

Managing the next debt crisis:

Recent reform proposals

by Bodo Ellmers

Summary

The world is faced with increasingly complex sovereign debt situations, and the institutions and the instruments they use to tackle these crises are often inadequate and harmful to the most vulnerable in affected societies. The UN Financing for Development Conference in 2015 will be a unique opportunity to change the way debt crises are being managed to avoid forced 'defaults' like the one Argentina has recently faced, or crushing financial collapse like the one that Greece has experienced.

This briefing examines recent reform proposals to manage future debt crises by international organisations – one from the International Monetary Fund (IMF) and one from the United Nations – and spells out next steps in the process. It also makes concrete recommendations with respect to the role of Parliaments and steps that legislators and decision-makers can take in coming months to ensure that Europe influences future effective debt workout mechanisms that are responsible, fair and humane.

This briefing finds that:

- It is vital that a responsible debt workout mechanism for cases of sovereign insolvency is established and integrated into the international financial architecture.
- The UN's current proposals for development-friendly debt workouts based on human rights and responsible financing – which is the co-responsibility of creditors and debtors – offer the best chance of ensuring that countries can restructure their debts in an effective, sustainable and humane way.

European decision-makers and legislators can make this a reality by:

- Supporting initiatives for a resolution establishing a Multilateral Convention on sovereign debt workout at the United Nations General Assembly.
- Calling on the UN's Financing for Development Conference in Addis Ababa in 2015 to promote the institution-building process for an international insolvency procedure.
- Ensuring that any new international insolvency regime is mandated to deal comprehensively with debt problems, is independent of creditors in analysis and decision-making, provides a human needs-based approach to debt sustainability, and gives all stakeholders the right to be heard.
- Integrating debt (debt workout, debt sustainability and responsible lending) into the EU's Policy Coherence for Development Framework, and defining debt reduction as an explicit aim of the EU's development cooperation with third countries.
- The European Parliament should also recall and strengthen its earlier motion for an international insolvency procedure or fair and transparent procedure, and urge the EU to immediately take necessary steps for implementation.¹

Introduction

Debt crises are frequent, and they are here to stay:

Between 1950 and 2010, sovereign debt had to be restructured in more than 600 cases in 95 countries worldwide. In 427 cases, restructuring affected official bilateral creditors and was handled by the Paris Club, an informal coordination body of Western creditors that is hosted by the French Ministry of Finance. In 186 cases, private creditors were affected (18 bond restructurings, 168 bank loans). While the 1950s to 1970s were a relatively calm period,

most restructurings have taken place since the early 1980s after financial markets were deregulated.

The Greek debt restructuring of 2012 was the largest ever, affecting private bonds with a face value of EUR 205.5bn². This demonstrates how expensive debt workouts can be when debt overhangs are addressed too late. Most experts agree that the Greek debt restructuring could have been 'cheaper' and less harmful if the international community had reacted earlier – and had better instruments at hand.

New debt vulnerabilities are emerging

A recent Eurodad investigation into debt vulnerabilities and crisis risks within all country groupings (high, middle and low income countries) found that:

- In high income countries, including most of Europe, sovereign debt levels have surged and reached their highest levels ever in times of peace.
- Middle-income countries suffer from volatility and might soon face bursting speculative bubbles.
- In low-income countries we see ever riskier debt profiles as they replace development loans by fundraising on financial markets.
- All countries face increasing risks through hidden debt, the contingent liabilities that come from public-private partnerships or private banks that might need to be bailed out by the public.³

The international financial architecture is in urgent need of reform

There is currently no insolvency regime for sovereign debtors (or a sovereign debt workout mechanism) which could be used to restructure unsustainable debt burdens in a fair, timely and efficient manner – and thereby prevent debt crises and their devastating impacts on the social and economic fabric of affected nations. Existing institutions address either only a share of

a nation's debt burden (such as the Paris Club that deals with bilateral official debt), or operate with suboptimal policies and instruments (such as the IMF).

In early 2013, both the IMF and the United Nations (UNCTAD) started new processes that aim to reform existing sovereign debt resolution processes and address the new challenges that arose in Greece and Argentina. The following chapters describe and assess these reform processes. The ongoing reform processes of the EU's own financial architecture are not the subject of this briefing.

The IMF proposal: Debt reprofiling

What does the IMF propose?

In June this year, the IMF released a proposal on how to reform its own debt restructuring framework.⁴ The essence of this "debt reprofiling" proposal is the extension of maturities of government bonds in countries that have lost market access, but where there is a high probability that

debt is sustainable, and the country is not considered insolvent.

The participation by private bondholders and other creditors would remain voluntary. They would need to agree to amend the terms of the debt instrument (usually bonds). Thus - the IMF stresses - it would be necessary to consult creditors closely and explain the need to extend the maturities to them. Creditor participation would be easier to secure if debt instruments contained collective action clauses with which a supermajority of bondholders could make decisions, even against the will of a minority of reluctant creditors.

What are the benefits?

The key advantage of debt reprofiling, as the IMF puts it, is that the temporary stay on debt repayments reduces the fiscal burden for a crisis country. The fiscal deficit is reduced because there is no debt service on maturing bonds for a certain period. It thus implies that an adjustment path can be more gradual (budget cuts can be smaller) than if

the debtor had to continue its debt service. The size of IMF crisis loans could then also be smaller as they would just have to meet the primary deficit, or the share of the fiscal deficit that is due to recurrent expenses. A welcome side effect for the IMF is that its own lending to a crisis country would not be used to pay off maturing loans of private creditors. Debt reprofiling is mainly a solution to the 'bail-out of private creditors with official loans' problem that was evident in Greece and other crisis countries.

In essence, the debt reprofiling proposal primarily intends to 'buy time' to assess if a country is really insolvent or just illiquid. If after a certain period, it turns out that there was just a temporary liquidity problem, for example due to a creditor panic, countries would just go back to normal debt servicing. If it turns out that the country is insolvent, debt restructuring (private sector involvement) would be the condition for further IMF support.

The new proposal would update the IMF's exceptional access framework of 2002, which allows for the provision of large-scale IMF finance when debt is considered sustainable, but requires debt restructuring as a condition for financial support when it is not. It would do away with the "systemic exemption" that was introduced in 2010 to make the IMF program for Greece and other European Monetary Union (EMU) countries possible.

Why is the IMF proposal insufficient?

The IMF's reform proposal could be a solution for the bail-out problem, and reduce the costs of debt crises. It is, however, far from what is needed as it has a number of severe shortcomings:

- **No binding agreements / legal predictability**

Participation is voluntarily and cannot be enforced, which means the proposal does not fully address collective action problems - i.e. the holdout creditors and vulture fund problems that have severely affected debt workouts in recent years.⁵ The IMF proposes a number of instruments to address the holdout problem, such as collective action clauses, creditor committees and even the use of some IMF money to incentivise participation. But none of those can fully guarantee that vulture funds won't sabotage the debt resolution procedure.

- **No independent debt sustainability analysis**

Key to the proposal is the question of whether debt is sustainable or not, and with what certainty. This would be subject to an IMF-led debt sustainability assessment (DSA). The IMF's track record, however, is that many DSAs have been too optimistic,

Recent developments with regards to debt crises show that the instruments we have for managing these crises are sub-optimal, and increasingly outdated:

- In **Greece**, official loans extended by the Troika were used to bail out private creditors who exited the country. When private debt was finally restructured, it was too little and too late. The insufficient haircut for private creditors, and the exclusion of official creditors from the restructuring, meant that Greece's sovereign debt levels remained high at more than 170% of GDP, three times the debt level that the EU's 'Maastricht criteria' consider sustainable. The harsh structural adjustment package led to huge unemployment and strangled the Greek economy which lost 25% of GDP since the beginning of the crisis. The living conditions of Greek citizens, and in particular the quality and quantity of public services, have deteriorated massively. With a timely re-structuring both Greece and its bona-fide creditors would have been better off.
- **Argentina** is still battling vulture funds before New York courts, 13 years after the country's debt crisis. After being hit by external economic shocks at the turn of the millennium, Argentina defaulted on sovereign

bonds worth USD 95bn in 2001. Two exchange offers in 2005 and 2010 aimed to restructure Argentina's bonds, and were accepted by bondholders who represented 92% of outstanding debt. But a minority held out and sold bonds to vulture funds, who bought at a tiny fraction of their nominal value. They have sued Argentina for full payment ever since. The lawsuit has now forced the country into a new default which could push them into a new debt crisis.

- **Heavily indebted poor countries:** To address debt overhangs in the poorest countries, the international community developed the Heavily Indebted Poor Countries Initiative (HIPC). Since the 1990s, 35 developing countries benefited from HIPC debt relief. The price was high, as a condition was to implement IMF-designed adjustment programmes. However, HIPC debt relief freed up budgetary resources for development and poverty eradication programmes and helped poor countries to reach their development goals. The HIPC Initiative is now expired, and there is no instrument to address debt crises when needed. In the poorest countries, where the major share of the population lives near subsistence levels, even minor economic disruptions can cost thousands of lives.

Can stronger collective action clauses tame the vultures?

Collective action clauses (CACs) have existed in debt instruments for many decades (in particular in British law bonds). They were introduced in New York (US) law bonds at the beginning of the 2000s, after major financial sector lobbying had undermined the IMF's attempts to introduce a sovereign debt restructuring mechanism (SDRM). The SDRM had been a statutory insolvency regime for sovereign debtors. That means it could have made legally binding decisions because it was based on the IMF Articles of Agreement and thus international law. CACs in contrast simply aim to facilitate joint decision-making of creditors over debt restructuring. A majority of creditors – usually 75% – can take a decision for a whole bond series,

even against the will of a minority of holdouts. A key characteristic is that decision-making power stays with the creditors, while a statutory insolvency regime would move it to independent arbitration panels or courts. This is why the financial industry's lobby prefers the CAC approach.

There are currently three main issues which explain why CACs are insufficient to manage debt crises:

- Not all bonds have them, in particular older bonds do not. So they cannot solve debt crises that include legacy debt.
- It is relatively easy for financially strong vulture funds to buy so many bonds of one series that they surpass the blocking minority of 25%.

- They usually only apply to one specific series of bonds, with each series being only a tiny share of a country's debt. In order to take collective action on restructuring all outstanding bond series of a country, aggregation clauses are needed. The introduction of aggregation clauses is still in its infancy.

The upcoming IMF paper is expected to address these problems. The risks are, however, that tiny improvements to CACs, and thus to the collective action problems, might distract decision-makers from addressing the more fundamental problems related to sovereign debt crisis management. These are manifold, as shown by the comprehensive approach of the United Nations.

that relatively high debt levels have been judged sustainable although it later turned out that they were not. In consequence, countries that needed it did not undergo a timely debt restructuring, or the haircut on creditor claims was too small. A key factor that might distort the IMF's DSA is that it is a creditor institution itself with exposure in many crisis countries, and it is controlled by rich countries which are mostly net creditors. Creditors are reluctant to acknowledge that claims need to be written off.

• No independent decision-making progress.

There will be no automatic trigger for debt reprofiling, or whether a restructuring follows or not. The decision would be made by the IMF – a creditor institution – and its Executive Board. But the IMF is a political body with unbalanced voting rights whose track record is to base decisions on political considerations – mainly the vested interest of the major powers that are overrepresented. This also implies that there is no predictability. It would be at the Executive Board's discretion to decide how a certain case is treated.

• Exclusive and intransparent process

Both the IMF staff's DSAs and the IMF Board's decision-making are opaque processes with limited transparency and accountability to other stakeholders or even the wider public. The only stakeholder groups that the IMF plans to consult with in the course of the debt reprofiling are the creditors. There is no indication that

interactions with parliaments or civil society organisations are planned.⁶

How did the IMF proposal come up?

IMF staff developed the proposal building on the mandate by the IMF's Executive Board from May 2013. Repeated requests for a formal consultation by civil society organisations have been rejected by IMF staff. (European CSOs were, however, able to present their views to the European IMF Executive Directors at side events of the 2013 Annual Meetings). Eurodad has no indications that parliamentarians have been consulted, despite their crucial role in sovereign debt issues as budget-makers and legislators.

The voluntary and market-based proposal that the IMF released now reflects the design of the consultation process, which was heavily tilted towards the financial industry. For many years, financial sector lobbyists have successfully sabotaged any kind of statutory sovereign debt restructuring regime. The new proposal is another success for the financial lobby's blockade strategy.

Where next?

The IMF's Executive Board discussed the IMF reprofiling proposal on 13 June 2014.⁷ However, no decision for reform was taken. The published minutes of the meeting indicate that some parties/directors pointed to the operational difficulty of assessing whether debt is "with high probability sustainable" which would be the condition to trigger the reprofiling.

Neither was there full consensus on removing the systemic exemption to the exceptional access framework (which had made the private creditor bailout in Greece possible). While some Directors pointed at the equity and moral hazard problems that such a bailout procedure for selected 'too big to fail' countries implies, others found it is needed in times of financial globalisation. Statements are not attributed in published minutes of Executive Board sessions, which is why it is not known which position individual EDs took, including those representing European countries.

At the June meeting, IMF staff were asked to do follow-up work on potential impact, and the design and implementation of the proposal, for example defining the length of the reprofiling period and the scope of sovereign debt that would be covered. Moreover, IMF staff are also working on new proposals to address collective action problems. This aims to complicate the holdouts and vulture funds activities that have been so costly in the case of Greece and HIPC countries, and that have made a solution to the Argentine debt crisis impossible.

The United Nations' approach: Development-friendly debt workouts

Parallel to the IMF, the United Nations are working on concepts for a new sovereign debt workout regime. Many decades before debt crises had arrived in Europe, they strangled economic development and impoverished people in the Global South. Since the early 1970s, the UN has been mandated by Member States to

work on improving the sovereign debt workout mechanism. The mandate has been prominently reinforced at the 2002 International Conference on Financing for Development, in which the international community agreed on the Monterrey 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.”⁸

In particular, developing countries at the United Nations have put pressure on for actual implementation. In September 2014, the UN General Assembly passed a G77 sponsored resolution that initiates a process to create a multilateral legal framework for sovereign debt restructuring processes.⁹ This resolution set up the overdue institution-building process for an international insolvency regime, in order to translate the conceptual work that has already been done by the UN system into practice. The text of the legal framework is to be agreed before the end of 2015.¹⁰

Responsible Lending and Borrowing

The UN can build on conceptual work done by the UNCTAD. In 2012, the UNCTAD released the Principles on Promoting Responsible Sovereign Lending and Borrowing, which build on the concept of co-responsibility of debtors and creditors, and state the responsibilities of both:

- For creditors they state that “In circumstances where a sovereign is manifestly unable to service its debt, all lenders have a duty to behave in good faith and with a cooperative spirit to reach a consensual rearrangement of those obligations. Creditors should seek a speedy and orderly resolution to the problem.”
- The obligations for debtors include to avoid procrastination: “If a restructuring of sovereign debt obligations becomes unavoidable, it should be under-taken promptly, efficiently and fairly”.
- They also contain an anti-vulture fund clause: “A creditor that acquires a debt instrument of a sovereign in financial

distress with the intent of forcing a preferential settlement of the claim outside of a consensual workout process is acting abusively.”

The UNCTAD Principles have been reinforced by the UN General Assembly. A number of EU Member States have separately endorsed them. More are expected to follow.

Towards a United Nations Debt Workout Mechanism

Since early 2013, the UNCTAD is regularly convenes a multi-stakeholder expert group to develop a concrete new debt workout mechanism. It is expected that this UN concept will go much further than the IMF’s proposal. While the IMF’s role and mandate is mainly to promote and secure financial stability, the UN’s mandate includes promoting development, democracy and human rights. This implies that the two organisations approach the obvious need for a sovereign insolvency regime from very different angles.

For instance, the New York session of the UNCTAD expert group discussed the elements that would make the new debt workout mechanism most legitimate. Discussions included:

- Source legitimacy: the new concept needs to be put in place by a legitimate process, for example by state consent, or even by more participatory processes.
- Process legitimacy addresses the debt workout and may include aspects such as impartial decision-making, transparency, a right for all affected parties to be heard, a check on allowance or disallowance of creditor claims, debtor ownership, a comprehensive and fair treatment of different debt categories, and well-reasoned decisions.
- Outcome legitimacy refers to the desired debt workout achievements: the debtors’ return to debt sustainability and to ‘normal’ financing on capital markets, a reasonable recovery of creditor money, and last but not least, to minimise the harmful impact of debt crisis and structural adjustment on development and on the human rights of affected countries and people.

This approach is of course very different from the IMF proposal, in which the source can be traced back to financial industry lobbying,

the process is IMF-managed, it depends on voluntary participation of creditors, and the intended outcome is simply to restore debt sustainability and the debtor’s return to capital markets.

It is expected that the UNCTAD will have the concept for the new debt workout mechanism ready before the end of 2014, for consideration by the UN General Assembly. The concept will also be a key input for the Third International Conference on Financing for Development which takes place in 2015 in the Ethiopian capital Addis Ababa.

The Way Forward

The political pressure to build an effective and fair international insolvency regime for sovereign debtors is increasing. In light of recent experiences that Europe has had, it should be clear that muddling through debt crises is no longer an option. It is time that Europe’s decision-makers took action.

European decision-makers and legislators should:

- Support the initiatives for a resolution establishing a Multilateral Convention on sovereign debt workout at the United Nations General Assembly.
- Call on the UN’s Financing for Development Conference in Addis Ababa in 2015 to launch an institution-building process for an international insolvency procedure.
- Ensure that any new international insolvency regime is mandated to deal comprehensively with debt problems, is independent of creditors in analysis and decision making, provides a human needs based approach to debt sustainability, and gives all stakeholders the right to be heard.
- Integrate debt (debt workout, debt sustainability and responsible lending) into the EU’s Policy Coherence for Development Framework, and define debt reduction as explicit aim of the EU’s development cooperation with third countries.
- The European Parliament should recall and strengthen its earlier motion for an international insolvency procedure or fair and transparent procedure, and urge the EU to immediately take the necessary steps for implementation.¹¹

- 1 Motion for a European Parliament Resolution on the follow-up to the Monterrey conference of 2002 on Financing for Development (2008/2050(INI): <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+REPORT+A6-2008-0310+0+DOC+XML+V0//EN#title1>
- 2 Bondholders representing €199.2bn accepted debt restructuring. €6.4bn of bonds (mostly foreign law bonds) stayed in the hands of holdout creditors. Cf. Jeromin Zettelmeyer, Christoph Trebesch, and Mitu Gulati (2013): The Greek Debt Restructuring. An autopsy; p. 13
- 3 Ellmers, Bodo (2013): The new debt vulnerabilities. Ten reasons why the debt crisis is not over (Eurodad) <http://www.eurodad.org/Entries/view/1546060/2013/11/11/The-new-debt-vulnerabilities-10-reasons-why-the-debt-crisis-is-not-over>
- 4 IMF (2014): The Fund's Lending Framework and Sovereign Debt. Preliminary Considerations; <http://www.imf.org/external/np/pp/eng/2014/052214.pdf>
- 5 Eurodad, (September 2014) Tackling the Vultures: A Briefing on Legislative Action to Tackle Vulture Funds
- 6 The IMF even refused to respond to the European Parliament's questionnaire related to the own-initiative 'Troika paper'. http://www.othmar-karas.at/admin/photos/eintraege/eintraege_2810_161136.pdf
- 7 "IMF Executive Boards discusses the Fund's Lending Framework and Sovereign Debt" IMF Press Release 20 June 2014; <http://www.imf.org/external/np/sec/pr/2014/pr14294.htm>
- 8 United Nations (2002): Monterrey Consensus of The International Conference on Financing for Development; <http://www.un.org/esa/ffd/monterrey/MonterreyConsensus.pdf>
- 9 United Nations (2014): Towards a multilateral convention to establish a legal regulatory framework for sovereign debt restructuring processes; A/68/L.57
- 10 United Nations General Assembly Resolution A/Res/68/304, 9 September 2014, http://www.un.org/en/ga/search/view_doc.asp?symbol=A/RES/68/304
- 11 Motion for a European Parliament Resolution on the follow-up to the Monterrey conference of 2002 on Financing for Development (2008/2050(INI); <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+REPORT+A6-2008-0310+0+DOC+XML+V0//EN#title1>

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The European Network on Debt and Development is a specialist network analysing and advocating on official development finance policies. It has 47 member groups in 19 countries. Its roles are to:

- research complex development finance policy issues
- synthesise and exchange NGO and official information and intelligence
- facilitate meetings and processes which improve concerted advocacy action by NGOs across Europe and in the South.

Eurodad pushes for policies that support pro-poor and democratically-defined sustainable development strategies. We support the empowerment of Southern people to chart their own path towards development and ending poverty. We seek appropriate development financing, a lasting and sustainable solution to the debt crisis and a stable international financial system conducive to development.

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