eurodad
european network on debt and development

We can work it out

10 civil society principles for sovereign debt resolution

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A list of the organisations that have endorsed the principles is included at the end of the paper.

The ongoing case for a debt workout mechanism: why look at these principles now?

The continued absence of a multilateral debt workout mechanism (DWM) or debt resolution framework (DRF)[1] to ensure a systematic and timely approach to orderly, fair, transparent, and durable sovereign debt crisis resolution, is a persisting gap in the international financial architecture.[1] In itself, this is not a revelatory statement. The necessity for a sovereign bankruptcy regime was noted by Adam Smith almost 250 years ago,[2] and despite failing to be incorporated into the Bretton Woods System, occupied the minds of its architects.[3] Nevertheless, states and their populations still remain uniquely unprotected as a class of debtors by any such standard bankruptcy framework.[4] With over 600 restructurings involving 95 debtor countries occurring between 1950-2010 alone, sovereign debt crises can hardly be considered exceptional events.[5] And while almost all the restructurings in that period involved developing or emerging economies, the global financial crisis (GFC) that marked subsequent years has provided a stark reminder that even advanced economies in a currency union are not immune to insolvency.

Civil society organisations (CSOs) and critics have long highlighted the absence of a fair and effective DWM and have put forward a number of proposals on how to fill the gap. Significant contributions over recent years include the concept of an International Board of Arbitration for Sovereign Debt, put forward by the Latin American economists Oscar Ugarteche and Alberto Acosta,[6] and the proposal to create a sovereign debt arbitration chamber at the Permanent Court of Arbitration in The Hague, developed by AFRODAD.[7]

Meanwhile Jürgen Kaiser, the Political Coordinator from Eurodad member erlassjahr.de, set out the operation of an *ad hoc* arbitration process to ensure fair and transparent restructuring in 2013.[8] Eurodad reviewed the genesis of these proposals in a 2016 discussion paper, 'The evolving nature of developing country debt and solutions for change'.[9] This present briefing is an update to a 2009 Eurodad paper '10 civil society principles for sovereign debt workout',[10] which built heavily on proposals for a fair and transparent arbitration procedure first advanced by Austrian development researcher Kunibert Raffer.[11]

A decade on, the need to address this topic is ever-present, as warning bells are again sounding over major sovereign debt vulnerabilities. The policy responses ushered in by economies in the global north to deal with the GFC triggered a lending boom, which has contributed to unprecedented levels of public and private debt across the globe. Concerns over a new wave of crises are widespread, matched only by the levels of anxiety regarding the evolving challenges to orderly and fair debt crisis resolution as this wave hits.[12] These include, in particular, the fact that developing countries now hold more diverse and expensive public debt stocks from an ever more complex landscape of creditors than in the past.[13]

The last ten years also saw an intensification and subsequent abrupt halt to international efforts to pursue a comprehensive statutory (legal) mechanism for sovereign debt crisis resolution. Attempts by International Monetary Fund (IMF) staff in 2013 to revive work on a proposal for a debt workout mechanism managed by the IMF itself, which was first put forward in 2001,[14] failed to secure political backing.[15] Progress at the UN later looked possible, when in 2014 the G77+China (a grouping of developing countries) secured a General Assembly (GA) resolution committing the body to work towards establishing a multilateral legal framework. However, the work of an *ad hoc* committee set up to take this forward was subsequently hampered by a lack of cooperation from G7 governments and others in 2015, with the EU amongst those boycotting negotiations.[16] This latter process nonetheless produced a set of nine UN principles on debt restructuring processes,[17] and saw a valuable contribution from the UN Conference on Trade and Development (UNCTAD) on how to create a coherent process.[18] Yet the principles have not been universally accepted, which has harmed their potential to mature into rules of customary international law.

Contractual or market-based solutions, which provide partial coverage of debt stocks, have moved forward: namely through developments in the design and use of so-called 'collective action clauses' (CACs) in sovereign bond contracts. Meanwhile, there has been a proliferation of voluntary principles and codes to encourage more responsible sovereign financing, such as UNCTAD's 2012 Principles on Promoting Responsible Sovereign Lending and Borrowing.[19]

1 Note that the terms debt workout mechanism (DWM) and debt resolution framework (DRF) will be used interchangeably in this briefing. DRF may be considered to be a more general, technical term, while civil society has long used the term DWM in policy discussions. Neither relate to a specific design of such a framework or mechanism as will be made clear in the briefing.

These advances have happened in the shadow of a number of key developments, including: a seminal US court ruling in 2012 against Argentina, calling into question the adequacy of existing means to tackle aggressive, uncooperative creditors seeking preferential treatment in restructurings (so-called 'vulture funds');[20] the biggest debt restructuring in sovereign default history, for Greece;[21] and the growing influence of new bilateral and non-traditional commercial lenders, and use of collateralised lending.

However, there is not much to suggest that the tendency of debt crisis resolution to involve 'too little' debt reduction, and to take place 'too late' to avoid damaging economic, political, and social costs for over-indebted countries, has changed in recent years. Rather, the aforementioned new dynamics may entrench this reality as they present greater challenges to creditor coordination and orderly restructuring. The impact of sovereign indebtedness meanwhile continues to play out in the diversion of much-needed public funds to creditors rather than to development priorities,[22] undermining the enjoyment of universal human rights,[23] and contributing to rising inequality.[24] Any serious efforts to meet multilateral commitments, such as the 2030 Agenda and Paris Agreement, require the renewal of international political efforts to address definitively the problem of disorderly and inequitable debt crisis resolution. This briefing seeks to reassert the principles that civil society consider to be essential to any international debt resolution framework striving to achieve this necessary goal.

The impact of sovereign indebtedness continues to play out in the diversion of much-needed public funds to creditors rather than to development priorities

A multilateral sovereign debt workout mechanism
10 KEY CIVIL SOCIETY PRINCIPLES

1. Creation of a body independent from creditors and debtors
2. Process may be initiated by borrower and the institution of automatic stay will apply
3. Initiation of the process should trigger a stay on creditor litigation and enforcement
4. Comprehensive treatment of a country's debt stock in a single process
5. Inclusive participation of all stakeholders
6. Independent assessment of debt sustainability and the validity of individual claims
7. Focused on debt sustainability that puts needs of population before debt service
8. Respect for international human rights law and the realisation of international development commitments
9. Transparency: negotiations and their outcomes must be made public
10. Enforceability

What is sovereign debt restructuring?

Sovereign debt restructuring is a process involving both a debtor government and its creditor(s) that changes the current terms for payment of outstanding sovereign debt instruments (e.g. loans from banks or other governments, or bonds). The process is formally aimed at enabling the debtor government to address liquidity or solvency difficulties resulting from its current payment obligations. Ostensibly, this is a legal process driven by economic and financial rationale. However, in practice it is a highly political affair, often underpinned by strategic interests (e.g. debt relief for Iraq after the 2003 Gulf War);[25] normative considerations (e.g. "a country 'living beyond its means' should pay its debts");[26] and even religious dimensions (e.g. the biblical concept of Jubilee year debt relief).[27]

Debt resolution or workout does not necessarily need to be realised through restructuring. It can also take place through debt forgiveness/cancellation, where a creditor chooses simply to write off an outstanding debt, partially or in full.[28] A debtor state can also choose unilaterally to repudiate and not repay debt that it considers illegitimate, odious, or illegal – such as that accrued by a previous government in violation of domestic or international law.[29] This briefing will, however, focus on debt resolution through 'orderly' debt restructuring.

Such sovereign debt restructuring actions generally fall into four main categories:

- debt reduction, where there is a cut in the nominal (face) value of a debt instrument;
- debt rescheduling, where the terms and conditions of repayment of a debt instrument may be changed e.g. extending the maturity of a bond, possibly at a lower interest rate;
- debt conversion or swap, where debt is exchanged for something of value such as equity in a development project, investment in a climate change mitigation measure, or investment or allocation of funds in basic services such as education; or
- debt assumption, where a third party takes over the responsibility for repayment.[30]

The non-regime and its basic elements

As it stands, there is no systematic process under which sovereign debt restructurings take place and no possibility for a country to restructure its entire debt stock in one place and in one comprehensive procedure. There is no bankruptcy code for countries to discharge legally their debt and they can only secure debt relief with the voluntary agreement of their creditors. Indebted countries are instead subject to a non-regime, characterised by *ad hoc* operations that have evolved through trial and error, and that are driven by the needs and interests of creditors and spread across a fragmented landscape of opaque, informal creditor forums.[31] This means that over-indebted countries are compelled to engage in a series of discrete negotiations with creditors when they are seeking to restructure, given a lack of coordination of creditors within different categories of debt, and across these categories (see Table 1).

When the debt sustainability of a developing country is at risk and sovereign debt becomes unmanageable, the country faces the lack of a comprehensive framework. Instead, it finds a fragmented system of different institutions, venues, and rules for different types of creditors. For certain types of instruments, there is no institution or negotiation forum.

Negotiating with bilateral creditors

The most institutionalised creditor forum is the Paris Club, which was first convened in 1956 and brings together 22 donor governments – so-called official, bilateral creditors – from the global north. Its age is a reflection of the pre-eminence of official lenders in development finance at that time.[32] The Paris Club has rules on how and to whom it grants debt relief, but these allow a high degree of flexibility,[33] leading to criticisms of inconsistent treatment of debtors and that the Club is a 'cartel' of creditors working primarily in their own interests.[34] Indeed, it was originally designed as a backstop solution to avoid a country missing payments to creditors, rather than "as a tool to restore debt sustainability or to improve the development prospects of heavily indebted nations".[35] Paris Club restructurings therefore have a strong political dimension, and subsequent reforms to how these restructurings operate have been driven mainly by creditors' geopolitical concerns.[36]

Table 1: A fragmented system

Creditor	Private		Public		
Debt instruments	Commercial bank loans	Bonds	Bilateral loans by Paris Club members	Bilateral loans by non-Paris Club members	Multilateral loans
Institution/ negotiation forum in case of a debt sustainability problem	"London Club"	Exchange offer	The Paris Club	(-)	(-)

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Restructuring commercial debt

The recycling of petrodollars and the lack of investment opportunities in developed countries during the 1970s saw commercial bank loans become a more important source of developing country financing and resulted in a steep rise in the external debt stocks of these countries.[37] From 1976, the restructuring of private debt was most commonly undertaken via voluntary renegotiations with informal, coordinated groups of banks, known collectively as the London Club – which lacked any standard rules of operation. However, this forum has since diminished in relevance, as bonds have taken over as a key source of private financing, tripling as a share of low-income country (LIC) external debt between 2007-2016.[38] However, there is no existing forum that can compel all bondholders to participate in or respect the decisions of a restructuring: rather, *ad hoc* and voluntary creditor committees may be formed to engage in negotiations with a debtor nation. A key problem here is coordination of bondholders across the different bond series issued by a debtor, and not only those within an individual series. This poses particular difficulties in securing a restructuring agreement that is binding on all bond series.

Relieving multilateral debt

The creditor clubs have been complemented by one-off initiatives to provide debt relief for a limited number of countries, namely the Heavily Indebted Poor Countries Initiative (HIPC) and Multilateral Debt Relief Initiative (MDRI).[39] These schemes offered almost complete relief of bilateral and multilateral debt to a group of developing countries, albeit in a lengthy and cumbersome process, and provided they met a set of *ex ante* policy conditions anchored around austerity and market liberalisation. Once again, creditors were in the driving seat. Significantly however, the HIPC Initiative saw multilateral debt (from the IMF, World Bank, and African Development Bank as well as the Inter-American Development Bank) being relieved for the first time: these creditors normally claim an exempt status in restructurings, meaning their claims are excluded from the process, and that they are implicitly understood as the first creditors to be repaid when a country hits financial distress or default.[40] Nonetheless, since the end of the MDRI, there is no permanent institutional set-up for coordinated action by multilaterals in the event of a restructuring.

> Indebted countries are subject to a non-regime, characterised by ad hoc operations...driven by the needs and interests of creditors and spread across a fragmented landscape of opaque, informal creditor forums.

Why we need reform: an increasingly inadequate system

How efficient is the status quo? As the IMF has noted, restructurings "have often been too little and too late".[41] Research on restructurings between 1950 and 2010 reveals this inefficiency: with 35 per cent of all commercial restructurings being followed by another commercial or Paris Club restructuring within one year, 60 per cent within two years, and 70 per cent within three years. Analysis of Paris Club treatments shows that debtor states from Africa have on average had to negotiate with the Club seven times, with no country being restored to debt sustainability after just one negotiation.[42]

With serial defaulters representing up to 61 per cent of countries that experienced a default or restructuring between 1978-2010,[43] the frequency of repeated restructurings by individual debtors[44] reveals a 'system' ill-suited to delivering durable crisis resolution that restores debt sustainability and market access – the ostensible aims of a restructuring, in the view of the IMF.[45] Crucially, the system is also failing to deliver debtor countries to a position where they can fundamentally reconsider how to fund public investments and development without reliance on debt financing.

The IMF itself has played a key role in embedding this system, particularly with regard to the timing of initiating a restructuring. When a state faces payment difficulties, the practice has been that it approaches the IMF for emergency liquidity (i.e. a loan), normally for up to three years and with harsh economic policy conditionalities attached (known as an adjustment programme). An IMF Debt Sustainability Analysis (DSA) is meant to guide decision-making over whether the state qualifies for a loan, and also establishes a financing gap that determines the size of any loan. The loan and adjustment programmes are mainly directed at preventing a full or partial default (i.e. the state missing a payment on some or all of those falling due).[46] Internal IMF policies mean it should not lend to an insolvent country, so a guarantee of IMF financing then plays the effective role of triggering restructuring negotiations with the Paris Club, for example, as the IMF seeks to encourage debtor-creditor engagement. In practice, political considerations are a key factor in whether the IMF lends, and so, contrary to stated ambitions, it has issued loans to insolvent states in the past without requiring a restructuring (e.g. Greece in 2010, and Ukraine in 2015).[47] This has intensified criticism from observers such as the Jubilee Debt Campaign UK that current IMF practice incentivises reckless lending to over-indebted states, as private creditors expect to be bailed out by an injection of IMF financial support, rather than suffer a write-down in what they are owed.[48]

The role that the IMF has carved out for itself to prevent disorderly defaults has also been a factor in the strengthening of a small and 'tight-knit' elite group of expert actors who well understand this dynamic.[49] This includes a handful of expert legal and financial advisors[50] who are repeatedly involved in debt crisis resolution and wield disproportionate power in a process related to public finances and yet remain largely opaque and resistant to public scrutiny. There is also little transparency over the appointment and remuneration of these advisors themselves.[51]

Failing to restore debt sustainability

Too often this system addresses immediate liquidity rather than resolving fundamental insolvency issues, with research showing current processes are "ineffective at restoring sustainability."[52] Unlike bankruptcy procedures for a company or individual, the existing mechanisms to address sovereign over-indebtedness therefore generally fail to deliver a fresh start to debtor states, with creditor-imposed austerity tending to protract difficulties. Too often this has left the populations of indebted countries with heavy social and economic costs to bear that are disproportionately borne by the most vulnerable.[53]

The delays in definitively tackling the sovereign debt crises of the 1980s led to a "lost decade of development" in Latin America, while in sub-Saharan Africa, "poverty did not fall below the level of 1981 until 2005."[54] The period during which states endure debt problems prior to an eventual restructuring is now generally longer (typically almost eight years) than in the past.[55] And with 47 per cent of low-income countries currently at risk of or in debt distress,[56] the persisting threats to development priorities are clear.

Inequity for all

The inequitable nature of the current non-regime is a further criticism. The absence of an objective, agreed standard against which to judge the results of restructurings reveals a partial system skewed in favour of creditors, and marked by the differential treatment of debtors. As Jürgen Kaiser underlines, "[e]xisting fora, mechanisms, and procedures like the Paris Club are characterised by a high degree of flexibility and a low degree of responsiveness to any legal standard".[57]

The closed-door nature of restructuring processes has meant knowledge and expertise is left in the hands of a few key institutional players, expert law firms and creditors, while the public in debtor states are shut out of the process, despite their role as 'informal' creditors through the social contract they have with the state.[58] This has resulted in debt restructuring steered by creditors' interests and marked by power imbalances that limit the room for manoeuvre for indebted, impoverished countries.

As UNCTAD has highlighted, "the dominant role of official creditors in setting negotiation parameters and structuring the process undermines impartiality".[59] The reality is that creditors act as "*de facto* insolvency judges"[60] in fora such as the Paris Club, while also being a party to the proceedings – representing a significant conflict of interest. Moreover, through its DSAs, the IMF plays a key role as a principle source of expert advice in determining the degree of relief that may be available to a debtor. Given that it is often a significant lender to low-income countries, this means that the IMF has a "direct influence on the recoverability of [its] own claims",[61] revealing again the inherent biases in the current system.

Yet inequity amongst creditors themselves is a further concern. Private creditors may consider that they are often subject to huge 'haircuts', while official debt is rescheduled. Meanwhile, Paris Club creditors repeatedly complain that private creditors do not adhere to the restructuring terms that the former agree with an individual debtor – so-called 'comparability of treatment'. In keeping with the nature of the non-regime, the Paris Club cannot enforce this, and has never spelled out exactly how debtors are supposed to ensure it happens.[62]

Holdouts and vulture funds litigation

With no agreed norms or standards, the door has been left wide open for national courts to play a more significant role in debt resolution, as uncooperative creditors seek to exploit the system to gain advantageous treatment in a restructuring. This was most vividly demonstrated in the case of Argentina, following its default on US$82bn of external bonds in 2001 and subsequent restructuring of close to 92 per cent of this debt through two exchanges in 2005 and 2010. A number of holdout bondholders sued the country, including four specialised distressed debt funds that secured a US federal judge ruling in 2012 preventing Argentina from making payments on any of its restructured debt until the four were paid in full. These 'vulture funds' ultimately made huge profits, some receiving a more than 900 per cent return on the principal.[63]

The ruling itself has been widely viewed as an unusual interpretation of the standard *pari passu* – or equal footing – bond clause aimed at ensuring equal ranking amongst different bond issuances, and of bonds with other unsecured debt (i.e. syndicated loans or bonds), in a restructuring.[64] As Professor of Law Anna Gelpern has starkly observed, the case "leaves behind a confused and contested jurisprudence, which will take years to sort out. On the other hand, the transactional precedent is clear: debt settlements favo[u]r the most aggressive litigants, incomplete restructurings can be hijacked by holdouts, and not suing is the one sure path for a creditor to be left out in the cold."[65] The current system – which relies heavily on voluntary, good faith agreements between parties – has thus been seriously threatened as it is now potentially more lucrative for creditors ***not*** to participate in restructurings.

The threat of holdout litigation is duly being seen as an increasingly common reason for debtors to delay the inevitable and ultimately drive up the social and economic costs they will endure. The debt crisis in Venezuela provided a shocking example of this reality, as the country continued to pay bondholders up to late-2017, "despite a lack of basic food and medicine and despite defaulting on most other creditors. According to press reports, legal risks were the main reason why bondholders were treated favo[u]rably."[66]

Indeed, creditor litigation against indebted sovereigns is increasing – albeit by a small number of vulture funds. Claims are becoming larger, cases more protracted, and are increasingly likely to involve efforts to seize sovereign assets – the latter a consequence of the fact that for creditors, the challenge has been less about obtaining a favourable award and more about attaching assets to secure these awards. This evolution in litigation is partly reflective of the fact that there are many more sovereign bonds in circulation now than in the past, as the IMF and others have encouraged more low- and middle-income countries to issue debt on international capital markets.[67] At the same time they have negligently failed to push for the firming up of the legal framework for restructuring, driving up the risks for developing countries. Rulings such as that against Argentina strengthen creditors and weaken debtors. This is happening at a time when the avenues available to creditors who seek enforcement of debt payments are widening via the inclusion of sovereign debt instruments in bilateral investment treaties, and litigation at the International Center for the Settlement of Investment Disputes (ICSID).[68] With commercial debt representing an ever-more significant part of developing country financing, can we really sit idly by as the incentives for aggressive holdouts multiply?

Sovereign immunity and moral hazard

Prior to the Argentina ruling, it had generally been considered that – in the absence of a supranational legal authority – sovereign debt was not fully enforceable. This meant that creditors could not force an indebted sovereign to repay, unlike the case for a bankrupt individual or company. This *de facto* immunity, where it existed, was seen as one incentive for a country that was unwilling or unable to service its debts, and wary of the political, economic and reputational costs of default, to over-borrow and delay an inevitable future restructuring: i.e. debtor moral hazard. Such costs might range from electoral losses to the prospect of exclusion from capital markets; of higher borrowing costs from creditors; or of unilateral trade sanctions from bilateral lenders. Similarly, a debtor country might avoid addressing unsustainable external debt and seek to tackle only debt governed by its domestic law, by unilaterally changing the repayment terms of that debt. While this might avoid or delay restructuring with external creditors, it could potentially destabilise a domestic banking sector that is heavily invested in sovereign debt.[69]

In practice, however, lending to a sovereign normally presupposes a waiver of immunity, so that loans can be taken under *jure gestionis* (relating to the commercial activities of a state) rather than *jure imperii* (pertaining to its public acts), with a corresponding assumption of enforceability.

Moreover, as UNCTAD has highlighted, "debtor moral hazard has been overstated. In reality, policymakers on the debtor side tend to avoid confrontations with their creditors as much as possible."[70] Delays to crisis resolution due to strategic, political defaults by uncooperative debtors are also overstated: Professor of Economics Christoph Trebesch has found that only a "handful" of clear-cut cases of debtors refusing creditor engagement or unilaterally ceasing payments without seeking further resolution occurred between 1978-2010, involving just five countries.[71]

Debtor countries even tend to repay debts when these can be considered illegitimate or flatly illegal. A prominent recent example is the case of Mozambique: in 2013 and 2014, US$2bn in odious loans were arranged by commercial banks, including Credit Suisse, for three state-owned enterprises with no revenue. The loans were not agreed by the national parliament and therefore were illegal under Mozambique law.[72] After the loans were revealed in 2016, a series of arrests (including of former Credit Suisse employees and governmental officials) finally took place in late 2018. Despite this, the Mozambique government was still intending to pay off its creditors up until early 2019.[73] This case also highlights the continued absence of any systematic procedure to assess the quality of claims, on grounds of illegitimacy or odiousness, under the current non-regime.

> Current IMF practice incentivises reckless lending to over-indebted states, as private creditors expect to be bailed out by an injection of IMF financial support

Why we need action now: new challenges

We have already seen some of the deficiencies of the current non-regime to deal with sovereign restructuring, and how these are contributing to costly and delayed efforts to tackle unsustainable debt. The urgency for reform is growing ever greater, due to several major evolutions in the sovereign financing arena.

A boom in bond issuance

As previously mentioned, an increasing share of developing country debt is now composed of commercial bonds traded on international capital markets. According to the Jubilee Debt Campaign UK, 25 low- and lower-middle income countries had issued such bonds by the start of 2019, which represented 23 per cent of their external debt.[74] This implies much riskier and more expensive debt for these countries,[75] as they are borrowing on commercial terms and rates, and are exposed to exchange rate fluctuations where bonds are issued in foreign currencies, for example. This form of financing also poses huge obstacles to creditor coordination in the event of a restructuring: the Argentinian bond restructuring in 2005 alone involved around 600,000 investors.[76]

As we have seen, litigation is growing more frequent, and the possibilities for creditors to enforce payments are widening. This is in spite of recent welcome moves to adopt national legislation against the aggressive actions of vulture funds in Belgium, France and the UK.[77] In the absence of a formal institutionalised process to convene bondholders in a restructuring, contractual approaches have been improving to prevent holdouts, through the use of collective action clauses (CACs) in international bonds. These define how to initiate and conduct restructuring negotiations, and allow a qualified majority of creditors to modify the conditions of a bond series, and bind all holders of these bonds to the decision.

However, first generation CACs still provide the possibility for large strategic investors to purchase blocking minorities and safeguard their chances to holdout. The limitations of these CACs were exposed in the 2012 Greek restructuring, for example, where holders of bonds containing CACs refused to cooperate and received full repayment. Subsequent to this and to the aforementioned Argentinian restructurings, enhanced, aggregated CACs have been developed to allow for qualified super-majorities to be established across bond issuances, and to further limit the possibilities for potential holdouts to purchase blocking minorities. Nevertheless, there is no single, standard design of these clauses, and those in use are not necessarily watertight.[78] Furthermore, they do not solve the problem of the large volume of existing bonds that do not contain CACs: in late 2017, the IMF estimated that only 27 per cent of total outstanding bonds contained enhanced CACs.[79]

With over US$13bn of low-income developing country bonds maturing over the next four years, major problems with restructuring and refinancing are on the horizon.[80] Nevertheless, bonds are only one of the reasons for the growing debt vulnerabilities in the global south and solving coordination problems in one category of debt will not solve the wider, systemic issue of the challenge of coordinating creditors across all categories of debt.

The declining significance of Paris Club official creditors

Over recent years, the official creditor landscape has changed considerably. Since the HIPC initiative, financing from Paris Club creditors to LICs has increasingly taken the form of debt relief or grants, rather than debt-creating loans. At the same time, non-Paris Club (NPC) bilateral official creditors – such as China, Saudi Arabia and India – have grown in relative importance as sources of funding for LICs in particular. "The result is that the largest part of official bilateral debt in many developing countries is now owed to NPC creditors."[81] For example, the share of total sub-Saharan African states' public debt held by non-Paris Club creditors doubled between 2007-2016, from 15 per cent to 30 per cent, while the share of Paris Club bilateral debt fell from 25 per cent to 7 per cent.[82] Nonetheless, multilateral institutions (e.g. the IMF and World Bank) and private lenders remain more significant as creditors to the region, holding 35 per cent and 32 per cent respectively of African government external debt, with 55 per cent of external interest payments going to private creditors.[83]

No institution exists to coordinate cooperative restructurings by NPC creditors, which exacerbates the existing risks of delayed, complex crisis resolution at a moment when these creditors are increasingly implicated in the debt stocks of vulnerable LICs. Despite the reluctance of NPC creditors, efforts continue by Western nations to incorporate them into the Paris Club – for example, through the Paris Forum, which convenes a wide group of official creditors and debtors to mull over policy developments.[84] But understandably, as Gelpern notes, "classifying the debt and finding a forum to renegotiate it is more of a challenge when both debtors and creditors view the prevailing regime with suspicion, and are grossly underrepresented in its institutions."[85]

Traditional players such as the IMF have long been concerned about the lack of transparency over the terms of NPC lending, given that it often includes "implicit or explicit collateralization, foreign exchange clauses, and variable fees",[86] as opposed to the traditional, and often ideologically-focused economic policy conditionality favoured by PC lenders. Uncertainty also reigns over how NPC creditors will therefore behave in restructurings, compounded by a growing blurring of what constitutes official or commercial debt (for example, Russia's approach to Ukrainian bonds issued under English law that it held in 2015)[87] and the prevalence of sovereign wealth funds as sovereign bondholders. This poses further complications for debtor nations, as it may imply expensive, lengthy and repeated bilateral negotiations as well as potential litigation.

Simply drawing new members into the Paris Club does not address any of the concerns that persist over the impartial, inconsistent and opaque approach that the Club takes to debt restructuring. Expanding the Paris Club is not a solution to the shortcomings of the system. Moreover, the current zeal for transparency by the IMF, EU, G20 and others does seem to be motivated more by the waning geopolitical influence of traditional bilateral creditors, rather than by a drive to address the power imbalance for low-income country debtors in the current system, or a drive to improve public scrutiny over debt restructuring operations.[88]

Public-private partnerships and contingent liabilities

The lending boom triggered by unconventional monetary policies in the global north in response to the GFC has driven major capital flows to low-income countries: a key driver in the upshot in LIC bond issuances. In addition, capital export instruments are becoming the standard institutional approach to development finance and to funding the Sustainable Development Goals (SDGs), pushed by the World Bank, the EU and the G20 in particular – including Paris Club members. These so-called 'blended finance' instruments see public funds used to mobilise private investment – particularly to finance major infrastructure projects – in lieu of traditional grant support or concessional/low-interest financing by donor countries or international financial institutions.[89]

But these instruments can carry huge budget liabilities for LICs, both due to the scale of borrowing required for major infrastructure projects and the nature of the financing. Increasingly, public-private partnerships (PPPs) are being pushed as a financing solution, requiring explicit and/or implicit financial guarantees from a debtor government to secure returns for private investors (so-called 'contingent liabilities'). The volume of PPPs in low-income developing countries has duly increased rapidly in recent years: the IMF notes that "for a small number of countries with relatively large stocks of public-private partnerships, the estimated fiscal impact of [projects in difficulty] would exceed 10% of GDP".[90] Absurdly, the IMF itself continues to promote these policy solutions at country programme level and through the imposition of austerity measures that steer governments towards expanding PPPs through constrained budgets,[91] albeit with a degree of caution seemingly missing from the zeal for PPPs shown by its sister institution, the World Bank.[92]

Such contingent liabilities effectively delay budget expenditures rather than implying a lower debt impact, often undermining transparency through off-balance sheet activity. Tools such as the IMF-World Bank Debt Sustainability Framework are being improved to better capture these risks, but given that PPPs are not being properly monitored in many countries, most IMF country teams consider that determining "a reliable estimate of exposures and risks associated with PPPs is usually beyond their reach".[93] Often these investments mean that the genuine level of public debt may be difficult to ascertain – clouding how sustainable debt stocks may actually be, and the level of any relief required. Recent scandals over hidden debts linked to government guarantees and state-owned enterprises in Mozambique, the Republic of Congo and Togo have starkly illustrated the stakes at play, and the implications for the complexity of subsequent restructurings.[94] Indeed, it is not always clear how the resources of blended instruments themselves will be dealt with in any future restructuring (e.g. for the proposed International Finance Facility for Education).[95]

Collateralised debt

Linked to the developments above is a further troubling evolution in how public debtors are securing financing. Collateralised lending, where loans are secured against existing assets (e.g. land), or future revenues (e.g. from the sale of commodities, or project returns), is an increasingly common form of financing that is being employed by new NPC creditors and non-traditional private creditors – most notably commodity trading firms. In 2016, the China Africa Research Initiative estimated that "33% of Chinese loan finance in Africa is secured by commodities or exports of natural resources".[96]

There is little transparency over the collateral requirements linked to loans – meaning it can sometimes be difficult to determine whether claims are even commercial or official. This opacity extends to the scale of their use, which has tended to be exposed when countries hit a crisis.[97] Recent, high-profile cases of hidden oil-backed debts in Chad and Congo have pointed to reckless lending that entails heavy costs for debtors and feeds the commercial interests of private creditors. For example, in 2014, Chad agreed approximately US$1.45bn in loans from Glencore on the back of oil proceeds: but the subsequent commodity price crash meant the country hit repayment difficulties. With loans equating to 98 per cent of external commercial debt, by the end of 2016, 85 per cent of Chad's oil revenue was being diverted to the company.[98]

The risks from official creditors are no less troubling: China has been heavily criticised for its seizure of assets when countries being financed under its Belt and Road Initiative fall into crisis. Indeed, it has been accused of saddling vulnerable countries with unsustainable debts precisely to secure strategic geopolitical infrastructure or natural resources.[99] The most widely-cited instance was a debt-for-equity swap with Sri Lanka in 2017, when the country was unable to service a US$8bn loan used to build a port in the southern city of Hambantota. China subsequently secured a 99-year lease to manage the site.[100]

But it is not just new players that are using collateralisation as a means to ensure repayment. In February 2019, sales-tax-backed-bonds were issued by Puerto Rico's Sales Tax Financing Corporation (COFINA), as part of the restructuring of the territory's debt. The COFINA bonds will be paid for through a sales tax, which has recently been raised from 7 per cent to 11.5 per cent, reportedly the highest rate in the US. While a share of fiscal revenue would naturally go to repaying debt, in this case government revenue is earmarked from the very beginning, with the restructuring plans meaning 53.65 per cent of sales tax revenue is automatically transferred to bondholders.[101] According to CADTM, vulture funds stand to make profits in excess of US$1bn,[102] and reports suggest they are already netting huge rewards.[103]

Collateralisation complicates debt restructuring as it limits the scope of action for debtors when crisis hits, by giving ***de facto*** seniority to the relevant creditors – i.e. the debtor has little option to defer payments to them. Experts also point to contradictions between such loans and 'negative pledge clauses' in the non-concessional lending policies of the World Bank among others, which "prevent a debtor pledging as collateral assets that might jeopardize the repayment of an existing creditor".[104]

Human rights, development and inequality

Despite continued pressure from civil society, developments such as the 2011 UN Guiding Principles on foreign debt and human rights,[105] the 2018 report of the UN Independent Expert on the effects of foreign debt about the links and the impact of economic reforms and austerity measures on women's human rights,[106] and recognition in the Addis Ababa Action Agenda that "successful debt restructurings enhance the ability of countries to achieve sustainable development and the sustainable development goals",[107] there is still no explicit, systematic consideration of human rights and development priorities in the current non-regime. This is all the more shocking given the heavy human rights costs populations in countries in protracted debt crisis have had to pay due to delayed or insufficient crisis resolution in recent years (e.g. Greece[108]), and in particular, women and girls.[109] Furthermore, provisions to protect other types of debtors exist in relevant insolvency codes: Chapter 9 of the US insolvency code, which pertains to municipalities, explicitly provides for the safeguarding of essential services and the resources needed to deliver them.[110]

The current system falls short of providing countries with a fresh start, instead incentivising debtors to keep paying down debts and delay steps to seek restructuring, despite the social and economic costs to their populations. Crucially, it also incentivises irresponsible lending often to states struggling to meet essential public service provision. These services are particularly vital to reducing and redistributing women's unpaid care and domestic work – unpaid work on which the implementation of austerity measures rely. The case of Venezuela's so-called 'hunger bonds' in 2017 is a miserable illustration of this tendency, where investors such as Goldman Sachs sought returns of over 20 per cent, sucking out valued foreign reserves needed for food imports, while the country suffered widespread malnutrition.[111]

Opportunities to reform the approach used in debt sustainability analyses (DSAs) carried out by the IMF-World Bank and other creditor-aligned institutions to consider international human rights commitments and development goals have been missed.[112] These generally continue to take only financial considerations into account, looking to identify the capacity of a country to continue servicing its debts and determine borrowing limits.

This failure means IMF lending with conditionality remains the reflexive approach to creating fiscal space in indebted nations, rather than seeking a necessary restructuring. However, as Eurodad research in 2018 has shown, programme conditionality based on over-optimistic DSAs has "in most cases been ineffective, perhaps even counter-productive, when it comes to restoring long-term debt sustainability", with the majority of countries in the sample being recent repeat borrowers from the IMF.[113]

Moreover, human rights impacts are perhaps much more a function of the particular kind of adjustment policies used in loan programmes and not only a function of the timing and the size of any restructuring. And the creation of fiscal space through adjustment must, indeed, be coupled with an enabling of policy space to further human rights and development, including opening doors to sufficient gender-responsive public spending. However, it would seem that the current system – exemplified by loan conditionalities that promote harsh, austerity-focused fiscal adjustment – is indeed working against both debt sustainability and development. Recent research by Forster et al shows that "policy reforms mandated by the IMF increase income inequality in borrowing countries";[114] meanwhile Andreasen et al have built on previous empirical research and found that inequality makes defaults more likely.[115]

Conversely, a review of Paris Club treatments since 1956 has shown that restructurings involving nominal haircuts had a "significant, positive effect" on Gross Domestic Product (GDP) growth, health expenditures, poverty reduction and inequality[116] – demonstrating the social and economic benefits that substantial debt relief can deliver. It is notable that the IMF itself is increasingly recognising the need to reform its approach, highlighting the need to do more to protect social spending, 'sharpen' DSA tools and recognising the significance that restructuring can play in allowing debtors to overcome debt vulnerabilities.[117] For the populations of indebted countries bearing the social costs of austerity-focused conditionalities and ineffective, delayed, restructurings, these reforms cannot come soon enough.

There is now widespread consensus within the international finance and development communities that a new wave of debt crises is unfurling. Global debt is reaching new peaks.[118] The IMF points to elevated debt-to-GDP ratios in emerging economies last seen in the 1980s,[119] while debt sustainability in developing countries is considered by UNCTAD to be 'deteriorating fast'.[120] Erlassjahr.de estimate that 122 countries in the global south are currently critically in debt.[121] Servicing debt implies an opportunity cost for many countries, given that every cent destined to pay back a creditor is one lost to the public spending to guarantee the protection and realisation of human rights and meet development priorities: sustainably financing the delivery of the SDGs in the current sovereign debt context is unattainable without substantial reform in the way we tackle unsustainable debt burdens.

With the existing deficiencies of the current 'system' for sovereign debt restructuring only intensifying under the new dynamics outlined above, renewed international efforts to develop and agree upon a multilateral sovereign debt workout mechanism are ever more critical. To stimulate and inform these efforts, we are restating below 10 key principles that we see as essential to the functioning of any framework that genuinely seeks to overturn the shortcomings of the current 'non-regime'.

A multilateral sovereign debt workout mechanism: 10 key civil society principles

1. Creation of a body independent from creditors and debtors

A fairer and more efficient process for debt resolution requires a level playing field for all the parties involved. A body that is independent of any creditor is needed to make decisions.

Institutional independence – an 'honest broker' – will be a stronger assurance of impartiality, increasing the political legitimacy of both the process and the outcomes, as creditor conflicts of interest inherent in the current system are removed: i.e. creditors can no longer be both party and judge to an insolvency process. This is likely to speed up decision making, thereby helping to address the 'too little, too late' problem, to ensure fair outcomes that can better garner public support in debtor states, and to deliver more equitable burden-sharing among all stakeholders involved.

The debt resolution 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 seek mediation as a precursor to a binding arbitration procedure.

2. Process may be initiated by borrower and the institution of automatic stay will apply

To foster more orderly and timely action to address over-indebtedness and reduce the economic, political, and social costs paid by populations for delayed crisis resolution, any DWM should allow for debtors themselves to approach the independent body to initiate the restructuring process, and they should have the exclusive right to do so in a pre-default phase. It is any sovereign debtor's right to choose to initiate a debt restructuring process.

This should be complemented by an automatic standstill on all external debt payments to ensure the equitable treatment of creditors and support efforts to restore debt sustainability. The standstill should be approved by the independent debt resolution body, to increase legitimacy, and should include transparent conditions on its duration.

3. Initiation of the process should trigger a stay on creditor litigation and enforcement

This automatic stay should take effect once a decision to restructure is announced and approved by the independent body, to prevent litigation by vulture funds and other uncooperative creditors, which undermines restructuring negotiations. This reinforces the equitable treatment of creditors in the process, and efforts to restore debt sustainability through the protection of state assets. Such a stay could thereby contribute to generating fair outcomes that have wider legitimacy and support, and thus greater durability. In order to avoid speculation on distressed debt, the amount of money that a creditor can recover through litigation must be limited to the amount paid when the debt was purchased on secondary markets.

4. Comprehensive treatment of a country's debt stock in a single process

To ensure a speedy resolution of unsustainable debts, and the equitable treatment of creditors, any DWM must ensure that the entirety of a country's debt stock can be dealt with in a single process.

Removing forum fragmentation from sovereign debt restructuring will address the inefficiency and reduce the costly delays implied by uncoordinated and repeated restructuring negotiations.

By functioning, as a matter of principle, on the basis of fair and equal treatment of all legitimate creditors' claims, it will also help reduce incentives to holdout and prevent aggressive litigation by vulture funds.

5. Inclusive participation of all stakeholders

Maximising participation in any debt restructuring process will support its legitimacy by allowing all relevant stakeholders the right to be heard. Importantly, this includes the participation of debtors, creditors, and individuals/organisations representing citizens in an indebted country. The latter are indirect claimants/creditors in view of their relationship with the state, and are directly impacted by the outcomes of the process. As a rule, proceedings should take place in the debtor country, with provisions made for citizen participation, including public hearings.

An inclusive process can also reduce opportunities for inequitable treatment through exclusion of some stakeholders, and generate agreements that are more likely to be respected by all parties concerned, duly supporting more durable outcomes.

6. Independent assessment of debt sustainability and the validity of individual claims

To remove the conflict of interest risks inherent in a creditor acting as an expert advisor to the debt resolution body, debt sustainability analyses (DSAs) used to determine the economic situation of the sovereign debtor and inform restructuring negotiations should be carried out by an independent body. Impartial assessments should be reinforced through the use of multiple sources of information, including mandatory human rights impact assessments.

The validation of claims must include an assessment of the legality and legitimacy of debt: this process should be informed by comprehensive and transparent public debt audits that involve the participation of citizens.

Impartial assessment and verification of the legitimacy of claims will ensure fairer treatment of different creditor groups, and recognise the co-responsibility of lenders and borrowers for over-indebtedness. This should lead to outcomes that do not unjustly penalise the populations of debtor states for the reckless financing decisions of creditors and governments. In the spirit of fair burden sharing between different creditor groups, illegal and illegitimate debt must be cancelled. Sanctioning irresponsible lending that way will provide an effective incentive for responsible lending ex ante, thereby reducing the risk of debt crises and protecting the resources of both citizens and responsible lenders.

7. Focused on debt sustainability that puts needs of population before debt service

Current approaches to debt sustainability that are limited to a highly subjective analysis of a country's capacity to repay and/or take on further debt, imply far-reaching political judgements about resource allocation. Debt sustainability should legitimately also consider human rights and development (see principle 8) both to increase accuracy in analyses and the fairness of outcomes for the populations of affected states, by balancing their needs with those of creditors. The purpose of any DWM must be to restore a country to a position where it has the fiscal space to meet the essential needs and services of its citizens uninhibited by outstanding debt servicing.

8. Respect for international human rights law and the realisation of international development commitments

Restructuring or relief operations should not impel or compel a country to derogate from its international human rights obligations. This is vital to ensure the durability and legitimacy of these operations and fair outcomes for the populations of debtor countries.

Gender-sensitive human rights impact assessments (HRIAs) must be used systematically in debt sustainability analyses to widen their focus solely from economic considerations to consider also the impact of a country's debt burden on its ability to meet development goals and create the conditions for the realisation of all universal human rights.

HRIA findings must be used to support more timely triggering of debt restructuring or debt relief operations and guide decision-making such as on the revision of repayment terms; on the size of 'haircuts' to be taken by creditors; or on the distribution of losses incurred by different creditor groups. Adjustment programmes linked to debt relief and debt reduction must be designed with respect to this principle and subject to the systematic use of HRIAs.

9. Transparency: standard procedures for sovereign debt restructuring negotiations must be established, and the negotiations and their outcomes must be made public

Ending the closed-door and ad hoc nature of restructuring negotiations is a key component in increasing the legitimacy and equity of the process; improving accountability for irresponsible lending and borrowing; and helping to generate agreed outcomes that are in the public interest and can secure public acceptance.

Details of loans made to governments or involving any form of government guarantee should be publicly registered and disclosed ex ante, to be enforceable. This will strengthen the reliability and accuracy of debt sustainability analyses, helping to ensure all legitimate claims are taken into account, and thereby supporting more timely action to tackle over-indebtedness. It will also help to ensure that no responsible creditors are excluded from comprehensive restructuring negotiations. Public bondholder registries are needed to speed up debt restructurings and unveil conflict of interests.

To mitigate incentives to undermine debt restructurings, parties should also be required to disclose any holdings of credit default swap positions.

The process of appointment and remuneration of legal and financial advisors consulting sovereign borrowers should also be publicly disclosed.

10. Enforceability

All parties must respect the decisions of the independent body. An international treaty establishing a sovereign debt workout mechanism ratified by most states would be optimal in giving it authority. However, this is not a prerequisite for progress in this area. The existing mechanisms for debt resolution (such as the Paris Club) function without any explicit basis in international law. Instead they are based on the political will of creditors and exploit the lack of alternative solutions. This underscores why a multilateral sovereign debt workout mechanism must be independent of any creditor institution in order to ensure broad-based support and respect for its decisions.

Conclusion

Sovereign debt is hitting unprecedented highs across the globe. Middle-income countries are experiencing debt levels not seen since the 'lost decade of development' in the 1980s,[122] while the IMF estimates that 47 per cent of low-income countries are currently at high risk or in debt distress.[123] With figures from the Jubilee Debt Campaign showing developing country debt payments growing by 85 per cent between 2010 and 2018, and evidence pointing to falling public spending in the countries most affected, heavy public debt burdens are already directly impacting delivery of the SDGs.[124] The next wave of debt crises is taking hold, and its human costs are already being felt by populations across the global south.

Against this deteriorating climate, the dynamics of sovereign debt are changing. Developing countries are holding more diverse and expensive public debt stocks from an ever more complex landscape of official and private creditors,[125] exposing the persisting weaknesses of an inadequate non-regime for sovereign debt restructuring. The emergence of new bilateral and non-traditional commercial lenders; the growing use of bonds, collateralised lending, and leveraged private finance in development; and the threat of aggressive litigation by vulture funds are just some of the issues currently weighing heavily on policy-makers. And they starkly underline why the necessity for a multilateral sovereign debt restructuring framework can no longer credibly be ignored.

Civil society has previously put forward valuable contributions to the discussion on how to design such a solution: from Oscar Ugarteche and Albert Acosta[126] to AFRODAD,[127] and the arbitration processes advanced by Kunibert Raffer[128] and Jürgen Kaiser.[129] These have sat alongside institutional proposals such as Anne Krueger's 2002 proposal for an IMF-directed sovereign debt restructuring mechanism,[130] and UNCTAD's roadmap for a debt workout in 2015.[131]

However, political processes to drive forward this agenda have not yet matched the level of ambition in these proposals. The last serious attempt at the UN in 2015 was scaled down due to resistance from Western governments.[132] And despite welcome political declarations such as those from the European Parliament[133] and the Euro-Latin American Parliamentary Assembly[134] in 2018, and continued calls from CSOs,[135] the IMF, G20, and other guardians of the international financial architecture remain reluctant to revisit fundamentally the question of how to improve restructuring processes. This comes at a moment when they are among the loudest voices warning of new debt crisis risks.[136] The preference remains for incremental actions (e.g. expansion of the Paris Club), and market-based solutions (e.g. improving CACs). Meanwhile, institutional energy is being devoted to crisis prevention, through pushing for better debt management capacities and data transparency in low-income countries, for example.[137] These efforts are worthy but they are insufficient as responses to the problems at hand: crises are here, and they will continue to strike. Without a system that can deliver a fresh start to over-indebted countries, through timely, fair, equitable, and durable resolution, efforts to improve prevention will be a Sisyphean task.

The pursuit of incremental change reflects a pragmatism that is understandable, given the political obstacles that have doomed previous attempts to secure a DRF to failure. But we cannot let reform of the non-regime adopt its biggest characteristic: 'too little' action to remodel the system, 'too late' to prevent further heavy social costs in indebted states, is simply no longer acceptable. In the absence of any serious reform, the populations of over-indebted states remain at the mercy of restructuring processes that pay little regard to the legitimacy of debts; that ignore human rights and development commitments; and in which they play no part, despite being left to bear the costs.

While a multilateral sovereign debt workout mechanism is viewed in many quarters as an unachievable and unrealistic policy goal, no credible, comprehensive policy alternative exists. Political will is contingent, and can be (re-)built: that is why Eurodad and its partners are restating and reaffirming the need for such a mechanism. The first objective is to get this issue firmly back on the official policy agenda. Agreement on the precise nature of the mechanism will rightly depend on subsequent discussions. This briefing has set out the principles that civil society expects to see anchoring these discussions and its resulting outcomes.

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