International Debate on a Sovereign Debt Restructuring Mechanism

By Eva Hanfstaengl

In the context Argentinean debt crisis in 2000-2001 and at the Financing for Development Conference 2002 the need for an international debt workout mechanism was discussed and the following paragraph was adopted by consensus:
" To promote fair burden-sharing and minimize moral hazard, we would welcome consideration by all relevant stakeholders of an international debt workout mechanism, in the appropriate forums, that will engage debtors and creditors to come together to restructure unsustainable debts in a timely and efficient manner. Adoption of such a mechanism should not preclude emergency financing in times of crises." (Monterrey Consensus, para 60)

In 2001 the IMF put forward its proposals for a new Sovereign Debt Restructuring Mechanism (SDRM) in which some of the principles of domestic insolvency procedures were applied to sovereign countries. However, the SDRM had substantial flaws: It involved a cumbersome decision-making procedure that retained most of the inequities of existing processes. Primarily addressing public debt owed to private sector creditors the SDRM failed to deal with multilateral debt and bilateral creditors. More important the SDRM did not comply with basic demands regarding impartiality, transparency and a poverty perspective. In April 2003 the IMF's SDRM initiative was blocked. Opposition mainly came from the US Treasury Department which did not want to see a legally binding framework, preferring the voluntary inclusion of so called 'Collective Action Clauses' (CAC) in bond contracts instead. Also emerging market countries were reluctant. Their main concern was that their borrowing conditions would be negatively affected by the simple existence of a debt workout mechanism that would bail-in private creditors stronger than before.

The voluntary inclusion of CAC may be a small step forward to creditor coordination in new bond contracts. However, they do not offer an exit to any of the already existing contracts. Nor do they allow for civil society in debtor countries to be heard. The concerns of emerging market countries on the other hand clearly reflect the coercive power of the international financial markets. While the status quo gives centrality to the interest of creditors (including multilateral institutions), resolving a debt crises can only work when the basic human needs and rights of the poor are met. Also voluntary Codes of Conduct cannot provide a sufficient answer to this systemic problem of a one-sided bias, as they keep all control on procedures and results in the creditors' hands.

In September 2005, the World Summit and General Assembly adopted the following paragraph on debt[1]:

"Para 26. We emphasize the high importance of a timely, effective, comprehensive and durable solution to the debt problems of developing countries, since debt financing and relief can be an important source of capital for development. To this end:
(a) We welcome the recent proposals of the Group of Eight to cancel 100 per cent of the outstanding debt of eligible heavily indebted poor countries owed to the International Monetary Fund, the International Development Association and African Development Fund and to provide additional resources to ensure that the financing capacity of the international financial institutions is not reduced;
(b) We emphasize that debt sustainability is essential for underpinning growth and underline the importance of debt sustainability to the efforts to achieve national development goals, including the Millennium Development Goals, recognizing the key role that debt relief can play in liberating resources that can be directed towards activities consistent with poverty eradication, sustained economic growth and sustainable development;
(c) We further stress the need to consider additional measures and initiatives aimed at ensuring long-term debt sustainability through increased grant-based financing, cancellation of 100 per cent of the official multilateral and bilateral debt of heavily indebted poor countries and, where appropriate, and on a case-by-case basis, to consider significant debt relief or restructuring for low- and middle-income developing countries with an unsustainable debt burden that are not part of the Heavily Indebted Poor Countries

[1] 2005 World Summit Outcome Document.

Initiative, as well as **the exploration of mechanisms to comprehensively address the debt problems of those countries.** Such mechanisms may include debt for sustainable development swaps or multicreditor debt swap arrangements, as appropriate. These initiatives could include further efforts by the International Monetary Fund and the World Bank to develop the debt sustainability framework for low-income countries. **This should be achieved in a fashion that does not detract from official development assistance resources**, while maintaining the financial integrity of the multilateral financial institutions.

Proposal for an innovative mechanism: A Fair and Transparent Arbitration Procedure (FTAP)

Since the 1990s, Non-Governmental and church-related Organisations and some scientists such as the Austrian economist Kunibert Raffer have already argued in favour of a different neutral debt workout process which draws from the experience of insolvency procedures. They found support in Chapter 9 of the US Civil Code which regulates insolvency cases of municipalities taking into account their special situation as public bodies with responsibilities and duties towards their citizens. The aim is setting up of a fair and transparent arbitration procedure to address unsustainable debt burdens, based on a neutral decision making body, the right of all stakeholders to be heard, the protection of debtors basic needs, and the institution of an automatic stay of debt servicing. This demand for an "international insolvency law" later became known as the "Fair and Transparent Arbitration Process" (FTAP), an international procedure where neutral courts of arbitration are established to ensure fair and equal relationships between debtors and creditors.

A Fair and Transparent Arbitration Procedure (FTAP) would establish a comprehensive mechanism that would be open to all countries and that would address private as well as bilateral and multilateral debts. The FTAP proposal argues that a truly comprehensive debt restructuring process must be driven by an independent institution, such as an international arbitration panel. Longer-term, a permanent body should be institutionalised under the aegis of the United Nations to deal with successive debt, the UN being a more legitimate organisation to host and coordinate these efforts than the IMF.

The adoption of a predictable framework for debt arbitration that would replace the present ad-hoc, case by case, exclusive creditor-led approach to debt cancellation with a system that achieves fairer balance between the interests of creditor and debtor. One well developed proposal FTAP[2]/Chapter 9 framework applies principles of domestic bankruptcy law and provide for an independent third-party to make judgements on the claims of the creditors.

Recommendations for a debt crisis resolution framework, include the following conditions:

- An **independent authority** should make all decisions on the claims of the parties,
- The debtor country should be able to initiate a unilateral process where they obtain immediate **stand-still protection** – endorsed by the independent authority.
- The independent authority in charge of the process should be explicitly empowered to rule on whether debts are illegitimate or **odious**.
- All foreign currency debts owed by the sovereign government should be on the table. This should **include all debts** owed to private lenders, to other sovereign governments (bilateral debt) and to international financial institutions (multilateral debt).
- The process should be transparent and provide for the right of **civil society to be heard** at all relevant stages of the process: public hearings, publicity of sessions and decisions.
- Any agreement between the debtor and the creditors should ensure that the debt burden of the sovereign is reduced to a level that ensures that the service on the remaining debt does not impair the ability of the indebted country to fulfil **basic human rights** of the population and meet the MDG's. [3]

[2] Kunibert Raffer in CIDSE / Caritas Internationalis, 'Sustainability and Justice: A comprehensive Debt Workout for Poor Countries with an International Fair and Transparent Arbitration Process (FTAP), Sept. 2004

[3] Aldo Caliari, based on CIDSE / Caritas Internationalis, 'Sustainability and Justice: A comprehensive Debt Workout for Poor Countries with an International Fair and Transparent Arbitration Process (FTAP), Sept. 2004