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Sovereign Debt and Low-Income Countries: Dealing with Private Creditors

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EXECUTIVE SUMMARY

Rising interest rates, the economic shocks of COVID-19 and the war in Ukraine are adding to the financial challenges faced by low-income countries (LICs). Most LICs are either at high risk of or are already in debt distress.

A key area of concern is the lack of appropriate mechanisms to deal with the debt owed by sovereigns to private creditors. As most debt owed by LICs to private creditors is governed by English law, the UK is well-placed to address the sovereign debt crisis in those countries through domestic legal responses. This brief outlines three key legislative initiatives that may be considered by the UK Parliament to mitigate the crisis and ensure private creditor participation in sovereign debt restructurings.

POLICY BRIEF #10

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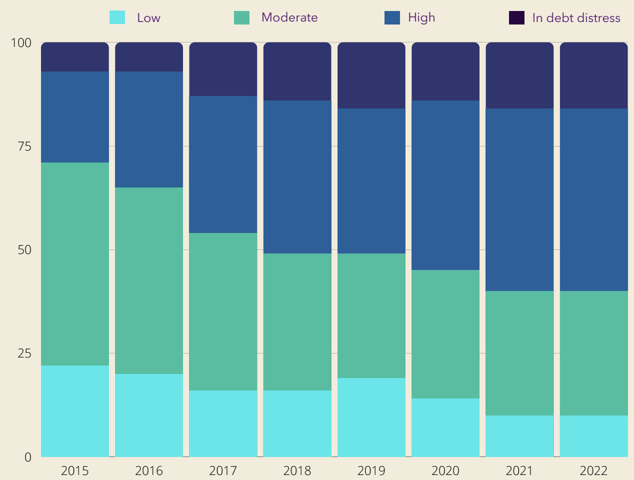
The Sovereign Debt Regime and Sovereign Debt Crises

The international community is facing significant economic and financial turbulence in the wake of the COVID-19 pandemic and intersecting global energy, food, and climate crises. In this scenario, sovereign debt crises in developing and emerging countries are on the rise. Currently, about 60 percent of LICs are at high risk of or are already in debt distress[1], risking a humanitarian crisis with unpredictable political consequences.

Figure 1: Growth of External Debt Distress

External debt distress ratings for LICs using IMF/World Bank LIC DSF, 2015 - 2022 (%-age of PRGT-eligible countries)



Source: United Nations (2022), Financing for Sustainable Development Report 2022: Bridging the Finance Divide, p. 124, fig. III.E.8. Available Online

In contrast to domestic and transnational insolvency regimes for individuals and companies, the international financial architecture currently lacks a rules-based mechanism to deal with sovereign debt crises. The absence of an appropriate regime to address such crises often results in disorderly defaults, as well as delays in restoring debt-distressed states to a sustainable fiscal position. A significant problem in recent years is the burgeoning debt owed by sovereigns, including LICs, to private creditors.

Recent global initiatives aimed at supporting LICs in the health and economic crises triggered by the pandemic, such as the G20's Debt Service Suspension Initiative (DSSI) and Common Framework for Debt Treatments, have not seen any meaningful participation by private creditors. This situation has hindered LICs from freeing up resources to fight those crises and advantaged private creditors, who benefited from the fiscal space generated by official debt suspension to keep obtaining debt repayments in full. The voluntary character of those arrangements has incentivised private creditors to refuse to engage in any future debt relief initiatives by free-riding on the concessions offered by official creditors–at the expense of the population of both creditor and debtor countries.

The lack of a binding mechanism to ensure the involvement of all creditors in debt relief initiatives represents a continuing stumbling block to global collective action to address sovereign debt crises. Previous experience with the Heavily Indebted Poor Countries Initiative (HIPC) and other Paris Club restructurings has 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. In addition, it may give rise to predatory holdout litigation, which involves the purchase of distressed debt at a significantly reduced price on the secondary market by speculative investors with the aim of suing vulnerable debtors for the face value of the bonds. Thus, statutory mechanisms are crucial to prevent the diversion of LIC resources–especially highly indebted countries–to debt service.

[1] Chabert, G, Cerisola, M and Hakura, D(2022) 'Restructuring Debt of Poorer Nations Requires More Efficient Coordination', IMF Blog, 7 April 2022, International Monetary Fund, Available Online

UK Domestic Responses to Sovereign Debt Owed to Private Creditors

As most debt owed by LICs to private creditors is governed by English law[2], the UK is uniquely placed to mitigate the debt crisis in those countries through domestic statutory responses.

Three key legislative initiatives may be considered by the UK Parliament to ensure private creditor participation in sovereign debt restructuring of LICs.

90% of sovereign bonds issued by DSSI countries are governed by English law

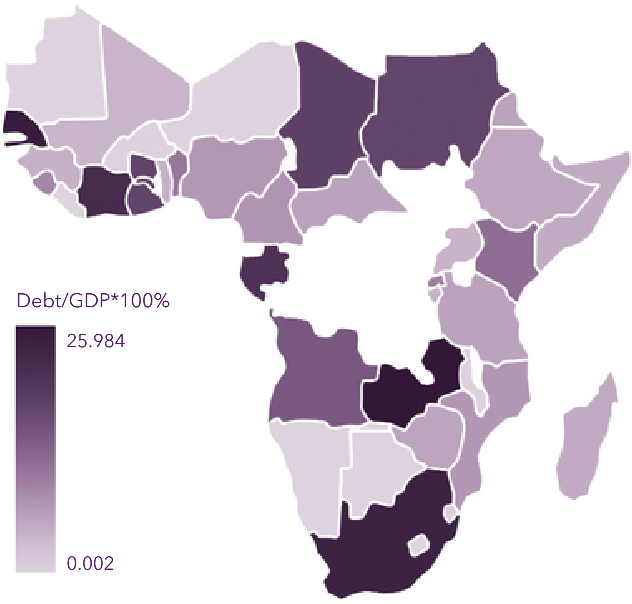
1. Introducing legislative reform to extend a form of a scheme of arrangement under Part 26 of the Companies Act 2006 to sovereigns. This is an in-court proceeding established under the Act to conduct corporate debt restructurings outside of insolvency law. A company may enter into a compromise or arrangement with its members or creditors (or any class of them) to restructure its financial obligations. Extending the scheme's eligibility to sovereigns would allow states to apply for a partial or full restructuring of their debts governed by English law under the supervision of an English court, in the same way as local and foreign companies.

2. Introducing new legislation to make the principle of comparable treatment established in the Common Framework and other Paris Club debt restructurings binding on all private creditors whose claims are governed by English law. Under such legislation, the maximum amount of qualifying debt recoverable by private creditors would be proportionate to the debt relief granted by official creditors.

3. Introducing new legislation to give legislative effect to the DSSI and the Common Framework with respect to private creditors by granting a statutory standstill to all eligible countries on qualifying debt governed by English law during the period of duration of such initiatives. 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.

Both proposals (2) and (3) mirror the provisions of the Debt Relief (Developing Countries) Act 2010, which prevented creditors of beneficiary countries of the HIPC Initiative from recovering an amount of debt in excess of that consistent with the debt relief provided under such Initiative. In a similar way as the 2010 Act, these proposals seek to prevent resources released through official debt relief to support health, humanitarian, and socioeconomic measures being diverted to servicing debt owed to private creditors.

Figure 2: Example of private creditor debt-Debt owed by African governments as a % of GDP (2018)*



Source: Connelly, S (2021) '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, p.661, fig. 7.
*The three countries which have applied for treatment under the Common Framework are Chad, Ethiopia and Zambia

> The UK is uniquely placed to mitigate the debt crisis in those countries through domestic statutory responses.

[2] In 2020, Jubilee Debt Campaign UK (JDC UK) (now Debt Justice) estimated 90% of bond contracts issued by DSSI-eligible countries are governed by English law. See JDC UK (2020), 'The UK's Role in Supporting the G20 Debt Suspension' (1 May 2020), Available Online

RECOMMENDATIONS

The UK Parliament has various legislative pathways to mitigate the debt crisis in LICs:

1. Extending the eligibility for a form of scheme of arrangement under Part 26 of the Companies Act 2006 to sovereigns.

2. Making the Paris Club and G20 Common Framework's principle of comparable treatment binding on private creditors.

3. Making the standstill established by the DSSI binding on private creditors.

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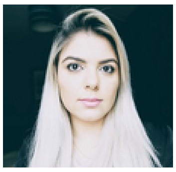

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For more information, see:

Connelly, S; Patricio Ferreira Lima, K and Tan, C (2022), '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', 22 June 2022 https://committees.parliament.uk/writtenevidence/109458/pdf/

Connelly, S, Patricio Ferreira Lima, K and Tan, C (2020), 'Proposal for debt suspension legislation' The IEL Collective, Law and Finance Working Group, 3 June 2020 https://warwick.ac.uk/fac/soc/law/research/centres/globe/ielcollective/working-groups/lawfinance/debt/proposal_for_debt_suspension_legislation_-_final.pdf

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