thereon totalling around $100 billion, in which it agreed to issue new bonds to creditors worth less than 30 cents against every dollar of the value of the old bonds. To ensure this sovereign-debt exchange, the parliament enacted a 'lock law,' that effectively prevented any further deal with those who chose to stay out of the negotiations and the deal. However, those who stayed out still accounted for $25 billion of the original debt. Many of these “holdouts” were “vulture funds” or investors who had acquired the bonds in the secondary markets at a deep discount in the hope that they would through litigation recoup the full face value of the bonds.

Litigation was pursued along two tracks. Along one, suits were filed against Argentina in different New York, London and Frankfurt courts, given the laws that were seen to apply to disputes around the bonds. Along the other, eight Italian banks established a front called “Task Force Argentina” (TFA) that negotiated the right to serve as proxy for around 180,000 Italian bondholders. TFA then approached the ICSID with a request for arbitration on grounds that Argentina’s actions violated a bilateral investment treaty between Italy and Argentina signed in 1990. This case has subsequently come to be known as Ablacat and others vs. The Argentine Republic. In 2010, perhaps suspecting that some of the litigants were losing their patience with lack of success both in the courts and at the ICSID, the Argentine government temporarily stayed its “lock law” and made a second offer on the same terms to the holdout investors. Holders of around 70 per cent of the un-restructured debt agreed to this renewed offer of a debt swap and “haircut”, reducing the share of the holdouts to just 7 per cent of the total debt in default.

But those holdouts, consisting largely of the vulture funds, have surprisingly won preliminary victories along both tracks. In the US, Judge Thomas Griesa of the United States District Court in Manhattan ruled that the Argentinian government had violated the pari passu clause in the original loan agreement, which promised "equal footing" treatment to all its creditors It was therefore required to (i) pay the holdouts the full $1.33 million due to them if it pays the next installment of $3 million due to the holders of the restructured bonds; and (ii) keep the sum due to the holdouts in an escrow account till the matter was finally decided after appeal. In addition, Griesa made the judgment applicable to third parties as well, which would include the bond indenture trustee and the clearing system that are involved in managing transfers to the holders of the restructured bonds. That would imply that if Argentina did not comply with the judgment it would be forced to default on the remaining debt due to the holders of the restructured bonds as well. Argentina has gone on appeal, but the review may still validate Griesa's injunctions. The judgment has for the first time tied the hands of a sovereign debtor and found a way of making it extremely difficult for the latter to address a distressed debtor situation without upsetting financial markets.



If this were not bad enough, the litigants have earned an early victory in a jurisdictional decision taken by the ICSID tribunal in a disputed but majority decision. Argentina's case has been that bonds are contractual claims, that they do not satisfy the definition of "investment" and therefore do not fall under the BIT, that the ICSID is not expected to entertain mass action claims of the kind brought by TFA on behalf of those it "represents", and that for this and other reasons the ICSID does not have jurisdiction over a debt restructuring decision that is challenged by a few holdouts. In a first of its kind ruing by the ICSID in a debt restructuring case, the ICSID has dismissed these contentions and held that it has the jurisdiction to consider this claim for arbitration under the BIT.

The implications of this award though still jurisdictional, are many. But three stand out. The first is that a bond issued by a sovereign is an investment in the sense referred to in an investment treaty. The second is that unless expressly ruled out in the conditions associated with the bond, the terms of the BIT override any implicit terms of the bond. The third is that the interest of the investor, enshrined in the BIT, overrides any material conditions that make restructuring the only politically feasible alternative for the government.

As of now the Argentinian government seems set to reject any award that requires surrendering to the vulture funds. Not rejecting it would require revisiting its deal with those it had persuaded into accepting a bond exchange at a cost. Rejecting it would require withdrawing from the ICSID with some implications for Argentina's ability to approach global bond markets.

However, even the bond markets are not happy with the prospect of being held to ransom by the vulture funds. It would definitely mean that a restructuring of debt which seems to be the only way out in a context like Greece and possibly elsewhere in Europe would be difficult to implement. Further, in future, countries would insist on collective action clauses (CACs) in debt agreements that are not subject the terms of any BITs they have signed. These CACs would require all bondholders to join a restructuring negotiation if a specified majority chose to do so. That could slow the market. This would be bad if there is a crisis, as in Europe today. Moreover, countries frightened by the Griesa judgement may choose to stay out of the market. That would generate uncertainty that adversely affects the debt market even if there was no immediate crisis.

When private creditors buy into debt issued by different agents they are conscious of the fact that they are buying into risk as well, with the return being higher the greater that risk. One form the risk takes is that the debtor, because of unanticipated developments or because of unexpected shocks, finds it impossible to service the repayment and interest commitments associated with the debt. If that results in debt repudiation, the loss to the creditor is complete, while the debtor would in all probability be shut out of credit markets. On the other hand, if default leads to a negotiation in which debt is restructured, with reduced value, lower interest payments and extended repayment periods for example, the debtor can possibly overcome difficulties, repay the restructured loan, and remain in business. The loss to the creditor in this case is partial and would vary depending on circumstances. Since the latter outcome is in the best interest of both and possibly others indirectly involved, countries have framed laws under which debt restructuring is facilitated. A typical example is Chapter 11 of the United States' Bankruptcy Code that allows a business facing bankruptcy to reorganise its operations without being subject to litigation for a specified period.

It has for long been realised that there is no equivalent of a Chapter 11-type process when it comes to the foreign debt of sovereign governments. However, evidence shows that balance of payments, debt or currency crises, that warrant sovereign debt restructuring, are the norm, especially with the spike in cross-border capital flows under globalisation. When they occur default is a strong possibility, and multiple agents exposed to the debt of the country concerned need to be brought to the table and a resolution to the problem found. This is what led to the search for a Chapter 11-type restructuring framework for sovereign debt in the form of the Sovereign Debt Restructuring Mechanism suggested by some analysts and taken up by the IMF. There were no takers, so governments and markets had to find their own way to resolution, as Argentina did. What Griesa and the ICSID have done is subverted even that process. None but the vulture funds would celebrate such an outcome.

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