Professional Perspective

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Sovereign Debt Challenges Ahead

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Sovereign debt levels around the world were at record-high levels before the Covid-19 crisis, and the trend is continuing upward. A 2020 International Monetary Fund (IMF) paper on public debt vulnerabilities showed that half of the countries covered in the report were assessed to be at high risk of or already in debt distress.

With countries globally increasing spending to alleviate the pandemic's adverse health and economic effects, at times when revenues are plummeting due to decreased income and trade, a growing number of governments are at risk of sovereign debt default. As of September 2020, the IMF reported that at least seven countries had announced defaults, including Gambia, Lebanon, Mozambique, the Republic of Congo, Suriname, Venezuela, and Zambia.

Just as debt quanta have risen, the types of creditors have also increased, opening up a new set of issues for restructurings. This change in structure gave rise to many challenges for sovereign debt restructurings, especially with bonds more easily ending up in the hands of distressed debt funds, whose opportunistic approach to restructuring may differ from the approach of the older school of investors.

Regrettably, despite the severe costs of default and litigation, the international community has failed to produce an effective sovereign restructuring mechanism, making sovereign debt crisis resolution a very complex and costly process. How nations learn to live with heightened debt levels or find orderly—or less orderly—ways to reduce them will have a crucial impact on people's lives around the globe.

The Challenge in Restructuring Sovereign Debt

Unlike when corporations are in financial distress, governments cannot be liquidated. In addition, there are no standardized reorganization processes such as those that bankruptcy laws provide, and there is no supranational legal authority to enforce repayment. So, when a government cannot pay its debts, the only recourse is to enter voluntary negotiations with its creditors, which are a mixture of private and public entities with different agendas. In contrast to the bankruptcy process for private borrowers, participation in a sovereign debt workout is optional, and creditors may choose to opt out by bringing lawsuits on the face value of defaulted debt.

One of the key challenges in restructuring claims against sovereign borrowers is creating a balance between the interests of the majority of the creditors and those of minority creditors. Holdout creditors serve as a check on "opportunistic" defaults—where a sovereign debtor is unwilling, but not unable, to pay—and unreasonable restructuring terms, yet their presence can interfere with the restructuring process.

Political factors may also influence the restructuring process. For example, by influencing banking regulations, the governments of the countries in which creditor banks are chartered may pressure those banks to provide supplementary financing to strategically important sovereign debtors. At the same time, international development organizations, including the IMF and the World Bank, can influence the restructuring process by enforcing requirements on the financing that they provide to settle temporary liquidity crises. These conditions typically include mandated changes in macroeconomic policies and may include the privatization of state-owned enterprises.

The challenge in restructuring sovereign debt is managing these complexities to engineer a voluntary process by which a sovereign borrower and its creditors can negotiate a feasible debt payment schedule without irreparably harming market confidence. Many factors—such as protracted restructuring processes during which payments on existing debt are suspended, repayment terms that appear to be unreasonably low, and unequal treatment of creditors—can threaten the success of individual restructurings and the long-term strength of the international capital markets.

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Litigation & Restructuring Dynamics

Historically, litigation against sovereign borrowers has been relatively limited. Defaulting governments were shielded by the principle of sovereign immunity, and there was no universal legal authority to enforce repayment. Panizza, et al., 2009. To the extent that sovereign debt litigation has arisen, it tends to be brought after a restructuring, and there has been little evidence that the likelihood of litigation has significantly held up restructurings.

Over the last decade, however, there has been a significant rise in litigation. Sovereign immunity has gradually eroded, either because governments had waived such immunity in the debt contracts or due to the application of the "commercial activity" exception, which foreclosed the sovereign-immunity defense for countries that had accessed the U.S. debt markets and agreed to repayment in the U.S. As a result, banks and specialized hedge funds have successfully sued defaulting countries in courts in the U.S. and the UK.

The Argentine debt crisis of 2001 and its aftermath demonstrate a major change in the legal framework of global sovereign debt markets. In the wake of the default, multiple hedge funds filed suit against Argentina in New York and litigated for full repayment. Fifteen years later, these holdout creditors prevailed, and a favorable court ruling forced the Government of Argentina into a more than $10 billion settlement—a multiple of the debt's face value. This decision was one of the first cases of a court awarding specific performance based on a pari passu, or equal footing, clause.

Argentina's case is not an exception but part of a general trend. In recent years, almost half of debt crises involved litigation, compared to less than 10% in the 1980s and early 1990s. One study's case archive, based on direct coding from court documents, identifies 158 litigation cases against 34 defaulting sovereigns filed in the U.S. or UK between 1976 and 2010. This is a lower bound, since we focus on lawsuits by institutional investors and avoid double-counting. The claims under dispute have grown notably, from nearly zero in the 1980s to an average of 3% of restructured debt, or 1.5% of debtor country GDP, in the 2000s. Schumacher, et al., 2018. Compared to corporate debt markets, these are very large numbers.

Today, the question arises as to whether the record surge in sovereign debt levels is likely to bring on additional litigation, with effects on sovereign ratings, bond pricing, and debt restructuring processes. Three key changes in the sovereign bond market over the past two decades have prompted a modification in the rules for debt restructuring.

The first is the advancement of credit default swaps (CDS), an over-the-counter market instrument that allows investors to more easily and cost-effectively obtain insurance against default and without disclosure. With insurance against default, these investors have less of an incentive to agree to a timely restructuring.

The second factor is a U.S. Second Circuit ruling, which was upheld by the Supreme Court in 2014, which required Argentina to pay certain holdout investors in full before proceeding with the sovereign debt restructuring with the consenting investors. Given the voluntary nature of the restructuring process, creditors may refuse to participate in a restructuring and instead "hold out" in the hope of receiving better repayment terms or even the full value of their claims.

The third factor is the rise in heterogeneity and number of creditors. Compared to the 1980s, where lending to sovereign borrowers was dominated by commercial banks, today the sovereign debt market has become open to a more diverse population of creditors, including institutional investors, distressed debt funds, and retail investors.

Each of these changes has increased the complexities of successful restructuring and thereby increased the chances of litigation against sovereign debtors.

Rise of Vulture Funds

Distressed debt funds (sometimes called "vulture funds") specialize in buying debt in the secondary market at a discount and turning a profit on this investment. Typically, these funds buy struggling companies' debt at a steep discount, hold the debt for several years until the financials of the company improves, and then sell the bonds at a price closer to fair value—or perhaps exchange it for equity.

Vultures take a markedly different approach in the sovereign context than they do in corporate restructurings. As in the corporate context, vultures buy up the debt of distressed sovereigns on the secondary market at bargain prices. However, rather than working with the sovereign to guide it back to profitability, vultures seek repayment of full principal through litigation.

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Today, hedge funds account for most of the new cases, and they pursue more aggressive legal strategies than other types of creditors. Consequently, the lawsuits filed have become larger, are less likely to settle early, and involve more attempts to attach sovereign assets abroad—i.e., undergo legal proceedings that enable creditors to potentially seize assets or disrupt international debt payments. In one example, Elliott Capital, which bought Argentinian bonds in 2001, not only succeeded in pocketing profits of over 900%, but was even able to convince a court in Ghana to seize an Argentinian warship used to train their naval corps.

Practical Solutions

Debt restructurings are messy. With the U.S. Supreme Court ruling on the Argentina case, sovereign debt restructurings are likely to become even more complicated, and vulture fund litigation could be on the rise. Looking ahead, the evolution of modern sovereign debt litigation will be driven by the successes and failures of the legal strategies employed by vulture funds in obtaining judgments against governments. astounding

There have been many ongoing discussions on the need to create an orderly sovereign debt workout process, including proposals to tighten up debt contract language and introduce firmer debt contract clauses. The key focus has been on contractual reform—such as newly designed collective action clauses (CACs). These innovations are likely to lessen the holdout problem by establishing each creditor's agreement at the time of entry into the contract that minorities can be bound by supermajorities.

However, CACs will not remedy all of the problems. This is especially true in circumstances where a holdout creditor secures a sufficient percentage of a particular issuance, allowing it to offset the operation of the collective action clause in that issue. Given these obstacles and the prospect of a Covid-related systemic sovereign debt crisis, additional innovations in this space will be necessary to effectively address the crisis, including technical support to help governments restructure their debt on time and bolster their debt management capacity ex ante.

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