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ECOSOC Hearings with Civil Society; New York March 20th 2003:

Panel 1: "External Debt": The case for international Debt Arbitration

The Monterrey consensus has captured the upcoming reform debate on new debt workout mechanisms, when it stated: *"To promote fair burden-sharing and prevent moral hazard, we would welcome consideration by all relevant stakeholders of an international debt workout mechanism in the appropriate fora that will engage debtors and creditors to come together to restructure unsustainable debts in a timely and efficient manner." (para 60)*

The IMF has considered this as an endorsement of its efforts to establish a "Sovereign Debt Restructuring Mechanism" (SDRM), which during the Monterrey process started to be the axis of the reform debate, since it was first introduced by the Fund's Deputy Managing Director Anne Krueger in November 2001. Her proposal needs to be understood against the background of the looming Argentine crisis. Ever since, the number of countries in crisis has not diminished, and the severity of the economic downturn affecting over-indebted sovereigns in the South has, if anything, increased.

NGOs from a broad range of debtor as well as creditor countries have joined the IMF in considering that reform in international debt management is in fact overdue. We have analysed the IMF proposal and we do not consider the SDRM in its present form to be the kind of mechanism, which can lead to a lasting solution to Southern countries' debt crisis. It is a weak structure, which lacks decision-making power and the most important ingredient in any insolvency framework under national law, which is impartiality. Creditors and debtors need to acknowledge that without that key ingredient or with only the protracted form which we have in the current SDRM proposal, any new mechanism will not produce the new quality in international debt management, which is needed after decades of futile negotiations in the Paris Club and other creditor-designed and creditor-dominated fora.

This is not only so in the interest of development-oriented policies or the protection of the poor. Impartiality is first of all essential from the perspective of those bona-fide creditors and debtors, who are going for a true exit solution. This has been demonstrated time and again by the futile negotiations, re-negotiations and re-re-negotiations, countries have had to undergo in the Paris Club or under the two HIPC initiatives. It is positively demonstrated by the successful use of mediation and arbitration techniques in national insolvency laws, as well as in just a few cases of international debt renegotiation, like that of Indonesia 1969.

This is why the following remarks will not suggest some fine-tuning of the latest version of the IMF proposal. Instead they shall outline some of the basic requirements for an impartially-led process in international debt management. It needs to be pointed out that there is not one single format of an impartial process, but rather a variety of options for the selection and functioning of an impartial panel.

- **What must be the role and function of an effective decision making body?**

The panel must be in a position to actually decide on the case and not only give a recommendation, which is then up to the voting of either of the parties. This is not a contradiction to the general principle that an arrangement should always first be sought "in the shadow of the law". However, there must be the opportunity to have recourse to a legally binding and enforceable process in order to impose discipline on the parties.

The panel must therefore be in full control of the negotiations and their outcome.

The panel needs to be the institution, which ultimately defines the appropriate level of debt sustainability in any given case. Moreover, it shall already lead the verification of the claims' process, which must be the first step of the actual negotiations. The verification shall take place on an enhanced basis, which implies that the legitimacy of claims is not only examined from a mere technical and formal point of view. Instead the panel will hear any complaints from any party regarding the other party's behaviour at all stages of the lending (and an eventual earlier rescheduling) process.

- **How should members of the panel be appointed?**

There are in principle two ways:

- They can be selected in equal numbers by the parties involved. Whom they actually select, is left completely to the parties. Selected panel members then select an additional person as chairperson.
- They can be selected from an existing pool of arbitrators by a neutral institution which otherwise is not involved in the negotiations, like f.i. the Secretary General of the United Nations. Alternatively the president or board of the existing pool of arbitrators selects the panel members for an actual case.

The first option is certainly the preferable one, as it leaves more responsibility in the hands of the parties and thus tends to provide a greater sense of ownership. However, in a situation where one party (like f.i. bond creditors) is disperse and difficult to organise, it might be preferable to choose the second option in order to have the panel workable as soon as possible.

An intermediate version between the two options might moreover be useful: to let the parties select their representatives from a given set of pre-defined arbitrators. This, however, presupposes that the pool can be established with a sufficiently broad range of regional, personal, professional and political backgrounds, so that the parties have a real choice. Of course, neither the debtor nor an individual or a group of creditors can have a final say in the selection of pool members. Establishing that f.i. the Board or the Managing Director of the IMF would ultimately endorse members, would be the safest way to undermine the most important asset, arbitrators actually need to have: their impartiality.

- **<u>Who needs to be involved in the renegotiation process</u>**

NGOs prefer a "Fair and Transparent Arbitration Process" (FTAP) over the existing SDRM. "Transparency" particularly means, that negotiations are public. All stakeholders have the right to express their views to the panel before any decision is made. It is the panel's task to define a reasonable and feasible format for this process, for which inspiration can be drawn from rules and practice of chapter 9 of the US insolvency code, which regulates the insolvency of debtors with governmental powers. Consultation can take the form of public hearings with social organisations in the debtor country's capital over a reasonable timeframe; additionally the possibility to submit positions, evidence and commentaries via the INTERNET can be foreseen.

Monitoring must take place <u>during</u> the negotiations. While the panel would be in a position to allow for exceptions, any submission and documentation provided in the context of the procedure would in principle be publicly accessible. This principle does not intervene with the independence and full command of the panel over the whole process. Monitoring definitely cannot be done in a satisfactory manner through the publication of an annual report – as the latest SDRM proposal suggests.

- **<u>What is the specific role of the IMF with regard to the negotiations?</u>**

Presently the IMF has a double function as lender and research institution that manages considerable intelligence about the economic situation of the debtor. We welcome recently raised proposals for an institutional reform, which would overcome the inherent conflicts of this situation. In the absence of such a reform, its role in a reformed process is also a double one, though very different from what it is now:

- The Fund is a creditor among others and as such fully entitled to represent its interests via the nomination of panel members and in the course of the negotiations.
- Like any institution, which manages data about the debtor, the Fund is welcome to provide any evidence it has on the economic situation of the debtor (eventually also on the creditors) to the panel.

Neither of these functions, does imply any particular privilege or obligation for the IMF beyond those of other creditors or experts respectively. Under a fair procedure there must not be anything like the exempt creditor status, which the Fund has largely enjoyed in the past. Equal treatment among creditors is a fundamental principle in any functioning insolvency framework, and in the light of the Fund's track record as a consultant to indebted sovereigns, it is high time to impose the discipline of the market on the IMF. Having equal treatment among all creditors as the starting point, does, however, not necessarily mean, that it is also the outcome. If there is a consensus among creditors, that the position of one or some of them is to enjoy particular protection – f.i. in order to reward the provision of fresh money - this can, of course, be accepted by the panel. For the time being we would suggest that this reasonable purpose is best served by the set-up of a cut-off date without any special reference to any particular creditor.

Equally there is no space for a "natural" monopoly regarding the assessment of the debtor's economic situation. Given the need to handle an eventually huge and

complicated database on the debtor's economic situation, the panel will most likely employ a capable and independent institution for reconciling and interpreting data. The Fund is, like everybody else, most welcome to provide the appointed experts with data and any intelligence it may have. The final interpretation of those data, i.e. establishing a debt sustainability threshold, and hence the need for reschedulings or write-offs, remains the sole privilege of the independent panel – building on the expertise of the independent expert(s) as much as it wishes.

- **Who is to benefit from a reformed framework?**

Given the poor results of the HIPC initiative, it is not acceptable that a reformed framework will only deal with the debtors of emerging market countries. The need for reform has been older than the Argentine crisis; moreover, HIPCs that have not reached a sustainable debt level through the process, do need a HIPC-III designed in the same way, by the same actors and with slightly improved criteria.

A process which gives due regard to the most fundamental principles of the rule of law in international debt management, must be available to any Sovereign who, through its own fault, through irresponsible behaviour of its creditors or through force majeure has entered into an unsustainable situation.