EDITORIAL

Corporate Governance Lessons for the Sovereign Debt Crisis: Sovereign Equity

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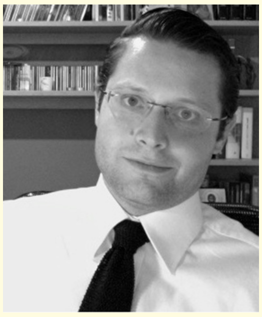

The sovereign debt crisis has pushed us corporate lawyers to the sidelines. What is happening in the Eurozone is so big that many believe that any policy proposal stemming from corporate lawyers will be far from providing any meaningful remedy to the ongoing economic disease.

This impression is wrong. Governments are financed through the capital markets; this is something that has been happening on a large scale since the oil crisis of the 1970s, when governments tapped the capital markets to finance their trade deficits.[1] The corporate governance and corporate finance institutions that we corporate lawyers know can help corporations deal with the exigencies of the capital markets and can be adjusted to assist governments in obtaining financing from the markets without compromising their country's growth prospects.

The security which governments issue to investors to obtain financing is universally the plain vanilla bond. Sovereign bonds are, however, pro-cyclical. At times of stagnation or recession, when governments have to throw more money into the economy, the fixed obligations incorporated in a sovereign bond put additional fiscal pressure on governments that need to introduce austerity measures to find the funds to service the debt. Austerity causes further recession and although the debt is temporarily serviced the debt-to-GDP (Gross Domestic Product) ratio looks worse. The economy thus enters a vicious circle and the probability of default increases. The question then is whether we can think of a real risk-sharing financial instrument that can make the burden for the sovereign issuer lighter in tough times but heavier when it is easier to bear. The answer lies in a new type of security: sovereign equity.

A corporation taps the capital markets either by issuing equity or debt (or hybrid securities); nothing seems to restrict a government from doing the same. In fact, financial engineering within the framework of recent sovereign debt restructurings has already created equity-like sovereign securities and we, corporate lawyers, by drawing on our experience in advising clients on the issuance of hybrid instruments can help in the design of that new class of sovereign paper.

The design of sovereign equity could link the payments to the security holder to the rate of GDP growth of the issuer. Small or zero payments would be made to the security holder at times of slower growth, freeing up space for public spending stimulus, and higher payments would be made during periods of rapid growth[2] when the government will be able to afford them from a fiscal perspective.[3] Therefore, sovereign equity would act in a counter-cyclical way, as it would discourage governments from exercising fiscal retrenchment during recessions while also curbing excessive expansionary fiscal policy in times of rapid growth that might, in the long-term, lead to unsustainable public finances.[4]

The knowledgeable corporate lawyer might say that if this security is to be real equity it will also have to carry some governance rights. According to agency theory, which has dominated the corporate governance thinking over the past decades, governance rights – for example, voting rights – are given to the shareholder in exchange for the fact that she is the ultimate risk-bearer in the organization. Though if the issuing State is viewed as an organization, the equity holder will not be the ultimate risk-bearer, who according to agency theory should be

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1 See Pavlos Masouros, *Corporate Law and Economic Stagnation: How Shareholder Value and Short-termism Contribute to the Decline of the Western Economies* 64–65 (2012).

2 See Daniel Gros & Thomas Mayer, *Debt Reduction without Default?* 8 (CEPS Policy Brief No. 233/Feb. 2011). http://ssrn.com/abstract=1756842 (accessed July 18, 2012).

3 See Joseph Cotterill, *Irish GNP Warrants,* FTW, Fin. Times (Apr. 6, 2012). http://ftalphaville.ft.com/blog/2011/04/06/538126/irish-gnp-warrants-ftw/ (accessed July 18, 2012)

4 Stephany Griffith-Jones & Krishnan Sharma, *GDP-Indexed Bonds: Making it Happen* (DESA Working Paper No. 21, 2006). http://www.un.org/esa/desa/papers/2006/wp21_2006.pdf (accessed July 18, 2012)

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enfranchised.[5] The taxpayer is the ultimate risk-bearer, because – even in the presence of investors in sovereign equity securities – it is out of her money that any fiscal imbalances will be fixed, so the taxpayer remains the only one who, from the viewpoint of agency theory, should be enfranchised. After all, even in the corporate world we know that many jurisdictions allow corporations to issue non-voting shares, so if governance rights are not attached to sovereign equity securities the latter will still, in theory, qualify as equity.

It can be claimed that States are not corporations to be eligible to issue equity and that there are various issues that should be addressed before we embark on this security design exercise, for example, how the valuation of these instruments is to be made, what classes of investors will want to put their money in sovereign equity, etc. However, we need to be reminded that the seed for sovereign equity has already been sown. There are already GDP-warrants attached to sovereign bonds that were issued within the framework of sovereign debt restructurings. In the framework of the recent Greek PSI, Greece offered *inter alia* to bondholders GDP-linked notes, whose design carries the counter-cyclical features discussed above. If, for a reference year, the Greek GDP growth rate exceeds the projection for the growth rate of that year, then Greece will pay a percentage of the difference between the actual growth and the projected growth rate to the noteholder (subject to a cap). Argentina attached a similar GDP-warrant as a sweetener on the bonds, with which it replaced its old bonds in the Argentine 2005 restructuring. Because of Argentina's rapid growth, these warrants – after being detached from the underlying bond-trade at a premium in the capital markets. Other nations, such as Bosnia-Herzegovina and Bulgaria, have also issued GDP-warrants attached to their bonds; Singapore has issued to its citizens plain vanilla sovereign shares.[6]

Therefore, the investor community gradually becomes acquainted with financial instruments linked to the GDP growth rate of a nation. Some investors already participate in a nascent market of economic derivatives, which are financial instruments that allow traders to take positions directly on the outcome of macroeconomic data release;[7] so valuation issues for sovereign equity might not be so difficult to address. In Europe, the ECB or the ESM could take on the role of purchasing sovereign equity securities from Member States on the condition that with the proceeds governments will reduce their debt until it reaches 60% of their GDP. The purchase of sovereign equity by EU institutions does not seem to run the risk of running against the no-bailout clause, so it might eventually be a way round the current legal restrictions blocking the recovery. Thus, the Eurozone states will have the opportunity to reduce their debt to sustainable levels without compromising their growth prospects.

5 Frank Easterbrook & Daniel Fischel, *The Economic Structure of Corporate Law* 67 – 70, 91 (1996).

6 See Ken Miyajima, *How to Evaluate GDP-Linked Warrants: Price and Repayment Capacity* (IMF Working Paper/06/85). http://www.imf.org/external/pubs/ft/wp/2006/wp0685.pdf (accessed July 18 2012)

7 See Blaise Gadanecz et al., *Economic Derivatives,* BIS Q. Rev. 69 (2007).