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Insolvency Protection and Fairness for Greece: Implementing the Raffer Proposal

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Recalling Greek tragedies, misguided EU-decisions have produced catastrophe. Already crushed by her debt burden, Greece has been forced to borrow more since the crisis broke. The foreseeable result is more debts and less chances of recovery. In open violation of the Lisbon Treaty - whose Art. 125 clearly stipulates that no member state nor the EU shall be liable for or assume the commitments of another member state - and economic reason, EU-bureaucrats and politicians have wreaked unnecessary damage on the Eurozone and particularly on Greece. Member-states are expressly prohibited from assuming Greek debts both openly or under whichever flimsy disguise, e.g., pretending that these are mere loans on which the “lenders” are going to make profits, as purported by Austria’s politicians. Exerting pressure on members wishing to act lawfully, respecting the Treaty by not joining in breaching Article 125, is illegal. The EU did so. Few politicians dared defend the Rule of Law and economic sense, by preventing their country from participating in this illegal activity, as Slovakia courageously and correctly did.

Obviously, some of the bail-out money will never be recovered. Official acknowledgment that Greece would need additional cash after terms were softened shortly after the bail-out had started, of a need for “reprofiling” debts, rumours of Greece leaving the Eurozone, S&P’s downgrading by two notches, the “voluntary” participation of the private sector – all this corroborates the obvious keenly denied by official EU-sources for so long: the impossibility of full repayment of Greece’s debts.

When Argentina defaulted in 2001, her debt/GDP-ratio was near the Maastricht target, 63%. In July 2001, when IMF-employees considered a debt reduction of 15-40% necessary, it was roughly 50%. Germany’s debts were roughly halved in 1953. A debt service ratio of 3.35%, and a debt-exports-ratio of 85% (1952) were considered absolutely unsustainable. Greece and Ireland were among those forgiving German debts. A national of the debtor, a German banker, was allowed to tell creditors how much Germany could afford to pay. No one even dreams of asking a Greek nowadays to tell creditors how much they are to lose. In addition, Article 5 of the London Accord exempted some claims totally. Art. 5.2 postponed the settlement of claims of victim countries originating from WWII forced loans and occupation costs these countries had to finance until the final settlement of the question of reparations. Gladly accepting relief when Germany needed it, the German government has meanwhile strongly opposed any relief on the high moral grounds that all debts must be honoured, turning the sternest creditor of its own benefactors.

Official lending is prolonging and worsening the crisis, postponing and increasing eventually unavoidable haircuts. In quite a few jurisdictions penal law sanctions delaying insolvency proceedings, precisely because it makes things worse. The illegal and economically absurd bail-out of "investors" rather than Greece may eventually threaten the solvability of would-be savers themselves. A quick haircut, already proposed early on, would have contained losses (not least of the budgets of those bailing-out speculators) and spared the Greek people unnecessary hardships. Already in February 2010 the proposal to halve Greece's debts came from the banking

community. Gros and Mayer (2010; for comments see Raffer 2010a), the latter chief economist of the Deutsche Bank, proposed a solution whose main elements seem to be eventually realised now, unfortunately with some unhealthy extras added by politicians changing things for the worse and after worsening the situation dramatically, most notably a higher stock of debts and a shrinking Greek economy. Gros and Mayer proposed the establishment of "a European Monetary Fund", which, in the event of a default, could step in and offer all holders of debt issued by the defaulting country an exchange against new bonds it issues. The EMF would require creditors to take a uniform "haircut", or loss, on their existing debt in order to protect taxpayers" as they wrote in the Economist (18 February 2010). They called the proposed "haircut" of 50% "only a *modest* [stress KR] loss rate for those who bought up the debt more recently" (Gros and Mayer 2010, p.4). In exchange for a fee of 50% investors would have bought guarantees by EU-member-states (by economically strong members really, as the authors contend), exchanging bad debt for good titles. Compared with the EU's strategy that followed, this is an excellent, virtually unselfish proposal. With hindsight (one obviously hesitates to write "benefit of" under circumstances) and after what EU-functionaries and our governments did, I have to admit that I (Raffer 2010a) did not do full justice to the Gros-Mayer proposal, focussing too strongly on elements in the interest of the banking sector. Trading off losses for guarantees is economically acceptable. 50% seems a fair and honest proposal. The unlawful 100% bail-out dolled up as "solidarity with Greece" that followed was incomparably worse. More recently Mayer was quoted in the Wall Street Journal, observing: "Taxpayers will end up buying out the private sector" – right after the WSJ had pointed out that Greek "debt will consist increasingly of emergency loans and ever less of bonds held by private investors".
Repeatedly, voices from the banking sector proposed a haircut, an opinion endorsed by many academics, even private investors including Mohamed El-Erian, CEO of PIMCO, one of the biggest investors worldwide with over one trillion dollars in assets. El-Erian said Greece was in a "debt trap", drawing attention to the increase in debts by the rescue. Debts would have to be reduced to below 90% of GDP and the burden would have to be equally shared and could not just go to the taxpayer. Such opinions were ignored. Against the law and economic reason the EU decided to bail-out the financial sector fully. Meanwhile reality seems to dawn on official creditors. They softened terms and pursue optimistic ideas such as voluntary participation of private creditors. The very expression "bailing-in" private creditors is absurd. They were already "in" before public authorities broke the law to bail them out, protecting lenders from the results of their own lending decisions.

The *Telegraph* formulated: "Vulture Funds stand to make a fortune from second Greek bailout" (Aldrick 2011). Busily buying Greek debt, hedge funds see (in the words of one leading manager) the Greek crisis as "certainly a great chance to make money". Without the official bail-out this would not be so. German banks reduced their claims substantially as well in the meantime. Economically this means that many original investors have already realised losses. Taxpayers' money increasingly benefits venturous speculators.
The official bail-out caused an increase in Greek debts since the crisis broke. It fuelled the crisis by encouraging speculation against other euro-countries. It signalled to speculators that they would be bailed out at taxpayers' cost and could go on speculating. Naturally, the crisis spread. This invitation to engage in risk-free

speculation was gratefully accepted. The bail-out cannot avoid but only postpones the unavoidable haircut. EU-politics made things worse for everyone except some bureaucrats and politicians parading themselves as trouble shooters, and so-called vulture funds. In quite a few jurisdictions such lending, only prolonging crises, is called abusive credit, entitling *bona fide* creditors to damage compensation. Juan Pablo Bohoslavsky (2010) tries to transform the concept of the responsibility for abusive granting of credit into a general principle of international law. He argues that claims of lenders postponing the insolvent lender's crash by granting economically unjustifiable credits, thereby increasing other creditors' losses should be subordinated to those not classified as abusive. The EU already thinks about a ladder of preference unjustly privileging and protecting abusive claims of the official sector including their own against *bona fide* creditors.
Meanwhile, these disastrous, so-called "rescue operations" have even tainted institutions traditionally seen as bulwarks of stability. The German Bundesbank, e.g., has amassed net claims against "the euro-system". These increased enormously during the recent past. So-called Target liabilities of crisis countries amounted to over €300B in March 2011. These are hidden claims within the euro-system, financing current-account deficits. Eurostat counts the creation of Target claims against other countries' central banks via the ECB as a capital flow between the national central banks. These "balances come close to short-term eurobonds. Moreover, their size dwarfs the parliament-approved bailouts extended to Greece, Ireland and Portugal." (Sinn 2011). One cannot but concur with Sinn: it is a "normal payment mechanism [that] became a bailout mechanism". The European Central Bank (ECB) has violated its ironclad taboo by buying up the bonds of countries in distress. It is now sitting on assets of doubtful quality, becoming an EBB (European Bad Bank) – as some cynics joke. What is officially touted "solidarity with Greece" is solidarity with the ECB and speculators rather than with the Greek. For the Greek it is not solidarity but the chronicle of a catastrophe foretold

The Raffer Proposal - Insolvency Protection for States and Their Population
All domestic legal systems have introduced insolvency as the only economically efficient and fair solution. Its record and the fact that no one wants to abolish it, strongly suggest emulating national insolvency mechanisms for countries, as already advised by Adam Smith and proposed early on after the 1982 Southern debt crisis. A solution to an overhang of sovereign debts is needed that differs markedly from any debt relief granted by creditors so far that usually prolonged and deepened crises. The need to deal satisfactorily with sovereignty was used as a powerful argument against the first generation of proposals advocating the emulation of US corporate insolvency (Chapter 11) in the 1980s until the IMF itself proposed emulating corporate insolvency out of the blue in 2001.

Nevertheless, the point that states differ substantially from corporations and that this must be taken into account by any meaningful insolvency framework have great merit. In 1987 I therefore presented a proposal countering the arguments against adapting Chapter 11 for countries by proposing a mechanism adapted to and practical for sovereigns: applying the essential features of US municipal insolvency (Chapter 9, Title 11 USC) to countries. This proposal, kindly dubbed Raffer Proposal by Prof. Galbraith and Prof. Streeten and Fair Transparent Arbitration Procedure (FTAP) by many NGOs, has been propagated globally, in particular by the Jubilee Movement. It is the only appropriate procedure and the best solution for a sovereign debt overhang. It upholds the Rule of Law, respect for human rights, the most fundamental legal principles vocally touted by anyone, and economic efficiency. As my proposal has been presented repeatedly (e.g., Raffer 1990, 2005, 2010b), this paper only recalls its main features briefly. Specific features making it fundamentally different from creditor dominated "solutions" or the present "handling" of Greek debts are:

- Impartial decision making and respecting the Rule of Law
- Debtor protection
- Right to be Heard (which may be seen as part of debtor protection)
- Treating the problem of sovereignty
- Fair and equal treatment of all creditors
- Improved sustainability

The basic function of any insolvency procedure is the resolution of a conflict between two fundamental legal principles: the right of *bona fide* creditors (which excludes EU bail-out lending) to interest and repayment versus the generally recognised principle, limited not just to lending, that no one should be forced to fulfil a contract if this causes inhumane distress, endangers one's life or health, or violates human dignity. Debtors should not be forced to starve themselves or their children to be able to pay.

- *Impartial Decisions:*

A proper mechanism to solve the problem of a sovereign debt overhang must comply with minimal economic, legal and humane requirements and be fair to all involved. Impartial decisionmaking and debtor protection are the two essential features of insolvency, both denied to debtor states nowadays. Ideas such as a "Berlin Club" (called "Institutionalized Disempowerment" by Spiegel-online) with sequestration of the debtor by creditors prove open contempt for the Rule of Law. It means stepping back beyond the 19th century, even though debtors had usually more rights then after all. One has to agree with the Bruegel proposal of a European mechanism for sovereign debt crisis resolution (Gianviti *et al* 2010) that an institution that is neutral, not a creditor, is needed to supervise debt reductions as a court would do domestically, and that putting a government under receivership is inconceivable because this would contradict the nature of democracy. However, the authors' prime choice, the Court of Justice of the EU seems highly problematic. It may be discussed whether this EU-institution would remain neutral. Their alternative, an entirely new institution sounds better.

My proposal upholds the very foundation of the Rule of Law. As national courts in debtor or creditor countries might not be totally beyond political influence, I have proposed arbitration. Following established international law practice, each side (creditors - debtor) nominates one or two persons, who in turn elect one more person to achieve an odd number. While institutionalised, neutral entities are technically feasible, *ad hoc* panels are preferable, not least because they can be established at once. No long negotiations necessary to draft a treaty, nor ratification are needed. The panel should proceed on the basis of the essential, internationally relevant features of Chapter 9, recognise or void individual claims. Naturally, it must reject the debtor's demand if unfounded, denying this debtor any advantage from starting the procedure. This is no different from intra-US Chapter 9. The plan filed by the municipality of Harbour Heights was rightly denied approval because the district had assets greatly exceeding its liabilities and “there was no sufficient showing, why District’s tax rate should not have increased sufficiently to meet Districts obligations” (§943, note 3, 11 USCA, quoted from Raffer 1990, p.303).

Arbitrators would mediate between debtors and creditors, chair and support negotiations with advice, provide adequate possibilities to exercise the right to be heard, and, if necessary, decide. Ideally, the panel would just confirm agreements reached between creditors and the debtor. As all facts would be presented by both parties and the representatives of the population during a transparent procedure, decisions would be unlikely to affect substantial sums of money, but would rather resolve deadlocks.

Before the 1970s, arbitration was the usual means of solving disagreements between creditors and sovereign debtors. This was also the case in outstanding, historic examples: loans by the League of Nations before WWII usually contained arbitration clauses, e.g., Austria's when she got a structural adjustment type loan from the League of Nations, a controlling High Commissioner in Vienna grafted upon Austria by the League included. Though resulting from the dictate of victors after WWI, both the Dawes and the Young loans to Germany contained arbitration clauses (Waibel 2011, p.160). The London Accord established arbitration for disagreements with creditors; debt relief was so generous, though, that it was never invoked. Recently, arbitration on debts has become increasingly popular with creditors, seeking it at ICSID (International Centre for Settlement of Investment Disputes) or under bilateral investment treaties. While supported if perceived as in the interest of creditors, our governments shun arbitration as a fair and general principle whenever they see the danger of justice or fairness to debtor nations.

- *Respecting Sovereignty:*

Chapter 9 protects governmental powers. It is therefore immediately applicable to sovereigns. In the US the court's jurisdiction depends on the municipality's volition, beyond which it cannot be extended, similar to the jurisdiction of international arbitrators. US municipalities cannot go into receivership, and change of "management" (i.e. removing elected officials) by courts or creditors is not possible - nor should this be possible in the case of sovereigns. Only voters should have the power to remove elected politicians from office. Obviously, similar guarantees are for obvious reasons absent from Chapter 11. Ideas such as a European Ministry of Finance overruling national parliaments go into the opposite, undemocratic direction.

The concept of sovereignty does not contain anything more than what §904 protects in the case of US municipalities. Titled "Limitation on Jurisdiction and Powers of Court", it states with outmost clarity:

> “Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with -
> (1) any of the political and governmental powers of the debtor
> (2) any of the property or revenues of the debtor; or
> (3) the debtor's use or enjoyment of any income-producing property.”

While this may be seen as giving the debtor too strong a legal position, the economic necessity to settle the problem and to re-gain normal access to capital markets counterbalance this strong position. Furthermore, a public interest in keeping the debtor functioning exists. Thus, when some creditors refused to agree to the plan, insisting on higher payments (financed by tax increases) by the City of Asbury Park in the 1930s, the US Supreme Court (quoted from Malagardis 1990, p. 68) prevented this: "The notion that a city has unlimited taxing power is, of course, an illusion. A city cannot be taken over and operated for the benefit of its creditors, nor can its creditors take over the taxing power." Briefly, Chapter 9 is particularly suited for sovereign debtors. What is happening to Greece now could not happen to a municipality.

- *Protecting Debtors and Democracy:*

Debtors - unless they are countries in distress - cannot be forced to starve their children in order to be able to pay more. Human rights and human dignity enjoy unconditional priority, even though insolvency only deals with claims based on solid and proper legal foundations.

A US municipality must be allowed to go on functioning and to provide essential services to its inhabitants. Resources necessary to assure this are exempt. This principle must also be applied to sovereign countries. Resources necessary to finance minimum standards of basic health, primary education etc. must be exempt. Private creditors have always been aware that some money simply cannot be collected for what they often call “political” reasons, meaning public resistance against social expenditure cuts. Eventually, anti-poverty measures under HIPC II have recognised this principle, at least verbally. The SDRM, by contrast, fell back behind this minimum standard, not mentioning any kind of debtor protection at all. This does not mean that there is no reduction in government expenditures. Of course, no insolvent debtor can just go on as before, saving and economising are unavoidable. The question is uniquely whether any and which services are exempt, though reduced in scale.

Exempting resources necessary to finance minimum standards of basic health services, primary education etc. can only be justified if that money is demonstrably used for its declared purpose. The solution is quite simple - a transparently managed fund financed by the debtor in domestic currency. The money going into that fund would not be phantom debts (i.e. debts existing on paper but uncollectable in reality) but money that could actually be recouped if no debtor protection existed, as is presently the case. The management of this fund could be monitored by an international board or advisory council. Members could be nominated by NGOs and governments (including the debtor government). As this fund is a legal entity of its own, checks and discussions of its expenditures would not concern the government's budget, which is an important part of a country's sovereignty.

Creditors have, of course, the right to demand selling some of the debtor’s assets to reduce their losses. This is part and parcel of any insolvency case, fair and justified. Quick fire sales under enormous pressure as presently and loudly requested from Greece are not. They are likely to yield unfairly low prices, damaging both *bona fide* creditors and the debtor, though allowing some lucky (allegedly well connected) few to get these assets on the cheap. Participation of the municipality's inhabitants is guaranteed in two ways:

1) The affected population has a right to be heard
2) If electoral approval is necessary under nonbankruptcy law in order to carry out provisions of the plan it must be obtained before confirmation of the plan pursuant to §943(b)(6).

In strict analogy to domestic Chapter 9, the population affected by the solution must have the right to be heard, exercised, of course, by representation in the case of countries. Domestic Chapter 9 foresees both exercising this right individually or by representation. Trade unions, entrepreneurial associations, religious or non-religious NGOs could exercise this right to be heard, representing the affected population, presenting arguments and data before the panel. Affected people would thus have the right to defend their interests, to present estimates and arguments, to show why or whether certain basic services are necessary. The openness and transparency usual within the US should become the norm of sovereign insolvency. In short, I propose to apply the same legal and economic standards to all debtors, to guarantee equal treatment of indebted people everywhere, irrespective of nationality or colour of one’s skin. There is no logical reason why someone living in an insolvent municipality must be treated in a more humane way than people living in another public debtor, such as Greece.

Rejected as utopian when first proposed (Raffer 1990, p.305), participation officially became part of the Enhanced Highly Indebted Poor Countries Initiative (“HIPC II”). Civil society is to participate in designing poverty reduction strategies. Obviously, participation is possible. In fact, it already goes beyond what I initially thought possible when I proposed this in 1987. Furthermore, one cannot keep people from expressing their views. In Argentina, for instance, civil society “participated” in the streets by banging pots. In Greece, violent demonstrations and street fights have expressed the affected population’s discontent and disagreement. Formal representation seems a better way of voicing opinions.

Further participation by parliaments or the electorate could easily be integrated. The debtor government can choose to leave the task of nominating panel members either to the parliament or the people. Voters could, e.g., elect arbitrators from a roster. Experts reaching a minimum of supporting signatures by voters would have to be on this roster. One arbitrator might be chosen by parliament, the other by voters. The parliament might establish a special committee to handle insolvency, including members of the cabinet, as proposed in a bill drafted on the initiative of Argentine Congressman Mario Cafiero. This bill would have established a Comisión Representativa del Estado Nacional. Consisting of members from both Houses and the executive power, it was to nominate panel members and represent Argentina during the proceedings. Solutions to sovereign debt problems need not destroy democracy – as presently planned in the EU.

- *Fair and Equal Treatment of All Creditors:*

Insolvency laws usually allow preferential treatment of certain types of claims. Ladders of priority are plain vanilla. Treating all creditors equally is not a procedural necessity, but in my model all creditors are to be treated equally. Except creditors lending during the procedure to keep the country afloat, all private and public creditors must get the same haircut. This avoids unfair burden sharing. Demanding that those official creditors that have aggravated the situation by illegal lending must not enjoy preference is extremely justified and indispensable.

Especially in the Greek case official creditors worsening the situation must not be rewarded financially. Rather, they should be taken to account.

Basel regulatory norms practically pushed banks into euro-zone government papers summarily anointed AAA by the big rating agencies. Thus, Greek instruments had capital weights of zero. To use Soros' words, banks "obliged to hold riskless assets to meet their liquidity requirements were induced to load up on the sovereign debt of the weaker countries to earn a few extra basis points". This regulatory original sin, a brilliant example of policy-encouraged crashes, renders any preference ladder privileging public money all the more unfair. Attempts to establish new preferences for EU-actors, such as a ladder IMF-EU/(ESM) claims-other creditors would involve greater and unfair losses for *bona fide* private creditors and penalise banks for lawfully playing by the rules established in Basel. It would further encourage the public sector responsible for these rules to bungle on at least as badly in the next crisis as in Greece now. Legally, the IMF is not a preferred creditor (cf. Raffer 2010b, pp.225ff) but given unlawful *de facto* preference already. A solution is needed that is fair to anyone involved.

Equal haircuts, arguably subordination of abusive public credit, is therefore an important feature of my sovereign insolvency model, which is based on specific economic, legal, and ethical reasons: on the necessity to establish the equivalent of national liability and tort laws, and on fairness to *bona fide* creditors, who like debtors would have to pick up part of the bill of failures by official lenders.

- *Improved Sustainability:*

A sustainable solution would emerge from the facts presented and discussed openly and by all affected. As the population concerned would have the opportunity to present their arguments in a transparent procedure, one can either expect agreement on one specific solution or differences between positions that are quite small. Ideally arbitrators would just have to rubberstamp the plan agreed on by the parties, the creditors and the debtor.

Conclusion

Unfortunately, bungling on seems the most likely "strategy", although haircuts are meanwhile accepted as inevitable and the same evolution towards losses as in Latin America after 1982 is clearly discernible. But lessons were not learned. When over-exposed Wall Street banks demanded a bail-out, the US Treasury refused to use tax money. Instead, banks first had to go on lending (so-called "forced lending). Admittedly, the Bretton Woods Institutions also increased their lending, which was some form of bail-out. Once banks were able to digest haircuts they had to grant them ("Brady Initiative"). Officially, of course, banks did all this "voluntarily". Reducing debts to the amount that can be serviced is unavoidable. It should be done in a civilised, humane, fair, and efficient way: extending the time-tested mechanism of insolvency to the last debtor still denied insolvency protection. My proposal safeguards the debtor's sovereignty, and gives the affected a voice, as usual within the US. Quite a few essential points made in the 1980s have meanwhile become accepted (e.g., debtor protection in HIPC, transparency by including NGOs, even reducing multilateral claims, although still with undue and illegal preference), but the cornerstone of the Rule of Law – that one must not be judge in one's own cause – continues to be violated openly. As long as creditors remain judges, experts, and bailiff, arbitrariness substitutes arbitration. Debt management will reflect the errors and injustice of the last decades. Greece will continue to suffer under EU-receivership. What largely goes unnoticed is the huge advantage that most debt is subject to domestic law, an advantage that must not be traded away.

Eurobonds are no alternative to proper and sufficient debt reduction. Debtor countries would save interest costs, marginal, though, compared with relief needed. Lower interest would attenuate the problem but definitely not solve it. Somewhat lower interest service would not greatly affect Greece's debt burden, even assuming that investors do not see eurobonds as another offer to charge relatively high interest because "economically sound" euro-countries guarantee claims. The EFSF's first bond issue carried such a high interest rate that it was hugely oversubscribed, nearly nine times. The German newspaper *Frankfurter Allgemeine* (29 January 2011) rightly titled "Saving Europe and Profiting from It". So far, official guarantees and money have not reduced spreads for crisis countries. On the contrary, spreads increased and more and more euro-countries have been targeted by speculators. Why should speculators let another offer to make profit with EU-guarantee slip by, not charging relatively high interest although "economically sound" euro-countries remove risk? High risk premia without risk are a speculator's dream and a taxpayer's nightmare. The market mechanism forcing lenders to check country risks and to take the losses debtors routinely pay for in advance via by higher spreads would be removed in favour of speculator welfare.
In contrast to possibly small relief, political implications are extremely dangerous. Understandably, those countries guaranteeing debts would also want to control lending and expenditures of those benefitting from such sureties. Whether one uses eurobonds or another form of international subsidy, those guaranteeing will want control over those using these guarantees. Quite logically Trichet demanded a European Finance Ministry, a group of unelected bureaucrats taking away their most important right from democratically elected parliaments: voting on the budget. Thoughts such as a fiscal union or a European economic government, perfectly understandable from the economistic point of view of guarantors putting their money on the line, are aired. Greece, the cradle of democracy, might thus also become its grave.

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