

FINDING REAL SOLUTIONS TO UNSUSTAINABLE DEBT:

A Comparative Analysis of the
IMF's Sovereign Debt Restructuring Mechanism
and the
Fair and Transparent Arbitration Process

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EXECUTIVE SUMMARY

International debt management since the 1980's has been characterized by fragmented and inadequate efforts on the part of creditors to restructure or reduce debt, resulting in increasingly unpayable debt burdens in developing countries. A renewed sense of urgency amongst creditors has resulted in calls for new measures, driven by factors including: recurrent financial crises resulting in sovereign default or near default, increasingly large and ineffective official sector "bail outs" of private creditors and the rise in influence of minority creditor and their claims against sovereigns.

The International Monetary Fund's Sovereign Debt Restructuring Mechanism (SDRM) proposal aims to internationalize insolvency proceedings by creating a mechanism to allow private creditors to negotiate a restructuring arrangement with a debtor government that is insolvent or approaching insolvency. By establishing a framework for debt workout, the proposal is designed "to facilitate the orderly, predictable and rapid restructuring of unsustainable sovereign debt while protecting asset values and creditors rights". With the SDRM proposal, the IMF is attempting to both "safeguard its resources" and regain international credibility by re-positioning itself in international debt management.

The response to the SDRM proposal has been largely critical. The private sector strongly opposes the "radical plan promoted by the IMF" and is particularly resentful of the IMF exempting its debt from any restructuring negotiation. France has offered an alternative "Trichet" proposal, which responds to the shortcomings in private sector proposals and the political barriers associated with the SDRM. The response of civil society has become uniformly negative as the SDRM proposal has evolved.

The SDRM does not offer an acceptable solution to the external debt burden faced by insolvent middle-income countries. Rather than benefiting from the lessons learned in the flawed Heavily Indebted Poor Countries (HIPC) initiative, the IMF has effectively created a copy of it with the SDRM – a "Massively Indebted Middle Income Country" (MIMIC) initiative.

The SDRM mimics the HIPC initiative with additional provisions that further weaken debtor interests and enhance the authority of the IMF acting on behalf of private sector creditors. The SDRM:

- **Is biased towards creditors** in violation of the concepts of fair and impartial treatment to achieve a just and viable solution. The SDRM does not aim to cancel the debt in the interest of a sustainable exit from debt for the debtor, but merely to restructure in the interests of creditors;
- **Exempts the IMF and World Bank from the restructuring process** claiming "preferred creditor" status thus creating unequal burden-sharing between creditors and the resultant inability to achieve a comprehensive solution. The IMF is the very "rogue creditor" a viable debt restructuring mechanism would address;
- **Requires that all participant countries adhere to IMF-imposed structural adjustment** policies as a condition of debt restructuring. These same fiscal,

- monetary and exchange rate policy conditions have contributed to declining debtor economic and social viability;
- **Effectively concedes to the IMF the role of determining what level of debt will be deemed “sustainable”.** Under the HIPC initiative, the IMF has been widely criticized for overestimating the debt load a country is capable of carrying in order to minimize creditor costs to cancel debt;
 - **Effectively requires the surrendering of democratic decision-making** by the debtor as IMF prescriptions for debtor economic restructuring are not negotiable.
 - **Fails to recognize or address the illegitimacy of debts** and therefore the responsibility of creditors who lend imprudently and the right of citizens to refuse to pay illicit loans;
 - **Provides no provisions to protect domestic budgetary resources for the poor,** nor any discussion of the criteria for determining a sustainable debt load post restructuring;
 - **Fails to engage the public on whose behalf debt was contracted** in any aspects of the SDRM and its proceedings or to guarantee basic budget protection.
 - **Seeks to re-legitimize and expand the influence of the IMF in global economic financial governance** through changes to the IMF’s Articles of Agreement creating a new legal entity and expanded conditionality requirements.

As the world staggers between financial crises, amid the social wreckage of crippling sovereign debt loads, the establishment of a procedure to address the insolvency of middle-income countries in an equitable, independent and comprehensive manner has become a global imperative.

The proposed Fair and Transparent Arbitration Process (FTAP) provides a neutral forum for the resolution of insolvency that respects and balances the rights of debtor and creditor. Only a neutral body, independent of the IMF, can address the significant geopolitical power imbalances between creditors and debtors that have led to failed debt reduction programmes in the past. The FTAP includes “debtor protection”, a legally binding commitment to secure basic needs of citizens before creditor claims. Creditor interests would be addressed only after the fundamental human rights of people in debtor nations are assured.

The FTAP is designed to introduce discipline into international financial markets, which have been lending excessively and unwisely for decades, through the re-introduction of democratic principles into international capital markets. It aims for a comprehensive solution to insolvency and is therefore inclusive of all forms of debt – private sector, bilateral and multilateral. The FTAP would effectively reduce the role for the IMF in international debt management and avoid the conflict of interest inherent in the SDRM.

The FTAP offers equal and comprehensive treatment, impartial arbitration, treatment of illegitimate debt and a commitment to debtor viability. It ensures basic protection of human rights and human dignity. The FTAP seeks to transform the existing unjust balance of power between international finance and debtor nations and their people. Meaningful long-term resolution of the global debt crises demands nothing less.

1. INTRODUCTION

International debt management since the 1980's has been characterized by fragmented and inadequate efforts on the part of creditors to restructure or reduce debt, resulting in increasingly unpayable debt burdens in developing countries.

A renewed sense of urgency amongst creditors has resulted in calls for new measures, driven by factors including:

- recurrent financial crises resulting in sovereign default or near default with particular concern over the most recent crisis in Argentina;
- increasingly large and ineffective official sector "bail outs" of private creditors;
- the rise in influence of minority creditors and their claims against sovereigns.

After the Asian financial crisis of 1997-98, G-7 officials debated how to 'involve' the private sector in debt restructurings in order to make private lenders bear some of the costs of the crises they contributed to through overzealous, imprudent lending. G-7 efforts to develop a 'new financial architecture', however, have been unable to prevent or more effectively manage subsequent financial crises. By talking openly about the need for a debt restructuring mechanism, the IMF acknowledges that G-7 led efforts have been, at best, insufficient and that the financial crises witnessed over the last decade in Mexico, South East Asia, Russia and Argentina are likely to continue.

Massive IMF-led bailout loans that nominally go to the governments of heavily indebted middle-income countries but benefit private lenders while leaving countries deeper in debt have been the subject of widespread criticism since the Asian financial crisis. Big bailouts to private creditors increase the risk of moral hazard and not only fail to address the underlying causes of financial crises, but encourage more consequence-free lending.

The increasing size and frequency of bailouts has put financial pressure on limited IMF coffers, further undermining the authority of an institution whose credibility was seriously eroded through its financial mismanagement of the crises economies. According to IMF First Deputy Managing Director, Anne Krueger, "The presence of a formal mechanism that would encourage them to restructure would help convince private institutions that the official sector is not waiting on the sidelines to bail them out when things go wrong."¹ With the SDRM, the IMF is attempting to both "safeguard its resources"² and regain international credibility by re-positioning itself in international debt management.

New factors are also driving the effort to find new international debt management measures. Since the 1980's, the composition of sovereign debt has changed dramatically.

¹ Krueger, Anne (2001) "International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring." Speech to the National Economists' Club, Washington.

² Krueger, Anne (2002A) "A New Approach to Sovereign Debt Restructuring", 21.

Official flows and syndicated bank lending has declined dramatically and sovereigns have come increasingly to rely on a diversity of bond instruments to raise capital.

Creditors are increasingly numerous, anonymous, and aggressive in pursuit of their claims. “Rogue creditors” or “vulture funds” buy up minority stakes in a country’s foreign debt and then take legal action to demand full payment. Such actions may result in the rogue creditors getting paid off first at the expense of the larger creditors. Actions by minority bondholders can also trigger “cross default clauses” forcing the larger creditors to undertake long and costly court battles that might be avoided through a renegotiation process.

The extent to which the “rogue creditor” problem represents a real threat is unclear,³ as only one action has resulted in settlement to date⁴ and it would not likely have survived legal challenge.⁵ The existence of vulture funds and the increasing use of diverse bond issuances, however, have focussed calls for increased inter-creditor coordination in the private sector.

Finally, and perhaps most importantly, pressure from the US administration, increasingly resistant to big bailouts, has hastened the move towards new measures to address unsustainable debt. The IMF Sovereign Debt Restructuring Mechanism proposal was published in April 2001, following closely upon US Treasury Secretary O’Neill’s Congressional testimony expressing the need to develop terms of a global treaty allowing nations to restructure debts more smoothly. The Sept. 27, 2002 communiqué from the G7 Finance Ministers stated they expected to have a concrete proposal from the IMF by April 2003.

2. IMF SOVEREIGN DEBT RESTRUCTURING MECHANISM

The IMF proposal⁶ aims to internationalize insolvency proceedings by creating a mechanism to allow private creditors to negotiate a restructuring arrangement with a debtor government that is insolvent or approaching insolvency. By establishing a framework for debt workout, the proposal is designed “to facilitate the orderly, predictable and rapid restructuring of unsustainable sovereign debt while protecting asset values and creditors rights”.⁷

³ Russia, Pakistan and Ecuador recently restructured claims with little, if any litigation.

⁴ Elliot Associates bought US\$ 20 million of commercial debt guaranteed by Peru and sued for full repayment. In June 2000, it obtained a judgement for \$56 million and an order against Peruvian assets used for commercial activity in the US.

⁵ Krueger, Anne (2001) “International Financial Architecture for 2002: A New Approach to Sovereign Debt Restructuring.” Speech to the National Economists’ Club, Washington.

⁶ As articulated by First Deputy Managing Director Anne Krueger on November 26, 2001 and followed by subsequent elaborations by IMF staff including Krueger (April 2002), IMF (August 2002A) and IMF (November 2002B). Throughout this paper, the IMF proposal will be referred to as a singular concept, with specific references to the various evolutionary aspects as reflected in the papers, recognizing that the proposal remains a work in progress.

⁷ Krueger, Anne (2002A) “A New Approach to Sovereign Debt Restructuring”, p.4.

The SDRM aims to address the “collective action” problem faced by creditors during sovereign debt crises. While it is in the interest of creditors as a group to act collectively to restructure sovereign debt in order to ensure the best settlement for the majority, individual creditors have the incentive to call their loans when they sense financial trouble. These free riders or rogue creditors threaten to create a creditor “stampede to sue” that pits creditor against creditor, blocking any restructuring proposal and gutting debtor assets. The SDRM aims to ensure that all participating creditors are bound by what a super-majority decide in negotiations with the debtor.

The SDRM proposal, modelled after the US Chapter 11 corporate bankruptcy procedures,⁸ would function generally as follows: a middle-income country with a severe debt problem would seek an out-of-court settlement with its private sector creditors through a mechanism created by the IMF. The decision on the terms of restructuring would be in the hands of a qualified majority of creditors (likely 75%) negotiating directly with the debtor. Arrangements resulting from this process would then be binding for all parties, including minority creditors who might refuse to participate. The latter would be prevented from litigating against the debtor in national courts through the new judicial organ created by the IMF, known as the Sovereign Debt Dispute Resolution Forum (SDDRF). Additionally, new bond issues would include collective action clauses to bind in minority creditors and prevent rogue creditor litigation.

The essential elements of the IMF’s SDRM most recent proposal, including institutional framework, legal status, eligibility, steps in the process and unresolved issues are summarized on page 18.

3. RESPONSE TO THE SDRM

The response to the SDRM proposal has been largely critical, resulting in new proposals from the private sector, the French government and non-governmental organizations.

A. Private Sector - SDRM as “Unnecessary and Counter Productive”

The private sector, led by the Institute of International Finance (IIF), an international organization representing the world’s largest banks, securities firms and investment management companies, has labelled the SRDM “an unnecessary and counter-productive mechanism”.⁹ It strongly opposes the “radical plan promoted by the IMF” and is particularly resentful of the IMF exempting its debt from any restructuring negotiation.

The IIF supports a “market-based” approach, which would effectively alter new bond contracts to allow groups representing the majority of the owners of a particular bond

⁸ Unlike a Chapter 11 model, however, there is no provision for an automatic stay on repayments to give debtors breathing room. As with Chapter 11, creditors cannot trigger an insolvency negotiation nor can a sovereign’s assets be liquidated by creditors.

⁹ <http://www.iif.com/press/pressrelease.quagga?id=55> December 17, 2002.

issue to negotiate with the debtor government.¹⁰ Any negotiated agreement would then have to be approved by a supermajority of up to eighty percent of bond owners. Collective action clauses are a device to allow the largest players to negotiate together and use their majority voting power to keep smaller players in line.

Collective action bond clauses (CACs), while a useful instrument and an aspect of both the SDRM and the FTAP proposals, are insufficient to address the problem of either inter-creditor coordination or insolvency. These clauses are not retroactive and will only affect new bond issues, thus the weakness of this approach in addressing the massive stock of pre-existing debt, which is the source of the insolvency problem. Further, each clause would apply to one bond issue only thus creating the problem of aggregation across numerous bond issues. As debt is issued in several legal jurisdictions there are risks of non-uniformity of treatment and the difficulties of cross-jurisdictional coordination. Finally, as the collective-action clauses approach is voluntary, the likelihood of uniform application across issues and around the world is highly unlikely.

In spite of the flaws in this proposal, the influence of the IIF and its members on the US administration has been effective. The US is alone among G7 countries in advocating the exclusive use of collective action clauses in bond contracts and against the creation of a debt workout mechanism. US influence has led to a two-track approach to insolvency and the significant weakening of the SDRM proposal from early drafts. G7 Finance Ministers emerged from their April 2002 meeting with a 2-pronged “action plan” that endorsed both the market-oriented approach (bond clauses) and “further work by the IMF to elaborate on its proposed approaches to sovereign debt restructuring that may require new international treaties, changes in national legislation, or amendments to the Articles of Agreement of the IMF.” The resistance of the European Union to the private sector-led US position resulted in a rift between the US and EU at the IMF Board in December 2002 and the introduction of the French “Trichet” proposal in January 2003.

B. Europe – The French “Trichet” Proposal

The “Trichet” proposal by the Banque de France offers an intermediate approach between the SDRM and CACs. It responds to both the shortcomings in the private sector proposal as noted above and the political barriers resultant from the problems of legality, enforceability and start-up time associated with the SDRM. It does not contradict the use of either CACs or the SDRM but seeks to fill the “present vacuum” and offer stakeholders a “workable way” to move forward.

The proposal calls for a Code of Good Conduct (CGC), a voluntary agreement between debtors and a qualified majority of creditors to negotiate restructuring in good faith. The CGC would be agreed ex-ante and supported by CACs and the use of the SDRM should negotiations fail or rogue creditors refuse to respond to market and peer pressures of the majority creditors. Key provisions include:

¹⁰ IIF. “Sovereign Debt Restructuring”- discussion paper. <http://www.iif.com/data/public/SDRM.pdf>. The paper also proposes the creation of a voluntary international Code of Conduct for crisis management to be applied on a case-by-case basis to guide the behaviour of all parties involved.

- a commitment that the debtors financial situation be preserved and that debt sustainability be restored quickly;
- a concerted stay on payments and litigation;
- the use of a neutral third party as mediator or arbitrator;

The IMF would have a central role in the CGC process and would serve as a catalyst for the designing of the CGC. The IMF would assist in the activation of the mechanism, it would lend into arrears and would be solely responsible for debt sustainability analyses. While not exempting multilateral creditors explicitly, the proposal notes, “ the financing of critical activities might call for the exclusion of some categories of claims from the renegotiation process”.¹¹

The process by which the Code would be drafted and agreed is vague, though the proposal makes no claim to be comprehensive at this stage. It does, however, provide an option to help break the political deadlock in the SDRM debate.

C. Civil Society - a MIMIC of Previous IMF Failures

The response of civil society from around the world, while initially cautiously optimistic, has become uniformly negative as the SDRM proposal has evolved. Support for a equitable and viable debt restructuring mechanism, first developed by Austrian economist Kunnibert Raffer in the early 1980s, has grown. The Fair and Transparent Arbitration Process (FTAP), as it has come to be know, will be profiled in Section 5.

Halifax Initiative, actively engaged in the international debate on debt management since 1995, firmly rejects the SDRM as a viable means to address the insolvency crises of middle-income countries. Halifax Initiative endorses the FTAP and is concerned that the IMF’s SDRM proposal exhibits many common features with another flawed IMF debt initiative, the Heavily Indebted Poor Countries (HIPC) initiative. The SDRM mimics the failing HIPC initiative with disturbing new provisions that further weaken debtor interests and enhance the authority of the IMF acting on behalf of private sector creditors.

The HIPC initiative was launched in 1996 and enhanced in 1999 with a stated goal to provide a “lasting exit” to unsustainable debt burdens for the world's poorest countries. The initiative was a first ever attempt to deal in a comprehensive manner with the debt held by a range of creditors including the IMF and World Bank.

The IMF has admitted, however, that the HIPC initiative will have been a failure for half of the countries it was supposed to benefit for it will not have provided a lasting exist to unsustainable debt. As of September 2002, only 26 out of an original list of 42 countries have even qualified for the enhanced HIPC Initiative. Of those, only six have seen any substantive debt stock reductions, and Uganda, Mauritania and Burkina Faso, for example, still have unsustainable debt levels in spite of HIPC treatment. Thirteen of the remaining 20 countries have had their HIPC debt relief suspended at some point during

¹¹ Banque de France, “Towards a Code of Good Conduct on Sovereign Debt Re-Negotiation”. January 2003. p.9.

2002 because they had failed to adhere to strict IMF and World Bank structural adjustment conditions requirements for privatization, liberalisation and fiscal austerity.

Rather than benefiting from the lessons learned in HIPC, the IMF has effectively created a copy of it with the SDRM – a “**Massively Indebted Middle Income Country**” (MIMIC) initiative. For many of the same reasons, the SDRM is also destined to fail. The IMF’s SDRM proposal is analogous to HIPC in several respects. SDRM:

- **Is biased towards creditors** in violation of the concepts of fair and impartial treatment to achieve a just and viable solution for debtors;
- **Requires that all participant countries adhere to IMF-imposed structural adjustment policies** as a condition of debt restructuring;
- **Effectively concedes to the IMF the role of determining what level of debt will be deemed “sustainable”**. Under the HIPC initiative, the IMF has been widely criticized for overestimating the debt load a country is capable of carrying in order to minimize the creditor costs to cancel debt. Debtor countries have no right to challenge the IMF debt sustainability assessments;
- **Fails to recognize or address the illegitimacy of debts** and therefore the responsibility of creditors who lend imprudently and the right of citizens to refuse to pay illicit loans;
- **Provides no provisions to protect domestic budgetary resources for the poor**, nor any discussion of the criteria for determining a sustainable debt load post restructuring;
- **Will only sanction the write-off of debts that are un-collectable** in the first place at the cost of drastic restructuring of debtors’ economies;
- **Effectively requires the surrendering of democratic decision-making by the debtor** as IMF prescriptions for debtor economic restructuring are not negotiable.

Not only does the SDRM mimic HIPC for the reasons noted above, but it differs in disturbing ways. The SDRM:

- **does not aim to cancel the debt in the interest of a sustainable exit from debt** for the debtor, but merely to restructure “to preserve asset values” in the interests of creditors;
- **Exempts the IMF and World Bank from the restructuring process** claiming “preferred creditor” status thus creating unequal burden-sharing between creditors and the resultant inability to achieve a comprehensive sustainable solution;
- **Seeks to re-legitimize and expand the influence of the IMF in global economic financial governance** through changes to the IMF’s Articles of Agreement creating a new legal entity.

4. FUNDAMENTAL FLAWS IN THE SDRM PROPOSAL

An analysis of several of the fundamental flaws in the SDRM are outlined below.

A. SDRM is Inequitable by Design

The IMF proposal's orientation is explicitly that of the creditors. In a fundamental violation of the rule of law, creditors are plaintiffs, judge and jury in their own case. The SDRM would facilitate an inequitable process of "negotiation" among majority creditors to decide collectively on the terms of any debt restructuring. Creditors will carve up the pie once debtors have disclosed how little of it remains. A negotiation between a group of powerful creditors over the debts of an embattled sovereign is inequitable and unjust by design.

Historically, bilateral or multilateral debt "relief" or "restructuring" measures have been determined by creditors, effectively allowing them to enforce their interests in a mockery of the concepts of justice. Because it is the creditor that determines what a debtor can pay, initiatives controlled by the World Bank and IMF (HIPC) or the G7 (Paris Club) have consistently failed to provide debtors with a meaningful exit from crippling debt burdens. Debt stock reductions or cancellations are simply too small to return a country to viability. Restructuring usually postpones payments rather than substantially writing them off, a process that effectively shuffles deck chairs on the Titanic.

The SDRM, based on the right of creditors to preserve their asset values as a first and defining principle, is equally destined to fail middle-income countries. The failure to aim to give insolvent countries a "fresh start" undermines the very concept of a bankruptcy forum. Insolvent debtors cannot be made viable through a forum with a stated goal of preserving the assets of creditors first.

There is no scope for empowering debtors within the SDRM process beyond the recognition that they could initiate a debt restructuring process either directly or indirectly through the IMF. The extent to which the IMF would approve or certify that a debt problem is sufficiently grave and that debtor adjustment policies sufficiently orthodox to allow debt restructuring negotiations to begin remains under debate. There are no provisions to protect domestic budgetary resources for the poor, nor any discussion of the criteria for determining a sustainable debt load post-restructuring.

The failure to engage the public in debtor countries in any aspects of the SDRM and its proceedings or to guarantee basic budget protection is profoundly anti-democratic. Sovereign debt is treated as privately contracted debt out of view of the citizenry on whose behalf debt was contracted. Under a SDRM, transparency of the process and its outcomes would be guaranteed to creditors only. The participation of debtor government citizens in any aspect of the proceedings would be denied. Access to documents would be forbidden to the public. Only through an annual report would any information about the SDRM be made publicly available.

Transparency by debtors to foreign creditors, however, would be extensive, ensuring that they are informed of the extent to which domestic debt is "taking a haircut". Thus, while claiming that domestic debt is in the hands of domestic courts and not subject to SDRM control, SDRM transparency provisions ensure that negotiations on claims are linked.

Foreign creditors will likely insist that domestic debt will not be favoured in any write-down.

As the SDRM has evolved, concessions to creditors have increased, reflecting the influence of the private sector on the IMF. In a clear concession to wealthy international banks, for example, committees of creditor classes drawn together in negotiating blocks would be funded to participate in the SDRM by a bankrupt or near bankrupt debtor government.¹²

Additionally, the automatic stay in repayments and litigation, a fundamental principle of bankruptcy protection designed to give the debtor breathing room, was dropped in the November 2002 SDRM paper in favour of a complex set of provisions with as yet unclear implications. "Activation would not automatically trigger any suspension of creditor rights. There would be no generalized stay on enforcement and no suspension of contractual provisions, (including provisions relating to the accrual of interest)."¹³ Unlike conventional bankruptcy protection, stays would be selective and subject to creditor approval, interest would continue to accrue after activation of the SDRM, and creditors could seek payments through the courts.

Under a provision known as "hotchpot", creditors can sue for payment but must not receive more than they would have under an SDRM. "... (I)f creditors eventually approved a restructuring agreement under the SDRM, amounts recovered by a creditor through litigation would be deducted from its residual claim under that agreement in a manner that neutralizes any benefits of such litigation vis-a-vis other creditors."¹⁴

The implications of this provision are under debate. While there is no longer any stay on litigation, it appears there is no benefit to litigation either, for litigants will receive no more than they would have under the SDRM, and will "bear the considerable expense of legal action".¹⁵ If however, litigants get more than they would have under the SDRM, the difficulty becomes in retrieving the money. Further, it is unclear whether the ability of courts to set rate precedents will influence the SDRM negotiations or if the legal system will be disinclined to pass judgement while negotiations proceed.

B. SDRM Would Expand the Authority of the IMF

The IMF, through the SDRM, is attempting to consolidate international debt management under its roof in a clear attempt to expand its mandate. Previously, the IMF had no authority in private sector debt coordination initiatives or bilateral restructurings and write-downs, though its influence has always been pervasive. From being one creditor, albeit the most influential one, among many, to being the global institutional home for creditors attempting sovereign debt restructuring constitutes a significant expansion of

¹² IMF (2002B). "The Design of the Sovereign Debt Restructuring Mechanism – Further Considerations" p.44.para164.

¹³ *ibid.* p.9.para.20.

¹⁴ *ibid.*

¹⁵ *ibid.* para 133.p.35

IMF authority. Specific provisions in the SDRM that would consolidate IMF authority in international debt management include:

- the proposed inclusion of bilateral creditors under IMF mechanism in early iterations of the proposal (now under debate);
- IMF control over the administrative body of the SDRM, known as the Sovereign Debt Dispute Resolution Forum (SDDRF) in preliminary versions of the proposal;
- IMF de facto if not legal authority over debt sustainability calculations for non-multilateral debt;
- IMF conditionality expansion further undermining debtor sovereignty.

While the IMF acknowledged that as a creditor, it is not a neutral body, it was only vocal external criticism over perceived IMF conflict of interest that led to the creation of the Sovereign Debt Dispute Resolution Forum at “arms length” from the IMF as the proposal evolved. The IMF’s subsequent emphasis on the development of an elaborate selection and approvals process designed to establish the SDDRF as an “independent, competent and impartial”¹⁶ body masks the forum’s essential powerlessness and reveals the unwillingness of the IMF to cede authority for debt management to any autonomous body.

The IMF alone would approve the candidates to the SDDRF forum, which is an administrative body only, with limited decision-making authority. “The SDDRF would have no authority to challenge decision of the Executive Board, including with regard to the adequacy of a member’s policies or the sustainability of the member’s debt for purposes of Fund financial assistance.”¹⁷ The SDDRF would be funded by and financially accountable to the IMF.

Even prior to the activation of the SDRM, the IMF would influence the terms of any debt restructuring negotiation through its “debt sustainability” calculations – the determination of how much debt a sovereign can bear post-restructuring. The unrealistic projections of economic growth and commodity export earnings used by the IMF and the World Bank to calculate how much debt relief would be needed to achieve “sustainability” have been some of the most enduring criticisms of the HIPC initiative. Unrealistically high calculations of export growth and incorrect assessments of current borrowing practises effectively limit debt reduction, resulting in the failure of debt restructuring measures to return an affected country to viability.

Under the SDRM, the IMF would be responsible for debt sustainability calculations subject to challenge by neither the debtor nor the SDDRF panel. As a “preferred” creditor the IMF will base its calculations on the assumption that debt owed to it would be paid in full and on time, regardless of how the continuation of payments may cripple a debtor’s chances to return to economic viability or how private creditors, about to have their loans written down, protest the injustice. Recent silence from the IMF regarding debt

¹⁶ *ibid.* paras 227, 240.p57,60.

¹⁷ *Ibid.* para 259.p 67.

sustainability calculators and calculations¹⁸ reflects growing discontent among private sector and other creditors regarding IMF conflict of interest and interference.

A third means by which the IMF will both control the SDRM and expand its influence, is through loan conditionality. To “protect creditor interests” and as a condition for debtor participation in the SDRM, the IMF would insist that insolvent countries implement the same fiscal, monetary and exchange rate policy conditions that have contributed to their declining economic and social viability. Additionally, and in what amounts to a new degree of intrusion into domestic sovereignty, the IMF would also insist on further conditions involving “the nature and terms of any domestic bank restructuring, the continued operation of the domestic payments system, the country’s bankruptcy regime and the nature of any exchange controls it imposes.”¹⁹ These conditions would be attached to loans that the debtor would receive during and after the proposed SDRM process.

It is interesting to note, that while conditionality expansion and its inherent intrusion on sovereignty should have debtors enraged, their powerlessness ensures their silence in the SDRM debate. Private sector and bilateral creditors, however, have been vocal opponents of the provisions of the SDRM that would affect their interests. Revisions to Anne Krueger’s original SDRM proposal have responded exclusively to the pressures of creditors anxious to protect their turf.

C. SDRM is Incomprehensive – casts the IMF as “rogue creditor”

Private sector creditors will be the only creditor group subject to the SDRM, as multilateral and bilateral creditors will remain exempt. The IMF retains its status as “preferred creditor” and would continue to receive debt payments ahead of every other creditor.²⁰ Thus, while it oversees the negotiations of private creditors to determine the extent of their losses, the IMF will continue to be paid by the debtor, on time and in full. By exempting itself specifically, the IMF protects its own balance sheets and leverage at the expense of the private sector while claiming to promote the concept of creditor equity. The outrage of private creditors at these terms is only to be expected.

Exempt creditor status, while not enshrined in the founding principles of either the IMF or the World Bank, effectively allows the two institutions to take economic decisions risk-free. IFIs, which exert massive influence on debtor economic policy through loan terms, are not financially responsible for those loans. The IFIs regularly take economic decisions but decline to participate in the risks involved by refusing to accept any losses. Full payment is obligatory, regardless of whether the terms of the loans caused or contributed to the debtors inability to pay. “This perverted incentive system is totally at odds with any market economy - with unsurprising results.”²¹

¹⁸ There is no detail in the IMF’s most recent paper on debt sustainability calculations or responsibilities.

¹⁹ Krueger, Anne (2002A) “A New Approach to Sovereign Debt Restructuring”, 16.

²⁰ *ibid.* 17.

²¹ Raffer, Kunibert (2002) “Sovereign Debt Workout Arrangements” presented at the Alternatives to Neoliberalism Conference sponsored by the New Rules for Global

Regarding bilateral debt, the Paris Club of G7 bilateral creditors has refused to participate²² and the IMF has subsequently proposed to exclude bilateral debt yet have the SDRM take on some coordination and sequencing responsibilities or include bilateral debt as a separate class under the mechanism.²³

History reveals the inadequacies of fragmented approaches to debt rescheduling, reduction and cancellation. The mere fact that more countries are reaching the point of insolvency is testament to the failure of previous initiatives. These programmes, including patchwork debt cancellation and/or debt stock reduction done bilaterally including through the Paris Club of bilateral creditors, the Brady private sector write-downs of the 1980's and the multilateral HIPC initiative noted above, underscore a fundamental coordination problem.

Resources freed-up from one creditor write-down or write-off are used to pay another creditor demanding full payment. The history of debt stock reduction is one of payments shuffling with debtors never emerging from the debt trap. Debt reduction terms are negotiated in secret by the various creditor classes and are arbitrarily determined. Tossed between one set of creditors and the next, most debtor countries are not only deeply frustrated, but still deeply in debt. There can be no “fresh-start” for over-indebted countries when all creditors do not act collectively and comprehensively.

The defining concept of and motivation for a SDRM is that creditor coordination and collective action ensures that all creditors will take their share of the responsibility for insolvency. Unless the burden of providing relief is fully shared, each creditor will have an incentive to hold out in debt negotiations and hope that all other creditors will provide relief. The IMF makes a mockery of its own proposal by exempting itself from it. The IMF is the very “rogue creditor” a viable debt restructuring mechanism would address.

D. SDRM Fails to Address Debt Legitimacy

While the IMF admits that “moral hazard”²⁴ not only exists, but is providing political motivation for both the curtailment of massive bail-out packages and development of the SDRM, it fails to acknowledge the illegitimacy of the loans contracted. If the lending was illicit, how are the loans then good?

The SDRM proposal would not question lender liability or the legitimacy of creditor claims. The SDDRF would only verify creditor claims; it would not, nor could the debtor, challenge and reduce them. While the IMF will likely determine how much of the debt is sustainable, there is no reference to the illegitimacy of debts. By failing to examine and

Finance Coalition, May 23-24.

²² October 2002.

²³ IMF(2002B). “The Design of the Sovereign Debt Restructuring Mechanism – Further Considerations”, p.44, para.164.

²⁴ the tendency of lenders to lend impudently if they perceive they will be bailed out by public authorities in the event of a crisis.

determine the legitimacy of insolvent country debt, the SDRM refuses to acknowledge the responsibility of creditors for reckless lending and the right of citizens to refuse to pay debt incurred illegally.

While the term ‘illegitimate debt’ had not been used in any law or court until a federal judge in Argentina ruled in 2000 that debts contracted during the military dictatorship of 1976-83 were illegitimate,²⁵ the argument that not all debt contracted is debt owed is gaining intellectual and legal credence internationally. A South African reparations case was filed in the eastern district of New York in November 2002, under the Alien Torts Claim Act in the US, against creditor banks for their alleged irresponsible lending which knowingly aided and abetted a murderous regime. Further, the IMF, in its own conference papers, recognized that “a rationale for debt relief is that some debts were illegitimate in the first place.”²⁶

The concept of illegitimate debt is critical for the determination of justice in any debt restructuring initiative for it puts the liability for bad lending back with the creditors, where it belongs. An examination of debt legitimacy calls into question creditor claims that bad debt results from corrupt or incompetent borrower behaviour and challenges the ‘blame the victim’ culture that places creditors above scrutiny.

Creditor malfeasance is evident in debts “contracted against the interests of the population of a state, without its consent and with the full awareness of the creditor”,²⁷ as well as loans with usurious interest rates, no legal, administrative nor economic justification, that violated national law or contained impossible terms. All these debts would be considered valid and payable under the proposed SDRM. Under the SDRM, a debt contracted is a debt owed.

While the classification and determination of the various types of illegitimate debt as well as the determination of appropriate institutional frameworks to address such debt present significant challenges in international law and public policy, the failure to acknowledge creditor culpability will ensure international capital markets continue to lend dubiously and odiously and that no solution to recurrent debt crises is ever found.

²⁵ Argentine federal court Judge Jorge Ballesterro ruled in July 2000, that during the period of military dictatorship the process by which Argentina’s debt grew from 1976 to 1983 did not have legal, administrative nor economic justification. Additional conclusions included: the procedures were discretionary revealing transgressions, irregularities, misconduct and truly illegal acts; public enterprises were obliged to go into debt with private international banks when they did not need financing; public enterprises did not collect a single dollar from their supposed external debt etc.

²⁶ Kremer, Michael and Jayachandran, Seema, “Odious Debt”, paper presented to the Conference on Macroeconomic Policies and Poverty Reduction, IMF, Washington, 4 Mar 2002. <http://www.imf.org/external/NP/Res/seminars/2002/poverty/index.htm> as referenced in Hanlon, Joseph (2002) “Defining illegitimate debt and linking its cancellation to economic justice”, 6.

²⁷ This definition of odious debt is based on a synthesis of legal literature on odious debt yields in: Centre for International Sustainable Development Law. “Advancing the Odious Debt Doctrine”, February 2002.1.

5. THE FAIR AND TRANSPARENT ARBITRATION PROCESS

*“The basic function of any insolvency procedure is the resolution of a conflict between two fundamental legal principles. In a situation of over-indebtedness the right of creditors to interest and repayments collides with the principle recognised generally by all civilised legal systems that no one must be forced to fulfil contracts if that leads to inhumane distress, endangers one’s life or health, or violates human dignity. Briefly put, debtors cannot be forced to starve themselves or their children to be able to pay. Although their claims are recognised as legitimate, insolvency exempts resources from being seized by bona fide creditors. **Human rights and human dignity of debtors are given priority over unconditional repayment.**” (Kunibert Raffer, 2002)*

Based in principle on US Chapter 9 insolvency procedures between a municipality and the private sector, the proposed Fair and Transparent Arbitration Process (FTAP) provides a neutral forum for the resolution of insolvency that respects and balances the rights of debtor and creditor. Whereas the protection of creditors interests is the SDRM’s goal, a “fresh start” for the debtor is the objective of the FTAP.

The proposed FTAP includes “debtor protection”, a legally binding commitment to secure basic needs of citizens before creditor claims. Debtor protection ensures that money to service a country’s debts must not be raised by destroying the debtor’s economic future or basic social services. The FTAP proposal therefore assures “survival with dignity” for debtors and their citizens. It includes re-organization with reasonable prospects of financial stability and economic viability including sufficiency of capital.

Additionally, the right of citizens affected by a debt crisis to have their voices heard in the resolution of that crisis is guaranteed. Recognizing that debt held by a sovereign is debt held by its people, respect for their rights as stakeholders is essential. Citizens have a right to actively participate in, and influence the arbitral tribunal, and to be central to the outcome of its award. Freedom of information and transparency of the process and its outcomes are required to ensure both widespread participation of and accountability to debtor publics.

The FTAP seeks to transform the existing unjust balance of power between international finance and debtor nations and their people, based on the legal precedent of US bankruptcy law. For the first time, creditor interests would be addressed only after the fundamental human rights of people in debtor nations are assured.

The FTAP is fundamentally different from the SDRM, for it does not treat a nation as a collection of assets, but a human society with attendant priorities, needs and rights. By explicitly recognizing the rights of the debtor nation over the rights of corporate creditors, the FTAP affirms democracy over capital. Like the SDRM, the FTAP is designed to introduce discipline into international financial markets, which have been lending excessively and unwisely for decades. Unlike the SDRM, however, it does so through the

re-introduction of democratic principles into international capital markets rather than the withdrawal of public handouts.


The FTAP proposal would function generally as follows: a middle-income country with a severe debt problem would seek an out-of-court settlement with all its creditors through a neutral arbitration process. The decision on the terms of restructuring would be in the hands of the arbiters, which are appointed by both debtor and creditors. Arrangements resulting from this process would then be binding for all parties, including the International Financial Institutions and minority creditors who might refuse to participate. The latter would be prevented from litigating against the debtor in national courts through legislative changes to US and UK bankruptcy laws governing sovereign immunity. Virtually all debt contracts are governed by New York or London law. Additionally, new bond issues would include collective action clauses to bind in minority creditors and prevent rogue creditor litigation.

A short comparative analysis of the FTAP and the SDRM including institutional framework, legal status, eligibility and steps in the process can be found on the following pages. A further elaboration of some of the key elements of the FTAP follows the chart.

COMPARATIVE ANALYSIS – IMF SDRM and FTAP

IMF's Sovereign Debt Restructuring Mechanism Proposal	Fair and Transparent Arbitration Process
<p>Basic Principles:</p> <ul style="list-style-type: none"> • Based in principle on US Chapter 11 insolvency procedures regulates corporate solvency without provisions for automatic stay on payments and enforcement; liquidation of debtor, creditor trigger of proceedings and debtor bankruptcy restraints; • SDRM is designed as a mechanism to overcome inter-creditor coordination issues (vulture funds suing countries for full claims) NOT to free debtors from unpayable debt; • SDRM uses a statutory approach “to facilitate orderly, predictable and rapid restructuring of unsustainable sovereign debt while protecting asset values and creditors rights” if country cannot agree on restructuring with creditors; • Proposal revisions are careful to defer to creditors rights – “Any interference with contractual relations should be limited to those measures that are necessary to resolve the most important collective action problems.”(<i>extent of rights under debate</i>). 	<ul style="list-style-type: none"> • based in principle on US Chapter 9 insolvency procedures between municipalities and private sector including “debtor protection” a legally binding commitment to secure basic needs of citizens before creditor claims; • Assures “survival with dignity” for debtors and their citizens that includes re-organization with reasonable prospects of financial stability and economic viability including sufficiency of capital; • FTAP is designed to address power imbalances between creditors and debtors through independent arbitration independent of the IMF; • Debtors rights take precedence over creditors rights until basic needs addressed then equal treatment;
<p>Institutional Framework:</p> <ul style="list-style-type: none"> • Proposed new institution – the “Sovereign Debt Dispute Resolution Forum”(SDDRF) to be established “at arms length” from IMF created by an amendment to the IMF Articles of Agreement – new institutions would have permanent pool of judges from which a panel selected through IMF (in consultation with private creditors) would be drawn upon for each negotiation. SDDRF would have no authority to challenge IMF decisions on debt sustainability or appropriateness of conditionality. SDDRF Mandate to verify claims, assure the integrity of voting process and adjudicate disputes ONLY; • The extent that IMF serves as “catalyst/gatekeeper” controlling and influencing the process is <i>under debate</i>. IMF insistence that it will mandate the process but not the outcome is belied by IMF authority to determine debt sustainability and therefore when a debtor can trigger the SDRM, enforce structural adjustment conditions, provide and finance the SDDRF Secretariat and approve selection of SDDRF panel. 	<ul style="list-style-type: none"> • Legal housing of independent arbitration panel is still <i>under debate</i>. Proposals include UN department or UN treaty or the International Court of Justice (ICJ) but most agree that an independent ad-hoc mechanism to which both debtors and creditors chose equal numbers of representatives and which is created on a case-by-case basis has sufficient legal status to be effective. No new institution or bureaucracy is required.
<p>Legal Status:</p> <ul style="list-style-type: none"> • Minority creditors legally bound from pressing for full claims through: <ol style="list-style-type: none"> 1. Collective action bond clauses (effective on new debt issues only, problems of non-uniformity of treatment, aggregation, cross jurisdictional coordination); 2. IMF Articles of Agreement amendment to provide “majority action” decisions (75% of major creditors to bind all minority creditors) and new judicial organ (SDDRF noted above) to verify claims or dispute resolution. Change of Articles implies legislative changes in all 184 IMF member countries. 	<ul style="list-style-type: none"> • Minority creditors legally bound from pressing for full claims through: <ol style="list-style-type: none"> 1. Collective action bond clauses (effective on new debt issues only, problems of non-uniformity of treatment, aggregation, cross jurisdictional coordination); 2. Amendments to domestic bankruptcy laws in New York and London to prevent any creditor from claiming immunity once arbitration procedures commence (void of waive of sovereign immunity clauses in debt contracts). Note that virtually all debt contracts are governed by New York or London law.

IMF's Sovereign Debt Restructuring Mechanism Proposal	Fair and Transparent Arbitration Process
<p><u>Eligible Countries:</u></p> <ul style="list-style-type: none"> • Middle-income emerging market countries although potentially also some HIPCs with large private sector debt burdens. 	<ul style="list-style-type: none"> • Middle-income countries only. Jubilee movement demands 100% cancellation of HIPC debt – therefore no FTAP necessary.
<p><u>Eligible Debt / Burdensharing:</u></p> <ul style="list-style-type: none"> • private sector creditors ONLY; • IMF/other multinational claims not subject to the SDRM - “preferred creditor” status; • Paris Club (bilateral creditors) refused to participate in Oct 2002. In response to criticism that the proposed “comprehensive” mechanism was a farce as a result of multilateral and bilateral creditor exclusions, IMF proposes to create a separate creditor class for bilaterals or address coordination and sequencing issues later (<i>under debate</i>); • Domestic debt excluded yet provisions for transparency to foreign creditors ensures that final settlement is contingent on efforts to force domestic creditors to “take a haircut” too; • Hierarchy issue may cause collapse of entire proposal as private sector increasingly dissatisfied with IMF “protecting its own balance sheets.” 	<ul style="list-style-type: none"> • Multilateral (debt to IMF/World Bank and other development banks), bilateral and private debt are all included; • equitable burden-sharing of liabilities between creditor and debtor; • no hierarchy of creditors – equal treatment /co-responsibility; • scope of debt to be dealt is <i>under debate</i> – potentially all debts that affect state budgets or balance of payments. Potential to exclude domestic debt to encourage future growth of domestic financial markets and in recognition of existing national mechanisms to deal with it. • Illegitimate debt to be addressed though means to determine <i>under debate</i>;
<p><u>Public Participation and Transparency</u></p> <ul style="list-style-type: none"> • No engagement of debtor country stakeholders; • Equity and transparency of process to creditors only with possible transparency on final decisions only through publication of annual report. 	<ul style="list-style-type: none"> • Population of the debtor country has a right to be heard by panel; • All decisions of panel made public.
<p><u>Process:</u></p> <ul style="list-style-type: none"> • a NEGOTIATION between a majority of creditors and debtor requiring agreement of a super majority of creditors (75%). Final proposal is voted on by creditors ONLY. • Debtor first attempts debt restructuring negotiations with creditors (non-binding negotiations) prior to activating SDRM; • Only debtor can trigger the SDRM process; • The need for an institutional endorsement of the use of the SDRM and the terms of the stay on debt repayments is <i>under debate</i>. Options include: <ol style="list-style-type: none"> 1. Debtor either unilaterally requests a stay in debt repayments which triggers the SDRM or does so only after consulting with IMF which would offer some form of approval based on its assessment that debt is unsustainable and that new lending unlikely. Whatever the endorsement process, the initial term of standstill may be extended – extension requires 75% creditor approval and assurances of SAP implementation. 2. To satisfy private sector, automatic stay on repayments and litigation has been removed. Creditors can sue for payment but must not receive more than they would have under an SDRM (called “hotchpot”). Selective stay in repayments may result if only if majority creditors approve. Under this model and unlike standard bankruptcy protection, interest would continue to accrue after activation. 	<ul style="list-style-type: none"> • an INDEPENDENT ARBITRATION between super majority of creditors and debtor, the settlement of which will be imposed upon all parties - decision on terms of restructuring in hands of arbiters with no appeals process; • Debtor first attempts debt restructuring negotiations with creditors (non-binding negotiations) prior to activating FTAP; • Only debtor can trigger the FTAP process; • Debtor declares intention to activate FTAP and a stay in debt payments is automatically triggered as result – all external and domestic repayments subject to standstill; • Approval or endorsement of stay by an international body is <i>under debate</i> based on questions associated with legal status/framework – some assert debtor can invoke themselves by depositing demand at UN (Raffer) while others suggest ICJ/other forum must approve – agreement that the IMF is not appropriate entity due to conflict of interest as creditor; • Debtor government is not expected to stop providing essential services for the health, safety and well-being of its people at any time during FTAP or after.

IMF's Sovereign Debt Restructuring Mechanism Proposal	Fair and Transparent Arbitration Process
<p>Process (continued):</p> <ul style="list-style-type: none"> • Creditors including potentially the IMF lend into arrears to ensure debtor has necessary credit to remain viable; • “Provision of seniority” in negotiations for private creditors who continue to lend; • IMF to ensure country conducts policies to “preserve asset values” by imposing economic policy prescriptions throughout entire process. Prescriptions extend beyond fiscal, monetary and exchange rate control and into domestic banking restructuring, domestic payments system operations, the country’s bankruptcy regime and the nature of exchange controls imposed; • IMF-approved temporary exchange controls may or may not be invoked to prevent capital flight; • independent verification of creditors claims (no determination of legitimacy of debt). IMF considers recourse to arbitration but only over accuracy of information provided by debtor. No provisions for consideration of debt legitimacy; • Creditor committees to be established based on credit classes in negotiations. In a concession to bankers, the IMF proposes that the debtor in default or near default pay for the work of committees; • IMF role in assessing debt sustainability <i>under debate</i>. While initially claiming its authority to do assessments, widespread and vocal criticism of the IMF monopoly as well as acknowledged failings with HIPC debt sustainability analyses has led to IMF silence on who will assess and using what criteria; • Termination of SDRM procedure by SDDRF or creditors ONLY. If 10% of outstanding principle isn’t satisfied with negotiations, the entire process could be voted upon. 40% vote in favour would result in termination. Debtor termination discouraged through IMF sanctions (unarticulated); • IMF to approve the entire restructuring agreement reached by majority creditors. No provisions for appeal articulated in proposals. Sanctions for sovereigns include penalties on future use of IMF resources. No sanctions for creditors; • TIMELINE: Article of Agreement changes alone will take 2-3 years contingent upon support of IMF member governments. 	<ul style="list-style-type: none"> • Creditors including potentially the IMF lend into arrears to ensure debtor has necessary credit to remain viable (no IMF SAP conditionality); • “Provision of seniority” in negotiations for creditors who continue to lend; • All other creditors will have payments suspended; • Terms and conditions associated with essential spending for budgetary needs including poverty reduction and governance requirements to be set by panel and overseen by all participants; • Comprehensive capital controls to stem capital flight; • Who will determine legitimacy of debts and by what criteria is <i>under debate</i> - whether and to what extent outstanding debt a product of reckless borrowing/lending by debtor/creditor – some maintain that the FTAP panel is too small/mandate too limited to take on legitimacy questions particularly in light of no agreed international criteria for assessment; • Debt sustainability judged by independent panel allowing for the determination of sustainability in development context – government revenues to be balanced against the financial needs arising from government obligations to finance poverty reduction programmes; • Decision of independent arbitration panel binding on debtor and creditor with no appeals process; • TIMELINE: Ad hoc arbitration panels could be arranged relatively quickly. Provision for longer-term housing of mechanism will require undetermined amount of time.
<p>Text based on: Fritz/Hersel (Aug 2002), Jubilee Research (Feb 2002), IMF - Krueger (April & June 2002), IMF - Boorman (Oct 2002), IMF (Aug 2002), IMF (Nov 2002), Kaiser (June & September 2002 and Jan 2003), Palley (Nov 2002) and Raffer (May and September 2002).</p>	

6. CRITICAL COMPONENTS OF FTAP

A. FTAP is Equitable, Independent and Fair

The equity of the process is the fundamental difference between the SDRM and the FTAP. Insolvency proceedings that can broker and ensure a sustainable, long-term solution to the debt crisis of the middle-income countries demand independent and just institutions and fair settlements. The FTAP provides a neutral third party process, which assumes the co-responsibility of creditors and the debtor government. Only a neutral body, independent of the IMF, can address the significant geo-political power imbalances between creditors and debtors that have led to failed debt reduction programmes in the past.

Arbitration is a streamlined dispute settlement mechanism wherein two parties bring their arguments and evidence before a tribunal which rules on the issues in question. An arbitration proceeding is held by an independent third party and provides a neutral and equitable procedure offering no undue advantage to any party. At the beginning of any arbitration, the conflicting parties agree on a framework of rules that the arbitration proceeding should follow including tribunal membership, timeframe for decision-making and whether an arbitration award will be final and binding. Among the available dispute resolution alternatives to the courts, arbitration is by far the most commonly used internationally and is considered efficient and cost effective.

The setting up of public audits of the sovereign debt, and of hearings related to the debt, would be an integral part of the tribunal's deliberations. The FTAP would provide independent determinations of both outstanding contracts and the debtor's ability to pay as well as a settlement that aims at fair burden-sharing after the basic living standards of the debtor are assured.

While the proposed FTAP has sufficient legal status to be effective and can be successfully applied on an ad-hoc basis using existing forums, ongoing debate regarding the legal housing of the arbitration panel or court point to important gaps in global economic governance particularly as regards international finance. Proposals for long-term housing of an FTAP include utilization of a United Nations department or through a UN treaty mechanism or the International Court of Justice. All proposals require detailed and further evaluation. A perception that there are few if any other institutions or institutional frameworks within which such procedures might feasibly operate must not result in an IMF default position. The IMF's inherent conflict of interest can never be removed by legal and administrative chicanery.

B. FTAP Reduces the Role of the IMF in International Debt Management

The failure of previous debt initiatives results largely from the blatant conflict of interest of all creditors who control the outcome of any negotiation. The basic principles of the rule of law dictate that conflict of interest must be eliminated from any proceedings to

ensure justice. It is only when creditors, including the IMF, become plaintiffs only, will any justice be served on international debt.

The role for the IMF in the FTAP is therefore that of a any other creditor participating in restructuring negotiations, with its claims given equal weight in assessment and subordinate to the requirement that a debtor country maintain basic services to its citizens. The IMF would have no involvement in debt sustainability calculations aside from the provision of statistical information when requested nor would its staff have a role in the determination of necessary terms to ensure future debtor viability.

C. FTAP Ensures Comprehensive and Equitable Burdensharing Between Creditors

The FTAP would be inclusive of all forms of debt – private sector debt, bilateral debt owed to other governments, multilateral debt owed to the international financial institutions (IFIs). In order to comprehensively address insolvency, only a mechanism that addresses all the debt held by a country will succeed.

The fragmented solutions offered by individual creditors, the Paris Club of bilateral creditors and the World Bank and the IMF through the HIPC initiative have not reduced the debt stock of the most indebted countries to “sustainable” levels. As noted on page 9, only six HIPC countries have reached the “completion point” under HIPC when they are supposed to have achieved a lasting exit from “unsustainable” debt burdens. Three of these 6 countries – Uganda, Mauritania and Burkina Faso - still had “unsustainable” debt burdens even after receiving the full HIPC treatment. HIPC has been a failure, even on its own terms, for half of the countries it was supposed to benefit. As the HIPC initiative has unfortunately revealed, incomprehensive solutions controlled by single sets of creditors do not deliver long-term sustainability.

D. FTAP Addresses Illegitimate Debt

Proponents of a FTAP agree that illegitimate debts must be cancelled. There is some debate, however, concerning how illegitimate debts should be evaluated and by whom. The FTAP itself could be empowered to evaluate all debt held by a sovereign and dismiss those debts deemed illegitimate. Submitting debts to arbitration, however, could imply an ‘a priori’ acceptance of their legitimacy. Thus, some argue that public audits of sovereign debts and the assessment of the legitimacy of debts could be carried out prior to engagement in the arbitration process.

These assessments and determinations may be done by a UN body or an inter-governmental body or by a private organization or legal experts commissioned by the debtor state. National criminal law courts would offer the best means to address certain debts, such as money stolen by leaders and put into foreign banks²⁸.

²⁸ African Forum and Network on Debt and Development (2002) “The Efficacy of Establishing an International Arbitration Court for Debt”, Technical Paper No.1,33.

As the concept of debt illegitimacy has largely not been tested in international law, the development of a viable FTAP may initially be hampered by this shortcoming. It will be essential to develop legal definitions, criteria and precedents in parallel with the development of an FTAP.

7. CONCLUSION

“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.” (Adam Smith, 1776)

As the world staggers between financial crises, amid the social wreckage of crippling sovereign debt loads, the establishment of a procedure to address the insolvency of middle-income countries in an equitable, independent and comprehensive manner has become a global imperative.

The International Monetary Fund’s (IMF) proposed Sovereign Debt Restructuring Mechanism (SDRM) is an unacceptable solution to the external debt burden faced by insolvent middle-income countries. The SDRM is not fair, for it explicitly favours creditors, it favours one class of creditor over all others, it lacks inter-creditor equity, and its outcome is effectively predetermined by the IMF. It is not open, for it excludes the very citizens on whose behalf sovereign debt was contracted. It is not even an avowed bankruptcy proceeding, for its goal is not a “fresh start” for debtors. Further, the SDRM dishonours the debtor by failing to take sovereignty, governmental power or the rights of citizens into account.

The SDRM reflects the current state of international debt management and will fail for the same reasons. The SDRM is effectively a “Massively Indebted Middle Income Country”(MIMIC) initiative for it mirrors another unsuccessful debt initiative (HIPC), which confirmed the power and influence of the IMF while providing no exit from unsustainable debt burdens for affected countries.

An essential component of any “new global financial architecture” is a fair and transparent process by which insolvent countries can become viable and imprudent lenders can be made responsible for their decisions. The Fair and Transparent Arbitration Process (FTAP) offers equal and comprehensive treatment, impartial arbitration and a commitment to debtor viability. It ensures basic protection of human rights and human dignity. The FTAP is a practicable means to address the debt crisis in the middle-income countries in a fair and equitable manner for both debtor and creditor. Meaningful long-term resolution of the global debt crises demands nothing less.

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