

71st General Assembly Second Committee Meetings

Side Event:

Sovereign Debt Restructurings: Lessons learned from legislative steps taken by certain countries and other appropriate action to reduce the vulnerability of sovereigns to holdout creditors

Organised by the United Nations Conference for Trade and Development (UNCTAD)

Date: Wednesday, 26 October 2016, 10 am – 1 pm,

Place: Conference Room 2, Conference Building, United Nations Headquarters, New York

Context and Background

So long as private debt defaults do not affect the wider economy, managing them essentially involves the application of commercial law in the jurisdiction where the debt was issued. Sovereign external debt poses a different set of challenges. Foremost amongst these is the consideration that the macroeconomic management of sovereign debt has far-reaching social, economic and political impacts on whole populations as well as through the provision of public goods. In addition, sovereigns are both more, as well as less, vulnerable than private debtors: On the one hand, sovereigns unable to service their debt cannot seek the protection of bankruptcy laws to restructure or delay payments, as private debtors can do. On the other hand, creditors cannot easily seize non-commercial public assets in payment for a defaulted sovereign debt. As a consequence, sovereign debt issues have historically been addressed through direct negotiations between sovereign debtors and their creditors.

The contemporary system of sovereign debt restructuring is highly fragmented and based on a number of ad hoc arrangements. This fragmentation has given rise to numerous inefficiencies. First, sovereign external debt problems tend to be addressed “too late” with “too little”. Debtor governments have been reluctant to recognize solvency problems for fear of triggering capital outflows, financial distress and economic crisis, while private creditors have an obvious interest in delaying explicit recognition of a solvency crisis, likely to entail haircuts. Second, the current system predominantly places the burden of adjustment on the debtor economies, through austerity policies and structural reforms, with a strong recessionary bias. And finally, the fast growing promotion of creditor rights as well as the rapid rise of bond financing in external debt markets has rendered sovereign debt restructuring enormously complex. In addition to the involvement of often thousands of bondholders with diverging interests as well as a range of jurisdictions, this has also facilitated the emergence of highly speculative funds, run by non-cooperative or holdout bondholders, including the so-called vulture funds.

Uncooperative or holdout creditors in sovereign debt workouts are thus mostly financial institutions or funds trading sovereign debt in secondary markets. While this does not apply to all uncooperative creditors, vulture funds specifically are usually hedge funds, that is, a limited liability fund pooling investor capital in securities and other financial instruments with no or little regulation for caps on leverage. The reverse does not, of course, hold: Not all hedge funds are vulture funds.

According to the UK Treasury, vulture funds [...] *buy up defaulted debts at very low prices when a country is in economic distress and aggressively litigate to recoup the debt's full value*".¹ Similarly, former independent expert on Sovereign debt and Human Rights, Cephias Lumina, states that "*the term vulture funds is used to describe private commercial entities that acquire, either by purchase, assignment or some other forms of transaction, defaulted or distressed debts, and sometimes actual court judgments, with the aim of achieving a high return*".² The African Development Bank further notes that vulture funds "*[...] purchase distressed debt at a steep discount, refuse to participate in restructuring, and pursue full value of the debt often at face value plus interest, arrears and litigation through litigation, if necessary*".³ These basic definitions raise three core points that characterize the role of vulture funds in sovereign debt restructurings:

- The type of debt purchased in secondary markets, i.e. distressed sovereign debt
- A clear intention not to participate in debt restructurings
- The use of litigation to obtain payment at full face value of sovereign debt instruments, including interest payments, and a financial returns strategy based on the often very large difference between the discounted purchase value of a sovereign debt instrument and its face value.

While the activities of vulture funds can be traced back to the 1970s, they have expanded rapidly since the mid-1990s: out of all litigation cases against sovereign debtors since the 1970s, 42.5% took place in the 1990s and 45.8% in the 2000s⁴. More than 50% of all lawsuits since the 1970s have been filed by hedge funds and 25% by commercial banks. Since 2000, in 75% of all litigation cases against sovereign debtors, hedge funds have been the main plaintiff.

In addition to concerns about the social and economic impact of creditor co-ordination failure, protracted litigation and delayed debt crises resolutions, increasingly aggressive attempts by some vulture funds to seize sovereign assets and their ability, in some cases, to push sovereigns to technical default, have raised questions about the legitimacy as well as the economic efficiency of their activities.⁵

Approaches to limit the activities of holdout creditors, including vulture funds, and to promote more effective creditor co-ordination have taken the form of contractual clauses, the adoption of national legislation, and semi-institutional principles-based frameworks. Proposed contractual measures include the adoption of Collective Action Clauses (CACs), Super-CACs, retroactive CACs, majority voting, minimum participation thresholds, and exit consents.⁶

¹ HM Treasury (2009). Legislation to ensure effective debt relief for poor countries. Press Release 69/09, 21 July, paragraph 1.2

² Human Rights Council (2010). Promotion of all human rights, civil, political economic, social and cultural rights, including the right to development. A/HR/14/21, 7 § 8 Report of the independent expert on the effects of foreign debt and other related international financial obligations of States on the full enjoyment of all human rights, particularly economic, social and cultural rights, Cephias Lumina.

³ AfDB. Vulture funds in the Sovereign Debt Context, supra n.4, §3. Available at: <http://www.afdb.org/en/topics-and-sectors/initiatives-partnerships/african-legal-support-facility/vulture-funds-in-the-sovereign-debt-context/>

⁴ Schumacher, J. C. Trebesch and H. Enderlein (2014). Sovereign Defaults in Court, May 6. Available at SSRN: <http://ssrn.com/abstract=2189997> or <http://dx.doi.org/10.2139/ssrn.2189997>

⁵ See e.g. Wolf, M. (2016). Argentina's debt dispute must not be repeated, Financial Times, 21 September. Available at: <https://www.ft.com/content/36a005a4-5803-11e6-9f70-badea1b336d4?siteedition=intl>

⁶ IMF (2014). The Fund's Lending Framework and Sovereign Debt – Preliminary Considerations. Staff Report, June. Available at: <http://www.imf.org/external/np/pp/eng/2014/052214.pdf>
http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2081&context=faculty_scholarship

In addition, some governments have proposed or adopted national legislation to target vulture fund activities. Thus, in July 2015, the Belgian parliament overwhelmingly adopted a bill “to combat vulture fund activities”. At the heart of this new law is the introduction of a ceiling for the amount the so-called vulture funds can reclaim from government bonds bought at highly discounted prices in secondary bond markets from economies close to default. The law allows Belgian judges to stop vulture funds from claiming repayment above the discounted market price it paid for government bonds, for example at original face value. The only other national initiative relating to vulture funds to have passed the test of a parliamentary vote is the United Kingdom Debt Relief Act (Developing Countries) of 2010, which prevents vulture funds from gaining massive profits from debt restructuring in developing economies. Other national legislative initiatives to this effect, and with a particular focus on developing-country debt, have been proposed in several European countries and in the United States, but so far they have not been enacted.

At the international level work has been done to identify and define soft-law principles to guide sovereign debt restructurings. In particular, in September 2015 the UN General Assembly adopted resolution A/RES/69/319 on Basic Principles on Sovereign Debt Restructuring Processes. The resolution stresses “the importance of a clear set of principles for the management and resolution of financial crises that take into account the obligation of sovereign debtors and their creditors to act in good faith and with cooperative spirit to reach a consensual rearrangement of the debt of sovereign States”.

Objectives

This side-event of the Second Committee will analyse, discuss and weigh the pros and cons of different approaches to addressing the drawbacks of creditor co-ordination failure and the role of holdout creditors in sovereign debt restructurings. Particular attention will be paid to national legislation and any implications for both contractual as well as non-contractual (international) approaches to the regulation of hold-out creditor activities.

The specific objectives of the side event are as follows:

- a. Contribute ideas and expert knowledge to inform the Committee's deliberations on specific challenges to sovereign debt crisis prevention and resolution, in particular those arising from hold-out creditors and vulture funds.
- b. Analyze existing measures to limit the activities of hold-out creditors, at contractual and national levels, and their implications for future regulatory efforts to improve sovereign debt restructuring frameworks.
- c. Make recommendations on how to move forward: which initiatives and approaches to promote and how facilitate the support needed from the UN system and international cooperation.

Structure

The side event will take the form of a three-hour expert panel presentation and interactive discussion. Presenters will be drawn from government, academia, civil society, and the United Nations system. A detailed agenda with confirmed panelists will be provided asap.

Suggested questions for discussion:

1. What, so far, can we reliably say about the social and economic impacts of creditor co-ordination failure and of vulture fund activities?
2. How applicable are efficiency arguments for and against 'vulture' investment strategies in markets for corporate re-structuring to those for sovereign debt?
3. What role can or should the international principle of national sovereignty play in weighing the pros and cons of vulture fund activities in sovereign debt markets?
4. How effective, so far, is national legislation, relative to contractual approaches and international regulatory frameworks?
5. How, and to what extent, can and must such regulation also safeguard the principle of the equal treatment of creditors?