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Battle Hots Up to Curb 'Vulture Funds'

By Martin Khor

Many countries are facing a worsening debt situation, and thus feel the urgency to curb 'vulture funds' and to set up a global debt restructuring mechanism.

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External debt is rearing its ugly head again. With the global economic slowdown, lower commodity prices and less tourism, many developing countries are facing reduced export earnings and foreign reserves.

No country would like to have to seek the help of the International Monetary Fund to avoid default. That could lead to years of austerity, high unemployment, cuts in social development and at the end of it, still no light at the end of the tunnel.

The debt stock might even get worse. Low growth, recession, social and political turmoil are probable. This has been experienced by many African and Latin American countries in the past, and by several European countries presently.

When it becomes clear that there is no solution within the present framework, some countries then restructure their debts. Since there is no international system for an orderly debt workout, the country would have to take its own initiative.

The results are usually messy, as it entails a loss of reputation with the markets, and having to face the anger of creditors. But the country may feel it is a pill that has to be swallowed, rather than face years or decades of economic and political turmoil at home.

Such was the experience of Argentina, whose public debt reached 166% of GDP in 2002. After many years of economic decline and political instability, and when it was clear the debt was unrepayable, Argentina defaulted in 2001.

Then in 2003, President Nestor Kirchner began negotiating a debt restructuring with its creditors. Argentina undertook two debt swaps in 2005 and 2010, and restructured its debt with 93% of its creditors, who agreed to receive about a third of the debt value.

But 7% of creditors, known as 'holdouts' did not agree to the restructuring. Worse, a few influential hedge funds (comprising only 1% of creditors) which bought some of the debt very cheaply on the secondary market, sought a court order in New York (where the original loans had been contracted) to be paid in full.

There are several such funds, now popularly termed 'vulture funds', that specialize in buying distressed debt at low prices (say, 10% of the original loan value) in the financial markets and then insist through the courts on being paid in full with interest thrown in.

Like vultures, they identify the bodies that are turning into or have become carcasses, then they circle overhead and swoop to make a meal of the dead or dying bodies. Only in this case the bodies are countries and they are asked to squeeze their shriveled economies further to pay the vulture funds, like drawing blood from a stone.

The US judiciary, after a long process that went all the way to the Supreme Court, decided this year that the holdout hedge funds that took up the case should indeed be paid in full, and with interest.

Worse, it decreed that the 93% of creditors who had already agreed to be paid at a big discount, are now not allowed to be paid, unless the vulture funds are paid in full at the same time. The New York judge used the principle of 'pari passu' (that all creditors should be treated the same) in reaching the decision.

Argentina had already arranged with a bank in New York to pay out interest to the 93% a few weeks ago, but the bank refused to do so, due to the court order.

The vulture funds want their pound of flesh. The main fund, NML Capital, would make an estimated 1,600% profit.

Argentina's President Cristina Kirchner refused to bow to these funds. If she did, the country might have to also repay all the creditors the full value, which is US\$120 billion, and that is impossible to do.

This incredible turn of events has caused outrage among many public interest groups and anger among developing countries' governments. The South Summit of the G77 in June in Bolivia criticized the vulture funds and called for a proper global debt restructuring mechanism.

Finance Ministries of developed countries have been concerned as well. After all, developed countries like Greece also went through debt restructuring, in which private creditors agreed to take a loss, a few years ago.

Accepting the court decision as the new template would make it quite impossible for any country to restructure their debts, since the now emboldened vulture funds would pounce,

and of course even more investors would imitate the behavior of such funds, since there is big and easy money to be made.

Influential Financial Times commentator Martin Wolf has supported Argentina in its battle with the vulture funds, even saying that it is unfair to the real vultures to name the holdouts such since at least the real vultures perform a valuable task!

At the end of August, the Swiss-based International Capital Market Association, a group of bankers and investors, issued new standards aimed at reducing the ability of holdout investors to undermine debt restructuring.

On 9 September, the Group of 77, representing developing countries, succeeded in promoting a resolution at the United Nations General Assembly which recognized that a state's efforts to restructure debt should not be impeded by hedge funds that seek to profit from distressed debt.

The General Assembly, by a vote of 124 in favour, 11 against and 41 abstentions, also decided to set up a multilateral legal framework for sovereign debt restructuring by the end of 2014, to increase the stability of the international financial system.

A global system for debt restructuring will be a systemic solution, since countries with debt crises can have recourse to an international court or system and would not need to do debt restructuring on its own.

Although the developing countries as a whole championed the resolution, there will now be an uphill battle to get it implemented, since the United States, Germany and the United Kingdom (which are key countries in global finance) were among those which objected.

Another resolution, initiated by Argentina and others, is now being considered by the UN Human Rights Council, aimed at setting up legal frameworks to curtail vulture funds' activities and for sovereign debt restructuring.

One good thing is that the UN, which is a universal body in which developing countries have a greater say in decision-making, is now at the center of the debt discussion.

The negotiations ahead to set up a global system will be tough but well worth it since preventing and managing a debt crisis is now a priority for a growing number of countries.

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