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# A fair and transparent debt work-out procedure:

## 10 core civil society principles

A report from the European Network on Debt and Development (Eurodad)

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- Support the empowerment of Southern people to chart their own path towards development and ending poverty.
- Seek a lasting and sustainable solution to the debt crisis, promote appropriate development financing, and a stable international financial system conducive to development.

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# A fair and transparent debt work-out procedure: 10 core civil society principles

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## A sovereign debt work-out procedure: Why now?

In an effort to respond to the global financial crisis, The Proposals for a sovereign debt work-out procedure for countries experiencing sovereign debt difficulties are not new. Since 1990, a number of different ideas have been tabled. Kunibert Raffer of the University of Vienna has proposed the internationalisation of Chapter 9 of the US bankruptcy code. Latin American economists, Alberto Acosta and Oscar Ugarteche have tabled the idea of a permanent 'Sovereign Debt Arbitration Tribunal' (TIADS) under the aegis of the United Nations. In 2001, the IMF's Anne Krueger put forward the idea of a 'Sovereign Debt Restructuring Mechanism' (SDRM) to be administered by the IMF. Most recently, Christoph Paulus and Steven Kargman outlined their proposals for a Sovereign Debt Tribunal which should be empowered to examine not just cases of unsustainable debt but also the legitimacy of individual creditor claims.

None of these detailed proposals has ever been implemented. In fact, the issue has slipped off the international public policy debate over recent years due in part to the agreement and implementation of international debt relief schemes such as the Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI). But the issue of how to reform international processes connected to the fair and efficient resolution of sovereign debt problems has not diminished. On the contrary, it has become even more urgent in the context of the recent global economic downturn and the increase in sovereign debt ratios which have inevitably accompanied this.

In November 2009, UNCTAD Secretary General Supachai Panitchpakdi warned that developing countries' debt burdens would increase by over 17% this year. This seriously damages countries' economic growth prospects, he said, and threatens governments' abilities to invest in achievement of the Millennium Development Goals (MDGs). In its 2009 Least Developed Countries (LDC) report, UNCTAD also pointed to serious concerns over the unsustainably high debt burden in 49 LDCs. The IMF also estimated that should ODA and FDI inflows decline by 30% relative to the levels seen in 2008 – and the short-fall is fully replaced with public external

(non-concessional) borrowing – this will add 4% of GDP to low-income countries' debt burdens over just one year. If as some analysts predict, the effects of the global recession play-out for a few more years to come, this will substantially increase the poorest countries' vulnerabilities to debt default.

Worryingly, the response of the international community to the estimated US\$350 and US\$635 billion shortfall in external finance in 2009 alone has been to step up the level of new loans extended to developing countries. In April 2009, the G20 agreed to funnel an additional US\$500 billion in resources to the IMF with substantial increases in funds for the multilateral development banks. In 2009, World Bank loans will be up 54% on the previous fiscal year. The G20 also announced an additional US\$250 billion in support for trade finance over the next two years. As EURODAD's recent "Debt in the Downturn" report revealed, between September 2008 and September 2009, 32 countries had reached agreements with the IMF for a total of US\$170 billion in new debt. Non-concessional loans made up the bulk of the new lending at US\$ 167.5 billion of the total. Concessional finance amounted to just US\$2.5 billion. This approach shores up substantial liabilities for countries in the future.

EURODAD and many of its member organisations have long advocated for the creation of a fair and transparent debt work-out procedure at the international level. We have consistently argued that current measures to deal with sovereign debt problems are seriously deficient.

Currently, there are three major approaches which are commonly used to deal with sovereign debt repayment difficulties: 1) the contractual approach as reflected in the use of so-called 'collective action clauses' in sovereign bonds; 2) the voluntary approach as reflected in codes of conduct for lenders and borrowers as they enter into negotiations (such as the "Principles for Stable Capital Flows and Fair Restructuring in Emerging Markets" of 2004); 3) the use of creditor-led forums such as the Paris and London Clubs to negotiate and restructure or cancel bilateral and commercial debt respectively. To the latter, we can add the Heavily Indebted

Poor Countries Initiative, which is another creditor-led initiative to cancel the multilateral debts of some of the world's poorest and most severely indebted countries. More recently, the World Bank and IMF have enhanced this list of supposed solutions to sovereign over-indebtedness with the 'debt sustainability framework for low-income countries'. This analytical tool claims to help prevent sovereign debt difficulties via the publication of a Bank/Fund assessment of the health of individual low-income economies. Lenders are urged to extend loans only on extremely concessional terms to the most vulnerable countries.

Why are these solutions so deficient? With respect to the statutory approach and the use of collective action clauses in sovereign bonds, these can certainly help to avoid situations whereby each bondholder acts individually to secure the most favourable outcome for him/herself; the collective action clause (CAC) allows a supermajority of bondholders to agree a debt restructuring that is legally binding on all holders of the bond, including those who vote against the restructuring. But sovereign bonds represent just one asset class and the country will typically owe funds to other private and also official lenders; these debts need to be fairly and efficiently tackled too. Thus CACs do not solve the coherence problem. CAC discussions also regularly arrange for voting between holders of the same, single debt instrument where there may be several types of sovereign bond in circulation which also need to be addressed. CACs therefore fall far short of the need for a comprehensive and impartial decision-making process, independent of both debtors and creditors.

Deficiencies with respect to the voluntary approach include the concern that those lenders that are more inclined to sign-up to voluntary codes of conduct are precisely those that are least likely to engage in bad-faith and irresponsible behaviour. This leaves the door wide open to creditor hold-outs and worse, vulture fund litigation. Purely voluntary codes of conduct have no enforcement powers and therefore cannot impose any discipline on lenders or borrowers. They therefore cannot be usefully be relied on to resolve repayments

difficulties equitably where they do arise.

With respect to the Paris and London Club forums – as well as the HIPC Initiative – it quickly becomes clear that creditors are in full control of sovereign debt negotiations. Erlassjahr.de argues: "looking at the relevant fora where debt is actually negotiated we find that creditors are the ones who define the process as such, set up the rules of the process, and decide upon particular cases on the basis of expertise they have commissioned or even produced themselves." Creditors retain the privilege of deciding which countries are eligible to receive partial debt cancellation or a lesser debt restructuring and on what precise terms. In practice, this has meant countries have been forced back to creditors again and again due to protracted debt repayment problems. Senegal has appealed to the Paris Club fourteen times for assistance with its bilateral sovereign debt. Many HIPCs have been granted additional debt relief (topping-up) under the HIPC Initiative when it became clear that their multilateral debts were still unsustainable even though they had completed the HIPC Initiative.

The World Bank and IMF's debt sustainability framework (DSF) has been widely touted as a new innovative solution to the problem of sovereign over-indebtedness. And while debt sustainability analyses can certainly provide useful information about the state-of-health of particular economies, history shows us that there will always be instances where countries run into sovereign debt difficulties. It also suffers from several other important deficiencies which mean that it cannot be considered a reliable instrument to prevent sovereign over-indebtedness in the future. For example:

- The thresholds of when a debt is considered sustainable or unsustainable are again set by creditors. And we have recently seen that these definitions can quickly be flexibilised by creditors to suit their own needs;
- The basic funds that countries need to meet the MDGs are not taken into consideration when calculating a country's capacities to repay its external debt;

- The DSF carries a threat of sanctions against the debtor (in the form of reduced IDA assistance or IDA loans on harder terms) if the World Bank and IMF deem that it has borrowed irresponsibly; no sanctions are considered against creditors who lend imprudently (such as their claims will be rendered null and void).

Moreover, debt sustainability analyses will only be systematically carried out on low-income countries. As the current global economic downturn shows, many middle-income countries have been hardest hit and are at arguably greater risk of sovereign debt distress.

Countries which have recently exited from substantial levels of debt cancellation are now being extended aggressive levels of new debt. And there is a real danger that we are entering a new round of irresponsible supply-side driven lending, for example via the US\$ 250 bn in expanded trade finance which the G20 committed in April 2009. This has rightly prompted fresh public policy debates about how to secure medium-term debt sustainability and resolve debt crises where they do arise.

There currently exists no international judicial body with competence to resolve issues between sovereign borrowers and their lenders. The world requires new institutions and we are at a decisive moment given recent events.

Several creditor governments have signalled a new interest in the issue of a fair and efficient debt work-out procedure at the international level. In Norway, in May 2009, the Foreign Affairs Committee in the Norwegian Parliament called on the government to work for the establishment of a sovereign debt work-out mechanism which would examine both illegitimate and unsustainable debt. In October 2009, the re-elected government issued a political declaration (Soria Moria II) in which the government committed to “work for mechanisms to abolish international debts and deal with illegitimate debts [and] a binding international set of regulations for responsible lending.”

In Germany, before the September 2009 elections, all parliamentary parties supported the call for an orderly sovereign debt work-out

procedure. The governing parties then approved a parliamentary motion which called for such a procedure. The new centre-right coalition has pledged to work towards the establishment of an international insolvency framework as part of its broader development policy agenda.

In the Netherlands, the Ministry of Finance has put forward a new proposal to resolve disputes related to international loans. This proposal draws substantially on EURODAD’s Charter on Responsible Financing which argues that current forums to deal with sovereign debt disputes – such as the International Court for the Settlement of Investment Disputes – are unfairly skewed towards lender interests. The Dutch proposal suggests that the Permanent Court of Arbitration in the Hague, Netherlands would be a fairer and commonly-owned forum in which disputes related to international loans between sovereign debtors and bilateral lenders, multilateral bodies and private entities could be heard.

Recently, the World Bank indicated that it would conduct new research into the issue and would release a paper in March 2010. Amar Bhattacharya of the G24 secretariat also recently remarked that, in terms of what is missing from the G20 response to the global financial crisis, the legacy of debt and need for a sovereign debt work-out mechanism at the international level are notably absent.

The issue is gaining new political momentum. In this context, EURODAD believes it is vital to set out what it believes to be core principles for a fair and transparent sovereign debt work-out procedure at the international level. A debt work out mechanism will not only serve to deal with debt ex post, but will also discipline lenders and promote more responsible lending and borrowing ex ante.

This paper outlines ten principles which EURODAD believes are the essential components of such a mechanism. We urge policymakers to initiate an inter-governmental initiative on the principles set out in this document and should aim to establish – within a specified timeframe – such a procedure at the international level. Given recent pressures on many countries due to the global economic downturn, the moment could not be more opportune.

## Sovereign debt work-out procedure: 10 civil society principles

### **1. Creation of a body independent of creditors:**

The sovereign debt work-out procedure must be independent of any creditor institution or body. This is essential to secure a level playing field and international support for the mechanism. This means that – as creditors – the International Monetary Fund and/or World Bank cannot host such a procedure because they would not be viewed as impartial decision-makers (they have an interest in recovering their claims). This body may be permanent, for example under the auspices of the UN, or it may be ad-hoc and convene only to examine particular cases on demand. There should be the opportunity to go to mediation as a precursor to a binding arbitration procedure.

**2. Independence of arbitrators:** decision-makers should be neutral and independent from the parties involved.

### **3. Mandated to verify the validity of individual claims based on any allegations of illegitimacy:**

the independent arbitrators will decide on the (il)legitimacy of individual credits based on precedent and clear indicators/criteria of illegitimate debt. For example, has the ex ante loan contraction process closely followed the principles outlined in EURODAD's Charter on Responsible Financing? EURODAD believes that a sovereign debt work-out procedure must be able to deal with issues related to the (il)legitimacy of debt, otherwise it cannot be considered a truly fair and comprehensive mechanism. Important gaps will exist.

### **4. Mandated to deal with generalised sovereign debt repayment problems:**

independent arbitrators will decide if individual credits are valid. Legitimate creditors' claims will then be dealt with in one comprehensive process and all creditors will be treated equally and fairly. This will avoid the free rider problem evident from initiatives such as the HIPC Initiative where there is a perverse incentive to hold out. It will also help prevent vulture fund litigation because it will, as a matter of principle, function on the basis of equal treatment of all creditor claims.

### **5. Process may be initiated by borrower or lender and the institution of automatic stay will apply:**

there will be a standstill on all external debt repayments in cases of sovereign debt default or on the individual (il)legitimate loan under dispute while the case is heard.

### **6. Assessment of the indebted country's economic situation by a neutral body:**

in cases of sovereign debt default, a debt sustainability analysis should be carried out by an independent body, such as a United Nations agency. This means that the IMF and World Bank – as creditors – cannot provide the only assessments of the country's economic situation, although their databases will certainly be drawn upon by the independent body. The analysis should guide arbitrators' decisions on how far each legitimate creditor should take a haircut.

### **7. Protection of the basic obligations of the state to meet the essential needs and services of its citizens:**

the state must be assured the resources it needs to carry out its basic duty of care. Both domestic commercial and individual insolvency procedures, as well as Chapter 9 of the US-insolvency code which refers to the insolvency of municipalities, provide examples how "essential means" can be protected during any insolvency procedure.

**8. Transparency:** sovereign debt negotiations must be public and the results and agreements made must also be made public.

**9. Participation:** the procedure must be participatory and all stakeholders have the right to be heard. This includes borrowers, lenders and individuals/organisations which represent citizens in the debtor nation affected by decisions taken by the arbitration panel. All must argue, prove and document their points (rather than quibble between themselves which is the current situation). As a rule, proceedings should take place in the debtor country's capital.

**10. Enforceability:** all parties must respect the decision of the independent arbitrators. An international treaty establishing a sovereign debt work-out mechanism ratified by most nations would be extremely helpful; however is not a prerequisite for progress in this area. Current sovereign debt management procedures (such as the Paris Club and HIPC Initiative) also function without any basis in international law. Instead they are based on the political will of creditors and the lack of alternative solutions. This underscores why an international sovereign debt work-out procedure must be independent of any creditor institution in order to ensure broad-based support.

## Conclusion

The response of the international community to the global economic downturn has been a rush to “get money flowing”. New debt from official sector lenders such as the IMF and World Bank as well as rich country governments has been at the forefront of this strategy. But this approach has raised concerns that external debt ratios will rise to unsustainable levels at least in some poor countries. It has also raised concerns that new loans are extended in a responsible and legitimate manner and do not contribute to new rounds of illegitimate and unpayable debt.

Moreover, the landscape of development finance has changed considerably over the last decade. New creditors have entered the scene. Not only governments and banks from the North are creditors to the South; Southern governments are considerably exposed to other Southern governments. Some NGOs and international loan co-operatives are also creditors to Southern countries. The increasing complexity of actors involved in world of sovereign finance means that previous approaches are increasingly inadequate. It underscores the need to develop fair and predictable rules for dealing with sovereign debt problems.

The fair and transparent debt work-out mechanism would elevate disputes and sovereign debt repayment difficulties to a neutral forum empowered to make binding decisions. The proposal would bring cohesion, structure, fairness and predictability to a potentially disorganised group of stakeholders which all act individually to secure the most favourable outcome for themselves. In addition, the mechanism supports efforts to ensure that future loans are extended in a responsible and legitimate manner, as advocated in EURODAD’s Charter on Responsible Financing. This is because, contrary to present practice, creditors’ claims would be individually verified by the independent arbitrators. Creditors would therefore have a clear incentive to lend their capital in a more cautious and responsible way. If repayment difficulties do arise, legitimate creditors are assured that all lenders will shoulder their fair share of the losses. In addition, such a procedure will strengthen efforts to audit

developing country debts, another strategy long identified by civil society organisations as important. This is because both government and civil society sovereign debt audits can provide valuable evidence which can be used by the independent arbitrators in their decisions.

The procedure also promises to significantly reduce the costs of debt cancellation where they do arise. Because of creditors’ reluctance over many years to admit that most debts were fundamentally uncollectible from the poorest countries, interest and penalties continued to accrue on these loans. When they were finally cancelled after years of public pressure, the amount of debt on the books was far higher than it would’ve been had creditors admitted earlier that some debt cancellation was needed. This policy cost not only the taxpayer in the North more, it also cost developing countries dearly since debt cancellation is counted as official development aid.

A fair and transparent debt work-out procedure will help countries deal objectively with allegations of illegitimate debt. In cases of sovereign insolvency, it will help the debtor nation to emerge from any reorganisation process with better prospects for economic recovery and development. EURODAD urges policymakers to initiate an inter-governmental initiative which aims to establish – within a certain timeframe – such a procedure at the international level. The proposals outlined in this document should be used as a key input into this process. Given recent pressures on many countries due to the global economic downturn, the moment could not be more opportune. But more importantly, it will ensure that sovereign debt management procedures at the international level are reformed in a way which is much more conducive to development. And the commitment to development pledge is one which has been made by governments around the world.



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