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An International Insolvency Framework – Why it is needed and what it could look like

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Abstract

The dilemma that the EU is facing today due to the debt problems of Greece shows that there exists no comprehensive mechanism to reduce a country's exposure to all its creditors in a fair, orderly and pre-defined way. The international community has failed, to further develop any instruments for negotiating sovereign debt difficulties as they occur in the North and South. The HIPC and MDRI relief schemes were deliberately designed as one-off exercises, designed and led by one out of several classes of creditors, with others only reluctantly participating, if at all. It is therefore essential that the provision of fresh funding for Southern countries, which are suffering from the crisis must be accompanied by a new mechanism to deal in a comprehensive way, (i.e. involving all creditors), quickly implementable and fair way with new situations of sovereign over-indebtedness.

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An International Insolvency Framework –

Why it is needed and what it could look like

1. Between 1999 and 2005 substantial progress has been achieved in terms of debt relief for poor developing countries. Through a combination of partial debt relief and strong economic growth key indicators of indebtedness have been reduced considerably in several countries. In a few non-HIPCs individual agreements on debt cancellation have also led to considerable improvements (for example Iraq and Nigeria).
2. During this process the international community has failed, however, to further develop any instruments for negotiating sovereign debt difficulties if and when they occur. The HIPC and MDRI relief schemes were deliberately designed as one-off exercises, designed and led by one out of several classes of creditors, with others only reluctantly participating, if at all. Thus, a newly over-indebted developing country would face today the same problems, which countries faced with the outbreak of the debt crisis in 1982: there exists no comprehensive mechanism to reduce a country's exposure to all its creditors in a fair, orderly and pre-defined way.
3. Even before the global financial crisis took effect on the poorest countries, the World Bank acknowledged in its 2008 HIPC status of implementation report a "high risk of new debt distress" in 4 out of 24 countries and a "moderate" risk in an additional 10. Ever since, several country analyses by the IFIs, academics and NGOs have identified a far broader list of countries at risk.
4. In addition to post-completion point HIPCs, which run into new debt distress, it must be assumed that some non-HIPCs will also run into over-indebtedness as a result of emergency financing, or that countries which never really managed to get out of the debt crisis of the 1980s and 1990s will be pushed over the edge by the global economic slowdown.
5. At the same time the spectrum of creditors and the variety of instruments these creditors use, has considerably widened in the past years. Some emerging economies in Eastern Europe or the Global South have themselves become lenders to foreign sovereigns and so have private investment funds and domestic lenders. New debt can come in the form of new types of bonds, through the return of the classic syndicated loan by commercial banks, and also through a new wave of aggressive marketing by Export Credit Agencies.
6. The International Financial Institutions (IFIs) have tried to control this new borrowing with the help of the World Bank's Debt Sustainability Framework (DSF). The framework threatens to punish borrowers with a loss of access to highly concessional IDA financing, if they borrow beyond sustainability limits defined by the Bank. This approach is not likely to be overly successful. It unilaterally exerts pressure on the borrower, without providing much of an incentive for the creditor to forego an investment opportunity, simply because it would eventually endanger the borrower's long-term debt sustainability. Individual instruments like Collective Action Clauses (CACs) or Codes of Conduct can be useful at times. However, they generally refer to not more than one group of lending instruments or creditors.

7. The present emergency packages by the IMF and their co-financings from other multilateral institutions may be considered as being without alternative, if countries are not to slide into protracted recession. However, it must be remembered that debt owed to multilateral institutions was negligible at the beginning of the 1980s. It only became a costly exercise for the international community and a burden on development aid budgets through a long period of defensive lending. A clear-cut debt write-off at the end of the 1980s would have been less costly for everybody. Without any magic bullet available between the need to stimulate Southern economies, as well and the concern for debt sustainability, there is an extreme danger that in both, low and middle income countries, a new round of defensive lending by multilateral institutions will start a new debt cycle like the one of the 1990s.

8. It is therefore essential that the provision of fresh funding for Southern countries, which are suffering from the crisis must be accompanied by a new mechanism to deal
   - in a comprehensive way, (i.e. involving all creditors)
   - quickly implementable and
   - fair way with new situations of sovereign over-indebtedness.

9. Against this background the Doha process confirmed the Monterrey Consensus' call for new orderly debt workout mechanisms. Proposals mentioned in Doha include the IMF's Sovereign Debt Restructuring Mechanism and also farther reaching proposals by academia, civil society and Southern officials. Most of these proposals convene under an "International Insolvency Framework."

10. A new framework for sovereign debt workouts needs to differ from existing procedures in several aspects if it is to address the changed landscape of new lending. Key principles of an orderly, effective and fair debt workout mechanism are:
    - One single "insolvency" process needs to involve all creditors.
    - Impartiality in decision making, rather than the present creditors' hegemony over the negotiation process.
    - Automatic stay on loan enforcement, once a case has been filed.
    - Impartial assessment of a sovereign's sustainable debt level and hence income exempt from debt servicing.

    These principles essentially do not reflect more than leading principles of corporate or individual insolvency laws in civilized nations around the globe.

11. Several practical proposals to implement these principles have been made, notably:
    - The "Fair and Transparent Arbitration Process" (FTAP) as an ad-hoc procedure. It has been developed by the Austrian economist Prof. Kunibert Raffer and heralded by erlassjahr.de and other civil society organisations. It adds arbitration as a decision making technique to the fundamental principles of the chapter 9 of the US insolvency code, which deals with the insolvency of municipalities.
    - The proposals for a standing debt court. Practical proposals for a standing court have been worked out by Latin American economists Alberto Acosta and Oscar Ugarteche (*Tribunal de Arbitraje sobre Deuda Soberana - TIADS*) and by Jurists Christoph Paulus and Stephen Kargman (*"Sovereign debt Tribunal"*)

12. For any further information contact erlassjahr.de at

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