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Necessity Trumps Law: Lessons from Emerging Markets for Stressed Developed Markets?

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Necessity Trumps Law:
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Acknowledgement

INSOL is delighted to present the 25th Technical Paper under our Technical Paper Series titled "Necessity Trumps Law: Lessons from Emerging Markets for Stressed Developed Markets? written by Tim DeSieno and Katherine Dobson of Bingham McCutchen LLP, USA.

In this paper the authors examine the financial crisis experienced by the East Asian countries in the 1990s and also the sovereign debt crisis faced by Argentina in early 2000s and how the respective governments responded. On a more global scale - leading International Organisations responded to these crises by developing best practices for debt restructuring which were widely adopted by many countries and these are highlighted in this paper.

Several years later the world saw another financial crisis in 2008 and the paper covers the struggles in Europe among over-leveraged sovereign debtors and the cases of Ireland, Greece, Spain and Iceland are discussed. In the concluding part, the authors look at the short and long term policy ramifications including lessons from solutions previously deployed in stressed emerging markets.

INSOL would like to sincerely thank Tim DeSieno and Katherine Dobson for taking the time to write this excellent paper.

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Necessity Trumps Law:
Lessons from Emerging Markets for Stressed Developed Markets?

By
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Introduction[1]

Since the Asian currency crisis of 1997-1998 and the Argentina crisis of 2001-2002, global institutions have been very focused on international best practices in debt restructuring exercises. For example, the International Monetary Fund (IMF),[2] the World Bank,[3] United Nations Commission on International Trade Law (UNCITRAL),[4] INSOL International (INSOL),[5] and the Institute of International Finance (IIF)[6] each have published principles and guidelines that policy makers and professionals alike agree should be adhered to in times of financial stress, for companies, countries, and financial institutions. These principles include transparency, creditor engagement, and fairness of treatment among creditors. Notwithstanding the "Western" or "OECD"[7] roots of these best practices, which were launched in earnest in response to the behavior of a number of stressed emerging markets, the period of global financial stress that started in 2008 has engendered a curious trend. Since 2008, "developed" markets — in the United States and Western Europe — have resorted to debt restructuring techniques that suffer from some of the same alleged infirmities that were the subject of much criticism in the East Asian and Latin American financial crises. During the 2008 financial crises, where "developed" governments intervened intending to resolve problems, they often did so without providing transparency, meaningful communication, or fairness among creditors. Arguably, these actions have lacked a thorough respect even for the rule of law, and creditors' rights have been impaired *ex post facto*, through official behavior that many investors see as purely expropriatory.

In this paper, we examine some significant cases from the emerging markets precedents and standards, as well as some of the key official sector and other recommendations. We then examine what has happened in the current global financial crisis, and what responsive and preventative actions governments have taken. In that context, we consider how investors have been reflecting and reacting. We conclude with some thinking about what we have learned, including about official and investor behavior in the wake of a crisis, and about what systems and steps may be worth consideration in light of the candid learning.

Crises in the 1990s and Early 2000s: Governments' Behavior and Global Responses

A. The East Asian Financial Crisis

The history of sovereign financial crises is a very long one indeed.[8] It is easy to think of each financial crisis, or each period affected by crises, as unprecedented. But students of the subject do well to remind themselves that lessons from each previous crisis are useful in following crises. That statement is not meant to diminish the distinguishing features of each crisis — each one occurs in a given place and against the background of a particular cultural history — and it is important to understand these dynamics when seeking to understand, to navigate, or to manage a crisis. We aim here to reflect on recent financial crises in the spirit of both of these lines of thought.

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* The views expressed in this article are the views of the authors and not of INSOL International, London.
* The authors are in the Financial Restructuring Group of Bingham McCutchen LLP. They gratefully acknowledge the organizational and "sounding board" support of Spencer H. Wan, Columbia Law School, J.D. expected 2013.
1 Please note that facts are current through November 2012, though developments in Europe continue.
2 *Orderly & Effective Insolvency Procedures* (International Monetary Fund Legal Department, Washington, D.C.), 1999.
3 *The World Bank Principles for Effective Insolvency and Creditor Rights Systems* (The Worldbank, Washington, D.C.), December 21, 2005.
4 *UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment* (UNCITRAL), 1997.
5 *Statement of Principles for a Global Approach to Multi-Creditor Workouts* (London: INSOL International), 2000 (hereafter, "INSOL 2000 Principles").
6 *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets* (Institute of International Finance, Washington, D.C.), October 10, 2010.
7 Organisation for the Economic Co-operation and Development.
8 Carmen Reinhart & Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly* (Princeton University Press, 2009).

We begin with the Asian currency crisis of 1997–1999. This crisis started with a significant depreciation of the currencies in Thailand, Indonesia, and South Korea. Up to the time of the crisis, these countries had been seen as among the "Asian Tigers," who were testing the previously accepted wisdom that Western-style democracy and capitalism provide the best way to advance the interests of any nation's populations. These Tigers had been deploying their own forms of democracy that many saw as a variant of oligarchy or even benign dictatorship, and their own form of capitalism that many saw as much more state-influenced and/or relationship-based than the U.S. or U.K. "ideals" of democracy and rule of law, that emphasize the free, private markets and de-regulation. Many an expert and many a journalist were then writing about how the Asian model might have been showing the world a new way to prosperity.

When currencies crashed throughout Asia, investors were unsure what was happening or how to perceive it. Many observers speedily reached the conclusion that the Asian model was not so powerful after all, as it had been unable to prevent the crisis. Indeed, as the crisis unfolded, and regional companies and financial institutions became stressed, it became apparent that the region's legal systems were not capable of fostering efficient restructurings — financial or operational. These shortcomings added to the region's stresses.

Although the restructuring mechanics for companies had previously fallen outside of the focus of the IMF, when it was called on for financial and technical assistance, in the case of Indonesia and Thailand, the IMF quickly observed their importance to the recovery of sovereigns and their currencies. The basic idea, mostly unappreciated before that time, was that sovereigns are heavily dependent on the smooth and efficient operation of the financial institutions in their territory (this much was not new), but also that the health of these financial institutions is fundamentally dependent on the health of their assets — the loans to companies in the so-called "real sector." If financial institutions' portfolios become full of non-performing assets quickly in the wake of a currency or other financial crisis, then the banks' liquidity, their ability to lend to healthy businesses, and their ability to remain adequately capitalized and remain current on their tax obligations can each be profoundly threatened. The result can be additional and material stress on the sovereign itself, as the sovereign seeks resources to replace the lost tax revenue and resources to recapitalize the distressed banks.[9] Regardless of whether the Asian "model" had been better or not in good economic times, officials seemed to agree that, in order to be prepared for bad economic times, it is important for all countries to pay close attention to the connections among the sovereign's health and the health of its financial sector and its companies.

With this realization, the IMF began to include corporate debt restructuring in its policy recommendations to countries that sought IMF financial support. For example, in the policy conditionality for Indonesia, the IMF required that the country implement a focused corporate debt restructuring regime as a means to address the perceived linkages. The out-of-court debt restructuring program that the Indonesian Government and the IMF designed in 1998/1999 was called the "Jakarta Initiative", and it was based loosely on the principles that are known as the London Approach. The London Approach involves an out-of-court debt restructuring exercise that includes creditor organization, debtor information sharing, a basic standstill, and a transparent negotiation of restructured debt terms based on a respect for contracts and a common perception of sustainable debt levels.

The London Approach has been documented — effectively — by INSOL International.[10] INSOL's Global Principles for Cross-border Debt Restructuring (the "INSOL Principles") embody the core features that have gained the widest acceptance as "best practice" in this field. These features include creditor organization and standstill; debtor information sharing and independent creditors' verification; good faith discussion designed to lead to an agreed restructuring that is sustainable and that respects stakeholders' legal rights; and debtor responsibility for the costs of the exercise.

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9 We credit our former partner, Richard Gitlin, with having planted the seed with the IMF, initially in the business class lounge of the Grand Hyatt Hotel in Jakarta, Indonesia.

10 *See* INSOL 2000 Principles, supra note 5. These principles were designed by a global team, but the product has clear roots in the London Approach, as it was outlined in Pen Kent's seminal paper on the subject. Kent, Pen, *The London Approach* (Journal of International Banking Law 8:81-84, 1993).

The IMF viewed these rules as demonstrably helpful in maximizing efficiency and fairness, though earlier they had not been included in the Indonesian approach to debt restructuring. So the Jakarta Initiative was born to add these features to Indonesia's approach to debt restructuring with the full imprimatur of the Government. The Jakarta Initiative appeared to be reasonably well-received, and it appeared to help a number of companies restructure a significant amount of debt. While debt restructuring in Indonesia today remains a far cry from the London Approach, there is little doubt the Jakarta Initiative introduced the basic principles, structures, and ideas into the debt restructuring culture, and it has been possible to observe some progress since 1998.

In addition to the Jakarta Initiative, the Indonesian Government and the IMF also decided to revamp the Indonesian insolvency law. At the time, these officials felt the law was overly focused on liquidating financially stressed companies, and that it did not contain adequate tools for rehabilitating companies that would enable these companies to continue and to preserve asset value and employment. For example, the law did not include practical or useful means for organizing the creditors, providing creditors financial and commercial information, negotiating restructured debt terms, or obtaining creditor voting/approval. Certainly, the law contained nothing speedy in this regard — no practically useful pre-packaged plan possibility. So the authorities introduced a new law to enhance utility in these areas.

The law included many features that the authorities found to be important in the laws of the U.S. and other countries. Such features included clear case commencement standards, a moratorium during a reorganization effort, specified deadlines, debtor-in-possession financing, specified creditor treatment and voting rules, and even a pre-packaged plan mechanic.

As resolution of the regional crisis continued, rescue packages and other governmental programs began to include similar items. Specifically, out-of-court debt restructuring and insolvency law was bolstered in Thailand and South Korea, as part of IMF programs. Malaysia also introduced a specific out-of-court procedure.[11] All this work was heavily influenced by the INSOL Principles that INSOL had prepared as a representation of how effective and efficient debt restructuring exercises work in practice.[12] Even China — where debt finance and debt restructuring had long been perceived fundamentally differently from these "best practices" — has participated in this kind of work. For decades, China had wrestled with a law on bankruptcy of enterprises, though the effort had languished due to the nature of China's largely state-controlled economy. Stressed enterprises were more a matter of policy than of fixing an enterprise's finances or operations. But since China started fostering more capitalism, it seemed right that a law addressing financially stressed companies be introduced. In 2006, such a law was finally passed, and it too included many of the "best practices."[13]

Over the period 1998 – 2004 and even since, officials at the IMF and the World Bank spent quite a bit of time studying these issues and building expertise. Indeed, this work spawned even broader focus, which led to co-operation with efforts underway at UNCITRAL on establishing a model insolvency law. The IMF prepared a policy paper on the subject of best practices in insolvency laws, and the World Bank did the same.[14] A mini-industry developed to study and to build a collection of "best practices," and even to assess how countries' systems stacked up against the models. As a result, the fundamentals of these best practices — in or out of court — converged quickly, and there has almost always been agreement on what the principles are and why they are useful.

[11] The Republic of Korea established the Corporate Debt Restructuring Committee; Malaysia, the Corporate Debt Restructuring Committee; and Thailand, the Corporate Debt Restructuring Advisory Committee. *See also* Mako, William, *Maximising Value of Non-Performing Assets – Facilitating Out-of-Court Workouts in a Crisis: Lessons from East Asia, 1998-2001* (Forum for Asian Insolvency Reform (FAIR), Seoul, Korea, November 10-11, 2003); Peh Lee Kheng, Khoo Kay Ping and Effendy bin Othman, *Malaysia* (Zaid Ibrahim & Co., 2012); *Approaches to Corporate Debt Restructuring in the Wake of Financial Crises* (IMF Staff Position Note, January 26, 2010).

[12] *See* INSOL 2000 Principles, supra note 5.

[13] The 2006 Law of the People's Republic of China on Enterprise Bankruptcy Law, adopted at the 23rd meeting of the Standing Committee of the Tenth National People's Congress on 27 August 2006, and promulgated on that date, and effective as of 1 June 2007 (reprinted by the China Legal Publishing House) ("2006 PRC Enterprise Bankruptcy Law"). A translation by the Bankruptcy Law and Restructuring Research Center of China University of Politics and Law under the supervision of Professor Li Shuguang may also be found at (2008) 17(1) International Insolvency Review 33.

[14] *The World Bank Principles for Effective Insolvency and Creditor Rights Systems* (The Worldbank, Washington, D.C.), December 21, 2005; *Orderly & Effective Insolvency Procedures* (International Monetary Fund Legal Department, Washington, D.C.), 1999.

B. The Argentine Case

Only shortly after this policy work in East Asia, similar topics became relevant in connection with sovereign debt itself — in the case of Argentina, for example. Argentina experienced a financial crisis at roughly the same time as the East Asian crisis. It was soon apparent that Argentina would struggle to meets its obligations to external creditors, as would its banks. Notwithstanding some early efforts, rather than seek to resolve these issues consensually with the creditors, Argentina resorted to unilateral solutions, some of which the investment universe saw as aggressive and unfair. One example was the law that converted obligations of Argentine banks that had previously been denominated in U.S. dollars into Argentine pesos.[15]

In addition, as its crisis unfolded, Argentina notoriously took an aggressive approach with the holders of its external sovereign debt. Rather than engage its external creditors in a good faith dialog, Argentina designed and launched an exchange offer for its external bond debt. This offer asked creditors to take new debt instruments that included a material reduction in the face amount of their claim amounts and that included a GDP warrant that enabled further payments to creditors in the event the Argentine economy performed better than expected. The market's consensus of the Argentine package of exchange securities is viewed as imposing a Net Present Value ("NPV") reduction on the holders of the bonds of approximately 75%.

Rather than design its proposed terms after a good faith negotiation with a representative creditors' committee and based on an agreed vision of debt sustainability and fairness of treatment, Argentina effectively made its offer unilaterally in 2005. In order to coerce bondholders into agreeing to this haircut, Argentina made clear statements that it had no intention of paying anything to bondholders who did not agree to the exchange.[16] In order to make this commitment concrete, Argentina also passed a law (called the "lock law") that made it illegal for Argentina to settle with the holdouts.[17] Argentina took all these steps notwithstanding numerous efforts to organize the bondholders into a committee and numerous offers of good faith dialog.

Due to the strong-arm tactics Argentina openly deployed, these steps have been subject to much investor criticism, even though they led to a reasonably high degree of bondholder acceptance. Indeed, the Argentine case sparked adjustment of the IMF policy on lending to countries that are in arrears with their creditors. The IMF's 2002 policy recited that Argentina was a relevant case study, and the paper went on to outline the means for countries to engage their bondholders, especially in the wake of a default. The paper outlines details of information sharing and creditors' committee discussions.[18]

In addition to the IMF's policy on lending into arrears, Argentina's behavior played no small role in the IIF decision to build a set of principles for fair debt restructuring, which was initially targeted on the external sovereign debt of emerging markets countries,[19] but which the IIF has later extended to include all countries and all obligations in which the sovereign plays a major role in influencing the restructuring (e.g., in the case of systemically important banks). In the wake of the Argentine exchange, the IIF designed its principles to include requirements of (a) transparency and information flow to creditors, (b) debtor-creditor dialog, in order to seek to avoid restructuring, (c) good faith processes in any restructuring (e.g., respect for contracts and coordination with creditor organization), and (d) fair treatment among creditors — avoiding unfair discrimination.

[15] Law No. 25.466, Sep. 25, 2001, B.O. 29739 (Arg.).

[16] The Republic of Argentina, *Prospectus Supplement to Prospectus Dated Dec. 27, 2004* (Jan. 10, 2005); H.R. Res. 586, 112th Cong. (2012); The Republic of Argentina, *Prospectus Supplement to Prospectus Dated Apr. 27, 2010*.

[17] Law No. 26,017, June 2005, A.L.J.A. 436. In 2010, Argentina effectively reopened the exchange, and it had to suspend the lock law in order to do so. *See also* Hornbeck, J.F., *Argentina's Defaulted Sovereign Debt: Dealing with the "Holdouts"* (Congressional Research Service Report For Congress, July 2, 2010).

[18] *Fund Policy on Lending into Arrears to Private Creditors – Further Consideration of the Good Faith Criterion* (International Monetary Fund), July 30, 2002, *available at* http://www.imf.org/external/pubs/ft/privcred/073002.pdf; *IMF Policy on Lending into Arrears to Private Creditors* (International Monetary Fund, Washington, D.C.), June 14, 1999, *available at* http://www.imf.org/external/pubs/ft/privcred/lending.pdf.

[19] *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets* (Institute of International Finance, Washington, D.C.), October 10, 2010.

C. Best Practices

The result of all of the professional activity of the 1990s and the 2000s was the formation of a fairly widely adopted set of best practices for debt restructurings. Concepts of transparency, creditor engagement, information sharing, respect for contracts, and nondiscrimination among creditors were widely agreed to be best-suited to maximizing (a) the efficiency of the debt restructuring process and (b) the value of the enterprise for the benefit of all stakeholders. It seems fair to assert that these practices enjoyed approbation from restructuring professionals, from multilateral bodies such as the IMF and the World Bank, and from governments who had been involved in their design or who had received technical assistance in their implementation. These principles, while born in part of the U.S. bankruptcy code and the London Approach to out-of-court restructurings, had specifically been applied and extended to sovereigns who were wrestling with financial crises in their country or region. Between 2002 and 2007, it likely would have been difficult to find a globally credible professional organization advocating a materially different approach to debt restructuring.

Against this backdrop, global developments in debt restructuring practice since 2008 have been somewhat surprising, especially in their deviation from the widely accepted principles. We describe some of these developments below, and we then turn to an assessment of possible motivations and improvements.

Global Financial Crisis of 2008: Governments' Behavior and Investor Responses

From 2002 onwards, many commentators predicted that leverage (debt levels) throughout the world were becoming increasingly unsustainable and that the resulting credit bubble would burst sooner or later. For years, these predictions seemed to be wrong, as credit expanded ever more. Finally in 2007, some signs of stress in the credit markets started to appear, with erosion of confidence in what was known as the "sub-prime lending" market. This market consisted of lenders with exposure, most often "structured" exposure, to individual borrowers who had been granted credit — on their credit cards or in the form of (second) mortgages or other lines of credit — without a demonstrably sufficient cash flow to service all of the debt. During the time when sub-prime lending grew the fastest, U.S. housing prices were climbing steadily, and there was a perception that home equity would be sufficient in most cases to secure repayment of the debts. So credit grew and grew. But in 2007, investors' perceptions changed, and this sub-prime market began to tighten dramatically.

While the market's concerns were initially isolated on sub-prime lending, it did not take long before questions arose around the structured nature of the investments, and questions then began to spread to other kinds of structured investments. Structured Investment Vehicles ("SIVs") of all kinds came under stress, as investors began to scratch below the surface of many of the complex investment products they had been sold. These included a wide variety of instruments, including CDSs, TRSs, CDOs, synthetic CDOs, etc. As confidence continued to drain from the investment marketplace, institutional exposure to these vehicles came into question, as did institutional capability to meet all related obligations in connection with these vehicles, especially since there was no clarity on the extent to which any institution was exposed.

Among the growing lack of confidence, large U.S. banks came under stress, as the inter-bank lending markets dried up. The U.S. Government organized rescues for a number of these banks. But in the case of Lehman, there was no rescue, and Lehman was forced to resort to chapter 11 bankruptcy protection. This development fatally deflated confidence around the world. If such a venerable U.S. financial institution was in such trouble, which institutions could investors rely on as being healthy? Global credit markets froze, as did much of the world's commercial activity that was materially dependent on credit. Below we describe the impact of these developments in a few places that have produced some of the most surprising results, in light of the previous work on global best practices in debt restructuring.[20]

[20] These introductory paragraphs are a truncated (a kind of layperson's) explanation of a series of developments that we contend remains beyond the capability of anybody to explain fully. Time will likely teach us more, and of course there will be multiple legitimate perspectives. But these paragraphs help set the stage for the rest of the theme of this paper.

A. Ireland

Perhaps the most interesting impact on Ireland of the global crisis is its effect on the large Irish banks and the related Irish policy response. As in many other places, at the start of the global financial crisis, Irish banks were immediately hit by the global illiquidity. The banks encountered operational difficulties as well as related threats to their capital adequacy. The Irish Government observed these weaknesses and designed a program in 2008 that was intended to re-instill confidence in the Irish banks. Specifically, the Government passed a law that provided a state guarantee in respect of the banks' obligations (not just deposits, but funded debt obligations as well). In addition, the Government recapitalized the Irish banks by injecting liquidity in exchange for equity instruments in the banks.[21] These steps were designed to overshoot the perceived need, and thereby comfortably to assure investors that the banks were safe again.

For a time, these steps seemed to have their intended effects. The banks did not fall precipitously further or suffer massive depositor flight or need to be wound up. On the other hand, neither did the Irish banks fly and return to robust health. As time dragged on, investors realized that the Government's programs had not fixed a central issue in each of these banks: heavy over-exposure to the Irish property market, which, much like the U.S., had seen a significant bubble effect in the years leading to 2008. As the Irish property bubble deflated, market confidence in the Irish banks again waned. By 2010, it was clear that the Irish needed to take further action.

As things then stood, the Irish Government was heavily exposed to the banks. The State owned junior securities in the banks, and the State was on the hook for a wide variety of bank liabilities. The position was politically awkward: the Government had sought to rescue the banks with bold action in 2008, only to see the solution prove to be inadequate, such that further resources were needed. It was going to be difficult for the Irish "to pour good taxpayer money after bad," so the authorities began to reflect on where else the needed resources could be found.

At the time, Ireland turned to the so-called "Troika" of the IMF, the European Commission ("EC"), and the European Central Bank ("ECB") for a rescue package. Among the programs that Ireland launched in connection with that process was a means for addressing the illiquidity and undercapitalization of the banks. Among the tools that Ireland decided to implement was a new law focused on the banks' subordinated liabilities, and it created an unusual tool: it bestowed upon the Irish Minister for Finance (the "Minister") the power to sign a subordinated liabilities order ("SLO") for a given bank. An SLO could do a wide variety of things, all of which were targeted at diminishing (or even eliminating) a bank's subordinated liabilities as part of recapitalizing the bank, if the Minister concluded that doing so was needed in the interests of Ireland, such as to avert systemic crisis.[22]

The SLO mechanic was the clearest form of "bailing-in" the banks' subordinated creditors, as opposed to bailing them out, consistent with evolving IMF policy. Notably, however, the exercise of the SLO power did not require (a) any good-faith negotiation with creditors or (b) the impairment of interests in the bank that are junior to the subordinated liabilities in question. Instead, such junior securities — such as the preference shares that the Irish Government owned in the banks from the 2008 re-capitalization exercises — could remain outstanding. Many commentators concluded that the SLO power was therefore a fairly direct violation of the usual rule of priority that pertains under most laws: debt is senior to equity. Further, the SLO did not require good faith (or any) engagement with creditors, whether through information sharing or commercial dialog/negotiation.

The Minister actually deployed the SLO in the case of Allied Irish Banks. But the more important use of the SLO was as a kind of threat, providing the backdrop to liability management exercises that the major banks implemented, offering to purchase their subordinated liabilities at material discounts to par (between 20 and 30 cents on the Euro). Knowing the Minister might deploy an

[21] Credit Institutions (Financial Support) Act 2008 (Act No. 18/2008 (Ir.), *available at* http://www.irishstatutebook.ie/2008/en/act/pub/0018/index.html.

[22] Credit Institutions (Stabilisation) Act 2010 (Act No. 36/2010) (the "Stabilisation Act"), *available at* http://www.irishstatutebook.ie/2010/en/act/pub/0036/index.html. Under the Stabilisation Act, the Minister has the power, after consulting with the Governor to make several important orders, including an SLO. The Minister may issue an SLO with regard to an institution that has received financial support from the State if the Minister deems such SLO necessary for preserving or restoring the financial position of the institution. The SLO may include modifying rights to interest and the repayment of principal, events of default, timing of obligations or may facilitate a debt for equity swap. *See New Banking Stabilisation Act*, McCann FitzGerald (December 2010).

SLO, many holders felt compelled to agree to the discounted pricing. Many investors were openly disturbed that Ireland would pursue this path, and perhaps even more disturbed that the path seemed to have the full blessing of the Troika. According to these investors, the Irish approach was demonstrably inconsistent with the principle of creditor engagement as well as the principle that requires a respect for contract and similar treatment for similarly situated creditors. Indeed, in connection with the EC's consultation on the subject of unifying European law on bank restructuring and resolution,[23] one group of investors submitted a comment focusing on the Irish case and the pitfalls Europe should avoid.[24]

B. Greece

The global financial crisis' impact on Greece came in a somewhat different form. The sovereign itself was perceptibly overindebted, and global investors became concerned about the State's ability to continue to finance itself. There have been revenue issues in Greece, with apparent widespread tax evasion, and the resulting cash flow did not appear to be sufficient to repay significant liability maturities between 2012 and 2016. Greece seemingly needed debt relief, and it too ultimately approached the Troika for assistance. Initially, the policy position of the Troika members was that Greece's debt was sustainable, and that no restructuring would be needed. As time marched on, however, the Troika came to admit that a restructuring would be necessary, although initially only with minor NPV impairment for the creditors. In time, the Troika admitted that Greece's finances were worse and worse, and in the end the NPV "haircut" suffered by Greek creditors was on the order of 75%, akin to what Argentina had imposed.

From an early stage of the discussions, the preference of the Troika and the Greek authorities was to bail in the private sector creditors as well. One early concern with such a bail-in, though, was the possibility that, if it was handled the wrong way, it could lead to contagion — possibly even mass debt defaults across the financially stressed countries in so-called "peripheral Europe."[25] One of the biggest stated concerns was that the Credit Default Swap ("CDS") market would become a major transmission vehicle for financial stress. The concern was that so many European banks had sold so much CDS protection that large-scale financial sector stress would result from a Greek default, after which CDS protection sellers might be unable to make good on their protection promises.

So an early idea was that Greece should restructure its external debt on a purely voluntary basis, through a process where creditors volunteered additional credit or concessions, as a means of preventing CDS from triggering.[26] The idea was to follow in the pathway of the "Vienna Initiative" wherein European lenders had voluntarily agreed to continue credit lines to borrowers in Central Europe so as prevent significant defaults and afford the borrowers time to address their policy and restructuring needs.[27] This suggestion, however, entailed two rather material issues: (a) the Greek external debt was largely in the form of notes and bonds as opposed to the form of readily extendible bank loans and (b) much of the bond debt was held by the European Central Bank ("ECB") in connection with its Securities Market Program ("SMP"), in an effort to prevent spikes in

[23] *Technical Details of a Possible EU Framework for Bank Recovery and Resolution* (DG Internal Market and Services, 2011), *available at* http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf, which outlines an agenda in the EU for bank recoveries and resolution, including a legislative proposal for a harmonized EU regime for crisis prevention and bank recovery and resolution, aims of resolving and liquidating harmonized bank insolvency regimes under the same substantive and procedural rules, and creation of an integrated resolution regime.

[24] Memorandum from Tim DeSieno, partner at Bingham McCutchen, to the European Commission, DG Internal Market and Services on Technical Details of a Possible EU Framework for Bank Recovery and Resolution (March 3, 2011) (attached as Annex A).

[25] Specifically, Portugal, Italy, Ireland, Greece, and Spain (i.e., P.I.I.G.S). *See* Allen, Franklin, Caletti, Elena and Corsetti, Giancarlo, *Politics, Economics and Global Governance: The European Dimensions (PEGGED) Contract No. 217559* (FIC Press, Wharton Financial Institutions Center, 2011).

[26] CDS triggers for sovereigns typically occur in the case of (1) a failure by the sovereign state to pay any relevant debt, (2) a moratorium or repudiation declared by the sovereign state with regards to any relevant debt, (3) a restructuring of any relevant debt, or (4) in the case of emerging market sovereigns, an obligation acceleration, where one or more obligations of the reference entity become due and payable before they would otherwise have become due and payable as a result of the occurrence of a default, event of default, or other similar condition or event other than a failure to make any required payment. *See* International Swaps and Derivatives Association, Inc., *2003 ISDA Credit Derivatives Definitions* (May 2003), as supplemented by the *2009 ISDA Credit Derivatives Determinations Committees and Auction Settlement Supplement to the 2003 ISDA Credit Derivatives Definitions* (July 2009).

[27] The "Vienna Initiative" was launched at the height of the first wave of the global financial crisis in January 2009 by creating a working group on nonperforming loans in Central, Eastern and South-Eastern Europe (CESEE), established under the European Bank Coordination Initiative (EBCI). The group was jointly chaired by Sophie Sirtaine (World Bank) and Christoph Rosenberg (IMF). More information is available at www.vienna-initiative.org.

the pricing of the sovereign debt of "peripheral" European countries.[28] The ECB holdings meant that creditor concessions would lead to the need for the members of the Eurosystem to recapitalize the ECB, which would have been the opposite of the "bail-in" objective.

So the Greek authorities considered what steps they might take to navigate these facts. Fortunately for Greece, leading legal advisor to sovereign borrowers Lee Buchheit of Cleary Gottlieb had earlier posited a key possibility for Greece. Mr. Buchheit identified that the vast majority of Greek sovereign debt had been issued under Greek law, and only a small percentage had been issued under the law of other countries (of that percentage, most was under English law). As a consequence, it was open to Greece to amend its law so as to make adjustments to its external sovereign debt obligations. Though one could imagine numerous kinds of law reform that could reduce Greece's debt burden — especially in light of the Irish SLO law, for example — Mr. Buchheit suggested Greece deploy a more limited reform. Specifically, Mr. Buchheit suggested that Greece pass a law that made collective action mechanics applicable to the Greek law debt. These mechanics would enable holders of a specified majority of the Greek law notes to bind a dissenting (or nonvoting) minority of such holders to any given restructuring.

Here, Mr. Buchheit was drawing on years of policy work that had demonstrated the benefit to debt issuers of collective action mechanics.[29] The authors would argue that Mt. Buchheit was also keenly aware of the holdership of the Greek law bonds, much of which was in the hands of European banks, making them susceptible to suggestions and guidance from their national regulators. And indeed, Mr. Buchheit's foresight was keen. But the way the Greek restructuring story played out was both interesting and thought-provoking.

By the time the Troika started to acknowledge that a Greek restructuring was going to be necessary, the IIF's principles were at the center of focus among European lenders, in no small part in connection with the Icelandic bank restructuring discussions.[30] The principles require information sharing and good faith creditor engagement, and when Greece decided to commence work on a restructuring proposal, the holders of the Greek debt began to request that these principles govern any discussions. The major creditors enlisted the assistance of the IIF in the formation of a creditors' committee and a proposed forum for the Private-Sector Involvement ("PSI") exchange/discussion with the Greek authorities and the other official sector bodies. From external appearances, this effort bore fruit. The IIF became a kind of secretariat for the creditors' committee, and the authorities dealt with the creditors in the common IIF forum. It appeared as if information was exchanged, and terms were negotiated over a period of months. These steps and appearances were well-received among investors; there was an appearance of progress and respect for the principles at a certain level.

On the other hand, reports from committee members indicate there was much room for improvement. Two major dynamics detracted from investors' favorable perception of the Greek PSI committee process. First, many were concerned that the leading members of the committee's steering group were themselves European banks. In a vacuum, that would have been acceptable, but in the event, these banks' national regulators were keen to resolve the Greek crisis in the manner that the Troika felt was necessary. There was at least the perceived possibility that the steering group — the leading creditor spokespersons — were susceptible to influence from "the other side of the table." Second, even if the first concern may have been unfounded, all reports indicate that the exchange with the Greek authorities and the Troika was more one-directional than in the nature of a give-and-take dialog. Of course, the steering group made a significant impact on the outcome in creditors' interests. But the prevalent view was that positions and limits were

[28] The SMP was a monetary policy tool allowing the ECB to purchase distressed government bonds of the European periphery (Portugal, Italy, Ireland, Greece, and Spain). On August 2, 2012, the Governing Counsel of the ECB announced that it would replace the SMP and undertake Outright Monetary Transactions ("OMT") in secondary, sovereign bond markets, aimed "at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy." On September 6, 2012, the SMP was terminated. *See Technical Features of Outright Monetary Transactions* (ECB Press Release, September 6, 2012).

[29] *See* International Monetary Fund, *A New Approach to Sovereign Debt Restructuring* (April, 2002) (in which the IMF discusses its rejection of the corporate restructuring model for use in a sovereign restructuring, and the adoption of the view that collective action clauses should be included in sovereign debt obligations); *see also* European Commission, *European Financial Stability and Integration Report 2011* (April, 2012) (stating that collective action clauses should be included in all EU sovereign debt obligations from June 2013 onward).

[30] See infra Part D.

effectively dictated by the official sector, especially as debt sustainability analysis allegedly worsened and proposed PSI haircuts steepened.

Perhaps the culmination of these dynamics was the outright carve-out from the PSI treatment of the notes held by the ECB, which were exactly the same as the notes held by private sector participants. Even though the ECB-held notes enjoyed exactly the same legal rights and priority as all other similar notes, the terms of the PSI expressly excluded the ECB-held notes from the proposed haircut that was offered to private note holders. This aspect of the Greek PSI was quite similar in spirit to the effects of the Irish SLO, which had elevated the Irish State's bank preference share holdings over the subordinated debt holdings of private creditors.

In these respects, many investors consider that the Greek process also deviated markedly from the principles requiring creditor engagement and similar treatment for creditors with similar legal rights.

C. Spain

Investors have been watching the rest of peripheral Europe carefully, wondering what lessons governments may have learned from the Irish and Greek cases and what similar steps countries may take that are at odds with global best practices. At the time of this writing, Spain's efforts are new, but investors can already observe the contagious deviation from the principles. Many have hoped that Spain would escape the crisis without the need for extraordinary action or bailout. Indeed, until quite recently, Spain's national level debt was seen as relatively low and Banco de España was widely praised as being a more realistic regulator than many others in Europe.[31] But as the crisis has continued to unfold, and it has become clearer how over exposed the Spanish financial institutions are to the Spanish property bubble, the Spanish banks and "cajas" have come under scrutiny and increasing stress. The Government has enacted new laws designed to aid in the consolidation and revitalization of these institutions.[32]

While many of these laws were in process, a number of investors were assessing what Spain could do as well as what Spain might do, and what it might be unable to do. A common investor comment during the early stages of 2012 was that the subordinated debt instruments issued by Spanish banks had been widely sold to Spanish retail investors, as a kind of higher-yielding substitute for simple bank deposits. The conclusion was that it would be difficult for the Spanish authorities to implement an Irish-style SLO since so many Spanish retail investors would suffer impairments to their retirement savings as a result.[33] Over time, the Spanish also created a body that was designed to aid in the recapitalization of banks and "cajas," as needed, known as the FROB[34] (Fund for Orderly Bank Restructuring). The FROB had also purchased subordinated debt instruments of several of the Spanish institutions, bolstering investors' perception of protection.

But these dynamics proved to be false protection. The latest law Spain has enacted[35] adds procedures for bank reorganization and resolution, in an effort to harmonize Spanish law with the trends within Europe, including at the EC level. This law rather predictably (in light of the Irish and Greek experiences) provides for "bail-ins" of at least the subordinated debt instruments of the

[31] Our experience of the behavior of Spanish financial institutions in the insolvency proceeding of Martinsa Fadesa S.A. caused us to disagree with this latter view starting in 2008.

[32] *See, e.g.*, Ley 22/2003, de 9 de julio, Concursal (BOE de 10); Real Decreto Ley 5/2005, de 11 de marzo, de reformas urgentes para el impulso a la productividad y para la mejora de la contratación pública (BOE de 14) Tit. I Cap. II; Ley 6/2005, de 22 de abril, sobre saneamiento y liquidación de las entidades de crédito (BOE de 23); Ley 5/2005, de 22 de abril, de supervisión de los conglomerados financieros y por la que se modifican otras leyes del sector financiero (BOE de 23); Real Decreto 1332/2005, de 11 de noviembre, por el que se desarrolla la Ley 5/2005, de 22 de abril, de supervisión de los conglomerados financieros y por la que se modifican otras leyes del sector financiero (BOE de 23); Ley 36/2007, de 16 de noviembre, por la que se modifica la Ley 13/1985, de 25 de mayo, de coeficientes de inversión, recursos propios y obligaciones de información de los intermediarios financieros y otras normas del sistema financiero (BOE de 17); Real Decreto 216/2008, de 15 de febrero, de recursos propios de las entidades financieras (BOE de 16) (corrección de errores BOE 1 de marzo); Real Decreto-ley 2/2012, de 3 de febrero, de saneamiento del sector financiero (BOE de 4); Real Decreto-ley 10/2012, de 23 de marzo, por el que se modifican determinadas normas financieras en relación con las facultades de las Autoridades Europeas de Supervisión (BOE de 24).

[33] Our response to these comments was to predict that Spain would have to consider enacting a combination of the Irish SLO with something like Greece's ECB exclusion. And that is what Spain has done. *See* Ashurst Madrid, *Law Reform for Bank Restructurings in Spain* (Nov. 2012) (discussing price valuation criteria for the execution of SLEs and the case of HSCDs held by Spanish retail investors; mentioning that FROB-owned HCSDs are excluded from SLEs and that FROB can buy retail holders' positions; description of potential solutions to mitigate losses for retail investors in respect of HSCDs issuances), *available at* www.ashurst.com/page.aspx?id_content=8549.

[34] *Id.* (describing the Spanish Parliament's approval of Law 9/2012 and Royal Decree Law 24/2012, setting out a new Spanish regime for restructuring and resolution of credit entities). www.ashurst.com/page.aspx?id_content=8549.

[35] Reyal Decreto-Ley 24/2012.

Spanish institutions. But it also provides mechanics to carve out from "bail-in" instruments held by the Fund for Orderly Bank Restructuring ("FROB"), and it includes regulations to protect retail investors who acquire financial products that are not covered by the depositor protection scheme.[36] Like the Irish pathway, the law makes no requirement for good-faith negotiation with creditors.

In these ways, Spain has followed in the pathway Ireland and Greece carved in a rather patent deviation from the principles, including the principle that requires similar treatment for creditors with similar legal rights. By now, this deviation may be achieving greater acceptance than it should, if investors are seriously supportive of the principles.

D. Iceland

Much of the Icelandic chapter of the financial crisis story played out before the other countries' chapters described above. But because Iceland is such a small country that was so dwarfed by its banking sector,[37] it may be difficult to draw many firm lessons from its case. Still, Iceland's case included some important developments — happy and otherwise, from the standpoint of the principles — so it is worth a brief mention.

The Icelandic banks failed quickly in the wake of Lehman's chapter 11 filings. Within days of the failure, Iceland took the legislative and administrative steps required (a) to split the banks, in each case into (i) a new bank, with continued domestic assets and operations and (ii) an old bank, with foreign assets and obligations and (b) to introduce a priority for depositors over other senior unsecured bank creditors.[38] Both of these steps had the effect of removing assets from the legal reach of the banks' creditors and of subordinating their claims to the protection of depositors of all types. These steps led the banks' creditors to organize quickly and to pursue engagement with the banks and the Icelandic authorities on the consequences and the best next steps.

Despite firm initial resistance to recognizing and dealing with creditors' committees, the Icelandic banks rather quickly conceded and agreed to work with the committees. Indeed, from a reasonably early stage (after Iceland's initial steps described above), a rather familiar and frequent process of information exchange and discussion commenced, at least with respect to the bank splits. As a key example, over the course of the ensuing year and a half, the parties reached agreement on the old banks' obtaining stakes in the new banks, a mechanic that creditors wanted so as to ensure that creditors benefitted from any future improvement in the fortunes of the new banks. Despite initial resistance from the Icelandic authorities, this structure was ultimately agreed, and on the basis of a good degree of information sharing and creditor discussion. In getting to this result, a number of the creditors had enlisted the support of the IIF in explaining and promoting the principles. Arguably, the outcome is reasonably consistent with the principles that require creditor engagement, respect for contracts, and similar treatment for creditors with similar legal rights.[39]

Patterns, Lessons, and Next Steps

The astute observer has identified that since 2008 countries in Europe, the cradle of "the rule of law,"[40] have appeared to be willing to deviate from what many of Europe's institutions would have claimed was

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[36] "The new regulation is based on the public interest in (i) the financial system continuing to work normally regardless of the crisis of a particular bank, (ii) protecting deposit-holders, and (iii) minimizing public financial support: shareholders and creditors have to bear losses (bail-in mechanism) before the tax payers takes the strain (bail-out)." *The Spanish Bail-In Tool: Restructuring of Certain Bank Liabilities in Royal Decree-Law* (Linklaters, September 12, 2012).

[37] It was widely reported that Iceland's three main banks had assets at the commencement of the crisis that were close to ten times the size of Iceland's GDP.

[38] *See, e.g.*, Act No 125/2008 (the "Emergency Act"), which was brought in almost overnight in October 2008 to safeguard three Icelandic banks; Article 6 of this Act brought in depositor priority. This act also empowered the FME (the Icelandic regulator) to dispose of or transfer assets out of the banks, which was used to create the new banks); Act No 44/2009 (which made some of the temporary powers laid out in the Emergency Act permanent); Act No 98/1991 (the Bankruptcy Act, which was amended by the Emergency Act in relation to depositor priority).

[39] The issue of creditor damage as a result of depositor priority has not been resolved. In fact, that issue has been litigated to the Icelandic Supreme Court, which has ruled that the measure was consistent with applicable principles of the Icelandic Constitution. The measure was seen as necessary to the preservation of the Icelandic economy, and notwithstanding vigorous arguments to the contrary, as having been proportionate to the circumstances.

[40] The United States could be included as well, especially given many investors' perceptions of U.S. Government intervention in cases such as Chrysler Motors and AIG. *See* Andrew P. Atkins, *The AIG Bailout: Constraining the Fed's Discretion*, 14 N.C. BANKING INST. 335 (2010); Katalina Bianco, *A Retrospective of the Troubled Asset Relief Program*, WOLTERS KLUWER LAW & BUS. (Mar. 2011), http://business.cch.com/bankingFinance/focus/News/TARPwhitepaper.pdf.

the rule of law in connection with stressed credits in Latin America in the 1990s or East Asia around the turn of the century. Agreed procedural norms of creditor engagement have been de-emphasized during the European financial crisis. And respect for the principle of similar treatment for creditors with similar rights has also been disregarded. One might form the view that European nations have been less guided by the rule of law in these circumstances than by political expediency, or more charitably, by the perceived need to go to extremes to preserve national economies. Certainly the *ex post* law reform and administrative action seems to have been driven more by the limits of what governments can get away with in cases of expropriation than by a grounded support for the international “best practice” principles. For some observers, this outcome may be no surprise. For others, who have been listening to officials’ statements and advice to emerging markets governments over the years, the recent pattern may be somewhat surprising.

As usual representatives of private creditors, the authors contend that policy makers could do more to adhere to the principles, even in times of financial crisis, and, in fact, as a means of restoring confidence in a financial sector sooner than would otherwise result.

Annex A

This is a comment paper that Bingham prepared on behalf of certain clients in response to the EC consultation on bank resolution, in which we outlined the key issues in the Irish case, and we urged that EC law harmonization take heed. This document focuses on both creditor engagement as well as similar treatment for creditors with similar legal rights (ordinary rules of priority).

Annex B

This is a proposed amendment to the IMF’s rules against lending into arrears that Bingham assembled in 2005. This document addresses the proposed consistent use of creditors’ committees in cases of sovereign debt restructurings.

Annex A

Memorandum

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DATE: 3 March 2011

TO: European Commission, DG Internal Market and Services

FROM: Timothy B. DeSieno

RE: **Working Document - Technical Details of a Possible EU Framework for Bank Recovery and Resolution (the "EC Working Document")**

INTRODUCTION

Bingham McCutchen LLP ("**Bingham**") is legal advisor to an Ad Hoc Group (the "**AIB/BKIR Ad Hoc Group**") of holders of senior and subordinated debt securities issued by Allied Irish Banks ("**AIB**") and Bank of Ireland ("**BKIR**"). The AIB/BKIR Ad Hoc Group's members include a wide variety of institutional investors (insurance companies, pension funds, banks, asset managers, etc.) from around the world, and at formation, the holdings of the AIB/BKIR Ad Hoc Group exceeded €1.8 billion in face amount of these debt securities.

The AIB/BKIR Ad Hoc Group formed in response to a series of recent developments in Ireland that has caused them material concern about their investments in AIB and BKIR, as well as about the bank capital/obligation asset class in general, in Ireland and beyond. Central among these concerning developments is Ireland's recent Credit Institutions (Stabilisation) Law 2010 (the "**Irish 2010 Law**") and as of 28 February, also the Central Bank and Credit Institutions (Resolution) Bill 2011 (the "**Irish 2011 Bill**"). In the view of the AIB/BKIR Ad Hoc Group's Working Group (the "**AIB/BKIR Investor Working Group**"),[1] the Irish 2010 Law contains features that are unprecedented, and these features are enabling or encouraging behavior by Irish banks that is setting harmful precedents. In addition, the Irish 2011 Bill is similarly deficient in significant ways, which will also engender harmful behavior.

So the AIB/BKIR Investor Working Group is encouraged by the work of the DG Internal Market and Services in seeking to advance and to harmonize a sensible European approach to the subject of bank recovery and resolution. And the AIB/BKIR Investor Working Group considers that the ongoing developments and processes in Ireland are worth reporting and discussing in the context of the DG's work, so the Irish case may be factored into the design and implementation of the proposed European framework.

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[1] Bingham submits this paper on behalf of the AIB/BKIR Investor Working Group, and we gratefully acknowledge the assistance of AIB/BKIR Investor Working Group member Abaci Investment Management.

In this paper, we address a collection of points included in the EC Working Document that appear to the AIB/BKIR Investor Working Group to be implicated (positively or negatively) by the Irish case. In each instance, we offer a description of the relevant aspect of the Irish case, and we include a brief response to relevant questions that the DG included in the EC Working Document. The AIB/BKIR Investor Working Group would welcome the opportunity to discuss these subjects with the DG and others who are interested.

THE IRISH CASE - SPECIFIC AREAS OF CONCERN

The Commission's Principles. As the DG did in the EC Working Document's General Introduction, we would open our remarks on the subject of the principles that the European Commission addressed in its October 2010 communication. As explained in greater detail below, the AIB/BKIR Investor Working Group contends that the way the Irish authorities have handled the stressed Irish banks so far is enhancing moral hazard and defeating legal certainty:

- As detailed further below, the Irish 2010 Law's provisions do violence to the "normal order of ranking" of who should bear the burden of addressing a stressed Irish bank, potentially causing creditors to bear losses before shareholders do. In practice, this reversal will enhance moral hazard for equity holders.

- As also detailed further below, the Irish 2010 Law was introduced in the wake of the crisis, and it is retroactive in nature. These features, in addition to the significant period of predicted but unspecified law reform leading up to the Irish 2010 Law's passage and the current reports that the law is to change again, have all contributed to investors being greatly uncertain about relevant Irish law.

Creditor Engagement. The AIB/BKIR Investor Working Group contends the value of creditor engagement by stressed debtors is uniformly acknowledged. As has been widely written and advocated by bodies ranging from the International Monetary Fund (in connection with its lending into arrears policy) to the Institute of International Finance (the "**IIF**") to INSOL International ("**INSOL**"), it is generally preferable for stressed debtors to engage their creditors sensibly in driving toward an effective and sustainable restructuring. While rare exceptions are sometimes proper in cases where an instantaneous result is required (and feasible), in general, when creditors' rights are to be curtailed - at least outside the context of an emergency transfer (though even there, the ensuing valuation and asset management work should include creditor involvement) - creditors are to be consulted pursuant to known rules of engagement.

Examples of statements of these known rules include the IIF's Principles for Stable Capital Flows and Fair Debt Restructuring (a statement of these principles is available as Annex I to the 11 October 2010 report which is linked from this page: http://www.iif.com/emp/) and INSOL's Statement of Principles for a Global Approach to Multi-Creditor Workouts (available here: http://www.insol.org/pdf/Lenders.pdf). In recent years, and under the leadership of officials from the European Central Bank among other institutions, and under the observation of the International Monetary Fund, the IIF has been expanding a consensus that their Principles should apply in quasi-sovereign or non-sovereign situations in which sovereigns have influence over the restructuring process. The IIF's intention is to include precisely the kind of situation in which Ireland currently finds itself.

Nevertheless, the Irish case has deviated sharply from these widely-acclaimed rules. The AIB/BKIR Ad Hoc Group organized in December 2010 and has sought ever since to engage AIB and BKIR in a sensible process. And although these banks and indeed the Irish authorities have been designing and implementing structures and solutions all the while (i.e., there has been no apparent timing need to implement a debt restructuring instantaneously), there has been practically zero engagement with the AIB/BKIR Ad Hoc Group, or any other similar creditor organization, during this period. Indeed, the AIB/BKIR Investor Working Group has been rebuffed in almost every circumstance. Several meetings have been organized, but the consistent message from the banks and the Irish authorities has been that no creditor engagement is indicated.

It is noteworthy that neither the Irish 2010 Law nor the Irish 2011 Bill would require or encourage any different result. Specifically, while these laws set forth procedures for bridge banks, asset/liability transfers, special management, subordinated liabilities orders, liquidation, and recovery/resolution plans, neither provides for any kind of creditor engagement, much less anything close to the kinds of creditor engagement that internationally-accepted best practices would require. Based on the experience of its members elsewhere in Europe and beyond, the AIB/BKIR Investor Working Group firmly believes that nations who wish to maximize private investor interest and minimize litigation risk, must engage their creditors squarely in connection with, among other things, (a) the valuation of net assets that are transferred from distressed financial institutions, the structure of related compensation, and the management of remaining assets, (b) the rehabilitation work of a special manager, (c) the process of winding-up of a financial institution, and (d) the formulation and implementation of a financial institution's recovery/resolution plan.[2]

But it seems these forms of creditor engagement are not to be required in Ireland (yet). And as is always the case when creditors are so uniformly resisted, as they have been recently in emerging markets like Argentina and Ecuador, investors' confidence in the country and its financial institutions and markets is seriously eroded. That is just what is happening in the Irish case. Although a core stated policy objective of the Irish authorities is the re-attraction of private capital flows into the Irish banks, investors in the AIB/BKIR Ad Hoc Group uniformly indicate that Ireland's current non-engagement behavior is a material factor in sharply reducing that private investor interest.

The AIB/BKIR Investor Working Group considers creditor engagement is a subject that deserves material attention in any European framework for bank

[2] Even in the Icelandic case, notwithstanding media reports about how Iceland has chosen to minimize deference to creditors' rights, these forms of creditor engagement have evolved with a good degree of success.

recovery and resolution. We note that *Sub-part E1* *of the EC Working Document lists requiring a creditor negotiation plan as one of the powers a supervisor may choose to deploy. But we cannot find a portion of the EC Working Document that makes creditor engagement the rule (with tightly limited exceptions), as it certainly ought to be. Accordingly, the AIB/BKIR Investor Working Group would respond to the DG's* *Question 24b* *with a definitive "no". Whether as part of the supervisors' powers, or otherwise, the framework should require creditor engagement along the lines of the IIF and the INSOL principles.*

Seniority of Debt over Equity. The seniority of debt over equity is a fundamental aspect of the law and the investment climate in all working markets. The DG acknowledges this reality in Sub-part F4 and in the Annex of the EC Working Document, when it recites that shareholders of a stressed bank are to bear the first losses, and unsecured creditors are to bear only the residual losses after the shareholders' interests have been wiped out.

On the other hand, the Irish 2010 Law deviates sharply from this fundamental rule. Among other possibilities, the Irish 2010 Law includes provisions that enable the Minister for Finance to effectuate practically unlimited impairments to the claims and the fundamental rights of subordinated debt holders (including bald debt write-downs, and apparently regardless of whether the creditors' rights are governed by non-Irish law) without requiring any concessions from shareholders at all, much less requiring that shareholders' interests first be wiped out. In order to accomplish this result, the Minister simply has to request an *ex parte* hearing before a judge to obtain a so-called Subordinated Liabilities Order, and creditors are given a mere five days within which to object.. *See* Part 4 of the 2010 Law.

It is the specter of such a Subordinated Liabilities Order that has caused many investors to feel compelled to accept recently-proposed heavily-discounted tenders and exchanges proposed by Irish banks. Even if investors do not feel these banks' proposals are merited or fair under commercial dynamics or otherwise applicable legal rule, the possibility that the Irish authorities may impose even greater pain for investors, and on unpredictable bases, adjusts investors' attitudes. Again, investors' experience informs their judgment when sovereigns behave in this coercive kind of way. And the behavior results in sharply reduced investor confidence.

The AIB/BKIR Investor Working Group considers that the EC Working Document's focus, in *Sub-part F4* *and in the* *Annex**, on respect for the seniority of debt over equity is well-placed, and this fundamental rule of investment must remain a predictable, inviolate principle for the European framework. Accordingly, at least with respect to this fundamental principle, the response to the DG's* *Question 30a* *is a definitive "yes".*

Legal Certainty. Investors rely heavily on confidence that the laws that regulate their investments and the recovery of those investments are known *ex ante*, and they are not subject to change. Of course, investors accept that they take commercial and credit risk in making investment and investment management choices. But authorities who regulate working markets understand the value, ultimately in terms of reduced risk profile and reduced costs of capital, of preventing a market's legal/regulatory architecture from being uncertain. The DG acknowledges the fundamental importance of this subject (a) in the General Introduction to the EC Working Document, in which it recites legal certainty as a core principle and (b) in the Annex, in which the DG clarifies that any new framework is not going to be applied to debt already in issue.

On the other hand, the Irish 2010 Law had the effect of changing (limiting) fundamentally the legal rights and remedies of creditors of Irish Banks, especially subordinated creditors (as outlined above), and the law was designed specifically to address debt obligations already in issue. In addition to the provisions of the Irish 2010 Law, the sustained messages during the latter stages of 2010 from the Irish authorities about the possibility of law reform, and its potential impairing effect on creditors' rights, was itself perceived as a cudgel, useful to cause concern among investors that their rights were about to be impaired, in some then-unspecified ways. And indeed, the new appearance of the Irish 2011 Bill will add to concern that Irish law on the subject remains unsettled and subject to (perhaps material) further change, Ireland has proven willing to engage in law reform that is causing investors material concern.

The AIB/BKIR Investor Working Group considers that the EC Working Document's focus, in the General Introduction and in the Annex, on the importance of legal certainty and avoiding ex post changes to investors' rights is well-placed, and this focus should remain a high priority for the European framework. Accordingly, the response to the DG's Question 62a is that senior debt in existence at the time of introduction of a statutory write-down power should be excluded from such power.

Contingent Convertible Instruments. The AIB/BKIR Investor Working Group is pleased by the DG's focus, in the Annex to the EC Working Document, on contingent convertible instruments as likely a sensible part of the European framework's treatment for subordinated debt. Indeed, the AIB/BKIR Investor Working Group's core objectives have included causing AIB, BKIR, and the Irish authorities to work with the AIB/BKIR Investor Working Group to design this kind of instrument for subordinated debt as part of the remaining recapitalization and restructuring work. To date, the AIB/BKIR Investor Working Group has not yet received indications from any of these parties on their level of interest or willingness to cooperate on this subject.

But the AIB/BKIR Investor Working Group remains committed to working toward outcomes that include contingent convertible instruments in the Irish cases. Reasons for this position include the central appeal to many (long-only) institutional investors of an instrument that would enable them to continue to invest in European banks, that will generate fixed income, and that can participate in recovery/resolution of a stressed bank on a predictable basis, without concern of unpredictable future law reform or undue regulator discretion (the AIB/BKIR Investor Working Group accordingly would most favor instruments with statutory or contractual triggers that are quantifiable and capable of being assessed in advance).

As evidence of investor interest in this asset class, the AIB/BKIR Investor Working Group notes the widespread investor interest in Credit Suisse Group's recent issue of contingent convertible notes, which reportedly attracted bids of 11 times the amount on offer. The success of that offering indicates to the AIB/BKIR Investor Working Group that, were Ireland to rectify the areas of concern described in this paper, AIB or BKIR would be very well-positioned to issue similar instruments at acceptable prices as central support for their further recapitalization needs.

The AIB/BKIR Investor Group considers contingent convertible instruments are a critical component of a successful European framework, and the inclusion of these instruments as such in the <u>*Annex*</u> *of the EC Working Document is the right approach for the DG to take. In response to the DG's* <u>*Questions 63b and 64b*</u>*, the AIB/BKIR Investor Working Group would respond that there would certainly be a broad-based market interest in this kind of instrument, as evidenced by the preferences of management of the AIB/BKIR Investor Working Group members as well as by the deep market interest in the recent Credit Suisse offering.*

CONCLUSION

The AIB/BKIR Investor Working Group considers that the Irish case is worth careful study by the DG and others who are interested in the European framework. In many respects, the Irish case is proceeding in ways that are at odds with the contents of the DG's apparent thinking, and these deviations ought to be studied, so any harmful effects can be assessed and avoided in other countries. The Irish decision not to impair any senior debt seems to be consistent with the thinking in Europe, and the AIB/BKIR Investor Group firmly supports that approach. On the other hand, the AIB/BKIR Investor Working Group contends that Ireland's decision not to engage the banks' creditors is worth studying, including its harmful effects on investors' attitudes. We contend that this is a subject the DG ought to ensure is included in the European framework, and that the Irish case is good evidence as to why. And of course, while Ireland's reputation as an investment target is impacted by each week that passes without rectifying the shortcomings, there is still time for Ireland to correct things, to adjust its policies and behavior, so that its banks will be able to access the private capital markets again sooner and less expensively.

Annex B

OUTLINE OF PROPOSED AMENDMENT TO IMF POLICY ON SUPPORT FOR GOVERNMENTS RESTRUCTURING SOVEREIGN BOND DEBT

1. **General**. No government shall be entitled (a) to restructure its sovereign bond debt and (b) to enjoy any new financial support from the IMF, from and after the date (the "**Commencement Date**") that the IMF first discovers that such government plans or intends to restructure its sovereign bond debt, unless such government shall have fully complied with either the "Committee Guidelines" or the "Publication Guidelines" below. To the extent the IMF's lending into arrears rules are implicated, a government's compliance with these Guidelines shall be deemed to constitute its "good faith effort".[1]

2. **Committee Guidelines**. Unless the government shall fully comply with the "Publication Guidelines" below:

   a. If a single bondholder committee (a "**Committee**") that includes holders not affiliated with the government of at least [25]% of the government's total external bond debt shall not have formed within [__] days of the publication of the Commencement Date, the government may proceed to restructure its sovereign bond debt in any legal manner.

   b. If a single Committee shall have formed within [__] days of the publication of the Commencement Date, the government shall engage and finance (as defined below) the Committee. If the Government believes it would be useful, (using form documents to be designed) the government may finance a meeting of bondholders – or a series of them in the case of multiple bond issues – convened for the purpose of authorizing the Committee to act, although in a non-binding fashion, on behalf of all bondholders in the restructuring discussions. Unless a committee's role shall have been expressly rejected at a quorate bondholders meeting, such a committee shall be deemed to be the Committee for purposes of these Guidelines.

   c. For purposes of these guidelines, "**engage and finance**" shall mean:

      - execute a letter agreement (the "**Committee Letter Agreement**") with representatives of the Committee (using a form document to be designed) containing the government's commitment to work with the Committee toward a consensual deal and to reimburse the Committee's reasonable expenses for so long as the government shall be in discussions with the IMF, subject to earlier termination upon completion of the bond-related deal;

      - provided the Committee engages legal advisors within [__] days of its formation, execute a letter agreement with one legal advisory team (using a form document to be designed)

[1] Accordingly, these Guidelines will require augmentation so as to include other relevant aspects of the "good faith effort" as already prescribed by the IMF.

containing the government’s commitment to pay the reasonable cost of the advisory team’s services;

- either publish all documents in accordance with the “Publication Guidelines” below or execute a confidentiality agreement with representatives of the Committee (using a form document to be designed) committing to share confidential information with self-selected “restricted” Committee representatives for a limited period and committing to publish all shared material nonpublic information on an agreed schedule; and

- timely abide its undertakings in each of the foregoing agreements and negotiate in good faith with the Committee toward a consensual deal that (i) is based on the collection of information that the government has shared with its creditors, (ii) respects contractual rights, (iii) includes and is based on an agreed set of governmental policies and policy reforms, (iv) is designed to match the parties’ views of the government’s debt sustainability, (v) provides comparable treatment to all types and classes of debt claims, and (vi) is solicited and documented in full consultation with the Committee and its advisors.

3. **Committee Responsibilities**. For so long as the government is in compliance with the Committee Guidelines above, and for as long as the Committee Letter Agreement remains in effect, the Committee shall be obligated to undertake the following actions (which shall be specified in the Committee Letter Agreement):

   a. The Committee shall serve as the representative for bondholders in the restructuring discussion process, cooperating with the government and the other creditors in a good faith effort to achieve agreement.

   b. The Committee and its members shall refrain from litigation or other collection activity against the government, and consistent with market practice, the Committee shall support the government in opposition to the litigation or collection activity of other bondholders.

   c. The Committee shall cooperate with the government in the sharing of confidential information in a manner that assists the Committee in its deliberations, and the Committee shall strictly honor its confidentiality undertakings at all times.

   d. Consistent with market practice, the Committee shall assist the government in attempting to build market consensus in support of any proposals that the government and the Committee jointly support.

   e. Consistent with market practice, the Committee shall cooperate with the government in each reasonable way so as to maximize the speed of the restructuring process and to minimize its cost.

4. **Publication Guidelines**. Unless the government shall fully comply with the "Committee Guidelines" above:

    a. The government shall provide to the IMF written permission (using a form document to be designed) to publish on the IMF website (i) every document that the government provides to the IMF from and after the Commencement Date through the date of publication of the exchange offer or equivalent, except to the extent that a confidentiality-bound standing committee of investor representatives (the "**Standing Committee**"), in consultation with the IMF staff, determines that a document is not relevant or material to the consideration of any proposed restructuring terms and (ii) every document delivered to the IMF within the [__] days prior to the Commencement Date that the Standing Committee, in consultation with the IMF staff, determines is relevant or material to the consideration of any proposed restructuring term.

    b. The IMF shall have so published each such document within [__] days of having received such document (or the written permission to publish, if later).