Position paper

(How) can the Common Framework be improved?
An assessment of current proposals

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The debt restructuring framework “Common Framework for Debt Treatments beyond the DSSI” of the G20 has been in place since November 2020. This framework was intended to give all countries that qualified for the G20's Debt Service Suspension Initiative (DSSI) and which cannot simply resume their debt service without serious financial stress, the opportunity to negotiate their outstanding claims on a case-by-case basis. For the first time, China, the now most important official bilateral creditor, has been involved in a standing multilateral creditor coordination body. Some of the traditional creditor states, united in the so-called Paris Club, regard “disciplining” China in this way as a success. Unfortunately, the Common Framework does not have more to offer: in the 1.5 years since its adoption, there was no finalised debt relief negotiation. Despite rising global debt distress risks, the potentially beneficiary countries refrain from using the Framework. Since the creation of the Common Framework, civil society organisations from North and South have made it clear that, in its current form, the Framework is unsuitable for solving the debt crisis in the Global South in a timely and fair manner. Since the autumn of 2021, the International Monetary Fund (IMF) and the World Bank have also increasingly warned that the Common Framework, without improvements, cannot contribute to the solution of the global debt crisis, thus risking an "economic collapse" of countries or a "humanitarian crisis" in the Global South. Most recently, such fears came true on 12 April 2022, as Sri Lanka defaulted on its payments. Due to its per capita income, however, Sri Lanka was excluded from the Common Framework. And yet, the Common Framework was designed with the purpose of avoiding such disorderly sovereign debt defaults.

Given the threat of global instability due to increasing debt crisis risks while the Common Framework's progress stalled, the IMF and World Bank have been pushing for its improvement since December 2021. Although there are differing views – both within the IMF and between the IMF and the World Bank – as to how ambitious proposals for improvement should be, the following minimum consensus has emerged between both institutions at the 2022 IMF and World Bank Spring meetings:

- Countries must (1) be able to suspend their debt service payments for the duration of the negotiations under the Common Framework, with a view to support the debtor throughout the negotiations.
- Further (2) clarity must be sought concerning the detailed steps and timelines in the Common Framework.
- Further clarity (3) must be sought as to how comparability of treatment, i.e., the equal treatment of different creditors in the negotiations, could be guaranteed and enforced.
- The Common Framework (4) should also be extended to other highly indebted countries, that is, it should not be limited to the 73 countries with the lowest incomes.

How are these suggestions assessed by erlassjahr.de?

1. Building a more operational G20's Common Framework

1.1 <u>Suspension of debt service</u>

IMF's and World Bank's proposal:

- *Introduction of debt service suspension for the duration of the negotiations provided by public creditors to applicant Common Framework countries. The value of payments made during the moratorium to non-participating creditors should be fully accounted for when granting debt relief under the equal treatment clause.*

With the proposal for debt service suspension, the IMF and the World Bank aim to make the *Common Framework* more appealing for debtor countries. In the short term, debtor countries asking their creditors to restructure their outstanding debts will face a downgrading of their creditworthiness and, therefore, their exclusion from international capital markets. The granting of debt service suspension upon entry into *Common Framework* negotiations is intended to help debtor countries enjoy immediate and relevant benefits as the debt restructuring process gets underway, instead of waiting for seeing any benefits at the end of negotiations only.

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A debt moratorium is one of the elements of a fair and transparent sovereign insolvency process, which has long been demanded by civil society actors such as erlassjahr.de, and should be the basis of any rules-of-law-based insolvency procedure. It would therefore be very welcome if applicant countries were granted a comprehensive moratorium while negotiating under the *Common Framework*.

Besides the effect of immediate relief to debtor states, there is another reason why establishing a comprehensive debt moratorium is paramount to guarantee fair and efficient debt restructuring negotiations. A debt moratorium prevents individual creditors from gaining access to existing capital of the debtor before other beneficiaries. Since creditors must completely waive repayments during the negotiation period, a moratorium can also increase their willingness to participate cooperatively in debt restructuring negotiations, and to conclude them in a timely manner. However, a moratorium only fulfils this purpose when encompassing all creditors of the debtor country.

At present, the IMF and the World Bank are nonetheless considering a moratorium in which only the official creditors being responsible for the Common Framework, i.e., the G20 states and the Paris Club and thus only official bilateral creditors would be involved. In 2022, countries benefiting from the Common Framework will pay around 40% of their total debt servicing to official bilateral creditors. This would mean that a sizeable 60% of debt service would not be covered by the moratorium. If debtor states can only suspend repayments to their official bilateral creditors, the short-term relief effect is fairly limited.

And yet even more problematic is the fact that a moratorium granted by only a few creditors would fail to contribute to comparable creditor treatment. Conversely, it must be assumed that the willingness of (private) creditors - who continue to be paid out - to negotiate will be further weakened by such a partial moratorium, because it is precisely the concessions of individual creditors that allow the debtor country to keep on paying its remaining creditors.

The DSSI, the debt moratorium of G20 countries established at the onset of the pandemic, was hampered by exactly that major flaw: only official bilateral creditors were obliged to suspend the scheduled debt service. Private creditors were only asked to participate voluntarily, which they – unsurprisingly – refused to do. The bulk of the relief under the DSSI was therefore granted by China, the main official bilateral creditor. However, it is unlikely that China will continue to be willing to grant payment deferrals while (largely Western) private creditors continue to be paid out.

IMF staff, instead of making clear that, for a more effective debt relief framework, lessons should be drawn from the experience with the DSSI, they defend the lack of willingness of G20 countries to act. Such position stands on flimsy arguments as to why an equal treatment of all creditors would not be necessary in a debt moratorium: the fact that private creditors continue to be paid out through the concessions of public creditors is not a problem, they say, since equal treatment between all creditors can be retroactively ensured in the context of debt restructuring negotiations under the Common Framework. Such an approach, which sounds theoretically feasible, seriosuly misjudges the real political dynamics and power relations in international debt restructuring negotiations. Lacking international insolvency processes based on the rule of law, the only incentive for creditors to participate in multilateral debt restructurings is the risk of losses. Inducing creditors, who have already been paid out during negotiations, to participate retrospectively is simply unrealistic.

1.2 Timeline and sequence of steps in negotiations

IMF's and World Bank's proposal:

- *Greater clarity on the different steps and timelines in the Common Framework (such as that official bilateral creditors should aim at forming a creditors' committee within 4-6 weeks of the debtor country's application).*

The proposal to set hard deadlines and a clear timeline for negotiations under the Common Framework arises from the fact that, to this date, no negotiations could be concluded timely and, therefore, no further countries could be encouraged to join.

Assessment of erlassjahr.de:

Speeding up negotiations under the Common Framework is generally desirable. However, the IMF's and World Bank's proposal hardly clarifies what would happen specifically if a deadline passed without the wished result. It is questionable, whether the incentive for uncooperative creditors to join negotiations can be strengthened without any sanction mechanisms.

It must be avoided, that it is debtor countries that will be sanctioned, if negotiations fail to reach results soon enough. Negotiations in Zambia show the risk in this respect: in December 2021, a staff-level agreement with the IMF was finalized. When communicating the agreement, the IMF wrote that sufficient progress in debt restructuring negotiations was needed to disburse the IMF funds:

> *"In light of unsustainable public debt, the authorities' reform efforts will need to be supported by a comprehensive debt restructuring. We welcome the authorities' request for a debt treatment under the G20 Common Framework and hope that official creditors can quickly form a committee and provide financing assurances. We support the authorities' efforts to maintain a constructive engagement with private creditors to help secure a deal on comparable terms to official creditors. Sufficient progress on this front will be needed before the staff-level agreement can be presented to the IMF Executive Board for approval."*

As Zambia relies on the IMF financing during the debt restructuring period, this increases the pressure on Zambia to agree swiftly to a restructuring, even if this were not far-reaching enough. When it comes to the creditor side, the pressure on creditors to agree to the required level of debt restructuring will not be increased, however. Instead of simply putting pressure on debtors, the IMF should also sanction non-participating creditors, thereby increasing the incentive for sufficient participation. Thus, even if debt restructuring negotiations have not yet made sufficient progress, the IMF could still disburse funds from the loan programme if the debtor ceases to make payments to non-cooperative creditors (see point 3 for more details on the extended application of the IMF's Lending into Arrears policy). If creditors understand that a lack of agreement will necessarily lead to default, which can be sustained because the debtor receives financial and political support from the IMF (and official donors), they would be more likely to pursue an agreement. Therefore, it is not so much the setting of a specific timetable that would speed up the process. It is rather the clarification of the potential outcome should creditors delay the debt restructuring process.

1.3 Clarification of how comparability of treatment can be ensured for private and bilateral public creditors

IMF's and World Bank's proposal:

- *It should be clarified which parameters and processes are used to determine comparability of treatment, and how comparability of treatment is to be effectively implemented and enforced, beyond those already included in the Common Framework.*

The following approaches are being discussed:

- In view of the lack of methodological clarity as to what is meant by "comparable participation", the World Bank proposes an ex-ante definition of an easily comprehensible and transparent calculation method. The aim is to replace the previous approach whereby official creditors determine equal treatment ex-post at their own discretion, on a case-by-case basis.
- Private creditors should be included in debt restructuring negotiations at an earlier stage and should not first be confronted with an already established decision of official creditors on the extent of the debt relief – which they should then also grant to the debtor under the comparable treatment clause – without having had a say in it. This is not only linked to the hope that the whole process will come to a quicker conclusion, but also that it would prevent debt relief that is not efficient enough. The IMF and the World Bank also hope that official

creditors will be more willing to grant comprehensive debt relief if there are comparable concessions from private creditors.

Assessment of erlassjahr.de:

Ensuring that all creditors – and particularly private creditors – participate equally in necessary debt relief is one of the key challenges in making the Common Framework effective. As long as individual creditors fear that their own concessions will not serve the economic recovery of the debtor country, but the payment to other creditors, necessary debt restructuring will be delayed, since no individual creditor is willing to agree concessions as the first (and potentially only) creditor. Ensuring comparable treatment among various creditors is therefore one of the most important prerequisites for timely and comprehensive debt relief. In this respect, China's involvement in multilaterally coordinated debt restructurings is indeed a major success of the Common Framework. The problem lies, however, in that – just like the Paris Club – the Common Framework only deals with official bilateral claims, not private claims. As in Paris Club agreements, debtor countries are also obliged under the Common Framework to negotiate concessions with its private creditors (and also with non-Paris Club and non-Common-Framework bilateral official creditors) to the same extent as those granted by the Paris Club or G20 countries (so-called Comparability of Treatment clause). This principle of comparable treatment is intended to ensure that the claims of G20 and Paris Club members are not subordinated to those of non-members (i.e., other governments or private creditors). Empirical studies nevertheless show that the comparability of treatment clause has not worked in the last thirty years, and thus in a time when public creditors still held the lion's share of the claims. In principle, private creditors' claims were prioritized over official claims. Experience with the G20's debt moratorium DSSI, which private creditors have almost entirely refused to accept, and initial experience with negotiations under the Common Framework also indicate that equal treatment cannot be guaranteed without further effort.

Methodological proposals on how to treat different creditors comparably (approach 1) are to be welcomed. On the one hand, the proposed calculation method ensures that, firstly, all creditors – irrespective of the due date of their claims – participate to the same extent in the relief effort. On the other hand, it ensures that creditors whose loans have a higher interest rate will have to accept larger write-offs than creditors who lent at lower interest rates. Still, the agreement on a uniform method of calculating comparable treatment alone cannot effectively ensure comparable treatment among creditors. This is so because the missing incentive to participate is hardly related with the lack of clarity about what comparable treatment actually means. Indeed, private creditors' participation depends on whether they run the risk of receiving less, i.e., the risk of a (total) loss of their claims, should they fail to cooperate. The World Bank also indicates that, historically, the attempt of moral persuasion by official creditors was not the ultimate driver for private creditors to participate in debt restructurings.

Involving all parties in a debt restructuring process as early as possible (approach 2), rather than subsequently imposing public creditors' decisions on other parties, is desirable and certainly helpful to speed up the debt restructuring process. However, for a sustainable outcome, it is absolutely crucial to clarify how decisions on future debt relief are made. Instead of making granted debt relief conditional on what most creditors are willing to accept, there should be an explicit clarification or publicly articulated commitment that the scope of debt relief under the Common Frame*work* will be determined through a debt sustainability analysis (independent of private and official bilateral creditors). Under the current principles of the Common Framework, however, debt relief is not only aligned with the debt sustainability analysis – to be drawn up by the IMF and the World Bank – but also with creditors' considerations on what concessions they are prepared to give:

> *"The need for debt treatment, and the restructuring envelope that is required, will be based on an IMF-WBG Debt Sustainability Analysis (DSA) and the participating official creditors' collective assessment."*

Granting relief according to what creditors consider reasonable stands in stark contrast with granting relief according to the results of a debt sustainability analysis, which takes into account what the debtor needs to return to the path of economic recovery. In these circumstances – especially where substantial debt relief is called for – the earlier involvement of private creditors may potentially lead to the faster conclusion of a debt restructuring agreement. At the same time, however, it also means that debt relief is only granted to an extent that private creditors voluntarily agree to – and not to the extent determined by an independent debt sustainability analysis.

From the perspective of erlassjahr.de, the G20 should adopt measures to enforce comparable treatment as required. The pressure on private creditors can be increased firstly by the threat of a debtors' default and secondly via legislative measures.

From the point of view of erlassjahr.de, the IMF has a central instrument at its disposal to support debtor states in suspending payments to non-cooperating creditors: within the framework of its so-called *Lending into Arrears Policy*, the IMF can also lend to debtor countries in default towards private or public creditors. By applying this policy more proactively, the IMF could support the debtor country in its confrontation with blocking creditors. If, for instance, a creditor refuses to participate in restructuring negotiations or disagrees with the scope of the debt relief determined through the debt sustainability analysis, the IMF could still make payments out of an agreed loan programme, provided the debtor agrees to suspend payments to the non-cooperative creditors or to remain in arrears until they agree to the restructuring. Likewise, the G20 could support the country politically and financially in suspending payments, making its own debt relief conditional on the country suspending payments to blocking creditors or remaining in arrears with them. In doing so, the IMF and the G20 should make it publicly clear that the debtor has negotiated in good faith and that the default arises from the unwillingness of non-cooperative creditors to agree to the necessary debt rescheduling.

This process, of how creditors who refuse to participate will be handled, should be made clear transparently and publicly by IMF and the G20.

Indeed, in her first blog post on 2 December 2021 on the necessary improvements to the Common Framework, IMF director Kristalina Georgieva mentioned the *Lending into arrears Policy* along with the need to enforce comparable treatment. However, this reference no longer appears in subsequent speeches.

The IMF briefly discussed the second possibility of enforcing comparable treatment – legislative steps by the public sector – very cautiously in October 2020, but did not pick it up again. Unlike the World Bank in January 2022:

"The Framework could also be strengthened by the enactment of statutory or legal measures to inhibit preferential recoveries by private sector creditors that are subject to comparable treatment requirements."

From the standpoint of erlassjahr.de, the German Government should advocate legal safeguards for debt restructurings by initiating the creation of national legislation that makes it more difficult to undermine multilateral debt restructuring agreements within the framework of the G7. The example could be the UK Debt Relief Act 2010, which prevents private creditors from suing in British courts for more than they would have received had they signed up to the *Heavily Indebted Poor Countries Initiative* (HIPC). What is helpful under this piece of legislation is, that national legislators need not directly interfere with contract law, as the originally agreed claims are not changed through the legislation. They can just no longer be claimed through national courts. Further to this form of "anti-holdout legislation," there are other ideas for national legislation aimed at increasing the participation of private creditors in debt restructuring[1].

1.4 Expanding to other countries

IMF's and World Bank's proposal:

- *Expand the Common Framework to other highly indebted countries that would also benefit from better creditor coordination.*

Assessment of erlassjahr.de:

Early after the establishment of the G20 initiatives, the German Government advocated the expansion of the initiative(s) to all heavily indebted countries. Lacking consensus within the G20, the global debt crisis – and its solution – has been reduced to a problem of the countries with the lowest income (73). The IMF and the World Bank also followed suit until late autumn 2021, when they began to draw attention to the risks for highly indebted middle-income countries. The fact that middle-income countries will also require rapid and comprehensive debt relief is a welcome admission, albeit a late one. However, in order for heavily indebted middle-income countries to benefit from better creditor coordination, as the Common Framework would like to offer, it is even more of importance to find solutions for the inclusion of private creditors. After all, over 60 percent of claims on middle-income countries are held by private creditors, and the share of bilateral public creditors is just 13 percent. Given the public visibility of the first negotiations under the framework, a negotiation under the Common Framework is otherwise even less attractive than if countries simply had to negotiate with their creditors outside the framework in an equally uncoordinated manner. This has also been recognised by IMF staff in April, demanding not only the expansion of the Common Framework but also a global cooperation framework for other heavily indebted countries, in parallel with the (inoperative) framework:

[1] For example, a law that obliges creditors to take part in cooperative restructuring negotiation "in good faith" upon a restructuring process. See Lee Buchheit and Mitu Gulati (2021), "The Duty of Creditors to Cooperate in Sovereign Debt Workouts", https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3950529.

"Options should also be explored to help the broader range of emerging and developing economies that are not eligible for the Common Framework but who would likely benefit from a globally cooperative approach in the period ahead. Muddling through will amplify costs and risks to debtors, creditors and, more broadly, global stability and prosperity. […] A global cooperative approach is necessary to reach an orderly resolution of debt problems and prevent unnecessary defaults."

Even if the IMF authors do not provide further details on what such an alternative or additional framework should look like, the German Government could take on existing initiatives from precisely these debtor countries outside of the Common Framework. The Vulnerable20 Group, very much like the Alliance of Small Island States (AOSIS), has made concrete proposals for elements of a new debt architecture, making debt relief processes more impartial and efficient while bearing in mind the specific needs of certain groups, such as climate-vulnerable states. One concrete step along the lines of the IMF's and World Bank's proposal, besides a consensus within the G20, could be for the G7 under the German Presidency to take up the initiatives put forward by debtor states, and discuss such a "global cooperation framework" together with those concerned.

2. What is to be expected from the G7 and the G20?

The proposals to improve the Common Framework presented to the World Bank's and the IMF's Development Committee[2] in the spring of 2022 are not new. The Bank and the IMF have been advocating these proposals since late autumn 2021. At their meeting in Jakarta in February 2022, the G20 would thus have been able to address at least the need for improvement of the Common Framework in the communiqué and, in the best-case scenario, would have already taken up concrete proposals from their implementing institutions. However, they did not do so. Rather, they reiterated – as in previous communiqués – the importance of the involvement of private and other public creditors, but did not take any further measures to make this happen. Since the beginning of the Russian aggression against Ukraine a few days later, the G20 – of which Russia is a member – is now increasingly paralysed. For the time being, no ambitious reform decisions should be expected from the G20.

One of the priorities of the G7's Finance Track – which includes developed countries within the G20 and meets under the German Presidency in 2022 – is to improve the Common Framework:

> "As the G7, we are also committed to strengthening the implementation of the international debt strategy – in particular, an improved implementation of the G20 Common Framework for Debt Treatments – so that we can achieve sustainable debt treatment for the poorest countries."

But G7 members in particular are accepting the deadlock and current uselessness of the Framework so as not to jeopardise through "ill-considered steps", i.e., efforts to introduce the necessary changes,

[2] Forum at the level of finance and development ministers, which advises the Governors of the World Bank and the IMF on development policy issues, consisting of 25 members (partly congruent with G20 member states) .

the eventual "success" to integrate China into multilateral creditor coordination. The G7 would bear a much broader responsibility and would have to consider the big picture, as the argument goes. Possibly, guidelines would be developed for how the process currently works, a half-hearted attempt to implement at least part of one of the proposals of the IMF and World Bank. In view of the worsening debt crisis and the lack of debt relief, the "big picture" seems to be limited to the protection of creditor solidarity.

However, efforts to make participation of the private sector mandatory, especially from the G7, would not jeopardise the Common Framework but make it significantly more effective and functional. Although global financial and debt issues are largely discussed at the G20 today, the ball remains in Western countries' court as regards the binding involvement of private creditors: a large number of private creditor institutions are based in Western states, a large part of contracts are concluded under UK (London) or US (New York) law. Therefore, Western countries have a chance to agree on relevant measures and goals that can guarantee the binding involvement of private creditors. This is the only area whereby Western countries can incentivise progress within the G20. A corresponding step would help untie the deadlock within the G20: China, the largest bilateral public creditor and thus the country with the highest burden in the Common Framework, obviously has no great interest in financing the bailout of private – especially Western – creditors through its public concessions. Conversely, the German finance ministry argues that the focus remains on China's involvement, which the ministry believes is the only effective lever to ensure private sector participation. Accordingly, the G7 did nothing at all. In 2022, almost 60 percent of debt service payments from countries in the Global South will go to private creditors, whereas China's share is 9 percent. This is the big picture that the G7 are missing.