

Fair and Transparent Arbitration Process on Debt Policy Briefing

Executive Summary

1. The enormous debt burden still faced by the developing world represents one of the main obstacles to the achievement of the 2015 Millennium Development Goals. Debt flows from South to North continue to dwarf aid flows and all evidence suggests that the financial crisis will worsen this situation and may even lead to a fresh round of debt crises. The one-off debt cancellations of the last decade have not left in place any framework for preventing this eventuality.
2. A huge - though necessarily unknown - quantity of this debt burden violates *jus cogens*, the peremptory norms of international law, as it results from loans extended to unelected dictators, at ruinous interest rates or for environmentally catastrophic projects. No framework currently exists for bringing international law to bear on these illegitimate debts.
3. In the absence of such a framework, and in the context of developed countries' current scramble to boost exports, nothing exists to prevent a 'race to the bottom' in export lending, leading to the creation of huge new quantities of such illegitimate debt.
4. A Fair and Transparent Arbitration process would enable creditors and debtors to meet on equal terms to assess the cancellation of debts both on the basis of poverty and illegitimacy. There are clear institutional precedents and frameworks for such a body, which would require no new treaties to create.
5. The threat to the legacy of the HIPC programme, as well as the new consensus on the need to regulate international capital flows and the findings of the Stiglitz commission, bring this vital though ambitious project into the realm of the politically possible.

Debt, the MDGs, and the financial crisis

6. One of the most severe obstacles to the achievement of the Millennium Development Goals by 2015 is the huge debt burden still faced by the poorest countries in the world. According to the UN, US\$348 billion will be needed to cover MDG costs in 2010 and \$529 billion in 2015. But the flow of overseas

development assistance (ODA) between 2003 and 2006 was only US\$90 billion a year, a sum dwarfed by debt repayments from the developing to the developed world, which in 2005 stood at over \$US513.8 billion.¹

7. Even before the global financial crisis took effect on the poorest countries, the World Bank acknowledged in its 2008 status of implementation report on Heavily Indebted Poor Countries (HIPC) a "high risk of new debt distress" in 4 countries and a "moderate" one in an additional 10. When we consider that the IMF has now forecast much lower economic growth rates for the developing world, it must be assumed that the situation has already turned more critical for more countries since the report's publication, and will continue to do so during 2009.²
8. Additionally to countries that have gone through the HIPC process, which run into new debt distress, other developing countries are very likely to run into over-indebtedness as a result of the global financial crisis and ensuing downturn, and countries which never managed to get out of the debt crisis of the 1980s and 1990s will be pushed over the edge.³
9. Between 1999 and 2005 substantial progress has been achieved in terms of debt relief for developing countries. During this process the international community failed, however, to develop lasting institutions for the prevention of debt poverty. The Heavily Indebted Poor Country (HIPC) and Multilateral Debt Relief Initiative (MDRI) relief schemes have been deliberately designed as one-off exercises. Thus, a newly over-indebted developing country would face today the same problems which countries had after the crisis' outbreak in 1982.

Debt, illegitimacy and *jus cogens*

10. No current framework exists for dealing with the large proportion of this existing debt that violates *jus cogens* the peremptory norms of international law. This includes odious debts - such as those incurred by the apartheid government in South Africa - as well as those that were demonstrably incurred for no benefit to the people of a country, and those currently owned by so called vulture funds. These outstanding debts represent a violation not simply of a people's human right to subsistence, but also of their right to democratic participation and self-determination.
11. While currently countries can take steps to cancel, audit or repudiate these debts (as with the Norwegian cancellation of \$80 million in 2006 or the Ecuadorian audit of 2008) there is no existing process for co-ordinating these developments in a coherent way and under the rule of law. Equally the absence of any juridical framework prevents the emergence of an agreed definition of illegitimate debts that would be necessary for their wholesale cancellation.

1 World Bank figures taken from European Network on Debt and Development's 2009 briefing - *Addressing Development's Black Hole*

2 The most recent IMF projections are that developing economies will grow by a mere 3.3% in 2009, down from 6.3% in 2008. Sub-Saharan Africa will see growth of just 3.5%, having risen to 6.9% in 2007 - world Economic Outlook Update - January 2009. Some estimates put LDC growth as low as 1%

3 erlassjahr.de (Jubilee Germany) Submission to the UN Commission on Financial Architecture

12. Because of the absence of such a framework or collectively agreed definition, there is a continued dependence on voluntarism in the regulation of new lending, for example the OECD Guidelines to Promote Sustainable Lending⁴ and the Debt Sustainability Framework of the Bretton Woods organisations.
13. Rather than making available the essential productive credit that these countries need, lenders are thus even now beginning a 'race to the bottom' in the ethical standards of their lending to the developing world, leading to a rapid increase in the outstanding illegitimate debt stock. An example of this is the new Industry and Export (Financial Support) Act of the UK Government, which has succeeded in deliberately weakening the standards governing the UK's Export Credit Guarantee Department.

Fair and Transparent Arbitration

14. A Fair and Transparent Arbitration process (FTA), at which the debtor and creditor can meet on equal terms - and under the rule of law - to reassess the repayments of disputed debts, would provide a sustainable framework in which a country facing debt crisis could reduce its exposure to all its creditors in an orderly and pre-defined way. In the words of the last United Nations report on the project, 'it provides a forum for bringing some cohesion and structure to what is nowadays in cases of sovereign default usually a more or less potentially disorganised group of anxious stakeholders who initiate individual strategies to secure the most profitable outcome for themselves.'⁵

By collating and developing the relevant body of case law, such an institution would also be able to bring debt under the purview of *jus cogens*, enabling not simply the cancellation of existing illegitimate debt *ex post* but the prevention of a new wave of illegitimate export credits.

15. Paragraph 60 of the Monterrey Consensus called for

'consideration by all relevant stakeholders of an international debt workout mechanism, in the appropriate forums, that will engage debtors and creditors to restructure unsustainable debts in a timely and efficient manner.'⁶

The IMF itself admitted to the need for a form where debtor and creditor could meet to resolve debt disputes, when it proposed a Sovereign Debt Restructuring Mechanism (SDRM).⁷ Clearly, though as the IMF would itself have instituted this court under its own auspices, this would have violated the fundamental principal of the Rule of Law that no party can judge cases in which they themselves are involved.

16. The main practical manifestation of such a body would be a panel to which both creditor and debtor could nominate either one or two persons, in the presence of

⁴ See the OECD's *Principles and Guidelines to Promote Sustainable Lending Practices in the Provision of Official Export Credits to Low Income Countries (April 2008 Revision)*.

⁵ *Reforming the Proces of Sovereign Debt Restructuring* - Paulus and Kargman, UNFFD, 2008

⁶ UN International Conference on Financing for Development (March 2002), Monterrey Consensus (A/Conf/198/3), para. 60

⁷ See Raffer - *Debt Workout Mechanisms* - 2003

the neutral third party traditional in international law. The arbitrators would chair and support negotiations and if necessary reach a decision. CIDSE and Caritas Internationalis include the following further detail on the requirements for an FTA in their 2004 paper on the topic, based itself on Raffer's analysis:

- “The process shall be open to ALL debtor countries, including HIPC’s.
- The start of the process shall automatically trigger a standstill on all external debt repayments. This would protect countries from litigation by creditors such as “vulture funds”.
- The debtor and the creditors alike shall choose the members of an independent arbitration panel that could be established in an ad hoc manner. Ultimately a more permanent independent body to deal with successive debt crises could be institutionalised within a structure such as the United Nations, given its special responsibility for the follow-up to the Financing for Development process...
...The role of the IMF shall be restricted to that of a lender. The IMF cannot act in any “independent” role because of its creditor function.
- The whole process as well as the decisions of the panel shall be made public.”⁸

17. No new treaties are required to formulate such an institution, and there are several precedents for this form of arbitration which offer routes open to the international community in developing Fair and Transparent Arbitration:

- Arbitration is effectively used in the case of trade and investment disputes - through the International Centre for the Settlement of Investment Disputes - to whose jurisdiction both parties agree to beforehand in the case of dispute arising.
- The Permanent Court of Arbitration in the Hague could begin to take sovereign debt arbitration within its ambit were new loans to have a clause in them stipulating the use of this body in the event of dispute. This Court operates under the existing framework supplied by the United Nations Commission on International Trade Law (UNCITRAL), which involve 109 states and it has provided an effective context for Law of the Sea disputes.
- The World Bank itself, although not yet convinced by the argument for independent arbitration, offers general arbitral guidelines in Section 10.04 of its 1985 *General Conditions*, under which both parties agree on the neutral chair.
- Chapter 9 Insolvency in US law provides the domestic legal precedent and body of law, as argued by Austrian economist Kunibert Raffer⁹
- Arbitral decisions made in one state were agreed to be upheld in others 1958 New York Convention on the *Recognition and Enforcement of Foreign Arbitral Awards*¹⁰

18. Obstacles to the project are thus less in the realm of technical difficulties than political will, but there are various factors make this idea politically feasible even

8 CIDSE-Caritas Internationalis - *Sustainability and Justice: A Comprehensive Debt Workout for Poor Countries with An International Fair and Transparent Arbitration Process (FTAP)* 2004

9 See Raffer - *Debt Workout Mechanisms* - 2003

10 NY Convention, 1985 - article V

among creditor governments - including the UK government:

- The lack of any clear current idea among creditor governments as to how to deal with newly defaulting countries, and the threat to the legacy of the HIPC and MDRI debt-cancellations of the last decade.
- The absence of any coherent framework for dealing with audits, repudiations and cancellations on the basis of legitimacy, such as the 2008 Ecuadorian debt audit or the 2007 Norwegian cancellation.
- The absence of a framework such as Chapter 9 insolvency for coping with insolvency proceedings in developed countries such as Iceland.
- The desire of creditor governments to restore the smooth functioning of international markets within a more sustainable architecture. The Stiglitz Commission, mandated by the UN to report on the mechanics of global financial reform in April 2009, argued that:

'There is an urgent need for renewed commitment to develop an equitable and generally acceptable Sovereign Debt Restructuring Mechanism, as well as an improved framework for handling cross border bankruptcies. One way by which this might be done is through the creation of an independent structure, such as an International Bankruptcy Court. The United Nations Commission on International Trade Law provides a model that could be extended to the harmonisation of national legislation on cross border disputes dealing with trade in financial services.'¹¹

Concrete asks that can be made of the UK government

1. The UK government in 2007 made a commitment to developing a Charter on Responsible Lending. It is now even more critical for the Government to make progress with this initiative and for it to include provision for Fair and Transparent Arbitration.
2. The UK government, as part of a review of the operations of the Export Credit Guarantee Department, should include a clause that refers to Fair and Transparent Arbitration in all new loan agreements guaranteed by the Export Credit Guarantee Department (ECGD). This could be promoted at a policy level through the broad modelled on the suggestions laid out in the Charter for Responsible Lending of the European Network on Debt and Development (EURODAD)

'the loan document should provide a provision for an independent and transparent arbitration process in case of repayment difficulties or dispute (at the request of borrower or lender). There will be a stay on debt repayment difficulties or dispute (at the request of borrower or lender). There will be a stay on debt repayments while negotiations are underway. The borrower will also be protected from litigation while negotiations are in progress. Borrowers and lenders will abide by the decision of the independent arbitrator and there is a right to appeal.'¹²
3. The UK could use its standing within international fora to promote the development of Fair and Transparent Arbitration. In particular, it can take advantage of the UN Summit in June 2009 to champion the idea, as well as taking the opportunity of the G20 finance ministers meeting in late September.

11 J. Stiglitz - Recommendations by the Commission of Experts of the President of the General Assembly on reforms of the international monetary and financial system.

12 EURODAD Charter on Responsible Financing - 2008