Submission of Evidence to the House of Commons International Development Committee for the inquiry into debt relief in low-income countries, examining the impact of high levels of debt on development and the tools and strategies employed to reduce the debt burden

Key points:

- The existing fragmented and highly politicised regime for sovereign finance law and governance is exacerbating the sovereign debt crises in low-income countries (LICs).
- Aa key area of concern is the lack of appropriate mechanisms to deal with the burgeoning debt owed by sovereigns to private creditors.
- We have proposed an opt-in statutory standstill which will place LICs in a fairer position to negotiate debt relief with creditors.

A. The Sovereign Debt Regime and Sovereign Debt Crises

1. The COVID-19 pandemic has triggered what the International Monetary Fund (IMF) has called the 'worst economic downturn since the Great Depression'.[1] For LICs and other developing countries that entered in the pandemic in much more fragile and perilous conditions, the pandemic has worsened their financial and economic situation and they are facing further intersecting climate and conflict crises caused by natural disasters and global trade and economic disruptions resulting from the Russian invasion of Ukraine.[2]

2. The worrying global economic situation will only magnify the risks of serious debt crises in low and middle-income countries as debt levels are rising rapidly in response to pandemic-related and other emerging economic disruptions. World Bank figures indicate that borrowing by low and middle-income countries 'to mitigate the economic and social impact of the pandemic added around US$550 billion' to their combined external debt obligations in 2021, raising their external debt stock by an average of 6.9 percent in 2021 to US$9.3 trillion[3]. Debt ratios of LICs increased over the past few years and 60 percent of LICs are at high risk of debt distress or are already in debt distress, double the numbers from 2015 levels.[4]

3. This current debt crisis has been greatly exacerbated by deficiencies in the legal framework and governing regime for sovereign financing and the shortcomings in the international architecture of public finance. While there have been some measures

[1] Gopinath, G (2020) 'The Great Lockdown: Worst Economic Downturn Since the Great Depression' (IMF Blog, 14 April 2020.
[2] World Bank (2022), *Global Economic Prospects 2022*, Washington: World Bank Group, p 18, Box 1.1.
[3] World Bank (2022), *Debt Report 2022*, Washington DC: World Bank, June 2022.
[4] Chabert, G, Cerisol, M and Hakura, D (2022), 'Restructuring Debt of Poorer Nations Requires More Efficient Coordination', 7 April 2022.

taken by the global community to address the solvency crises of developing countries, these initiatives have been a patchwork, *ad-hoc* and largely reliant on the goodwill of major creditor states and bilateral negotiations between debtor states and their creditors and financiers. At the same time, there have been no significant changes to the corresponding architecture for sovereign financing, exacerbating the liquidity crises and storing up future solvency crises in LICs and in other developing and emerging economies (DEEs) which will have spill-over effects on LICs due to the globalized and interdependent nature of the international financial system and global economy.

4. Our research[5] indicates that the existing fragmented and highly politicised regime for sovereign finance law and governance is exacerbating the sovereign debt crises in LICs and DEEs and the legal, policy and regulatory framework of sovereign financing and sovereign debt have not kept apace with the developments in the sovereign debt landscape and broader international financial architecture, including the diversification in the creditor base of LICs and other developing countries in recent years.

5. Despite repeated cycles of financial crises and sovereign indebtedness and the wide-ranging adverse social and economic impacts on communities in countries facing debt distress, there remains little global collective action on this issue. Sovereign debt remains governed by a patchwork of municipal law, primarily of key financial centres, such as New York or London, the choice of forum for debt contracts, and supplemented by a network of official and unofficial organisations and networks, including international financial institutions (IFIs), such as the International Monetary Fund (IMF) and the World Bank, and informal creditor groups, such as the Paris Club (see below) for rescheduling official sector debt, the London Clubs (or Bank Advisory Committees) for commercial bank debt and creditor committees for sovereign bondholders.[6] Contemporary sovereign debt restructuring continues to rely largely on what Herman et al. have termed the 'informal imperfect coordination of the debtor and its creditors' under the oversight of the IMF and major creditor states in the G7.[7]

6. We are of the opinion that without significant reforms to the domestic and international regimes governing sovereign financing and sovereign debt, LICs and other developing countries are facing uncertain and perilous futures, jeopardising social and economic development, increasing investment gaps in the productive capacity and widening existing social and economic inequalities within and among countries. The absence of a formal, international mechanism or process with pre-determined rules of engagement to deal with sovereign debt crises has often resulted in messy and disorderly sovereign debt defaults and often delays to restoring debt-distressed states to a more sustainable fiscal position. The disjointed and ad-hoc

[5] See the Appendix for a list of our research relevant to the issues raised in this inquiry.

[6] Tan, C (2014), 'Reframing the Debate: The Debt Relief Initiative and New Normative Values in the Governance of Third World Debt', *International Journal of Law in Context*, Vol 10, No 2.

[7] Herman, B, Ocampo, J A and Spiegel, S (2010) 'Introduction', in Herman, B, Ocampo, J A and Spiegel, S (eds), *Overcoming Developing Country Debt Crisis,* Oxford: Oxford University Press, pp 489–96.

nature of sovereign debt governance has left the field exhausted and open to new state-controlled lenders pursuing their own geopolitical goals. These new actors have been able not only to provide significant credit to LICs, but in return they have been able to secure potentially exclusive control of LIC resources, affecting global commodity markets and tying LICs into unsustainable debt arrangements – arrangements that can lie beyond the reach of traditional, increasingly limited global debt governance levers. In one case examined by the respondent researchers,[8] a LIC agreed to hand control of over US$46.4 billion in resources and revenues to Chinese financial institutions to back what has proved to be just US$476 million of infrastructure loans.

B. Private Creditors and Sovereign Debt

7. While there are many gaps in the legal and regulatory architecture of sovereign debt that we have identified in our research, a key area of concern is the lack of appropriate mechanisms to deal with the burgeoning debt owed by sovereigns to private creditors. The diversification of the creditor base for LICs has created significant problems for coordination of collective action in times of sovereign debt distress as demonstrated during the past two years of the pandemic.

8. In response to the global economic shock triggered by the Covid-19 pandemic, the G20 and Paris Club announced the Debt Service Suspension Initiative (DSSI) for Poorest Countries on 15 April 2020. The DSSI commits member states official creditors to a time-bound suspension of debt service to eligible countries that request such forbearance.[9] A separate commitment was made by the Institute of International Finance (IIF) to support the DSSI[10] and terms of reference for voluntary private sector participation were published on 28 May 2020.[11] In November 2020, the G20 announced the creation of a Common Framework for Debt Treatments beyond the DSSI that seeks to facilitate debt restructuring by coordinating the participation of all official bilateral creditors of a debtor country and seeking the comparability of treatment between official and private creditors, in line with Paris Club policy.[12] However, the initial commitment by private creditors to give effect to the terms of the DSSI has not materialised and while negotiations are continuing to include the private sector in discussions for the G20 Common Framework, the lack of any binding mechanism to compel private creditors to offer debt relief to LICs represents a continuing stumbling block to global collective action to address the sovereign debt

[8] Connelly, S and Patricio Ferreira Lima, K (2021), *Report on Republic of Guinea's Resource-Backed Credit Facility Agreements,* December 2021, Natural Resource Governance Institute, New York.
[9] G20 (2020), 'Communiqué of the Virtual Meeting of The G20 Finance Ministers and Central Bank Governors',
Riyadh, Saudi Arabia', 15 April 2020.
[10] Paris Club and IIF (2020), 'Collaboration between the Paris Club and the IIF to Support the DSSI', 30 April 2020.
[11] IIF (2020), 'IIF Letter to IMF, World Bank and Paris Club on a Potential Approach to Voluntary Private Sector Participation in the DSSI', 1 May 2020.
[12] G20 Saudi Arabia 2020 Riyadh Summit, 'Statement: Extraordinary G20 Finance Ministers and Central Bank Governors' Meeting' (13 November 2020).

crisis. A study by the Jubilee Debt Campaign (now Debt Justice) found that private creditors received US$14.9 billion in debt payments from the 46 DSSI-eligible countries since the pandemic began, the largest amount of any creditor group while only suspending 0.2 percent of debt repayments.[13]

9. A notable side-effect of allowing commercial creditors to operate without oversight has been a lack of transparency in lending practices and the almost inevitable threat of corruption, on the part of both sovereign borrowers and lenders. Our research[14] has shown how the lack of a public register of commercial loans to LIC sovereigns led to the Mozambican Tuna Bond Scandal, where private bank employees in London and a corrupt official in Mozambique conspired to cause Mozambique to borrow millions which were then diverted to third party accounts. The Mozambican people were left to pick up the bill. We believe that this behaviour is encouraged by a 'Wild West' approach to sovereign debt governance. We argue that positive debt governance reform should also look to *ex ante* measures which prevents LICSs being saddled with odious and corrupt debts. Such measures should include a public register of private-to-sovereign debt agreements, and restructuring mechanisms with the power to strike down problematic loans.

10. We believe that it is imperative that private creditors be brought into global efforts to address the debt crisis and we believe that the UK plays an important role in leading initiatives domestically and internationally to introduce legal reforms to compel private creditor participation in sovereign debt efforts. The global community, including the UK, has made significant commitments to scale up aid, credit and debt relief to developing countries in the fight against COVID-19, the climate crisis and for humanitarian efforts. Statutory mechanisms are necessary to protect resources of low-income countries, especially highly indebted countries, from being diverted to debt service to commercial creditors. Previous experience with the Heavily Indebted Poor Countries (HIPC) Initiative and other Paris Club restructurings have also demonstrated that without enshrining debt standstills and/or cancellation into law, private creditors are unlikely to participate fully and give effect to multilaterally organised debt relief initiatives. Despite voluntary arrangements brokered by the IIF, question marks remain over the efficacy of a voluntary agreement covering a disparate class of creditors and protection against future litigation for missed repayments under a voluntary arrangement.[15]

11. Reliance on a purely voluntary arrangement may also generate collective action problems in which a group of private creditors would seek to benefit from the increased repayment capacity of eligible countries, generated by the official debt standstill, in order to keep obtaining debt repayment in full during this challenging time. The current situation poses the classic free-rider problem, in which some

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[13] Jubilee Debt Campaign (2021), 'How the G20 Debt Suspension Initiative Benefits Private Lenders', October 2021.
[14] Connelly, S (2022) 'The Tuna Bond Scandal: The Continued Lack of Transparency in Bank-to-State Credit Facilities Agreements', *Journal of International Economic Law*, Vol 24, No 3.
[15] Jubilee Debt Campaign (2020), 'The UK's Role in Supporting the G20 Debt Suspension'.

creditors may not engage in the initiative in the hope that they can free ride on the concessions offered by other creditors. This would create a strong incentive for otherwise cooperative creditors to refuse participation in the DSSI, thus undermining the arrangement as a whole.

12. Since most potentially eligible private debt is governed by English law, this situation has significant legal and political implications for the UK. If current debt relief mechanisms are not accompanied by a statutory standstills and restructurings for private debt, English courts (more than any other jurisdiction) could end up enforcing the debts of private creditors free-riding on current debt relief measures, including the DSSI, Common Framework, the Catastrophe Containment and Relief Trust (CCRT)[16] and other debt relief measures funded by the UK taxpayers. This could give rise to the same situation which provided the impetus for the Debt Relief (Developing Countries) Act 2010, that is, the purchase of distressed debt on the secondary markets by speculative investors with the aim of recovering the full-face value at a later date.[17] The 2010 Act was enacted by the UK to prevent creditors of HIPC beneficiary countries from recovering an amount of debt in excess of that consistent with the HIPC Initiative.[18]

C. Domestic Legal Responses to Deal with Private Creditors

13. As the majority of debt owed to private creditors are governed by English law, the UK is well placed to address some of the shortcomings of the international sovereign debt regime through domestic legal policy responses. We have considered three key legislative initiatives which may be considered by the UK Parliament to mitigate the crisis.

C.I. Legislation extending the eligibility for application to schemes of arrangement under Part 26 of the Companies Act 2006 to sovereigns

14. A scheme of arrangement is a formal statutory procedure under Part 26 of the Companies Act 2006 under which a company may enter into a compromise or arrangement with its members or creditors (or any class of them) to restructre its financial obligations. This is not a collective procedure, and therefore, it may not necessarily involve all creditors of a company. In addition, it is not confined to insolvency situations, being also used in takeovers, as well as to effect debt for equity swaps.

15. A scheme requires approval by a double majority of at 75% in value of each class of creditors and at least a majority in number of each class. This is an in-court proceeding that requires that court's permission to the meetings to vote on the

[16] IMF (2021), 'Catastrophe Containment and Relief Trust', 2 June 2021.
[17] See Waibel, M (2007), 'Elusive Certainty: Implications of Donegal vs Zambia', *International Financial Law Review* 31-4.
[18] HM Government (2011), 'Explanatory Memorandum to the Debt Relief (Developing Countries) Act 2010 (Permanent Effect) Order 2011'.

scheme, as well as judicial review of whether any division of the creditors into classes for voting purposes is appropriate.

16. Currently, schemes of arrangement are only applicable to corporate debt restructuring, and therefore exclude the possibility that sovereigns may use such schemes to restructure sovereign debt. Legislation could be introduced to extend the eligibility for application to schemes of arrangement under Part 26 of the Companies Act 2006 to sovereigns, thereby enabling sovereign debt under English law to be timely and more effectively restructured.

C.II. Legislation making the Paris Club and G20 Common Framework's principle of comparable treatment binding on private creditors

17. This proposal would make the principle of comparable treatment established in the G20's Common Framework, also utilised in Paris Club debt restructurings, binding on private creditors whose debt obligations are governed by English law. The legislation would make the maximum amount recoverable of any qualifying debt owed to a private creditor by a debtor country that signs a Memorandum of Understanding with participating official creditors proportionate to the debt relief granted by official creditors.

18. A legislation of this type would mirror the Debt Relief (Developing Countries) Act 2010, which prevented private creditors from enforcing any judgement allowing recovery against Heavily Indebted Poor Countries (HIPC) on qualifying debts exceeding the amount calculated as sustainable under the HIPC Initiative.

C.III. Legislation making the standstill established by the DSSI binding on private creditors

19. Legislation could be introduced to give legislative effect to the DSSI with respect to private creditors by granting a statutory standstill to all DSSI-eligible countries on qualifying debt owed by the country that are governed by English law.[19] The proposal would cover sovereign bonds, and those qualifying correspond to 90 per cent of the bond contracts owed by countries covered by the DSSI.[20]

20. The proposal is based on the wording for the Debt Relief (Developing Countries) Act 2010 which prevented creditors of beneficiary countries of the Heavily Indebted Poor Countries Initiative (HIPC) Initiative from recovering an amount of debt in excess of that consistent with the HIPC Initiative.[21] This proposal is underpinned by a similar rationale to the 2010 Act, i.e. that continuing debt service to commercial creditors at this time diverts resources provided through official debt relief (through the DSSI as well as through other channels, such as the International Monetary Fund (IMF)'s

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[19] Connelly, S, Patricio Ferreira Lima, K and Tan, C, 'Proposal for Debt Suspension Legislation' (IEL Collective, 3 June 2020).
[20] Jubilee Debt Campaign (2020), 'The UK's Role in Supporting the G20 Debt Suspension'.
[21] HM Government (2011), 'Explanatory Memorandum to the Debt Relief (Developing Countries) Act 2010 (Permanent Effect) Order 2011'.

Catastrophe Containment and Relief Trust (CCRT)[22]), intended to free up resources for countries to support health, humanitarian and social and economic measures during the COVID-19 pandemic. The proposal has been through a rigorous testing process before members of the UK judiciary and leading members of the City of London legal profession.

21. The temporary standstill would be voluntary, as debtor countries would have an option, not an obligation, to rely on it. Thus, whenever a creditor brings legal proceedings before an English court in respect of a qualifying debt, the debtor country is entitled to apply to the court in which the proceedings have been brought to stay the proceedings during the relevant period. In this regard, it is worth noting that the standstill would in no way release the debt of the country, nor amount to a waiver or forbearance on the part of the creditor.

22. The proposed legislation does not directly intervene in a contract to suspend debt payments, and as such it is still open to creditors to declare a default under the relevant contract. Instead, the legislation mirrors existing insolvency legislation in suspending the link between contractual default and the execution and enforcement of contractual rights, including with the aid of the English courts.

23. Enshrining a standstill in law will demonstrate the UK's leadership in global COVID-19 responses and reinforce its commitment to ensuring low-income countries have access to all the financial resources they need to contain COVID-19 and recover from this unprecedented health, social and economic crisis. However, this would not solve the solvency crisis experienced by several DSSI-eligible countries or any DEEs which are not eligible for the DSSI.

24. In April 2020, we published a proposal for a statutory standstill for countries which have sought relief from the DSSI which we believe can still be adopted for countries that are beneficiaries of other debt relief initiatives, such as the Common Framework.[23] The proposal is attached to this submission, and we would be happy to walk you through it.

25. The Appendix lists our research relevant to the work of the Committee in this inquiry.

26. We are currently undertaking research on the applicability of schemes of arrangement under Part 26 of the Companies Act 2006 to sovereigns and would be happy to share our insights and preliminary findings with the Committee should it be of interest.

27. For further information, please direct enquiries to celine.tan@warwick.ac.uk

Dr Stephen Connelly, School of Law, University of Warwick

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[22] IMF (2020), 'IMF Executive Board Approves Immediate Debt Relief for 25 Countries', 13 April 2020.
[23] See further on Connelly, S, Tan, C, Patricio Ferreira Lima, K and Tassis, C (2020), 'Policy Note: COVID-19: Suspending Debt Service for Indebted Countries' (GLOBE Centre, University of Warwick, June).

Dr Karina Patricio Ferreira Lima, School of Law, University of Leeds

Dr Celine Tan, School of Law, University of Warwick

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Appendix

Connelly, S (2022) '[The Tuna Bond Scandal: The Continued Lack of Transparency in Bank-to-State Credit Facilities Agreements'](), *Journal of International Economic Law*, Vol 24, No 3.

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