Market Spillovers from Sovereign Litigation

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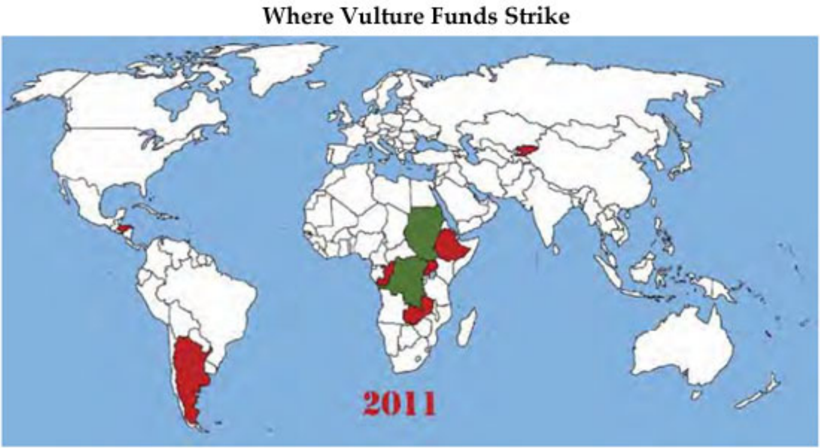
November 14, 2015

Vultures versus Argentina

Vulture activity



Recent litigation against Argentina

- August 23, 2013 ruling

"Faced with the prospect of paying the holdout creditors in full or risking a second default in 12 years, President Cristina Fernandez de Kirchner said in a national address yesterday she will offer a third swap at the same terms to owners of defaulted debt who rejected previous exchanges, as well as to holders of the restructured notes. The proposal is aimed at circumventing the U.S. court ruling without reneging on payments to the New York-law bondholders." (Bloomberg, 8/27/13)

- Argentina rejects decision, appeals to the US Supreme Court

Implications

Market reaction?

"There was always the expectation that if Argentina couldn't win in court, it would find another way to get its way, for example, by re-routing payments," Diego Ferro, co-chief investment officer at Greylock Capital Management... "It's a predictable patch solution that in the end guarantees that dollar debt will be paid." (Bloomberg, 8/27/13)

Policy

- Free-rider problem: "could have pervasive implications for future sovereign debt restructurings by increasing leverage of holdout creditors" (IMF)
- Weakens sovereign immunity: France files amicus brief in support of Argentina
- Strengthens creditor rights and enforcement

This paper

- Evaluate market's perception to sovereign litigation
- Potential effects: positive, negative, neutral
- Methodology: Event study of sovereign bonds in Latin America
- Findings: Differential effects in Argentina vs. rest of Latin America

Enforcing sovereign debt

Sovereign debt

- Enforcement problem
- Why do sovereigns pay?
- Legal recourse to debt (issued in another country)

Sovereign litigation

1. Obtain favorable ruling
2. Collect on the ruling (uncertain process)

Litigation and bond markets

Potential effects

- Negative spillovers: Credit markets/hold out problem
- Positive spillovers: Strengthen creditor rights
- Neutral: Argentina specific effects

Data and methods

Data

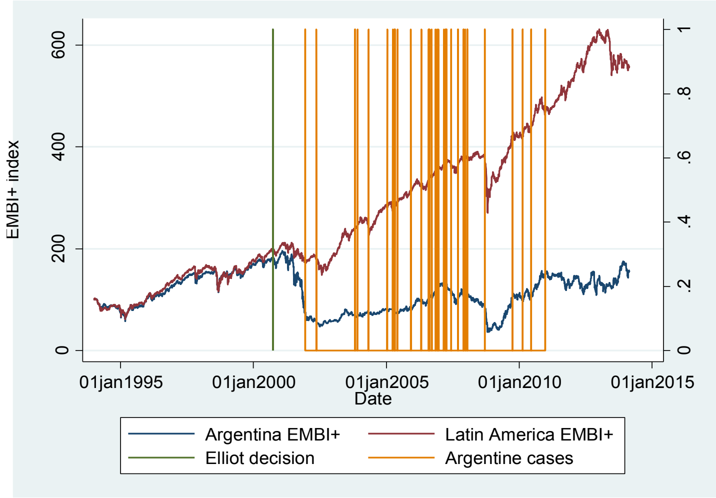
- Market performance: EMBI+ bonds (daily), December 1993 - March 2014
- Sample: Argentina, Brazil, Colombia, Ecuador, Mexico, Panama, Peru, Venezuela

- Events: Date of Argentine litigation events (mostly case filing)
- Original data: Westlaw, IMF, case histories, SDNY docket, newspapers (NYT, WSJ, FT)
- Identify 38 cases

Event study: Abnormal returns around litigation events

- Estimation period: 280 days before and upto 30 days preceding the event
- Regress country EMBI ("return") on Latin market return over estimation period
- Abnormal return (AR) = Actual return - Predicted return
- Cumulative abnormal returns (CARs) sum AR over the event window

Events and bonds



Abnormal returns and sovereign litigation

Sample:	All countries	Non-Latin	Latin		
	(1)	(2)	(3)	(4)	(5)
Window					
2 day	-0.007	0.001	-0.014	-0.014	-0.014
	(0.002)***	(0.001)	(0.003)***	(0.003)***	(0.000)***
Country FE				Yes	
Event FE					Yes
No. obs	538	266	272	272	272

Notes: Estimation via OLS using Scholes-Williams betas. Each row in each column reports the estimate from a separate specification. Robust standard errors, clustered by event reported in parentheses. *** = significant at 1%. Non-Latin countries include: Bulgaria, Indonesia, Nigeria, Philippines, Poland, Russia, S. Africa, Turkey and Ukraine. Latin countries include: Argentina, Brazil, Colombia, Ecuador, Mexico, Panama, Peru, and Venezuela.

Spillovers in Latin America

- Differential effects: Greater sovereign default risk in Argentina; reduced in rest of Latin America

	EMBI +				CDS spread	
	(1)	(2)	(3)	(4)	(5)	(6)
Sample:	Latin	Latin	Argentina	Non-Arg.	Argentina	Non-Arg.
2 day	-0.014	0.0195	**-0.154**	**0.0675**	**1.597**	**-0.202**
	(0.003)***	(0.021)	**(0.034)*** **	**(0.021)*** **	**(0.528)*** **	**(0.071)*** **
Controls		Yes	Yes	Yes	Yes	Yes
No. obs	272	271	34	237	18	126

Notes: Estimation via OLS using Scholes-Williams betas. Robust standard errors, clustered by event in parentheses. *, **, *** = significant at 10%, 5%, 1% respectively. Dependent variable is cumulative abnormal return (2 day) for EMBI+ bonds (columns 1-4) and "end of day" credit default swap (CDS) spreads on 5 year sovereign bonds (from Bloomberg, columns 5-6). Controls include: total reserves (% GDP), imports (% GDP), and ICRG com positive index.

Spillover "channels": Contagion and trade

- Correlational analysis for contagion and channels (Forbes 2012)

Dependent variable:	Cumulative abnormal return (2 day)			
	(1)	(2)	(3)	(4)
2 day window	0.043	0.043	0.021	0.085
	(0.023)*	(0.020)**	(0.023)	(0.026)***
Contagion	0.129		0.094	0.106
	(0.044)***		(0.042)**	(0.049)**
Exports to Arg.		-0.426	-0.793	
		(0.150)**	(0.234)***	
Imports from Arg.				-0.524
				(0.125)***
Contagion x Exp. Arg.			2.594	
			(1.350)*	
Contagion x Imp. Arg.				0.277
				(0.902)
No. obs	237	237	237	237
R-squared	0.13	0.16	0.21	0.21

Notes: Estimation via OLS using Scholes-Williams betas. Robust standard errors, clustered by event in parentheses. *, **, *** = significant at 10%, 5%, and 1% respectively. Sample of Latin American countries excluding Argentina. Dependent variable is 2 day cumulative abnormal return (of EMBI+). Contagion is equal to percentage of Latin America countries with a positive 2-day cumulative abnormal return (in response to the same event). All specifications include macroeconomic and political controls: reserves (% GDP), imports (% GDP), and ICRG composite index.

Conclusions

Enforcing sovereign debt

- Weakening of sovereign immunity and rise of sovereign litigation
- Debt holders sometimes successful; policy concern

Findings

- Spillover effects: Litigation has differential effects on abnormal returns across countries
- Raises risk in litigated country; lowers in neighbors