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STUDY

Resolving Sovereign Debt Crises

Towards a Fair and Transparent International Insolvency Framework

Second revised edition

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- Due to the global financial crisis, external sovereign debt has again become a problem to a broad range of countries – from European high-income countries to the poorest states on earth – even after they had obtained debt relief through existing multilateral initiatives.

- Despite long-standing experiences with sovereign insolvencies, however, no mechanism presently exists to deal with the complex debt structures of many countries in a comprehensive way. Existing debt workout procedures – such as the Paris Club, HIPC/MDRI, or Brady-style debt conversion – have either been one-off exercises not meant to be applied as a permanent mechanism, or they are reinforcing collective action problems for being piecemeal in character.

- This study therefore argues to apply principles and procedures of domestic insolvency to sovereigns, in order to reach a fair and sustainable debt workout. It explains the principles of an ad-hoc or an institutionalised framework, and describes the possibilities to obtain political support and technical advice for countries that may find themselves in need of an orderly debt workout process.

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Between the strong and the weak it is liberty that oppresses and the law that liberates.

Jean Baptiste Henri Lacordaire (1802–1861;
French ecclesiastic, preacher, journalist, and political activist

Introduction: Greece and the Resurgence of Sovereign Debt

On Monday the 12th of July 2010, German Finance Minister Wolfgang Schäuble proposed to his fellow members of the EU Task Force on the Strengthening of the European Monetary Union the creation of an international sovereign insolvency framework. Such an initiative by Europe's most powerful economy would have been unimaginable just half a year earlier. The de-facto insolvency of the Greek state had not only shattered the old continent's financial and banking system. It had also brought about important changes in some of the key orientations of policymakers. Strong discontent among the populace about the big bailouts of states as well as private investors pushed the conservative/liberal government in Germany towards the search for alternatives. Holding investors to account when official debtors run into difficulties is not just an innovative idea; it is basically in line with the way insolvent individuals or corporations are being treated within any European legal system.

Still, it took European governments nearly another two years to agree on a partial debt write-off for Greece; a write-off that did not come in the form Schäuble had suggested in July 2010, but through a quite disorderly and ad-hoc restructuring enforced upon Greek and international holders of Greek bonds. Immediately after the write-off of about 109 billion euro, it became clear that the relief provided would not be enough to restore Greek debt sustainability. Another small debt conversion followed at the end of 2012, and as of the writing of the second edition of this paper,[1] international experts increasingly agree that another substantial debt reduction will be necessary. Politicians, however, are saying exactly what they were saying ahead of the March 2012 write-off: no debt relief will ever again be necessary, and even if it were, it should not be granted because it would actually work *against* the debtor's interest. Moreover, next time it would be the official rescue funds that would have to be reduced in value, because the remaining private claims have an overly senior status after the spring 2012 operation.

Another astonishing feature of the European debate is the change from an attitude that would have ruled out any state bankruptcy for countries on the old continent to an attitude that assumes that nobody else but Greece and some other European countries (Portugal, Ireland, Italy, Spain) are really at risk. In reality the fact that states can and eventually will go bankrupt is neither a new phenomenon nor one that is confined to EU members. The European crisis comes on the heels of major sovereign debt crises in Asia, Africa, and Latin America. Typically, developing states in these regions have experienced the same cycle of political treatment, which runs from »no debt relief in necessary«, through »no debt relief is possible«, to the granting of »exceptional, single, and never ever to be repeated debt relief«, before finally returning where it started.

This paper tries to trace the reasons for this astonishing refusal of policymakers to acknowledge the reality of sovereign insolvency. It finds them largely in the power imbalance between sovereign debtors and their creditors, and it suggests reforming this setup by taking recourse to very fundamental principles of the rule of law.

Our intention is to guide governments, parliamentarians, and an interested public in today's critically indebted countries inside and outside Europe to possible alternative crisis resolution mechanisms. It presents and analyses existing mechanisms, their shortcomings, and the resulting need for reform in chapters 2 and 3. Subsequently, it outlines the basis principles and options for implementation of a sovereign insolvency framework in chapter 4 before highlighting the state of the political debate in chapter 5. Given the dynamic of this reform debate within as well as outside Europe, the political landscape may indeed change very quickly. Therefore, links to several online media in the Service section at the end of the report complement this part. Chapter 6 provides a brief, stylised agenda for a state insolvency process through international arbitration. This, in turn, is being complemented by links and contacts to possible supporting international institutions, like-minded governments, and NGOs that would be prepared to lend a hand to anybody who tries to avoid the mistakes of the past, while addressing the sovereign debt problems of today.

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1. The Persistence of Sovereign Debt as Systemic Problem in the Global South

By mid-2008 sovereign debt problems, which had plagued many countries in the global South over more than two decades since the outbreak of the Latin American debt crisis in the early 1980s, finally seemed to be a thing of the past. After the multilateral debt relief initiatives HIPC/MDRI,[2] some extraordinary debt reductions for selected countries beyond the HIPC group, and after six years of nearly unhampered global growth, the debt indicators of the vast majority of Southern countries had substantially improved. This does not necessarily imply that all countries came substantially closer to the fulfilment of their development targets.

This overall positive picture changed fundamentally with the recent global financial crisis and the ensuing global recession in 2008/2009.

While the origins of this crisis clearly lay in the rich countries' domestic financial systems, notably the US housing market and the breakneck exposure of European, Japanese, and US investors towards those markets, the fallout of the world-wide recession onto developing countries and emerging markets has been substantial. Reduced export earnings because of sluggish global commodity demand and plummeting commodity prices; dwindling remittances; stagnating development aid and reduced capital inflows from foreign direct investment (FDI); as well as lower tax income – and partly also additional public expenditure for fiscal stimulus – started to pose a new threat to the hard-won debt sustainability in quite a few countries in the global South.

Research undertaken by the international financial institutions (IFIs) as well as NGOs and academics has identified varying numbers of poor countries under threat of renewed debt distress, that is, a situation where countries are either entering into default, or where current debt service is upheld at irresponsibly high costs in terms of social deprivation or overexploitation of a country's natural and human resources as the crisis continues. Recent analyses include:

- By mid-2009 erlassjahr.de and the Friedrich-Ebert-Stiftung analysed prospects for »post completion point« HIPCs and found that out of 26 countries that had just obtained debt relief, 13 suffered »high« risks of renewed debt distress (Kaiser, Knoke, and Kowsky 2009);

- In June 2013, the IMF updated its own overview of debt sustainability of 76 low-income countries. The Fund concluded that from those 76 countries, 17 were either in debt distress or faced a high risk. Only 24 seemed to be beyond new debt problems; the remainder were at »moderate« risk.[3]

- erlassjahr.de looked at 108 low- and middle-income countries at the end of 2011; 65 of them showed either debt indicators beyond critical thresholds or faced high risks of deterioration in the immediate future – or both (erlassjahr.de and Kindernothilfe 2013).

In this critical situation, low- and middle-income countries were provided with access to vastly enhanced new financing. This included the support from multilateral lenders, such as the IMF, which countries obtain in order to stimulate their economies. It also included an extended access to non-concessional trade-financing by the export credit agencies (ECAs) of the major Western as well as emerging economies. While in principle support is welcomed in times of crisis, both resource flows imply a crucial choice for governments, which have to balance additional inflows against the need to maintain a sustainable external debt burden. With the threat of a »double-dip« recession not yet past and many other factors beyond the control of governments (e.g., commodity price developments, remittance inflows, natural disasters), the likelihood of new sovereign over-indebtedness in many poor countries continues to be very high. The need for a new wave of debt restructuring or debt relief seems to be virtually unavoidable despite all the efforts by debt managers to prevent a situation whereby these countries can no longer meet their obligations to their foreign and domestic creditors.

2. »Heavily Indebted Poor Countries Initiative« (HIPC) and »Multilateral Debt Reduction Initiative« (MDRI) (for a critical assessment of these two initiatives, see chapter 2.2).

3. The list is regularly updated at: http://www.imf.org/external/pubs/FT/dsa/dsalist.pdf.

However, by and large, no mechanism exists that could summarily address a new wave of sovereign over-indebtedness in low- and middle-income countries. As we shall demonstrate in more detail in chapter 3, the HIPC/MDRI initiatives for the poorest countries have been deliberately designed as one-off exercises that are not available to any country helped by them before. Debt management in middle countries, in turn, has always suffered from the incoherence of the various negotiation fora like the London and Paris creditor clubs and the inexistence of well-defined procedures for negotiating public bonds. All of these deficiencies combined underline the need for a new global framework.

2. Debt Management from the Crisis of the 1980s to the Debt Sustainability Framework

In contemporary history, the public debate around the proper way of dealing with debt crises and the call for debt relief for poor countries gained momentum in reaction to the Latin American debt crises of the early 1980s.

The first years after the outbreak of the sovereign debt crisis of the 1980s that affected first Latin America and, later on, a large number of other low- and middle-income countries around the world were characterised by the widespread belief that »states never go bankrupt«. Accordingly, debt re-scheduling and the swapping of debt instruments towards longer maturities were the instruments of choice. However, at the end of the 1980s, it became apparent that some indebted countries were indeed already in dire need of debt relief.

Creditors organised negotiations about individual countries' debt problem in several ad-hoc fora. These fora started as creditor »clubs« that dealt with just one part of a country's total external debt, for example, debt owed to bilateral official creditors. Only from 1996 onward was the attempt made to organise more comprehensive processes.

2.1 The Paris and London Clubs

The »Paris Club« was founded in 1956, when Argentina had repayment difficulties and the French Treasury hosted a meeting of official creditors. The Club is an ad-hoc negotiation forum with no legal status or rules of procedure. Its permanent members are 19 high-income countries, most of them founding members of the OECD. Additional creditor governments are invited to participate if they have relevant claims on the debtor in question. The Club's »agreed minutes« need to be »translated« into bilateral arrangements between the debtor and all Paris Club members. The Club's informal character has been useful for flexible solutions to individual debtor cases.[4] However, this flexibility has also meant that countries were not treated in strict conformity with the various »terms« that the Paris Club has developed for different types of countries and debt problems. Rather, political considerations have often influenced the outcome of negotiations – thus undermining the Club's basic rationale: that comparable cases should be comparably treated.

Like the even more informal »London Club« (see below), the Paris Club only negotiates a part of a country's external debt; in the case of the Paris Club only debt owed to bilateral official creditors, very often debt from concessional loans provided as part of development aid. While it has unilaterally tried to extend its arrangements through comparability of treatment clauses to claims from non-members, this extension has earned the Club fierce criticism from both private as well as non-Club official lenders, who were not prepared to accept interference on their claims without even a basic right to be heard.[5]

Today the Paris Club has become a rather marginal forum for debt negotiations. Most countries that are dealt with in the Club's monthly sessions are »Heavily Indebted Poor Countries« or HIPCs, for which the type of treatment is already broadly agreed before the delegations arrive in the French Treasury, due to the calculations in the HIPC decision and completion point documents. »Non-HIPCs« have over the last years often been small island states with very peculiar debt problems and very small absolute amounts to negotiate.

4. As late as 2003, the Paris Club started to communicate with the broader public through http://www.clubdeparis.org (last accessed on 20.8.2013). Until then, part of its secretive culture was that no information beyond a meagre press release was published about its negotiations. Today, the abovementioned website features basic information about the terms, participation, and outcome of each negotiation, but still not the agreed minutes. For a critical look at the Club as an institution see Kaiser (2000).

5. The imposition of PC terms on other creditors has been described by a Russian commentator as »Gulag-sur-Seine«; see: Paris Club Comes Under Attack, in *EUROMONEY – IMF/WB Annual Meeting Issue 2000*, pp. 56–61.

Even more than its counterpart in Paris, the »London Club« is an informal group of creditors who meet to negotiate individual countries' needs for debt relief. In 1976, when former Zaire had to restructure its exposure to its private creditors, the first of several ad hoc »Bank Advisory Committees« was established by private international banks. The Committees were soon referred to as the »London Club« to distinguish them from the »Paris Club«. They have no defined membership but serve to bring those private banks together that are relevant creditors to a particular debtor country whose international debts have to be restructured. Hence, the »London Club« does not have a legal status nor bylaws, either. It does not even necessarily meet in London. Its host is regularly the bank with the highest exposure to the country in the negotiation.

Both clubs have lost some of their importance over the last years: They used to be strong institutions when the respective parts of the countries' external debts they covered were the most relevant categories. Over the last years, most countries' creditor profiles became more complex, either through the »multilateralisation« of their external debt (see below) or through the resurgence of sovereign bonds replacing syndicated bank loans as the preferred instrument for official financing in the 1990s. Under the changed circumstances, intercreditor group coherence became a most critical issue that »club« structures by definition are unable to address.

2.2 The Heavily Indebted Countries Initiative and the Multilateral Debt Relief Initiative

By the mid-1990s creditors found themselves forced to address an important shift in many countries' creditor structures: The continued re-financing of bilateral debt service by the multilateral institutions[6] had turned the multilateral lenders from rather marginal players in many poor countries into the most important creditor group. This change, however, conflicted with the dogma that multilateral claims – different from bilateral ones – could never be re-scheduled, and even less reduced, because of the multilateral lenders' character as a lender of last resort.

Skyrocketing debt indicators in some debtor countries that were heavily exposed to the World Bank, the IMF, and the regional development banks revealed a need for huge additional re-financing efforts – with questionable consequences – or the abandoning of the dogma.

In 1996 the G7 chose the abandonment option and started the Heavily Indebted Poor Countries initiative. HIPC was meant to complement Paris Club debt relief by additionally reducing remaining bilateral and persisting multilateral claims to an extent that brought the debt stock indicators below a pre-defined debt sustainability threshold. From 1999 onwards HIPC debt relief was conditioned upon compliance with a Poverty Reduction Strategy Paper (PRSP), which had to be jointly produced by the countries' authorities, the World Bank, and civil society.[7] HIPC allowed for the partial reduction of some countries' debts to the IFIs in a complicated and protracted process. It was built on the following pillars:

- Debt reduction under HIPC assumed the cancellation of bilateral debts, in most cases through regular Paris Club agreements (see above); the reduction of multilateral claims only comes second and goes as far as needed in order to reach a pre-defined »sustainable« debt level;

- Defining a »sustainable debt level« is the sole privilege of the World Bank and the IMF; this goes for the categorical definitions as well as for deviations in individual cases and circumstances;

- HIPC debt relief is provided in a lengthy process that at first required debtor countries to comply for three plus three years with IMF structural adjustment programmes before debt relief was actually granted; later this time frame was made more flexible, but countries still had to qualify for the initiative's »decision point« and then wait with only limited relief provided in the meantime, until full relief was granted at the decision point defined by the Bank and the Fund;

- Only a selected group of 39 poor and relatively small countries qualified for treatment under the initiative in

6. The most prominent actor in this process has been the World Bank's concessional window, the International Development Association (IDA), along with the IMF and the concessional windows of the African Development Bank, the Inter-American Development Bank, the African Development Fund (AfDF), and the Fund for Special Operations (FSO) respectively.

7. An HIPC overview and information on individual aspects of the complex HIPC programme are to be found at: http://worldbank.org/hipc (last accessed on 20.8.2013).

the first place. Throughout HIPC's history, some countries have been put off the list while other have been added;

- All debt relief under the HIPC initiative was conditioned upon the implementation of a structural adjustment programme with the IMF;

- Creditors beyond the Paris Club and the IFIs, such as non-OECD bilateral creditors, commercial banks, or smaller multilateral institutions, were called upon to provide comparable relief; however, the debtor was ultimately charged with obtaining this relief, which was essential for reaching the »sustainable« debt level.

Due to the very high sustainability thresholds defined in 1996, only six countries received some limited benefits through the initiative until 1999.[8] Therefore, it was overhauled at the 1999 G8 Summit in Cologne: more and faster relief under a more flexible framework was the result. However, by 2002 it had already become apparent that some countries needed additional »topping-up« of multilateral debt relief beyond the »Cologne« framework, which was then agreed upon at the G8 Summit in Kananaskis, Canada.

But even with those amendments, two major problems of the debt relief process became apparent when the G8 met in Gleneagles, Scotland, in 2005.

- Some countries suffered from renewed debt distress post-HIPC due in part to extensive new lending, and in part to adverse external conditions that had not been properly factored into the debt relief calculations.

- Administering relatively small amounts of old claims in some cases meant a disproportionate effort relative to the amounts at stake.

So, rather than addressing new debt distress in some countries individually, the G8 decided to wipe all HIPC slates clean and provide all countries that had passed through the full HIPC process with a full cancellation of all their debt to the International Development Association (IDA), the IMF, and the African Development Fund (AfDF). This additional relief scheme was labelled the Multilateral Debt Relief Initiative (MDRI).

Shortly thereafter, the Inter-American Development Bank (IDB) followed suit and granted comparable relief on debt owed to its soft-loan window, the Fund for Special Operations (FSO). This was meant to provide for equal treatment to the four (later with the inclusion of Haiti: five) Latin American HIPCs, relative to the relief all other HIPCs located in Africa received from the AfDF.

At first sight, the »full« cancellation under the MDRI seemed to have ended a long journey towards debt relief, which had started in 1989 with the definition of the Paris Club's first debt flow relief under »Toronto Terms«. As a matter of fact, however, the debt cancellation under MDRI was anything but »full«, because the IFIs applied cut-off dates of the end of 2003 (the multilateral development banks) or end of 2004 (the IMF). Only debt contracted before these dates is being cancelled under the initiative.

As the IFIs cannot legally write off any claim from their books like a commercial bank, »financing« the inevitable debt relief has been a problem throughout the HIPC and MDRI processes. Regarding MDRI, participants at the Gleneagles summit agreed to a complicated system of »netting out« the debt relief from commitments already made or foreseen under the IFI's performance-based lending schemes. This means in the case of the IDA that the debt service foregone will be annually deducted from a country's allocations, so that at first countries have to pay for their own debt relief. Only in a second step will rich countries then provide additional resources in the same amounts, which can then be distributed among all IDA recipients according to its performance-based allocation (PBA)[9] scheme. This practice has led to substantial reductions in the resources some countries have available for financing development (CFPIR 2009). The most fragile HIPC's are the most affected by this effect.[10]

8. Bolivia, Burkina Faso, Guyana, Mali, Mozambique, and Uganda received a combined assurance of debt relief to the tune of 3.4 billion US dollars. As under the enhanced framework, these commitments continue to be implemented as of today.

9. PBA is the regular resource allocation scheme of IDA, which takes not only the countries' financial needs but also their performance under previous allocations (as a proxy for countries' absorption capacities) into account.

10. Whether MDRI relief under these circumstances can be considered as »additional« as the G8 had promised in Gleneagles remains controversial. The new resources that are then distributed through the PBA scheme regularly come from rich countries' development budgets, that is, absent MDRI they would have been allocated to other development-related purposes.

Debt relief under HIPC-1 (starting 1996), HIPC-2 (starting 1999), and MDRI (starting 2005) has definitely helped to reduce unsustainable debt burdens of countries that have been included in the initiative. Two major problems, however, still remain:

- Compliance with the debt relief targets through the creditor community is uneven: while the authors of the initiative (Paris Club members, World Bank, IMF, AfDB, and IDB) unsurprisingly provide the debt relief they have defined themselves, other creditors are less inclined to do the same. Non-OECD creditor governments have provided up to 45 per cent per cent of the foreseen relief[11]; commercial creditors' participation rate could only be lifted above 20 per cent through big multilaterally financed buyback operations for Nicaragua and Mozambique; and even among smaller multilateral creditors, compliance is below 100 per cent (IDA 2011);

- HIPC has been deliberately defined as a one-off operation. It was never meant to become an ongoing mechanism. This is based on the implicit assumption that over-indebtedness was a temporary exceptional problem that could be overcome once and for all. This surprising assumption by the authors of the initiative was proven wrong as early as the end of 2008, that is, before the last country on the list would even have entered the HIPC process. In its status of implementation report 2008, the IDA and IMF identified four post-completion point HIPCs as facing a high risk of debt distress due to the global financial crisis fallout, among other factors. Calculations as to how many countries would face new debt distress have gone up and down ever since (see literature referenced in chapter 1.[12] The fact that HIPC/MDRI have not »solved« the problem of poor countries' debt for good is undeniable.

2.3 Exceptional and non-negotiated Debt Reductions

Not all debt relief agreements have followed the strict lines of the processes described above.

First, there have been considerable deviations from the terms, which would in principle have been applicable to any individual debtor country. This could have been for better or for worse, depending in most cases on the political standing the country had with important Paris Club members. A prominent case is that of Nigeria. The country had been part of the original HIPC list, but was then removed under a pretext in 2000, when the long-standing military dictatorship came to an end and creditors feared that they would no longer be able to deny HIPC relief to Nigeria on the grounds of the country's notoriously bad governance. But in 2005, Nigeria received a two-thirds debt stock reduction from the Paris Club under a special arrangement.

Another positive deviation was the case of the former Yugoslavia after the fall of the Milosevic regime in NATO's war against Serbia in 1999. The newly established pro-Western Serbian government received a two-thirds debt reduction from the Paris Club under conditions that were normally limited to low-income countries (»Naples Terms«).[13]

At its 2003 summit in Evian, the G8 then institutionalised the more flexible treatment by establishing the »Evian Approach«,[14] which in essence meant that regardless of other »terms«, Paris Club members could treat any country as they pleased. This flexibility was certainly a step forward for many countries, which otherwise could not have been properly treated under existing terms. However, it impairs an essential part of the Club's *raison d'être*, namely the principle of comparable treatment of comparable cases.

More interesting than certain flexibilities in the Paris Club or HIPC schemes are cases where countries have either helped themselves to debt relief or have received exceptional treatment from a broader group of creditors.

An example for the latter is the Paris Club's relief for Indonesia in 1969, based on an independent assessment of the country's capacity to pay (see box 2 on page 55).

11. The publication of regular and comprehensive HIPC/MDRI Update reports was discontinued after the 2011 annual report. This last available figure was taken from IMF: HIPC and MDRI Statistical Update, April 2, 2013, table 15. No newer data on private sector participation have been published.

12. Kaiser, Knoke, and Kowsky (2009), IMF (2009), erlassjahr.de/ Kindernothilfe (2013).

13. In fact the Paris Club insisted that the treatment was not in accordance with full Naples Terms as debt relief was less than a full percentage point lower than normal under Naples.

14. http://www.clubdeparis.org/sections/types-traitement/reechelonnement/approche-d-evian. (last accessed on 13.9.2010).

Prominent cases of debt relief made by the debtor are the Argentine debt swap after the state bankruptcy at the end of 2001, and the one orchestrated by the Ecuadorean administration under President Rafael Correa at the end of 2008. In both cases, newly elected governments enforced:

- a far reaching reduction in the net present value
- of an important section of the countries external debt
- through unilateral action
- with a political but never legally enforced reference to the questionable legitimacy of the claims under question.

In both cases, the exchange of old debt owed to private creditors implied a »haircut« [15] in the range of 70 per cent of its face value. Acceptance among creditors rose to over 90 per cent until 2013, which was considered a fairly good response. However, it meant that both countries were confronted with holdouts who command nearly 10 per cent of the old exchanged debt titles. As of this writing, Argentina is engaged in a protracted legal battle with a leading vulture fund (NML Capital), who was entitled to receive pro-rata payments from Argentina's trustee, the Bank of New York Mellon, whenever Argentina used the institution to make regular payments to the holders of its converted debt. The case is still pending as of this writing. Observers from all corners agree that the case has the potential to disrupt the existing debt renegotiation procedures as they have been described above. Should Argentina in fact be forced to pay NML Capital based on the standard *pari passu* clause in its bond contracts, this would constitute an overwhelming disincentive for any creditor to engage in good-will and voluntary restructuring, because a co-operating creditor would have to assume that his concessions would not serve to restore the debtor's debt sustainability, but to pay competing investors.[16]

15. »Haircut« is a common expression for the reduction of a creditor's claim, either through a reduction of the nominal value or a softening of interest and repayment terms.

16. Out of this fear, some governments have filed *amicus curiae briefs* in support of Argentina. For the latest one see: BRIEF FOR THE REPUBLIC OF FRANCE AS AMICUS CURIAE IN SUPPORT OF THE REPUBLIC OF ARGENTINA'S PETITION FOR A WRIT OF CERTIORARI. Supreme Court of the United States July 26, 2013.

Despite the fact that the enforced debt reduction was in both cases helpful in providing the debtor countries with immediate and essential resources for development finance, the confrontational nature of the debt exchange not only impaired both countries' external financial relations. It also hampered their re-access to capital markets. In that sense unilateral actions are no substitute for a fair, transparent, and broadly acceptable negotiated solutions, as described below.

2.4 The Debt Sustainability Framework: Preventing Future Debt Crisis?

After MDRI, creditors started to claim that new debt problems would be prevented, or at least mitigated, by a post-HIPC instrument, which in the hands of the World Bank would serve to deter debtor countries from excessive future borrowing, in particular on non-concessional terms. The World Bank's Debt Sustainability Framework (DSF)[17] for low-income countries was supposed to make sure that no post-HIPC country would take out new loans beyond its capacity to repay.

The DSF consists of two elements:

- It defines an upper ceiling for the sustainable debt of each low-income country, taking into consideration its economic prospects and the quality of its governance, as expressed in the Bank's Country Policy and Institutional Assessment (CPIA) indicator;[18]
- It threatens countries with cuts in their highly concessional financing from IDA and other concessional lending windows if they take out loans, which, in the view of the World Bank, put debt sustainability at risk.

This sanctioning mechanism is the essential difference between the DSF and the debt sustainability analyses (DSAs), which the Bretton Woods Institutions (BWIs) regularly provide for their low- and middle-income members.

17. For an overview and links to individual debt sustainability analyses in low-income countries, see: Factsheet: The Joint World Bank–IMF Debt Sustainability Framework for Low-Income Countries, http://www.imf.org/external/np/exr/facts/jdsf.htm (last accessed on 13.9.2010).

18. For a detailed description of the CPIA methodology see: http://siteresources.worldbank.org/IDA/Resources/CPIA2007Questionnaire.pdf (last accessed on 13.9.2010).

The technicalities of the DSF have been amply discussed and criticised (erlassjahr.de and EURODAD 2006). The focus of this critique has been on the questionable definition of the upper ceilings and on the one-sided character of the framework, which exerts pressure on the borrower without even considering questions about lenders' behaviour. The framework also focuses exclusively on the quantity of new borrowing taken on by low-income countries without any consideration of the quality or relevance of those same loans to countries' development programmes.[19]

At a very early stage of the DSF's development, the Bank had drafted guidelines[20] that went some way in taking into consideration recent critiques of the then current DSA practice.

- More realistic projections should be the result of a closer look at the countries' historical records (rather than global growth assumptions).

- Deviations of historical records from earlier projections should be explained and taken into account in the process of new projections.

- Assumptions regarding exceptionally positive development (notorious in the past for making higher debts appear sustainable) need to be explicitly justified.

While efforts to make projections more realistic are clearly discernible in recent DSAs, the good intentions look like they are being implemented in a somewhat vague manner (Rehbein 2010).

The most astonishing element of the DSF, however, does not lie in its functioning, but in the implicit assumption that it could prevent the recurrence of sovereign over-indebtedness in the future, and thus make any work on sovereign debt workout schemes redundant.

19. These considerations are occasionally made when the Bank decides on the granting of waivers for non-observance in individual cases. However, this relates only to the limited scope of Bank/Fund conditionalities, which may or may not be helpful for the country's fiscal and monetary sustainability. It is suggested here that consideration should be based on a broader set of criteria for debt illegitimacy, and that decision-making should be entrusted to an independent institution, because the Bank's own lending can be of low quality like anybody else's.

20. IMF and World Bank (2007).

As argued in chapter 1, it is completely unrealistic to assume that compliance with the DSF will spare the developing world from future debt crises and thus the need to improve sovereign insolvency procedures. The renewed debt risks, analysed by the BWIs themselves in relation to the crisis fallout on low-income countries (see chapter 1 above), demonstrate this clearly. Moreover, developments in the G20 process seemed to indicate – at least temporarily – a policy shift from a strong focus of maintaining debt below sustainability thresholds to giving more leeway to enhanced borrowing in order to stimulate growth in low- and middle-income countries, too. So the G20 decided at their London summit in April 2009, »[...] to review the flexibility of the Debt Sustainability Framework and call on the IMF and World Bank to report to the International Monetary and Financial Committee (IMFC) and Development Committee at the World Bank/IMF Annual Meetings.«[21]

Accordingly, the IMF/WB 2009 Spring Meetings' Final Communiqué foresaw the »[...] review of options to enhance the flexibility within the Debt Sustainability Framework.«[22] Staff responded to this call by introducing several proposals how to put the principles of enhanced flexibility into practice (IMF/World Bank 2012).

Essentially, the logic behind »enhanced flexibility« is that the framework's narrow limits, which put debt sustainability above the need for expansionary fiscal policy, have become obsolete, at least in the context of economic crises. They allowed for individually tailored treatments, while formally keeping the generalised rules and criteria intact.

For future loan-taking by HIPCs, this means that (a) the limits, which provided some form of equal treatment between countries, will be raised enough to allow for the inflow of fresh money that comes the way of an individual HIPC from official sources; (b) in cases where countries have already engaged in new borrowing to some critical level from other sources, the IFIs will have to decide: Will they use the DSF to prevent countries' access to multilateral resources – which will eventually be badly needed in order to safeguard national budget balances – or secure social spending or a growth-inducing monetary

21. G20, Final Communiqué, pt. 25.

22. http://www.imf.org/external/np/cm/2009/042509.htm (last accessed on 13.9.2010).

policy? It is certainly a welcome development that the IFIs have (a) set up transparent rules for their own loan-making, and done their utmost to improve the quality of their lending in line with those rules; and (b) applied those rules with some flexibility. What continues to be problematic is the Bank's de-facto rules-setting capacity regarding the overall borrowing portfolio – given the possible conflict of interests between its role as a lender and the (assumed) fiduciary responsibility as the expert for the country's overall debt sustainability.

3. Shortcomings of Current Sovereign Debt Management: The Need for Reform

As one consequence of the Eurozone crisis and the futile efforts to resolve it in time, the IMF (2013) has undertaken an extraordinarily critical look at its own role and track record as part of the *troika*. With unprecedented frankness it considered debt restructuring – particularly but not exclusively in the Eurozone crisis – as providing regularly »too little (debt relief) too late«. Some – but not all – of the shortcomings identified by the author below, are shared by the Fund's analysis, which, however, refrains from making any concrete proposals for remedy.

3.1 Paying the Price for Inefficient Crisis Resolution

As we have seen in chapter 2.1, the practice of dealing with sovereign debt problems and debt defaults started from the erroneous assumption that »states do not go bankrupt«. Until the end of the 1980s, this assumption guided policymakers' decisions to re-finance and reschedule current debt service, rather than provide the haircuts to creditors' claims, which are a normal element of any individual or corporate insolvency regime.

When it became apparent at the end of that decade that continuous re-financing would only contribute to the ongoing pileup of ultimately unpayable external debt, creditors decided to enter into an incremental process of granting piecemeal debt service – and from 1994 onwards limited debt stock – alleviation, rather than sharp cuts into the stock of creditors' claims. Both types of treatment functioned on the basis of pre-defined (and fairly limited) debt relief quotas, rather than on an individual assessment of the need for debt relief in order to restore debt sustainability. This quota-based system of the Paris Club was initiated with the »Toronto Terms« of 1989, which allowed the poorest countries to obtain a reduction of 33 per cent of debt service falling due in a limited time frame. Those quotas turned out to be insufficient in restoring debt sustainability – on average every 2.5 years – and were revised and raised. This had the consequence of countries having to come back to the Paris Club and having to renegotiate debt relief agreements, which occasionally had not even been fully implemented through the necessary bilateral agreements with all Club members. Senegal holds the record, with 13 rounds of negotiations in the Paris Cub.

From the very beginning of this process, observers and experts had been calling for one-off sharp reductions instead of piecemeal alleviation (e.g., Raffer 1990 and Raffer 1993), arguing that the orderly insolvency of a state would ultimately be less costly and painful for everybody. Later, the Bank of England and the Bank of Canada argued in a joint commentary on the emerging proposal for a Sovereign Debt Restructuring Mechanism (SDRM) in 2001: »A better approach would recognize that default is a natural feature of the market mechanism, not something to be avoided at all cost.« As a consequence, authors Haldane and Kruger (2001) strongly argued for orderly debt standstills instead of disorderly defaults. Even from the private sector, calls for institutions such as a »sovereign debt forum« were raised.[23]

At the time of the reorganisation of the global economy in 1944, no such mechanism for any orderly debt workout had been created, despite ample pre-war experiences of sovereign defaults and the enormous political and social consequences of de-facto state bankruptcies in the 1920s and 1930s. This does not mean that an incremental development towards a working framework – as witnessed since the 1980s – is necessarily a bad thing. The history of debt relief schemes since the outbreak of the Mexico crisis in 1982 shows that, despite fierce rhetoric to the contrary, in its early stage[24] ample debt relief – at

23. See: Gitlin (2002); at the time, Richard A. Gitlin was then a partner at the Boston Law Firm Bingham Dana.

24. Prominent among favourite arguments against any debt relief for sovereigns was the allegation that a state whose debt was reduced would thus exclude itself for good from international capital markets. Although historically and economically outright nonsense, this argument gained an astonishing degree of support among creditors who wished to stem the tide of unavoidable debt reductions foreseeable at the end of the 1980s. When bilateral creditors were already providing relief for several years, a variant of this argument was used for rear-guard battles, justifying that the relief of multilateral debt would still have this devastating effect on borrowers – while bilateral relief for some unknown reason would not.

least for some countries – can be agreed by the creditors. However, the poorest people in the indebted countries have paid a very high price for the 20-year-long history of too little relief being provided too late. Thus, the challenge in the current situation of the possible re-emergence of a broader sovereign debt crisis is whether the international community will be able to draw the right conclusions from the existing mechanisms' shortcomings, and whether they can be drawn in a speedy and efficient process. Or will debt relief again be withheld for years and years because of individual creditors' desires to maintain their hegemony over any debt restructuring process?

The following paragraphs will look at those shortcomings in the existing frameworks and will draft from this analysis the elements of a reform, which is at the heart of this study.

3.2 Incoherence between Various Negotiation Fora

Due to the lack of an agreed global forum, negotiations about debt restructuring between sovereign debtors and their creditors started in an ad-hoc and piecemeal fashion as the need for restructuring came up. From 1956 onward, official bilateral creditors offered their debtors the Paris Club as a venue for discussing debt problems. London Club negotiations became a prominent instrument after 1982, when debtors started to default on their private bank loans. Debtor countries tended to be exposed primarily to one single group of (bilateral) creditors in the 1980s. So this individual group – in some countries private banks, in others governments – sought to restructure their claims on the debtor at the lowest possible cost, not caring too much about the behaviour of fellow creditors from other sectors, who tended to be of marginal influence anyway.

From the mid-1980s onward, however, things started to become less clear-cut: middle-income countries in Latin America were still most heavily exposed to private banks; however, official sector lending was not negligible any more in countries like Brazil and Argentina. This was, among other factors, due to the fact that the governments in creditor countries tried to keep exports to the Southern hemisphere going through official financing, while private banks had exhibited reluctance after the 1982 defaults. The growing official flows of financing, moreover, consisted primarily of non-concessional financing, and only to a smaller degree official development aid (ODA). Terms of non-concessional official financing are broadly comparable to those offered by commercial lenders.

With some regional deviations, the following typical creditor profiles emerged and persisted well into the 21st century: low-income countries – without real access to international capital markets – usually were most indebted to official creditors with a growing multilateral (as opposed to bilateral) share; middle-income countries continued to be attractive for private lenders after the Brady Plan had helped to accommodate the spectacular defaults of the early 1980s. However, among the private lenders, the emphasis shifted from syndicated bank lending to bonds as the preferred instruments, and in part back to syndicated loans after some countries under pressure from official creditors included bonds into debt restructurings.

In this setup, creditor coherence started to become a critical issue in international sovereign debt management. It showed that the system of mutually independent piecemeal negotiations implied a strong incentive for holdouts, that is, each group of creditors could gain from waiting for another one to restore the debtor's capacity to pay by forgoing a part of its own claims. What resulted were delays in negotiating an obviously unsustainable debt problem, mutual accusations between official and private creditors, and – worst of all – the emerging industry of holdout creditors and vulture funds.[25]

Official creditors have tried to meet that challenge by inserting »comparability of treatment« clauses into their Paris Club agreements; that is, they oblige the debtor to seek a restructuring with any non-participating bilateral creditor, which was at least as favourable as the one agreed with the Paris Club. While comparable treat-

25. A vulture fund is an investment fund that buys distressed debt with a huge discount on the secondary market. After the indebted sovereign's ability to service debt has been restored through debt relief by other creditors, the vulture sues for full payment plus interest, compound interest, and eventually, penalties. In some cases vultures profits have been beyond 200 per cent of the invested capital. In others they have been unable to attach any debtor assets. However, the major of problems consist of the disruption of the debtor to become a normal participant in international financial markets. In May 2010, vulture funds were prevented from seeking legal recourse from UK courts through a »private members« bill passed immediately before the 2010 elections and initially valid for one year. In May 2011, the law finally became permanent.

ment was certainly the order of the day, the instrument of those clauses was not appropriate. It put the burden to accomplish such treatment (even under the threat of Paris Club relief being withheld), upon the shoulders of the debtor. The debtor, however, had very little leverage to actually enforce the clause on creditors, which normally were non-Paris Club countries, banks, or bondholders – sometimes entities on whose future cooperation the debtor was dependent, economically or politically. Those creditors were often rightly appalled by having a third party intervene into their claims without even allowing them to be heard about the case. So compliance tended to be low, and problems with holdouts were the consequence rather than an orderly and comprehensive reduction to a debt level that the Club – based on the analyses of the IMF and the Word Bank – would consider sustainable.

When the »comparative treatment model« was enshrined into the subsequent HIPC initiative as well, compliance rates were extremely low: less than 50 per cent among non-Paris Club official creditors, and below 20 per cent among commercial creditors (see above).

The consequences of the reform are obvious.

- Once a country has to renegotiate an unsustainable debt, *negotiations should take place in one single coherent forum,* where everybody who holds a claim on the debtor must participate, or at least have the right to be heard.

- In principle *all creditors need to be treated equally*. There can be no preferred or even exempt creditor status other than by mutual consent. Such a consent could be based, for instance, on some creditors' willingness to support a recovery process with fresh money, on an agreed upon cut-off date, or a *de-minimis* threshold.[26]

- Comparability of treatment can only be achieved if decisions are being made by a *neutral decision-making body*, *or* by a *creditor mandated to negotiate on behalf of all other creditors*.

26. »De minimis« describes a minimum level of claims on a debtor. Only claims that exceed this threshold are included in the negotiated re-scheduling agreement, while claims below the threshold are to be serviced in full. The purpose of defining a de minimis threshold is to avoid the necessity of negotiating and to seek agreement on claims that, in effect, have no measurable influence on the restoration of debt sustainability. The Paris Club traditionally works with de-minimis thresholds of 500 000 or 1 million US dollars.

- Just as insolvency law is binding in national law, *creditors must be able to rely on the compliance with – and, if necessary, the enforcement of – the negotiated solution*. While debt arbitration can potentially take place »in the shadow of the law«, like existing procedures do, it should ideally be supported by an international treaty that helps to enforce compliance in national courts, where necessary.

Beyond these general features, a special challenge to a coherent process exists through the fact that some claims on the sovereign debtor are domestic in character and thus fall under national law, while external claims normally do not. In principle again, comparable treatment between domestic and external creditors should be the order of the day. However, considering the sovereign's opportunities to intervene with or even manipulate domestic claims, some flexibility regarding the definition of comparability will be necessary. One needs to take into consideration that domestic creditors can represent the full range from national pension funds – obliged to buy state bonds by law – to fraudulent state officials and outright criminals plundering state coffers and transferring their fortunes abroad.

3.3 Conflicts of Interests on the Creditors' Side

Any debt restructuring needs to be based on an assumption regarding the debtor's future capacity to repay – if a new over-indebtedness post-relief is to be avoided. The creditors developed their negotiation fora and procedures as described above. As processes became more and more standardised, and as more countries had to negotiate, it became obvious that also more standardised procedures regarding those assessments were needed – not least in the interest of fairness and equal treatment.

The result was the regular assignment of the role as an independent expert during such negotiations to the World Bank and the IMF. This was regulated in the standard procedures of the Paris Club. There, both institutions provide their assessments at the early stage of the process, and while others like the United Nations Conference on Trade and Development (UNCTAD) may also contribute their analysis and suggestions for a debt treatment as observers, the Club's deliberations regularly start from the opinions provided by the two Bretton Woods Institutions.

Box 1: Collective Action Clauses as a Substitute for a Comprehensive Process?

After the failure of the German initiative to set up a European sovereign insolvency framework, referred to at the beginning of this paper, a kind of face-saving, fallback position was the commitment to a broad use of Collective Action Clauses in bond contracts. With this position, the German government of 2010/11 repeated the experience of the IMF staff after the failure of the SDRM proposal (see below).

Collective Action Clauses (CACs) allow the amendment of contract terms if a supermajority of holders of that particular paper consents. CACs therefore are indeed a useful instrument to overcome collective action problems on the bondholders' side. They do, however have their limitations:

- They normally refer only to one individual bond, and only with (additional) aggregation clauses will they allow for arrangements across various bonds.

- They are still far from being standard in issuances worldwide, and even where they have traditionally been standard – such as under English law – they are not even fully included.[1]

- They cannot, of course, provide for the coordination ACROSS asset classes – i.e., bondholders vs. syndicated bank claims and claims by official creditors of sorts. This however, is where, for example in the implementation of the HIPC initiative, essential coordination problems originated.

What CACs can contribute to the resolution of sovereign debt problems, is thus valuable, but limited. They should consequently be introduced as broadly as possible into bond contracts, in order to ease the co-ordination with regard to their specific asset class. Nevertheless, they must not be misunderstood as a substitute for a coherent and comprehensive framework to restructure the entire debt stock of an over-indebted sovereign. Unfortunately, this is exactly how both IMF staff (after March 2003) and the German government (since 2011) have considered them.

1. The British Treasury is of the view that the standard inclusion under English law mandates CACs only in issuances of *foreign* emittents.

When Paris Club debt relief was complemented by the HIPC and MDRI initiatives, this strong position of the two institutions was driven even further: they controlled the whole process, and their boards even decided upon HIPC/MDRI relief based solely on their staff's own assessments.

This setup is critical from two perspectives:

- First, it is always problematic if institutions have a monopoly on expertise and ultimately on decision-making. While in domestic financial law, judges are free to select from a variety of independent experts once they require expertise for a given case; this BWI monopoly in cases of sovereign debt restructuring has never been challenged.

- Second, we are not only dealing with a monopoly but one run by a cartel of two institutions, which are creditors themselves. Particularly in the case of the poorest countries, World Bank Group members and the IMF often are the single most important creditors. As their assessments have a direct influence on the recoverability of their own claims, there is a classic conflict of interest. In Paris Club negotiations outside HIPC, which do not imply a reduction of IFI claims, they do have an incentive to enforce as much relief as possible onto Club members and even more so on non-Club members, which do not have a seat at the table, in order to safeguard their own repayments. While this setup can in some cases even work to the advantage of the debtor countries, it is by no means an instrument for achieving a fair burden-sharing and a sustainable solution with the highest possible degree of acceptance among creditors.

Research by NGOs, independent academics, and sometimes the Bretton Woods Institutions themselves has provided numerous anecdotal evidence that this conflict of interest has resulted in skewed analysis, insufficient debt

Box 2: The problematic role of the Bretton Woods Institutions in sovereign debt management – some case studies:

Example 1:

Nicaragua in the Paris Club 1995: Interplay between experts and decision makers, or who is fooling whom?

In 1995 heavily indebted Nicaragua was the subject of negotiations in the Paris Club and, a debt stock reduction of 67 per cent was agreed – a cancellation quota heavily criticised by debt campaigners and others. Nicaragua's second most important creditor was Germany, due to loan-based support the Sandinista government of the 1980s had received from the former East German government.

In response to an enquiry by an MP in the German parliament as to why the initial agreement was so adequate, the then German Secretary of State in the Ministry of Finance claimed that: »The respective balance of payments analysis was made by the IMF representative in connection with the third round of Paris Club debt rescheduling negotiations with Nicaragua, (…) it demonstrates that, in the long term, a cancellation quota of 67 per cent, (...) would be sufficient«. When the same MP made a direct enquiry to the IMF, the Fund's German executive director in his written answer flatly denied any responsibility of the fund in this: »as a matter of principle no particular cancellation requirement is ever assumed, but rather that, following discussion with the creditors, a ›cancellation offer‹ of what could realistically be expected from the creditors would be included in the calculations. We ourselves have, on order from the ministry of finance, repeatedly called upon the IMF staff to stick to this procedure, so that the Paris Club talks would not be prejudiced by eventual ›assumptions‹« (Kaiser 2000).

Later, in 2000, creditors finally officially recognised that Nicaragua needed all its bilateral debts owed to members of the Paris Club cancelled.

Example 2:

Argentina 2001–2005: The Fund as an honest broker or safeguarding its own claims?

The IMF's role as a financier and adviser during the large Argentine debt restructuring (2001–2005) has come under the spotlight in various analyses. A study published by the Spanish central bank in 2008 summarises the relevant aspects in the following way:

»One of the reasons why the LIA[1] policy has come under closer scrutiny in recent years is the broad-based discontent with the role played by the Fund during the Argentine debt restructuring (2001–2005). Indeed, this episode raised awareness about a number of shortcomings and ambiguities of the LIA policy, among which the following stand out in particular: (i) the Fund's financial exposure to the country that launches a restructuring tends to generate a conflict of interest for the institution, and hence reduces its credibility as an impartial/independent player in the crisis resolution process; (…) (iii) some have argued that, in order not to interfere with the negotiations between the sovereign debtor and its private creditors, the IMF should restrain from providing the ›resource envelope‹ of the restructuring through its program's macroeconomic framework. Others, instead, argue that this is a key feature of the public good provided by the IMF during a restructuring process; (iv) intimately linked to the above is the ambiguity stemming from the Fund's role as a provider of information and the question of whether the Institution should systematically provide the parties involved in the restructuring with a debt sustainability analysis« (Diaz-Cassou et al. 2008: 9).

The paper concludes that:

»This tends to undermine the debtor-in-possession argument as a justification for the policy of Lending into Arrears. Furthermore, it may create a conflict of interest for the IMF, which may come to be perceived as primarily concerned with safeguarding its resources and preserving its preferred creditor sta-

1. Lending into Arrears, that is, the provision of new loan resources despite the fact that the debtor is in arrears on existing commitments to other (official) creditors.

Box 2 continued

tus. In turn, this tends to undermine the Fund's legitimacy as an independent actor charged with providing a public good aimed at improving the outcome of the restructuring and limiting its impact on international prosperity. This conflict of interests tends to be accentuated in the case of large inherited programs where the Fund may fear the consequences of an extension of the default to multilateral obligations. This was the case of Argentina, which contributes to explain why the involvement of the Fund in that restructuring turned out to be so contentious« (ibid.: 28).

Example 3:

HIPC decision-point projections: A case of wishful thinking
Throughout the history of the HIPC initiative, future export earnings of HIPC countries seem to have been regularly overestimated by the IFIs, resulting in overoptimistic projections of sustainable debt levels, that is, a tendency towards underrating the need for debt relief. Especially during the first wave of countries passing their HIPC decision points, this bias was particularly visible. As a result, HIPC relief had to be complemented by the possibility to top it up at completion point in the case of external shocks as early as 2002. In 2005 the IFIs themselves made their own sustainability assessments largely irrelevant by just cancelling any claim on their books through the MDRI. When NGOs compared before the Gleneagles summit in 2005 the decision-point projections with actual data for fiscal years 2004/5 in five HIPCs, they found a systematic underestimation of debt indicators, mostly due to an overestimation of export earnings (erlassjahr.de and EURODAD 2006).

Example 4:

What is an external shock? Topping-up denied to Burundi
HIPC countries are entitled to a topping-up of their calculated debt relief when debt indicators breach critical thresholds as a result of internal or external shocks (e.g., an unexpected fall in prices of a country's export commodities). In the case of Burundi (which passed the completion point only in 2009), debt indicators at completion point turned out to be higher than anticipated, caused by a mistake in the World Bank's calculation of its own loan disbursements to Burundi. The IFIs subsequently refused a topping-up by arguing that (1) a miscalculation by the Bank could not be considered an external shock; (2) the foregone debt relief for Burundi was just minimal: 11.6 million US dollars.
Both arguments were in fact quite astonishing. If a miscalculation by an entity over which Burundi had no discernible influence was not an external shock (i.e., an adverse development beyond the government's influence), what would have been one? And 11.6 million US dollars were certainly ›peanuts‹ for the World Bank. For Burundi they amounted to roughly half of the annual education budget (IMF and IDA 2009).

relief, and unfair burden-sharing among creditors for a given level of debt relief (see box 2 below).

What are the consequences for a reform?

- *Debt sustainability assessments need to be made by an independent entity, over which neither the debtor nor the creditors exert any influence.* This very fundamental principle of the rule of law must be applied to sovereign debt negotiations as well as to any other debtor-creditor conflict.
- In the long run, the *mandates of the World Bank and the IMF need to be totally disentangled*: an institution can either be a creditor or an »independent expert«.

3.4 Creditors as Insolvency Judges

The above chapter has demonstrated the problems arising from creditors acting as de-facto insolvency judges. The double role as judge and party is very much at the heart of the current debt management system's inappropriateness. As we have seen, the conflict of interest goes even beyond the undue power imbalance between creditor and debtor, but also affects inter-creditor relationships, as in reality it is not the creditors who ultimately decide their own (and fellow creditors') cause, but rather it is a limited group of creditors who are able to shape negotiations according to their interests.

This imbalance not only has economic and legal dimensions. It has strong political implications, which tend to be in stark contrast to the economic logic that should guide debt negotiations, and even more in contrast to the human rights dimensions, which are a key element in individual insolvency regulations in most countries. And it even has a strong psychological dimension, as it presents debt relief for something other than what it is: an unwelcome but unavoidable consequence of any loan system. Debt restructuring is rather made to appear as an act of grace by a benevolent creditor who ultimately decides to »forgive« the borrower a debt.

Finally, the alleged »granting« of debt relief is a behavioural issue that serves to either co-opt or, where necessary, intimidate those who should be acting on equal footing with the creditors in the resolution of a mutual problem: the delegations and representatives of the debtor countries.[27] Their positioning into a structurally inferior position – even beyond the »natural« weakness of a poor country when confronting a cartel of rich ones – in fora like the Paris Club has two very practical consequences.

- One is the acceptance of a »natural« right of the creditor(s) to interfere with the debtor's domestic policy issues. If debt relief is an act of grace, the benevolent creditor has a moral and also a factual right to demand good behaviour in return. This good behaviour demanded and obtained by creditors like the IMF has in the past led to the debtor's acceptance of conditions that had nothing to do with the individual debts at stake, nor even with the common interest in improving the debtor's fiscal situation in order to allow the servicing of more debt in the future. It is related to things like opening markets to creditor countries' exporters and investors or even to make political concessions in return for debt relief.[28]

- The second is the interference of political interests in the resolution of debt problems. When the original HIPC framework (HIPC-I) was designed in 1995, the French government found that the scheme was unduly favouring English-speaking African countries where British and US influence prevailed. So they urged the inclusion of an additional criterion – the debt-to-fiscal-revenue indicator – to be included in the scheme. Thereupon, Cote d'Ivoire qualified as one of the biggest beneficiaries for HIPC. Likewise after the Gulf War of 2003, it was solely the political pressure of the Bush administration – through Special Envoy James Baker – that assured Iraq an 80 per cent debt relief. This came against strong opposition from a coalition of the particularly unwilling, led by Germany and Russia, who were both big creditors to Saddam's Iraq. No debt sustainability analysis would ever have demonstrated why exactly 80 per cent relief – rather than , for example, 50 per cent or full cancellation – was necessary in order to restore Iraq's external and fiscal sustainability.

What are the consequences for sovereign debt management?

Sovereign *debt negotiations need to be conducted under the leadership and the decision-making power of an impartial entity* that is economically and politically independent from both the sovereign debtor as well as its creditors.

4. Main Proposals for International Insolvency Procedures[29]

4.1 Principles for Settling Sovereign Debt Disputes

The UN Charter calls upon all countries to settle disputes early and peacefully. Fortunately, the era of gunboat di-

27. How this works, for example, when debtor delegations are received in the prestigious French Treasury in Bercy is described in Kaiser (2000).

28. One spectacular case in point was Egypt's 50 per cent debt cancellation in 1991, which was way beyond anything Paris Club members were prepared to provide to any other country in Egypt's situation, and ultimately a remuneration for the country's good behaviour during the Kuwait war.

29. In a stock-taking exercise, the IMF (2013) identifies a broader range of proposals, including those that are not statutory in nature, but contractual. The latter are not taken into consideration, because the author is of the view that contractual clauses, while helpful on some important issues – which they directly address– are no substitute for a binding framework that will cover all of a sovereign's external debt (see the paragraph on the relevance of CACs, above). Additionally, the Fund paper discusses the voluntary »Principles« approach developped by the Institute of International Finance (IIF). Those principles, while featuring a lot of common sense guidelines, are not more relevant than other such voluntary

plomacy in relation to sovereign debts is over, so peaceful settlements have indeed become the order of the day.[30] However, there is clearly room for improvement regarding the speed and timeliness of the settlement of sovereign debt disputes.

In the previous chapters, we have drawn some essential principles from the flaws in existing schemes. In this chapter, we shall explore ways as to how they can be implemented in practice.

Those principles are:

- An independent decision-making body;

- Independent assessment of the debtors fiscal and economic situation;

- The need for a comprehensive treatment, that is, all claims on a sovereign need to be treated in one single process.

Additional common features of a sovereign insolvency process will be introduced and discussed during the presentation of the practical proposals, as they are being emphasised to various degrees in the various proposals:[31]

- A stay on litigation in order to avoid the depletion of assets before an orderly process starts;

- The right of all affected parties, including civil society in the debtor country, to be heard;

- The right of the debtor to submit a proposal;[32]

- The legal enforcement of an award – even if it is reached through an Alternative Dispute Resolution mechanism (ADR) and not through a normal legal process.

frameworks, such as those drafted by UNCTAD or EURODAD: their binding application in sovereign debt management continues to be a remote perspective.

30. Although some authors have considered the structural adjustment policies imposed onto indebted sovereigns by the IMF and the World Bank as a modern-day and far more efficient form of gunboat policy.

31. For a broader list of elements see EURODAD (2009).

32. This essential right – and obligation – of the debtor under any potential sovereign insolvency framework is one of the lessons to be learnt from corporate bankruptcy. See: Bolton (2003: 16). Another one also discussed by Bolton is the strong position of the receiver under French and Japanese insolvency law.

The following chapters look at the main options for an international insolvency framework, which has been discussed at the international level for the last two decades, before evaluating them on the basis of six criteria that reflect the above principles for settling sovereign debt disputes. For our comparative analysis, we have identified three major policy proposals. At the end of chapter 4.4, the main features of the following three proposals are conveniently presented for comparison before the pros and cons of the two proposals, which are presently discussed, are presented in tabular form in chapter 4.5.

1. The proposal for an *ad-hoc debt arbitration process* that goes back to the Austrian economist Kunibert Raffer, who published it for the first time in 1989 and 1990 (Raffer 1990). With some of its features further developed, this concept was later on adopted by NGOs campaigning for debt relief (»Jubilee 2000 Campaign«) and is nowadays referred to as Fair and Transparent Arbitration Process (FTAP). A private sector counterpart to the development oriented Raffer proposal is the one by Richard Gitlin and Brett House, who outline a »non-statutory, non-institutional, un-codified Sovereign Debt Forum« as a place for negotiations between debtors and creditors (Gitlin and House 2012), which would take some but not all of the above mentioned principles on board and could be further developed incrementally.

2. The IMF's proposal for a statutory *SDRM*, which was proposed by this multilateral body for the first time in 2001, but later rejected by the IMF board in 2003.

3. The more recent proposals for the establishment of an *international insolvency court*, that is, the proposal of an International Board of Arbitration for Sovereign Debt, advanced by the Latin American economists Oscar Ugarteche and Albert Acosta (Acosta and Ugarteche 2003), the proposal for establishing a sovereign debt arbitration chamber at the Permanent Court of Arbitration in The Hague, Netherlands, as propagated by the African Network on Debt and Development AFRODAD (Lungu 2004), as well as the proposal for establishing a sovereign debt tribunal under the auspices of the United Nations by Christoph Paulus and Stephen Kargman (Kargman and Paulus 2008, Paulus 2012).

4.2 Ad-hoc Arbitration Process

As we have seen, sovereign debt management largely functions without any foundation in international law. It is rather based on the political interests of the parties involved. Existing 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.

Consequently, alternative procedures, which serve to implement the abovementioned principles, should also start from the (low) level of legal bindingness. This brings us to techniques that are commonly referred to as ADRs. ADRs cover a very broad range of extra-legal conflict-resolution techniques, from the most informal ways of seeking independent advice to quasi-legal processes, the binding power of which is based on international conventions.[33] All of them have their strengths and weaknesses and the selection of a technique by the parties is regularly based on a balance of those strengths and weaknesses in each individual case. What all those techniques – from neutral fact-finding[34] to full-scale arbitration – have in common is:

- processes balance the parties' interests, not the strengths of their legal arguments;

- costs are low compared to formal legal procedures;

- parties remain autonomous; they do not submit themselves to any decision-making body;

- confidentiality of the process; an agreement in the shadow of the law is face-saving for everybody: there are no winners or losers, but normally there is a compromise between the parties.

Eichengreen and Portes tried to apply the strengths of ADRs to sovereign debt as early as 1995, when they called for the establishment of a »mediation service for conciliation and voluntary arbitration« (Eichengreen and Portes 1995). Unfortunately, the effort was in vain.

33. For an overview, see: Orrego Vicuña (2001).

34. Regarding the strength of a process that just asks for independent fact-finding and expert opinion, see box 2 on Indonesia's debt reduction in 1969 on p.55.

Searching for a compromise rather than a court order, which implies full payment or the complete invalidity of a claim, seems to fit well for disputes over sovereign debt. However, there is also an important difference between most conflicts that are resolved by ADRs and those over sovereign debt: while the former normally solve one-on-one disputes, sovereign debt negotiations are characterised by one debtor facing a greater number of creditors, often with somewhat conflicting interests among them.

In order to address this particular setup, Raffer (1990) launched the proposal to emulate an existing insolvency scheme, adapting it to the particular situation of sovereign debtors. It has been extensively discussed in the academic community and among policymakers whether procedures for corporate insolvency like Chapter 11 of the US Insolvency Code could also be applied to over-indebted sovereigns. However, it was largely concluded that this was not possible, because sovereigns can and must not be put under receivership. Raffer's proposal[35] therefore suggests the emulation of Chapter 9 of the US Insolvency Code, which regulates the insolvency of »municipalities«, that is, entities that have governmental powers under the US Constitution. Detroit is presently the most prominent and biggest case of an insolvency filed under chapter 9. Paragraphs 903 and 904 provide for the protection of the sovereign sphere of the debtor, that is, they restrict the creditors' powers to interfere with economic decision-making by the debtor[36] or to access assets, which are essential for the functioning of the indebted municipality in the interest of society at large.[37]

Raffer claims that Chapter 9 basically contains all the necessary elements and regulations for a sovereign insolvency, if you substitute the insolvency judge, who does not exist at the international level for an ad-hoc arbitra-

35. In addition to the texts referred to in the annex, see more recent commentaries by the same author at: http://homepage.univie.ac.at/Kunibert.Raffer/ (last accessed on 20.8.2013).

36. §903 does explicitly rule out that the debtor can be forced to raise taxes in order to comply with payment obligations. What looks like an undue privilege to the debtor is meant to avoid pressure that would drive taxpayers out of the indebted municipality and thus trigger a vicious cycle in which everybody would be worse off. For a description, see: Kupetz (1995).

37. This is a very stark parallel to indebted sovereigns in the South, because the existence of failing states with all the social, political, and economic consequences are costly to the global community, the same as if the city of New York became an ungovernable swamp with no law enforcement, schooling and sanitary services and the United States had to rectify the situation. So chapter 9 is not a benevolent act of »grace« for the debtor, but a sound regulation to defend the long-term interests of those who happen to be creditors.

tion panel. The result of Chapter 9 + Arbitration would be informal, much like ADRs, in that it would remain completely in the hands of the parties. It would however, have clear, pre-defined rules and would obey principles that would particularly serve to protect the debtor's sovereign sphere. One of the additional features of Chapter 9 that would make it innovative for sovereign debt resolution is the ample »rights to be heard«, which it provides for all those affected by the outcome. This would open the doors to a far more participatory process through the need to listen to those sectors of civil society that would suffer (or enjoy) the consequences of a higher or lower repayment rate.

Moreover, a Chapter 9 process, like any insolvency procedure, necessarily functions through the inclusion of all creditors rather than just a group of more important or more privileged creditors. Building on the New York Convention on the Recognition of Foreign Arbitral Awards of 1958,[38] such a setup would go a long way in securing compliance with the result of the arbitration process – one of the major problems of the HIPC scheme, as we have seen above.

An emulated[39] Chapter 9 process would not require any new international institution to be created, with all the protracted processes that this normally implies. In principle, not even a technical infrastructure would be necessary, as the process would remain in the hands of the parties involved. However, it might be helpful to establish a small technical secretariat, conveniently located at one of the existing competent UN agencies. Its role would be to serve as a focal point for registering the need for an individual arbitration process and to serve as an archive of concluded processes and awards. Thus, it would be strictly technical with no interference whatsoever in the outcome of any individual arbitration process.

38. See http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NY-Convention.html (last accessed on 13.9.2010). To date 144 countries have subscribed to the convention; some, however, with reservations.

39. We are talking about emulation of principles, not necessarily a literal application, against which Bulow among others has warned (Bulow 2002). This, however, is uncontroversial among proponents of a chapter 9 procedure, too.

4.3 The Sovereign Debt Restructuring Mechanism and Its Impact on the Global Debate

In November 2001 the IMF surprised the international community with a proposal of its own for an International Insolvency Framework, called the Sovereign Debt Restructuring Mechanism (SDRM). In fact, the publication of the proposal, which had already been worked on by a small team in the Fund's legal department, was triggered by a decision on the part of then US Treasury Secretary Paul O'Neill. The US Treasury, under the shock of 9/11, was looking for ways to provide more global stability for times when sovereign debt solutions outside the scope of the poorest (HIPC) countries tended to be messy and protracted, and had a huge potential to stir anti-Western and anti-US sentiments in some major countries of the global South.

The ball was taken up by then First Deputy Managing Director Anne Krueger, who for two years became the front person for an innovative, albeit controversial, proposal.

At the heart of the SDRM was the creation of a Sovereign Debt Dispute Resolution Forum (SDDRF). This Forum was the ultimate decision maker in relation to any debt settlement under the SDRM, while, however, any »class« of creditors (normally the holders of a particular bond, eventually also the official creditors as a group) would have to consent to the SDDRF's proposal. The Forum itself would be established out of a pool of arbitrators, identified by the IMF board (in a later version by the Managing Director and a selection panel identified by him).[40]

At the IMF/World Bank spring meetings in April 2003, the SDRM was shelved due to lack of support from the United States and some major emerging market countries. However, it continues to be more than a reminiscence in the institutional memory of those who work on sovereign debt; so the broader proposal for an international insolvency framework is sometimes generally referred to as an »SDRM« – without necessarily meaning the IMF's specific proposal.

Three characteristics were essential for the SDRM, its perception, and finally its demise.

40. For the latest version, see: *Report of the Managing Director to the International Monetary and Financial Committee on a Statutory Sovereign Debt Restructuring Mechanism* (8.4.2003); http://www.imf.org/external/np/omd/2003/040803.htm (last accessed on 13.9.2010).

- An undeniable strength of the SDRM was the convincing possibility to secure compliance: as its functioning would be based on an amendment of the IMF's Articles of Agreement, practically all countries would be bound to its rules without any further legislation.

- This, however, also built one of its essential flaws into it: an overwhelmingly strong role by the IMF. A decision-making panel nominated by the IMF (board or director) would certainly not fulfil the requirements for independent decision-making, as the IMF would continue to be a creditor to many sovereigns, and dominated by its richest members.

- Additionally, the Fund's own claims, as well as those by other multilaterals, would be excluded from a restructuring, thus extending the preferred (or rather: exempt) creditor status of the IFIs to some bigger middle-income debtor countries at a time when, in the HIPCs, they had already become part and parcel of extensive debt write-offs.

In terms of process, the proposal was in line with internal political developments in the United States. It could surface when the Bush administration felt a strong need for more global financial stability, as it feared substantial destabilisation from the looming crisis in Argentina and a few other emerging markets. Additionally, it conflicted with the prominent case of Argentina: as a global rules reform is very difficult to implement when everybody knows to which case it is going to be applied, Fund staff upheld that the SDRM was meant for the Argentinas of this world (as opposed to HIPC-type countries), but not for Argentina itself. The SDRM's authors did not always manage to credibly transmit this complex message. And finally the US position was anything but clear-cut: while Paul O'Neill was still publicly advocating the SDRM, his Under Secretary of the Treasury, John Taylor, was already seeking alternatives to it as early as February 2002. With strong backing from an ever-sceptical private sector, Taylor had favoured the creation of obligatory »collective action clauses« (CAC) in bond contracts as an alternative to the IMF from the outset. And ultimately he was successful: today the majority of emerging market bonds include CACs, which allow a supermajority of holders (e.g., 70 per cent) of one particular bond to enforce a restructuring upon non-consenting bondholders.

Immediately after the SDRM's demise, legal department staff claimed that the concept would remain in the IMF's drawers, and it would be taken out again once the next crisis appeared. Since 2003, however, the staff toned down considerably and recently even declared that the IMF had learnt its lesson and would not burn its fingers again. And indeed, since the outbreak of the financial crisis, the IMF's role has been to mobilise resources to an enormous extent; in no way has it opened any drawers to pull something out, which would resemble a kind of comprehensive debt restructuring process. Obviously, Ms Krueger took the drawers keys with her when she left the IMF in 2006.[41]

Although there are no options for discussing IMF-led debt reduction schemes, there are some lessons to be learnt for a reform process from the SDRM project – in terms of substance as well as process.

- If a broad reform is to be implemented, its impartiality needs to be credible. The SDRM never managed to disperse the mistrust of the private sector, which feared that it would just block any attempts at legal remedies, without giving much in return. Equally distrustful were some emerging market countries that had not forgotten about the gross interference of the Fund into their domestic policies through the structural adjustments of the 1980s and 1990s. So they were not prepared to provide the institution with much credit.

- Whatever the status of the IMF would be in any reformed process, it must not reserve any decision-making power for itself. If this implies that the elegant way to secure legal enforcement via the Fund's Articles of Agreement is ruled out, then so be it, and alternatives must be found.

- Furthermore, there needs to be a clear-cut separation between the IMF's functions as a creditor and as an expert adviser to a decision-making body. This principle is relevant for any reform of the Bretton Woods Institutions beyond their role in debt workouts, too. No inner-institutional »firewall« can prevent the institution from running into conflicts of interest when it assumes both those functions. Whether 19th Street in Washington would be enough of a firewall – that is, confine lending to the

41. In their 2013 report, the IMF cites various proposals for a sovereign insolvency framework, without highlighting any of them as its own.

World Bank, and allocate all the think tank functions to the IMF – might in principle be debatable. However, no such division of labour is presently being seriously considered in either institution.[42]

- Finally, every reform needs to find its window of opportunity. Ideally, reforms are created in good times before burning country cases distort policymakers' views. However, the lesson from 2003 until the outbreak of the present global financial crisis was that no reform will take place without there being an acute problem to solve.

4.4 An International Insolvency Court

In the background of existing proposals for an ad-hoc arbitration, some NGOs and independent academics with affiliations to the NGO world felt that ad-hoc arbitration would not provide economically and politically weak indebted countries with enough legal security. They feared that very flexible ad-hoc processes could indeed be »flexibilised« by powerful creditors. Then at the end of the day there would not be much of a difference to the existing creditor-dominated procedures. Consequently, Southern NGO networks discussed options for a more formal and permanent debt arbitration court, tasked with the function of permanently addressing sovereign over-indebtedness.

The first advocates were economists Oscar Ugarteche from Peru and Alberto Acosta from Ecuador (2003), who presented their proposal for a sovereign debt tribunal, the *Tribunal Internacional de Arbitraje sobre Deuda Soberana* (TIADS).[43] Building on the writings of Raffer and others who had worked on the ad-hoc proposal, Acosta and Ugarteche's plea was to seek the establishment of a permanent arbitration tribunal building on existing mechanisms. With a view to political feasibility at the time when the SDRM proposal was the elephant in the room, at first they suggested that the arbitration function should been assumed by the International Chamber of Commerce in Paris. In their more recent paper, they proposed the establishment of an independent sovereign debt arbitration board, which would be composed of associations of sovereign debtors, private bondholders, private banks, and official lenders, respectively. The functioning of the board would be embedded into the establishment of a new global financial code, which in turn would have its base in a United Nations treaty.

In Africa the continental network of NGOs working on debt and development issues, AFRODAD, organised a series of conferences on sovereign debt arbitration, based on papers commissioned from various African legal and economic experts. As a result, AFRODAD propagated the establishment of a debt arbitration tribunal at an existing forum, and their first choice was the Permanent Court of Arbitration in the Hague (Lungu 2004). The Permanent Court of Arbitration (PCA), which resides in The Hague, was created in the 1899 and 1907 at the Hague Peace Conference.[44] The PCA acts as a registry for arbitral tribunals created ad hoc for specific disputes and maintains a panel of persons nominated by contracting states, from which states may choose arbitrators to adjudicate their disputes. States must accede to the PCA conventions to access its facilities.

In 1962 the PCA began to accept disputes between state and »non-state« organisations or individuals. In 1996 the PCA adopted a set of »Optional Rules« based on the UNCITRAL Arbitration Rules.[45] The PCA thus has rules in relation to arbitrating disputes between states (to accommodate for bilateral debt issues), between state and international organisations (to accommodate for multilateral debt, e.g., the World Bank and IMF), as well as between two parties in which only one is a state (for private debt, public guaranteed debts, stolen money).

The organisation should also operate under well-defined rules, have a small administrative secretariat to assist in the administration of arbitrations according to its rules, and act as a decisive authority where parties cannot agree (on issues such as venue, appointment of arbitrators etc.). The PCA is a good example of an organisation having all of these characteristics.

42. Important Fund members, however, would be quite sympathetic to a substantial downscaling of the Fund's lending function to a merely »catalytic level« and its concentration on the role as an advisor and rule-setting institution. One of the them is the German Bundesbank. See: Deutsche Bundesbank (2013): *Weltweite Organisationen und Gremien im Bereich von Währung und Wirtschaft*; p. 105.

43. A later version has been published in English: Global Economy Issues and the International Board of Arbitration for Sovereign Debt (IBASD), *El Norte – Finnish Journal of Latin American Studies* 2 (Dec. 2007).

44. The PCA Conventions can be viewed at: http://pca-cpa.org/showpage.asp?pag_id=1187 (last accessed on 13.9.2010).

45. UNCITRAL is the United Nations Commission on International Trade Law, based in Vienna. The PCA »Optional Rules« can be viewed at http://pca-cpa.org/showpage.asp?pag_id=1064 (last accessed on 13.9.2010).

Table 1. Overview: Main characteristics of three debt workout proposals

Criterion/ Proposal	FTAP	SDRM	Debt Court
Basic principles	Independent decision-making and assessment of the debtor's situation as well as other relevant aspects by a neutral arbitration panel, set up in equal numbers by the parties with an additional person nominated by the arbiters .	Classes of creditors are aggregated as a basis for supermajority decisions; decision-making by the parties with facilitation by an SDDRF, established by the IMF »at arms length« from its regular staff.	Independent decision-making and assessment of the debtor's situation as well as other relevant aspects by an arbitration located at a suitable international institution, which itself is neither debtor nor creditor.
Institutional framework and process	Process driven by an independent ad-hoc panel, established by the parties, eventually with support from a technical secretariat. Right of the debtor to propose a plan.	Process triggered by the sovereign debtor; SDDRF established for individual cases has no decision-making power but serves as a facilitator. Debtor works out a plan, which upon verification by the SDDRF needs to be accepted by a supermajority of creditors, organised in asset classes.	Court's decision-making based on international law, building on a plan worked out by the debtor.
Legal status of the process and its outcome	Legal quality based on the ex-ante submission of the parties under the panel's decision-making power; implementation based on the New York Convention on the Recognition of Foreign Arbitral Awards of 1958 and/or domestic law of debt-issuing jurisdictions.	Amendment of the IMF's Articles of Agreement provides the legal basis for enforcement of agreements facilitated by the SDDRF.	Court's decision-making based on new international treaty, respectively existing treaty on which an existing institution (e.g., the PCA) is based.
Eligible countries	Any country in need of debt relief.	Countries in need of debt relief outside the HIPC initiative.	Any country in need of debt relief.
Eligible debt	All external debt of a sovereign debtor; domestic public debt as well as non-sovereign external debt may be submitted to equal treatment.	Debt owed to bondholders; debt owed to private banks and to official bilateral creditors may be included as separate asset classes.	All external debt of a sovereign debtor.
Criteria applied regarding debt relief vs. repayment	Debt sustainability, but also the legitimacy of claims, may be questioned by either party or any stakeholder while exercising his right to be heard. The debtor's sovereign sphere is protected in line with Chapter 9 of the US Insolvency Code.	Debt sustainability as assessed by the IMF.	Any relevant aspect brought forward by the parties, notably debt sustainability, but also the legitimacy of claims may be questioned by either party or any stakeholder while exercising his right to be heard.
Public participation and transparency	Any stakeholder has the right to be heard through representation by social organisations.	Process is strictly confined to the parties involved; no participation of a broader set of stakeholders whatsoever.	International court has to comply with relevant international standards for transparency and stakeholder participation.

Jurists Christoph Paulus and Stephen Kargman come to a similar proposal, not from an a NGO perspective, but that of legal experts.[46] Their major concern is that ad-hoc arbitration might function in an uncoordinated way, with the consequence that individual independent and unrelated cases would fail to provide equal treatment across cases. Predictability of treatment, in turn, would be essential for both by providing for legal coherence and winning an independent process with sufficient political support. Consequently, they suggest that a pool of arbitrators be set up through the Secretary General (SG) of the United Nations. From this pool, the SG should then identify arbi-

46. Based on earlier papers by Paulus, the authors submitted a proposal for a sovereign debt tribunal to the UN's Financing for Development Office in 2008 for consideration at the FfD follow-up conference in Doha at the end of 2008; see: Kargman and Paulus (2008) and Paulus (2012).

trators for individual cases submitted to him by the parties. Records would be kept at the SG's office, and pool members would understand themselves to be part of a global and coherent mechanism. They also suggest that arbitrators not only be jurists, but also economists and development experts, in order to accommodate aspects of financial viability and development commitments. This »pool« formally resembles the SDRM, albeit with the essential difference that pool members would not be either directly or indirectly nominated by a creditor (the IMF), but by an institution that is neither debtor nor creditor, namely the UN Secretary General's office. Interestingly, the precedence they give is the Iran-United States Claims Tribunal,[47] which they view as a broadly successful arbitration effort in an extremely sensitive area.

In all the abovementioned proposals, a formally legitimised body would work on the basis of an international convention or treaty. As in the PCA case, this could eventually take the form of an amendment of an existing institutions and convention.

47. The US-Iran Claims Tribunal was set up in 1981 and served to clear mutual claims between US and Iranian citizens after the relationships between the two countries had collapsed as a consequence of the hostage crisis.

4.5 Pros and Cons of the Above Options

As the SDRM as a reform process is presently on hold, and thus details of an eventual revival cannot be assessed, the following overview concentrates on the two major strands of proposals for a comprehensive and impartial debt workout process. Both these general options – ad-hoc and institutionalised arbitration – would constitute substantial progress over existing procedures, fulfilling the reform criteria we identified in the previous chapter. They both have their pros and cons in relation to each other. In many aspects, circumstances of each individual case also matter. Therefore, the following table just provides a brief overview of major drawbacks and advantages. It is important to note that the two options for a reformed debt workout procedure do not rule out each other, but – as we purport at the end of this chapter – may also be logically sequential.

Table 2. Overview: Major drawbacks and advantages

Criterion	Ad-hoc arbitration	Standing insolvency court
Feasibility	Easily practicable in the short run; requires an initiative by the debtor country and political support by a critical mass of like-minded creditors.	Requires a global reform process that has already been started through the UN Financing for Development (FfD) process among other things; it may, however, take time before a new scheme is operational; easier if a standing court is not built from scratch but emerges under the auspices of an existing arbitration court system like the PCA.
Legal security	Depending on participating and non-participating creditors' willingness to allow for litigation and attachment of assets in their respective jurisdictions.	High, based on unwaived acceptance of the 1958 New York Convention on the Recognition of Foreign Arbitral Awards.
Equal treatment across individual cases	Questionable, as all individual processes are independent from each other; precedents may, but do not necessarily have to be, taken into consideration.	High, due to institutional continuity under one single institutionalised arbitration forum.
Comprehensiveness (inclusion of all creditors)	Enforced by the debtor's refusal to serve non-participating creditors' claims; thus depending on debtors' and like-minded creditors' willingness and ability to credibly rule out payments to any holdouts.	Strong, thanks to the formal legal status of the process, which makes legal recourse by holdouts unlikely.
Participation of civil society and transparency	High, as the process would take place in the debtor country; implementation of the stakeholders' rights' to be heard could be facilitated through public hearings.	Rather difficult within existing arbitration mechanisms, which tend to work on the basis of confidentiality.
Consideration of the quality of claims	The verification of claims would necessarily allow for challenging validity of individual claims, either by the debtor government or by the civil society through public hearings.	Depending on guidelines of the chosen arbitration forum.

Particularly with regard to the first criterion, there seems to be something like a logical sequence of reform steps: as the consequences of the global financial crisis 2008/2009 are still being felt and the threat of a »double-dip« recession with substantial need for additional fiscal space in some countries is not yet passed, it would be inappropriate to concentrate reform efforts on the creation of a new institution alone. The decisive strength of an ad-hoc approach is that it could be implemented immediately – if the political will to do so is there. Thus, starting ad-hoc arbitration in cases of unsustainable public debt and then developing step-by-step a more formal process seems to be the most promising way forward.

State practice could thus acquire the quality of »soft law«, that is, an accord between parties that is not law in and of itself but is still influential, as it guides the parties' behaviour.[48] It should be recalled here that all the terms established throughout the history of the Paris Club have never had any legal status. Still they have guided decision-making on sovereign debt workouts to a considerable, albeit diminishing extent. So a »soft law«-based reform process seems to be particularly appropriate here.

Box 3 below describes a case that would have had the potential to institute impartiality as a key element into future sovereign debt negotiations. The fact that this never happened – even after the very successful conclusion of the case – is regrettable. However, debtors could still today refer to the good experience of an impartial assessment in the very complicated financial and political environment of Indonesia in 1969, and insist on the same type of assessment.

In the next part of this study, we shall show where we are with this kind of reform process. In the last chapter on practical steps towards a reform, we shall assume the scenario outlined above: an indebted Southern country seeking a fair and sustainable solution through an ad-hoc arbitration process. This process may then subsequently lead to a reform of global institutions and procedures.

All four reasons would apply to a considerable portion of the external debt of other countries today. The first bullet point is particularly interesting, as it convincingly contradicts one of the favourite arguments of creditors today, namely that a debt reduction would exclude a debtor country from capital markets.

48. Smith and Kufour demonstrate the influence of soft law with the example of the Helsinki Accord on European Security and Co-operation in 1975. It was never voted into law in any of the participating countries. However, its transformative power in encouraging change in Eastern Europe can hardly be overestimated. See: Smith and Kufour (2000: 15).

5. The Political Debate

5.1 From Adam Smith to »Financing for Development«: Calls for a Sovereign Insolvency Framework

Much of the logic of orderly insolvency frameworks can be traced as far back as the Old Testament's Jubilee year regulations, which stipulated that individuals and families in ancient Israel should regularly be relieved of their debt burdens, independent of their responsibilities for the debt and irrespective of the political prerogatives of the time.[49]

The first important reference in modern economic history goes back to Adam Smith, who called for an orderly state insolvency in his famous book *The Wealth of Nations* in 1776.

> When it becomes necessary for a state to declare itself bankrupt, in the same manner as when it becomes necessary for an individual to do so, a fair, open, and avowed bankruptcy is always the measure which is both least dishonourable to the debtor, and least hurtful to the creditor.

Much as this quote from the father of modern economics has never been much referred to, there is also a forgotten history of Latin American discontent with the disorderly way in which the numerous defaults of most Latin American countries in the 1930s were dealt with (Eichengreen and Lindhert 1989). The focus of this discontent was the Pan American conference in Montevideo in 1933. Mexico's Foreign Minister, José Manuel Puig, called on the conference to explore »the possibility of establishing public international organizations to take care of debt negotiations and agreements, in order to exclude

49. Namely regularly every 7x7+1=50th year; see: Deuteronomy 25, pp. 8–55. See also David Graeber's argument that regular redistributions of collected collateral was not unique to Israel, but almost common practice in many jurisdictions of the time. See: Graeber, D. (2011): Debt: The first 5000 years; p.82. Graeber's point sheds an interesting new light on the question of whether a regularly mandated redistribution would actually be feasible.

Box 3: Historical Illustration: Impartiality Pays Off – Mediation between the Paris Cub and Indonesia 1969[1]

Impartiality in decision-making on sovereign debt is not an invention of this century. Nor is it without precedence. In 1968 the Paris Club became aware that Indonesia would not be able to service its total external debt, which at the time stood at 2.1 billion US dollars – moderate by today's standards, but in the late 1960s, Indonesia was at the lower end of low-income countries and moreover emerging from considerable political turmoil. Within the Club there were fierce disagreements over whether this creditors' cartel should stick to their then policy of no debt relief but only debt re-scheduling, or whether an innovative solution should be found, not least in the geopolitical interests of the United States in South East Asia.

Only governments were creditors to Indonesia then. One of the biggest creditor governments, however, was the Soviet Union, along with some of their allies, which considerably complicated any decision-making in the Club (of which the socialist countries were not members).

In 1965 a bloody military coup had ousted the state founder, Soekarno, and started the long period of »guided democracy« by General Soeharto. The military killed an estimated 500 000 people during the coup, and a comparably liberal political climate in Indonesia gave way to a long-lasting dictatorship. In the middle of the Vietnam War and after the end of Soekarno's prominent role in the non-aligned movement, the fiercely anti-communist generals were important allies for the West, and for the United States in particular.

In this situation the Paris Club, driven by the Netherlands, the United States, and the United Kingdom, concluded that an independent mediator was needed in order to resolve the complicated and unsustainable debt situation of the country in a way that would be acceptable to all.

After some alternatives had been considered, the pick for the mediator role was the German banker Hermann Josef Abs. At the time, he was head of the Board of Deutsche Bank, and in one of his many side activities he also served on the board of the state-owned *Kreditanstalt für Wiederaufbau* (KfW). In this latter capacity, he was asked to assume the mediator's role and accepted it. For the Indonesian government, he qualified particularly because of his prominent role in negotiating the extensive debt relief for West Germany in the London Debt Accord of 1953.

In early 1969 Abs started to work with a small staff, expenses of which were equally shared between the World Bank and the KfW. Formally, his role was neither that of an arbitrator nor of a mediator. He rather was tasked with providing a realistic perspective on Indonesia's future repayment capacity. This led de facto to a recommendation to the Paris Club, the Indonesian government, and the creditors outside the Club about how Indonesia's foreign debt should be treated. The case thus demonstrates how far-reaching these recommendations can influence the outcome of debt negotiations, even if they are not made in a formal capacity as a decision maker.

Between March and October 1969, Abs engaged in a kind of shuttle diplomacy between Jakarta and the creditors' capitals. He suggested a solution, which would substantially lower the unsustainable debt service ratio of 20 per cent, based on the following principles:

- full repayment of capital
- equal treatment of all claims on the debtor
- repayment over 30 years in equal instalments with no grace period
- no interest payments

Due to the last point, about half of Indonesia's payment obligations over the full repayment period were cancelled.

Not all creditors were equally delighted by Abs' proposal. Interestingly, the various German governments during the time of his mission featured prominently among the sceptics. In mid-1970 the agreement was signed on the basis of Abs' proposal all the same. Due to pressure from the sceptics, the full cancellation of all interest was changed to a reduc-

1. For a more detailed description of the case see: Hoffert (2001)

Box 3 continued

tion to 0.5 per cent, which diminished the reduction effect, but not to any substantial extent. After the agreement, Indonesia resumed its payments – like Germany did after the London Accord in 1953 – and had no sovereign debt problems until the Asian crisis struck in 1998.

When elaborating his proposal, Abs had to accommodate concerns by major creditor governments that his proposed Indonesia solution might serve as a precedent that would be referred to by other indebted nations as well. As we know today, the Paris Club was not approached by other nations once the deal was done. However, the reasons given by Abs as to why the Indonesian case was so special provide a very interesting checklist for governments supposing that their external debt of today might also be worth an independent assessment.

- Without a far-reaching debt reduction, Indonesia could not be expected to ever regain access to capital markets and fresh money in general.
- The debt under negotiation had not been contracted by the present government but by an ousted dictatorship (that was the official Western reading of the Soekarno era).
- This »dictatorship« had not used the loans productively; instead current debt service would fall on the state budget.
- If Indonesia were forced to service the debt at face value, there would be considerable political and social risks.

thereby the intervention of bankers' committees and to look for the interest of both debtors and creditors.«[50] Helleiner (2008: 6) understands the Mexican and a few other initiatives at the conference as an attempt to limit the power of (European) gunboats and bankers' committees (to the benefit of governments' influence). On the positive side, those initiatives aimed at incorporating the »Drago Doctrine«, which, through a formal treaty, prohibited the use of (European) force to collect debt in Latin America. Other proposals brought forward by a group of Latin American governments included a series of independent Latin American financial institutions that in some way would lead to »the definite economic liberation of Latin America from creditor control.« The »New Deal« of the US administration supported much of the thinking behind those proposals, helped by the fact that, to a large extent, the gunboat way of collecting debt had become obsolete anyway.

The proposals ultimately failed because: (a) not all Latin American states supported them – some feared that the creation of an independent debt workout institution would impair their access to capital markets[51]; (b) the United States, while not outright opposed, was not interested in creating a body that ultimately would force the US government to take a stance on private claims/debts of its citizens. The initiative finally failed to gain the necessary support of two-thirds, that is, 14 participating countries, and was shelved.

Helleiner (2008: 9–12) concludes that this same sentiment in the US government also frustrated the next substantial attempt to establish an orderly and impartial multilateral debt workout procedure 10 years later. During the preparation phase for what became the Bretton Woods Conference in 1944 for reorganising the world economy after the Second World War, the US Head of Delegation, Henry Dexter White, had proposed to task the emerging IMF with guiding a debt workout process and taking it out of the hands of private bondholders. No country, White suggested, should be allowed to default without the approval of the Fund. In return, this multilateral institution would organise a compulsory arbitration process once a default occurs. White argued that this provision would help boost the recovery of international lending after the chaos of the 1930s by creating a more orderly and fair resolution of debt crises. As he put it, »it can hardly be expected that objective decisions on default can be made by the defaulting country or by the country gaining most by continued servicing of a debt. To make what takes on the character of compulsory arbitration in debt adjustment an acceptable and workable in-

50. Quoted from the record of the conference in Helleiner (2008: 5).

51. Regarding the validity of this concern, see box 2 on Indonesia's debt workout on p. 55.

strument, the proposed judgment must be that of a large group of nations, the majority of whom are not directly and immediately affected by the decision. Considerations of the pros and cons of a contemplated default by the Fund would seem to promise that kind of objectivity, and therefore would not be a requirement that would stand in the way of acceptance by any government.«[52]

This impartiality of the emerging IMF (and equally of the World Bank) was, of course, assumed by White long before either of the two institutions could have become a systemically important creditor to indebted sovereigns themselves. The reasons are unknown as to why this proposal by the strong man of the US delegation in the Bretton Woods process was shelved before any statutes of the IMF were brought to a vote. But Helleiner shows clear indications that the key factor was again the unwillingness of the United States to be drawn into private lenders' businesses abroad.

Surprising is the fact that nowhere in the debate about the IMF's own SDRM proposal between 2001 and 2003 was any visible reference made to these early attempts to establish a sovereign debt workout mechanism with the IMF squarely in the middle.

In relation to the modern sovereign debt crisis, it was UNCTAD rather than the IMF that took up the concept of an international insolvency framework for sovereign debtors. In its Trade and Development Reports of 1986 and 1998, it called for the establishment of such a mechanism. In the 1998 report – under the impression of the unfortunate role of the IFI's definitions of debt sustainability under the HIPC-I scheme – UNCTAD included the demand for an independent assessment of debt sustainability »by an independent body not unduly influenced by the interests of creditors« (UNCTAD 1998: XII). However, at the time, the further development of international debt relief mechanisms had already been concentrated in the hands of the World Bank and the IMF. Due to the general loss of influence that UNCTAD suffered following its political flourishing in the late 1970s and 1980s, this proposal also went nowhere.

Among individual states, the only known political initiative had been taken within the Swiss Parliament. Upon request by an MP, the government concluded in the »council of states« that indeed the lack of an orderly workout mechanism was a deficit in international law and that Switzerland would take an initiative to fill it. However, when consulting with other (European) governments, it was concluded that there was no sufficient support and the initiative was shelved.[53]

5.2 Existing Multilateral and National Political Commitments

Since the Swiss initiative in the early 1990s, at present four Northern and one Southern government have expressed their interest in a global debt management reform focussed on the creation of a state insolvency framework.

Norway has taken the lead on some innovative proposals in terms of international debt management, most prominently its practical steps towards the cancellation of its own questionable claims on Southern countries, and the international consultative processes it has launched on illegitimate debt.[54] In relation with these processes, it became clear that in order to reach broader acceptance on issues like illegitimate debt and responsible lending, a reshuffling of decision-making powers in sovereign debt management was necessary. So in October 2009, the re-elected government issued a political declaration (Soria Moria II) in which the government committed to »work for mechanisms to abolish international debts and deal with illegitimate debts [and] a binding international set of regulations for responsible lending.«[55]

In Germany, the centre-right government – which assumed office in November 2009 – confirmed in its coalition treaty that it would work in the coming four years

52. Horsefield (1969), *The International Monetary Fund 1945–1965: Twenty Years of International Monetary Cooperation*, vol. 1, Washington, DC: International Monetary Fund, p. 71, quoted from Helleiner (2008: 9).

53. Ständerat Dokument 92.1072: Einfache Anfrage Gadient vom 19.6.1992: Insolvenzrecht zur Entschuldung reformwilliger Entwicklungsländer.

54. In August 2013, Norway published the first ever creditor claims audit, produced by the international auditing firm Deloitte. See: Deloitte (2013): *Report. Norwegian Debt Audit*.

55. http://arbeiderpartiet.no/Kontakt/Information-in-English/. This part built on the earlier (2005) declaration by the previous government by the same coalition. The 2005 Soria Moria declaration read: »The Government will support the work to set up an international debt settlement court that will hear matters concerning illegitimate debt«; see: http://arbeiderpartiet.no/Kontakt/Information-in-English/The-Soria-Moria-Declaration-on-International-Policy (last accessed on 13.9.2010). These commitments are still standing.

towards the establishment of an international insolvency framework.[56]

The Dutch government considered the necessity for a fair and comprehensive form to overcome debt problems mid-2009. Under the pressure of the global financial crisis, Dutch authorities feared that countries would not be able to comply with the rigid thresholds on new debt established under the DSF and would consequently run into new debt distress. The Dutch were sceptical, however, regarding the setup of any new mechanisms or institutions and suggested instead to consider tasking the PCA in The Hague with the setting up of an additional chamber dealing with sovereign debt issues. The Dutch government decided to start a consultation process with international experts and stakeholders in order to discuss possibilities to establish a debt arbitration chamber at the PCA. Unfortunately, they staffed this experts group with representatives of institutions, which would have the most to lose through a rule-of-law-based reform, specifically the World Bank. Consequently, the final report of that experts group, which was submitted in 2012, came to the conclusion that the establishment of a debt arbitration framework was unnecessary or unfeasible or both.[57]

Upon initiative from civil society, the Swiss parliament started a new initiative to develop a new, genuinely Swiss proposal for an orderly sovereign insolvency framework. The »motion« by the Liberal MP Felix Gutzwiller triggered an extensive consultative process after the first positive reaction by the Administration.[58] As of this writing, the administration has drafted a response, which will be presented to the Parliament (Ständerat) at the end of 2013.

Among Southern (debtor) governments, it was Argentina that took a leading role. On the background of its own protracted crisis history and its many similarities with the Eurozone crisis, the Christina Kirchner administration occasionally advised progressive organisations and the Greek government regarding debt crisis resolution. Early 2012, it convened – together with the World Bank – a major symposium in Buenos Aires, which took stock of reform proposals.[59] Since then, the Argentine government has on several occasions expressed its commitment to a global reform process, without making new proposals of its own.

Among parliaments there were stand-alone decisions by regional parliaments, namely the Andean Parliament and the European Parliament.

The regional parliament of the Andean countries decided in 2003 to work towards the establishment of a new debt workout mechanism based on the respect of human rights and using the instruments of international arbitration.[60]

The European Parliament took the issue up in the context of its resolution »Towards a New Partnership for Sustainable Development«, adopted in 2002,[61] stating that the Parliament:

> 18. Welcomes the proposal in the Monterrey Consensus for an international debt workout mechanism as a first step in the direction of a much needed fair and transparent arbitration procedure for indebted countries and calls on the EU to come forward with a concrete initiative for the Johannesburg Summit (…)

The EP resolution thus reflected the position assumed by the UN system through the Monterrey Consensus at the 2002 Financing for Development Conference in Mexico. This call was reiterated six years later during the FfD follow-up conference in Doha, although in somewhat more vague language, talking about »new debt workout mechanisms« rather than explicitly calling for an independent and transparent arbitration process.[62]

56. See the text and comments by erlassjahr.de at: http://www.erlassjahr.de/blog/2009/10/24/insolvenzverfahren-im-koalitionsvertrag/ (last accessed on 13.9.2010).

57. See: »Arbitration and Sovereign Debt. A Paper presented by the Steering Committee of the Netherlands Government and the Permanent Court of Arbitration.« July 2012.

58. Answer of the Federal Council (Swiss Government) to the postulate of MP Felix Gutzwiller in favour of an insolvency framework for states http://www.parlament.ch/d/suche/seiten/geschaefte.aspx?gesch_id=20114033.

59. »The Missing Link in the International Financial Architecture: Sovereign Debt Restructuring.« Buenos Aires December 7, 2011.

60. Parlamento Andino 2.4.2003: Decisión No. 1045: Endeudamiento Externo de los Paises de la Subregión Andina.

61. European Parliament resolution on the Commission Communication to the European Parliament, the Council, the Economic and Social Committee, and the Committee of the Regions entitled *Towards a Global Partnership for Sustainable Development* (COM(2002) 82– C5-0173/2002 – 2002/2074(COS)) (pp. 18–19) http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P5-TA-2002-0251+0+DOC+XML+V0//EN (last accessed on 13.9.2010).

62. http://daccess-dds-ny.un.org/doc/UNDOC/LTD/N08/630/55/PDF/N0863055.pdf?OpenElement (last accessed on 17.7.2010).

The most recent multilateral proposal was surprisingly raised in the context of the calls for a European Monetary Fund (Gros and Mayer 2010). In their proposal, the authors include the option of an orderly state insolvency as an alternative between constant re-financing and the exclusion from the Eurozone for troubled EU/Eurozone member states. The authors are not entirely specific on the functioning of such a proposal. However, the idea that a straightforward insolvency might be a preferable option over both constant re-financing and political retrogression in the European unification progress has received strong tailwind since its proposal.[63]

In order to have a stronger impact on global sovereign debt management reform than that of a small, though wealthy lender, the Norwegian government decided in 2012 to finance a consultative process, tasked with developing a proposal for a sovereign insolvency framework. To that end, it provided considerable financing to UNCTAD, which allowed this UN body to establish an »experts group« to start working on a proposal in early 2013. The experts selected by the UNCTAD secretariat include renowned academics from the legal and economic fields, practitioners, NGOs (including the author), and international financial institutions, such as the IMF, World Bank, and the Paris Club as observers. The group is supposed to work through a multiyear period.[64]

6. Practical Steps towards Resolving a Sovereign Debt Crisis

In this chapter we look at how governments that fear a situation of debt distress avail themselves of the fair and transparent process outlined above.

In the next three paragraphs, we discuss the legal scope that governments have in order to start an impartial and independent negotiation process. We then outline, in some stylised way, how such a process could be developed step-by-step from the decision-making at the debt management office and cabinet levels for the resumption of payments after an award has been ruled by the arbitration panel. Finally, we consider some of the common counter-arguments against the logic, process, and feasibility of a sovereign debt arbitration process.

6.1 Political and Legal Scope for Debtor Governments

Debt contracts are regularly subject to either the creditors' or an agreed-upon third-country's national laws. Loans from official sources are mostly under the jurisdiction of the lender, while private lenders in most cases prefer New York or London law. In theory, there should be clear and well-defined legal recourse for the parties, once disagreements over payment or non-payment of a sovereign debt arises. However, sovereign debts differ from commercial debts because the sovereign sphere of the debtor, which regularly includes most of its assets, is immune from attachment. This limited impact of normal legal procedures is the basis of the need for negotiated settlements and the bodies that the creditors have organised for the purpose of those negotiations. In that sense, both sides have to strike a balance between the gains they obtain through eventual non-compliance with an agreed or – as in the case of HIPC/ Paris Club – often decreed arrangement and those secured payments it receives through them. With regard to sovereign debt, non-compliance is always an option for all parties. However, this study argues that both the sovereign debtor as well as good faith creditors have the most to win through an impartially facilitated compromise, raising the likelihood that everybody considers the compromise as the best possible deal under the given circumstances as it offers the least incentive for non-compliance.

In this sense, sovereign debt is being dealt with »in the shadow of the law«, and as a matter of principle as well as practice, the debtor has the same rights to organise this negotiation process as his creditors. As we have seen above, such practice on the part of the debtor could as well be codified into soft law or even hard-law procedures as any mechanism designed by the creditors. International law often emerges through state practice being translated into global treaties or conventions**.**

For the envisaged arbitration process, this implies that arbitrators can be nominated freely by the parties based on a mutual agreement regarding number, qualification, and terms of reference for the work of the arbitration

63. So it has been taken up by, among others, German Finance Minister Wolfgang Schäuble in his pro-EMF stance; see: W. Schäuble, Wie Europa gestärkt aus der Krise kommt, *FTD* (12.3.2010), p. 26.

64. UNCTAD-Press Release (July 15, 2013): »Sovereign Debt Workout Mechanism First UNCTAD Working Group Meeting: Toward an Incremental Approach.« 2.07.2013.

panel. In practice it would indeed be advisable that legal and economic experts be nominated by the parties, who, if possible, would count on experience with sovereign debt management. That is the logic behind the suggestions by Kargman and Paulus to set up a kind of pool of arbitrators in order to facilitate institutional continuity and coherence between various cases. However, there is no legal restriction against the parties dealing with the question of nomination of arbitrators as they deem best.

The award of an arbitration panel, in turn, would build its enforceability on two pillars:

- one is the New York Convention on the Recognition of Foreign Arbitral Awards, which in a great number of cases would allow national courts to turn down requests by dissenting creditors once an arbitration award has been made;

- the second is that the process be inclusive and fair to all parties from the outset, which would most likely restrict the number of holdouts and dissenting creditors in general to fairly small numbers, which could then rather easily be dealt with by legal or political means.[65]

6.2 A Step-by-Step Guide to a Fair and Transparent Debt Workout Procedure

It is assumed the Ministry of Finance of a country X[66] that requires a comprehensive solution to a looming or an acute sovereign debt problem seeks to find a fair and comprehensive solution through an ad-hoc arbitration as outlined above. The individual steps to such a solution would include the following.[67]

1. The Ministry of Finance will realistically assess the sustainability of the country's sovereign debt, normally through the expertise of its Debt Management Office (DMO), and conclude that negotiations with creditors need to be called for. Another reason to start the negotiation process may be serious questions about the legitimacy of individual claims or entire portfolios by individual creditors. As the questionable legitimacy of individual claims normally should be negotiated individually with the creditor concerned and not with the whole creditor community in a comprehensive process, this brief outline assumes the unsustainability of the debt to be the problem that triggers the process – and not the issue of legitimacy. But in that type of process, concerns over debt legitimacy can, of course, also arise and be dealt with by the arbitration panel (see step 9 below).

2. The Ministry of Finance notifies all creditors – as far as it can identify them – of the general stay of payments. If the country is not a »pioneering« case, a small secretariat for technical support to sovereign debt arbitration will already be established within the UN system or elsewhere. In that case the secretariat is informed at the same time. The ministry immediately ceases to make any payment to any of the country's long-term creditors. This is essential in order to assure all creditors that there will be no asset-grabbing permitted on the part of any creditor, and so there is no need for any one of them to take the country to court. The ministry may decide to make token payments, covering a part of the originally scheduled debt service to a fiduciary account, in order to underline its willingness to negotiate in good faith.

3. The Ministry of Finance contacts individual creditors whom it assumes to be politically supportive towards a restoration of debt sustainability, even at the price of a loss of some of their own claims. These should normally be creditor governments with whom the country has particularly friendly relations. It may also be multilateral development banks with a prominent role in the country, or even private lenders who intend to maintain their long-term engagement in the country. The ministry must never seek their support by promising better individual treatment, as this would contradict the principle of equal treatment, which is essential for a bona fide negotiation process. Ultimately, assigning haircuts to individual creditors would be in the hands of the arbitration panel anyway. In principle the broader and more diverse the »friends of country X« group is, the better this is for a smooth negotiation process. The first and most prominent role of the »friends« group would be to coordinate the creditor side in the arbitration process as much as possible.

65. Given the overwhelming rejection of the »vulture fund« business model, as expressed repeatedly by the G8 and in the respective chapters of the various HIPC *Status of Implementation* reports by the IDA and IMF.

66. For an illustration of the stylised process in the concrete case of country Z, see Rehbein (2012) on Zimbabwe.

67. Much of the advice that Debt Relief International provides for negotiations in the contexts of traditional creditor-driven negotiations is also technically relevant for negotiations under an insolvency framework. See: Gueye, Vaugeois, Martin, and Johnson (2007).

4. The Ministry of Finance nominates two (alternatively one or three, but two should in general be sufficient and workable) arbitrators. It chooses personalities in whose professional skills and personal integrity it fully trusts, but who are in no way dependent on the government, or with whom the debtor state has any professional or contractual relationship. While nationals of the debtor country are not ruled out for the arbitrator's role, it may be advisable to prefer nationals of other countries. The ministry nominates one of the selected persons as acting chair of the panel. The acting chair's only function is to facilitate the first meeting of the full panel after the creditors have elected their arbitrators. In that session the elected arbitrators elect a fifth (third, seventh) arbitrator, who will then assume the function of chairperson (see step 6 below).

5. The Ministry of Finance needs to be prepared to cover the costs for the negotiation process, as far as this is not already provided by the secretariat. If necessary, the debtor government may ask the »friends« group for support. It should be kept in mind that assuming the costs for the process, which will probably be insignificant compared to the debt at stake, sends a strong signal of a bona fide attitude from the debtor's end to creditors at a fairly critical stage of the process, that is, at a time when they have to be organised in a single negotiation process covering various corners of the world, and as a group that has never acted as an entity before.

6. The Ministry of Finance calls upon creditors to nominate the same number of arbitrators as it has already nominated. Nominees are referred to the persons who have already been nominated, and a draft time schedule for the work of the negotiation panel is suggested. In order to contact the probably quite dispersed creditors, the ministry will build on the support of the »friends« group. Alternatively, creditors should be contacted through relevant global associations: the Paris Club secretariat for official bilaterals; the Institute of International Finance for the money centre banks; and the Trade Association for Emerging Markets (EMTA) as well as other bondholder associations. Multilateral lenders are limited in numbers and can be contacted directly.[68] It is advisable to be flexible regarding the timing and organisation of the process on the creditors' side. As the whole process starts up under the full stay of payments, the MF can trust that creditors will not intentionally delay the process but rather work to get their acts together as quickly as possible.

7. The Ministry of Finance suggests an institution that could undertake an impartial assessment of the country's debt sustainability. However, the ultimate choice is with the arbitration panel.

8. The full arbitration panel starts its work. This should normally happen in the debtor's capital city. Alternatively, a venue can be chosen on the basis of convenience for the arbitrators, for example if all are from the same continent, in order to minimise their efforts in terms of time and travel, or in relation with the secretariat, if it already exists.

9. The Ministry of Finance prepares the verification of claims process. This is not novel. Paris Club negotiations also start with a conciliation of data brought forward by the debtor and creditor sides. The difference is that this time the verification is also the moment to question the validity and legitimacy of individual claims before the independent arbitration panel. The process will consist of panel hearing arguments against the validity and legitimacy of claims, consider them, and either reject them as obviously unfounded (which would still leave the panel with the task of reconciling eventually diverging data), or keeping them for consideration during the process, which would normally imply listening to the creditors opinions and raising them with stakeholders (see next point below), as well as conducting/commissioning further research.

10. The Ministry of Finance suggests a sustainable debt level. While doing so, it will insist on the government's responsibility to fulfil obligations with internationally agreed development goals such as the Millennium Development Goals (MDGs).[69] There are several approaches to define debt sustainability in the light of MDG financing needs.[70] Safeguarding essential spending from attachments by creditors is a principle not only in corporate and

68. This goes for official bilateral lenders as well. However, it may still be advisable to contact them through the Paris Club in order to signal the transparency of the process, that is, that the debtor country is not intending to make any side deals with any individual creditor.

69. In September 2005 then UN Secretary General Kofi Annan called for a re-consideration of the debt sustainability concept, suggesting it should be »redefined as the level of debt that allows a country to achieve the MDGs and to reach 2015 without an increase in debt ratios«, Annan (2005).

70. For an overview, see: erlassjahr.de and EURODAD (2006) and Gunter, Rahman, and Shi (2009).

individual insolvencies worldwide but also in Chapter 9 of the US Insolvency Code. Even if the panel will not follow the MF's argumentations *in toto*, it is essential for a sustainable solution that this principle is upheld. Therefore, the governments at large needs to provide as much assurance as possible that eventual savings from debt relief will indeed be spent according to the development priorities.

11. The Ministry of Finance facilitates public hearings about the debt together with the panel. One of the essential features of a municipality's insolvency procedure under Chapter 9 of the US Insolvency Code is the right of all stakeholders to be heard. Besides various sectors of the creditor communities, for which the panel may define a forum for hearing them – either virtually or through a series of key meetings with stakeholders – the most important stakeholder is the populace of the debtor country, which would necessarily be affected by the payment or non-payment of a debt that its government considers as unsustainable. Therefore, the government has a responsibility to make sure that concerns of the populace can be voiced. They may be as diverse as those of recipients of state transfer systems, which might be impaired by a continued servicing of an unsustainable debt on the one end, and local entrepreneurs fearing a credit crunch on the other – if national banks' relations to external creditors are disrupted. Moreover, the constitutional rights of parliaments to be part of the process need to be respected. It should be borne in mind that those processes, possibly through public hearings with representatives of major social organisations, not only serve to accommodate legitimate concerns by those groups. They also have the important function of building internal support for the administration in a complicated conflict with external creditors.

12. The panel gives a final award, taking all aspects of the process into consideration.

13. On the basis of the panel's ruling regarding a debt reduction rate and eventual further decisions regarding special treatment of individual creditors (e.g., on the basis of continued involvement with fresh money), the MF prepares a payment plan and submits it to the panel for verification.

14. Upon the panel's verification of the proposed plan – or an amended version thereof – the Ministry of Finance complies with the award.

In the final paragraphs there is some practical advice regarding the start of a fair and transparent debt workout process for individual countries. We shall first look at institutions that will provide technical as well as political support, complemented by a frequently asked questions section. Finally, there are suggestions for further reading, Internet links for updated information on the state of the global reform debate, and finally contact details of the many institutions referred to in the following paragraphs.

6.3 Political Support for Governments Seeking a Fair and Comprehensive Debt Workout[71]

Many countries have in the past already received technical support in their debt management at large or, more specifically, in the preparation of their negotiations in traditional fora, like the Paris Club. Institutions that have lent their support there will, of course, also be helpful in preparing negotiations in a new and more balanced framework. Likewise, an international insolvency process will also require diligent preparation on the part of the debtor country – their support can be essential to produce the best possible results. The two most important organisations in this category are:

- UNCTAD/DMFAS (Debt Management and Financial Analysis Software; the support unit of the United Nations Conference on Trade and Development). DMFAS provides software, software support, and consultancy on technical debt management issues;

- Debt Relief International (DRI) is an international NGO funded by several creditor governments and provides technical debt management support, particularly to low-income countries during their debt negotiations in the Paris Club as well as the broader HIPC process. In large parts, DRI works through regional affiliates in Africa and Latin America. Moreover, DRI coordinates the joint positioning of HIPC Finance Ministers during World Bank/IMF annual meetings and supports them in defining joint positions at other global events.

71. All contact details for institutions referenced here can be found in chapter 7 (relevant Internet links).

Additionally in the UN family, the UNDP's Bureau for Development Policy (BDP) has been working on the linkage between MDG attainment and debt sustainability. When it comes to defining the need for debt reduction along the principles of an international insolvency framework, this link can be of crucial importance. The UNDP-BDP can be approached for advice in this particular field of expertise.

Political support beyond technical advice in individual cases can be expected from governments that have expressed their support for a global reform process.

The governments of Norway and Germany have committed to work towards a reform of international debt management. Both have strong and long-standing bilateral relations with many countries in the global South and can be approached through their development ministries for support in a comprehensive debt workout process. In both cases, support may be provided directly or through specialised agencies that have expertise in the field of debt management or development policy at large. More important than the technical help may, however, be the political support in international fora as well as the facilitation of contacts to other creditors through institutions like the OECD, Paris Club, and the European Union among others.

Finally, governments may wish to avail themselves of the support of NGOs and academics who have specialisation in the field.

Among NGOs, the major reference points are the continental networks of NGOs working on debt and development: AFRODAD based in Harare, Zimbabwe; LATINDADD with its secretariat in Lima, Peru; and EURODAD, based in Brussels, Belgium. Each of these networks will provide contacts to relevant NGOs in the region or even in the country itself, as well as contacts to NGOs in major creditor countries that may support initial contacts to relevant governmental entities, support demands for a fair and transparent debt workout through media work, and help with contacts to parliamentarians and other influential groups in the creditor countries.

Depending on where the most important creditors of an individual debtor country are based, NGO networks can also help with contacts to colleagues in countries not specifically listed in this short guide, like JubileeUSA or JubileeAustralia.

Relevant academics to contact may include those who have been working in the macroeconomic field, for example, analysis of debt sustainability issues, alternative definitions of debt sustainability, tackling questions of debt legitimacy, among other topics. Additionally, legal experts can be asked for advice in securing the broader participation of creditors in a debt workout process and in making a negotiation process litigation-proof.[72] So far, the potential for cooperation among academic experts and debtor country authorities has not always been used to its full potential.

6.4 Dealing with Arguments against an International Insolvency Framework

In the following paragraphs, we take a closer look at the most common questions raised against the need and the opportunities for an international insolvency framework in the last few years. Most of the points discussed here have already been mentioned in earlier parts of this study in one way or another. So the purpose of this part is to provide a quick overview of common arguments against an international insolvency framework and how they have been dealt with in the global reform debate.

Argument:
Insolvency is for firms; for countries it is not applicable, as countries are sovereign.

Response:
If one considers the common perception of corporate or individual insolvency, this is legally right. But that is precisely why Chapter 9 of the US Insolvency Code is proposed as a model. Chapter 9 has been designed and implemented in order to deal with the specific opportunities and constraints that debtors with governmental powers are facing. All its principles can and should be applied internationally.

Argument:
»International law knows no bailiff« – arbitration cannot be enforced.

72. Litigation refers to the business model of vulture funds; see fn 21 above.

Response:
Right – there is none. But this is so in all arbitration cases, including those that are unrelated to debt. Still, arbitration works fairly well in international disputes and as a settling mechanism in the framework of international bodies like the WTO. In all these cases, absence of formal enforcement is of no concern. The same is true for existing agreements on debt, for example, with the Paris Club. Agreements between countries and their creditors cannot be enforced in the same way as treaties between individuals within a country. The only reason sovereign countries have to honour international agreements like those over debt payments is that they consider the gains – political, as well as economic – to be greater than the losses they would incur by running into conflict with those they have seen at the negotiation table.
Regarding this fundamental weakness of international relations, an arbitration procedure is formally neither better nor worse than the existing creditor-dominated procedures. In practice, the fact that agreements have been reached with broader participation of all parties involved tends to rather bring about better and more sustainable results. Nobody proposes to do away with the Paris and London Clubs simply for being unable to enforce compliance by sovereign debtors. Paris Club rulings, in fact, happen to be disregarded by individual creditors or debtors. One reason for this is that usually only a selection of a country's sovereign creditors is involved in working out the Paris Club arrangement – normally the OECD countries, which also happen to be members of the Paris Club. Other creditor nations – be they emerging economies or HIPCs themselves – often see no reason to grant relief to a debtor because an agreement has been set up in which they have no influence. This is even more the case for private creditors, whom Paris Club members try to involve through »equal treatment clauses«, which state that a private creditor has to grant the debtor comparable terms to those agreed upon by the Club. Especially at times where private flows to the global South are up to nine times the volume of public flows, private creditors tend to accept this kind of tutelage even less. In contrast, an agreement that has been worked out with the participation of all parties involved has a much better chance to be honoured by all stakeholders.

Argument:
Countries will never receive any new loans after an insolvency/arbitration procedure; they will effectively exclude themselves from capital markets.

Response:
If that were true, no reorganised company could ever get any new loans – which is manifestly wrong, as daily experience shows. It is also wrong for sovereign borrowers: Indonesia was granted a reduction of its debts in its de-facto insolvency in 1969 (see box 2 on p 55). In the mid-1970s it had the »Pertamina« (the country's parastatal oil company) crisis because the public sector had again been able to over-borrow.
Moreover, investors make their decisions first of all by considering the probability of repayment in the future. The debtor's track record regarding the servicing of past loan contracts is one, but by far not the most important, aspect they take into account.
On the other hand, they logically see future repayment prospects improved, once they can be sure that the debtor will not have to use parts of the hard currency they bring in for servicing old failed or unprofitable investments.

Argument:
A new international bureaucracy would have to be created in order to deal with insolvency procedures.

Response:
It is important to stress that an international Chapter 9 insolvency procedure would not at all need a new international organisation, nor a costly bureaucracy. Arbitration panels are temporary. Once the task of starting a workable composition plan is achieved, the panel can be dissolved. If further disagreements should develop later on, the same persons (or, if necessary, other arbitrators) could reconvene again to solve them. Theoretically, not even an international treaty establishing international insolvency proceedings ratified by all (or the most relevant) creditor nations would be needed as long as all (or the most relevant) creditors are determined to solve the problem. Practically, though, an international treaty would certainly be helpful.
What about the technical personnel necessary for an arbitration? Both creditors and debtors employ qualified personnel managing re-schedulings or other debt-related issues. In an international Chapter 9 procedure, these people would simply do what they have done so far: negotiate and argue their points. But now they would do so before the arbitrators instead of among themselves, with the ultimate decision-making power in the hands of one party, namely the creditors. As the panel comprises three or five arbitrators plus perhaps the same number

of secretarial and technical staff per case, one can hardly speak of a huge international bureaucracy, even considering that there could be quite a few cases due to the backlog accumulated. In the case of the WTO (which has permanent staff), this concern about new bureaucracies was not voiced at all.

Should ad-hoc arbitration develop later on into a standing international insolvency court (which would have many advantages), this might indeed imply the creation of a new institution. However, in relation to its importance, this could be an equally slim structure, much like the ad-hoc panels described above. And existing institutions like the Paris Club, the London Clubs, and the debt management departments of the World Bank and the IMF, which then would in part become redundant, are by no means cost-free.

Argument:
Countries will tend to borrow irresponsibly once they do not face the uncomfortable prospect of having to see the Paris Club in case of default.

Response:
Under an arbitration procedure, debtors would still face extensive investigations into their assets as well as into their past lending and governance practices. This would take place under public surveillance, which would enforce rather more than less discipline on debtor governments and civil servants.
However, the disciplinary effect of existing mechanisms has been extremely one-sided. In reality, bad borrowing necessarily implies bad lending and this, in turn, presupposes that there is a bad lender. The need for enforcing discipline not only on the borrowing but also on the lending side has never been taken into account in existing frameworks. History reveals that the deterring effect of existing mechanisms against bad borrowing has been minimal in the past. Corrupt and oppressive rulers hardly consider long-term repayment or renegotiation aspects when taking out loans for their immediate needs. In contrast again, creditors who in the 1970s handed out »petro-« and »metrodollars« in large amounts without asking questions would have thought twice had they faced questions about future defaults.

Argument:
Instead of inventing completely new mechanisms, one should better improve the existing ones. In fact HIPC is already taking a lot of the insolvency/arbitration elements on board.

Response:
This latter assertion is quite far from the reality of HIPC's situation. Out of the four basic principles of an international insolvency procedure, HIPC contains only trace elements of one: there is no independent decision-making, no hearing of all stakeholders before a decision on debt relief is made, and the procedure – though it is pretended to be so occasionally – is not comprehensive. The only element of an insolvency procedure that HIPC has a certain right to claim it honours is the protection of the basic needs of an indebted country through debt relief. However, the expectations for »debt sustainability« that have been suggested throughout the scheme's history were at first so unrealistically high that some countries even paid more after they were »relieved« from their debt burden than they did before. Only through the addition of the MDRI relief scheme could this defect be largely fixed.
This obvious failure is not by chance. It mirrors the fundamental defect that a sustainable solution in a conflict cannot simply be achieved if one of the two parties is a judge in its own cause. Therefore, a »reformed Paris Club« would be no solution. A creditors' cartel can, in the best of all cases, act benevolently towards a debtor. It can never do justice. This is why impartiality is one of the key elements of the rule of law.

Argument:
We never did it that way…

Response:
Not totally right. When Indonesia was at the brink of default in 1969 and the Paris Club was lacking the instruments and procedures to relieve the country of some unbearable payments – but at the same time had a strong interest to stabilise a pro-Western regime in a strategically important corner of the world – Club members did not lack imagination in finding a solution. The Club contracted an experienced banker to work out a compromise that was coherent (even including the Soviet Union, which happened to be an important creditor to Indonesia) and acceptable to everyone. The »mediator« came up with a solution that actually neglected essential principles of the Paris Club at the time. In the end he was able to convince all parties to accept a nearly total write-off of interest on past claims. Though this »mediation« was not an arbitration in the strict sense of the word, it contained

a lot of its basic elements, and highlighted the superiority of negotiated solutions over those enforced by creditors (see also box 3, p. 26).

Selected Bibliography and Internet Links

A great number of publications has been issued since the outbreak of the modern debt crisis. The following list features just some of the most important contributions. Further reading can be found in the literature lists of the papers presented here. Current new contributions can also be found at links to the websites named in the second part of this service section.

The basic introductory papers into the concept of ad-hoc arbitration and the idea of international insolvency courts, respectively, are:

Raffer (1990), whose paper basically introduced the proposal for an ad-hoc arbitration panel based on the principles of Chapter 9 of the US Insolvency Code;

AFRODAD (2002): The efficacy of Establishing an International Arbitration Court for Debt; Technical Paper No. 1/2002; (calls for the establishment of a sovereign debt arbitration court through a treaty);

Kargman and Paulus (2008) is the most recent proposal for a more institutionalised court to deal with international debt. This latter has also been advocated in the first proposal coming out of the global South: **Acosta and Ugarteche** (2003); and the updated version of the proposal by the same authors in **Acosta and Ugarteche** (2007).

Chapter 9 of the US Insolvency Code is briefly explained in: http://en.wikipedia.org/wiki/Chapter_9,_Title_11,_United_States_Code

A good summary of the history of proposals for a debt management reform can be found in **Helleiner** (2008) and the most recent overview paper on the state of the discussion is **Buckley** (2009).

A useful guide regarding the technical implications of debt management through existing fora is provided by **Gueye et al.** (2007).

The broad principles of a fair and transparent debt workout procedure from a civil society perspective are summarised in **EURODAD** (2009).

The most important statements calling for a fair and transparent debt workout mechanism from the floor of the United Nations have been:

UNCTAD (1986): *Trade and Development Report 1986.*

UNCTAD (1998): *Trade and Development Report 1998*.

Annan (2005): *In Larger Freedom*. New York: United Nations, September.

The Commission of Experts on the Reform of the International Financial System (2009): Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System. New York: United Nations.

Relevant INTERNET-Links

NGO networks:
http://www.erlassjahr.de
http://www.eurodad.org
http://www.latindadd.org
http://www.afrodad.org

UN Institutions:
http://r0.unctad.org/dmfas/
http://www.uncitral.org/
International Curt of Arbitration at the International Chamber of Commerce in France:
http://www.iccwbo.org/court/
Permanent Court of Arbitration (The Hague, Netherlands):
http://www.pca-cpa.org/

Academics:
http://homepage.univie.ac.at/Kunibert.Raffer/
International Consultants on Debt Management:
http://www.hipc-cbp.org
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Glossary

Agreed Minutes: Final result of a negotiation round in the Paris Club. They need to be »translated into binding bilateral agreements with each participating creditor.«

Brady Plan: Debt exchange agreement in the 1990s, organised by then US Treasury Secretary Nicholas Brady. Through the Brady Plan debtor countries obtained a limited cancellation of their external debt owed to private banks. The remaining debt in return was collateralised through US Treasury Zero Bonds.

Completion Point: The moment in time when the debt relief provided under the HIPC initiative is irrevocably cancelled.

Country Policy and Institutional Assessment (CPIA): Comprehensive set of indicators through which the World Bank assesses the strengths of a country's institutions and its economic policies. The CPIA serves to define countries' capacities to take out and subsequently service debt.

Debt Distress: The IMF considers a country to be in debt distress if it builds up payment arrears over a protracted period of time.

Debt Indicators: The most important debt indicators are debt stock as compared to GNI (EDT/GNI), debt stock as compared to annual export earnings (EDT/XGS), and annual debt service as compared to annual export income (TDS/XGS).

Debt Sustainability: According to the International Financial Institutions, a country's public and/or external debt is sustainable if the country can service it without building up protracted arrears. Others define debt more ambitiously: Former UN Secretary-General Kofi Annan suggested to redefining debt as a level of external debt that allows a country to comply with its multilaterally agreed development commitments.

Debt Sustainability Framework: A set of rules and thresholds through which the Bank and the Fund assess whether a country's debt is sustainable as defined by its institutional and political strength. An unsustainable debt burden may lead to reductions in the disbursement of multilateral funding.

Debt Swap: Exchange of existing debt against new debt, regularly at more favourable conditions in order to provides debt relief. Debt can also be swapped against new types of financial or even political commitments, such as financing of development projects, agreed with the original creditor.

Debt Workout: Agreement between a debtor country and its external creditors in order to relieve the debt to a sustainable level.

De minimis: Describes a minimum level of claims on a debtor. Only claims that exceed this threshold are included in the negotiated re-scheduling agreement, while claims below the thresholds are to be serviced in full. The purpose of defining a de minimis threshold is to avoid the necessity of negotiating and seeking agreement on claims that in effect have no measurable influence on the restoration of debt sustainability. The Paris Club traditionally works with de-minimis thresholds of 500 000 or 1 million US dollars.

Haircut: A common expression for the reduction of a creditor's claim, either through a reduction of the nominal value or a softening of interest and repayment terms.

Holdout: A holdout is a creditor who refuses to participate in a debt re-scheduling agreement negotiated with all or a majority of fellow creditors to a sovereign debtor.

Naples Terms: Debt relief terms defined by the Paris Club in 1994. Naples Terms allowed for the first time a (two-thirds) reduction of a country's debt stock (as opposed to debt service reduction, which was exclusively granted before). Naples Terms were enhanced to »**Lyon Terms**« (reduction of up to 80 per cent from 1998), and »**Cologne Terms**« (up to 90 per cent from 1999 onwards).

Vulture Fund: A vulture fund is an investment fund that buys distressed debt with a huge discount on the secondary market. After the indebted sovereign's ability to service debt has been restored through debt relief by other creditors, the vulture sues for full payment plus interest, compound interest, and eventual penalties. In some cases, vultures' profits have been beyond 200 per cent of the invested capital. In other cases, they have been unable to attach any debtor assets. However, the major of problems concern the disruption of the debtor in becoming a normal participant in international financial markets.

List of Abbreviations

ADR	Alternative Dispute Resolution mechanisms
AfDF	African Development Fund
BDP	Bureau for Development Policy
BWI	Bretton Woods Institutions
CAC	Collective action clauses
CPIA	Country Policy and Institutional Assessment
DMFAS	Debt Management and Financial Analysis Software
DMO	Debt Management Office
DRI	Debt Relief International
DSA	Debt sustainability analyses
DSF	Debt Sustainability Framework
ECA	Export credit agencies
EMTA	Emerging Markets Trade Association
FDI	Foreign direct investment
FfD	Financing for Development
FSO	Fund for Special Operations
FTAP	Fair and Transparent Arbitration Process
IDA	International Development Association
IDB	Inter-American Development Bank
IFI	International financial institutions
IMF	International Monetary Fund
KfW	Kreditanstalt für Wiederaufbau
MDG	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
ODA	Official development aid
PBA	Performance-based allocation
PCA	Permanent Court of Arbitration
PRSP	Poverty Reduction Strategy Paper
SDDRF	Sovereign Debt Dispute Resolution Forum
SDRM	Sovereign Debt Restructuring Mechanism
SG	UN Secretary-General
TIADS	Tribunal Internacional de Arbitraje sobre Deuda Soberana
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development

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