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Legislative reform to ease debt restructuring for lower-income countries

1. Summary

Lower income countries have been plunged into a debt crisis that is preventing them from addressing the needs of their people or responding to the climate emergency, threatening a wave of political instability.

Urgent debt relief is being blocked by the failure of bilateral, multilateral and private creditors to agree on sharing the burden of debt restructurings. The G20 initiatives in response to the crisis have neglected to include robust processes to require banks, hedge funds and oil traders to renegotiate their loans alongside governments and multilateral lenders. Private creditors have ignored repeated calls from the G20, the UK Government, the IMF and the World Bank to participate, and are continuing to be paid in full on often risky high-interest loans, while debt restructuring processes stall.

The vast majority of lower income country debt contracts are governed by English or New York law. This means that the UK could pass legislation to ensure that predatory minority creditors cannot undermine collectively agreed restructurings. This would protect countries which have negotiated a debt restructuring from being sued by predatory creditors seeking payment in full, as well as benefit responsible private creditors, allowing them to participate in restructurings without fear of losing out to competitors or reneging on any fiduciary duty to maximise returns for investors.

There is growing support for legislation in the UK and the US. The World Bank President David Malpass has said that "Major jurisdictions may need to look to legislative changes to support faster progress if private creditors aren't able to move forward on their own."

The UK played a key role in ensuring the success of the global initiative to address the last debt crisis by passing the Debt Relief (Developing Countries) Act in 2010, which ensured that no creditor could sue for more than they would have got if they had participated in debt restructurings agreed under the Heavily Indebted Poor Countries Initiative. This new debt crisis provides an urgent opportunity for the UK to play a similar global leadership role.

2. The case for legislative reform

Lower income countries have been facing increasingly unsustainable debt since the 2008 financial crisis, with debt payments increasing by 120% between 2010 and 2021, reaching their highest level since 2001. The economic shocks imposed on lower income countries from the pandemic have significantly exacerbated the situation. For the 69 countries they assess, the IMF assess that 37 are in debt distress or at high risk of being so, up from 17 in 2013.

As a result, resources needed to respond to energy and food price crises, the climate emergency and other locally determined needs are increasingly being diverted to debt repayments. Lower-income countries simply cannot afford to invest in mitigating and adapting to the impacts of the climate crisis, and in preparedness for climate-related disasters such as hurricanes and floods. This means that climate-related disasters will continue to have devastating effects on unprepared communities.

The G20 response has been inadequate. Recognising the risk that the pandemic would trigger a debt crisis, the G20 set up the Debt Service Suspension Initiative (DSSI) in April 2020, which allowed lower income countries to request the suspension of some repayments. However, the countries which applied to the scheme had on average just

23% of debt payments suspended. This was primarily because private creditors refused to take part, and only suspended 0.2% of what was owed to them. The DSSI came to an end in December 2021.

The remaining mechanism for addressing the debt crisis is the Common Framework for Debt Treatments Beyond the DSSI, announced by the G20 in November 2020. However, although the Common Framework requires private creditors to take part, it lacks a process to ensure this. Progress has been painfully slow: over two years since it was established, only four countries have so far applied, Chad, Ethiopia, Ghana and Zambia, and none have yet seen any debt cancelled. Chad has completed the process, but the only debt relief it received was a few payments to its private creditors - a consortium led by oil trader Glencore - moved into the future. Glencore delayed the process while continuing to get paid in full on its high interest loans.

The lack of cooperation of private creditors appears to be both blocking progress on the countries that have applied, and discouraging others from applying. Many of the most indebted and climate-vulnerable countries are excluded from applying on grounds of income level; some including Sri Lanka and Suriname are negotiating debt restructurings outside the Common Framework.

The participation of private creditors in debt restructuring is critical: 41% of lower-income country external debt repayments are due to Western private creditors between 2023-2029, compared to 33% to multilateral institutions and 12% to Chinese public and private lenders. Debt restructurings have to involve all creditors on a fair and equitable basis, recognised in the Common Framework in the principle of comparability of treatment. If private creditors refuse to participate, governments are rightly reluctant to grant debt relief that would simply allow private creditors to continue being paid, effectively using public money to bail out the risky (and usually higher interest) lending of banks and hedge funds. As a result, debt restructurings can become lengthy stand-offs, in which the debtor country is stranded between conflicting demands of different creditors, facing the invidious choice of continuing to make unsustainable payments or default, risking being sued by holdout creditors. The IMF recognises that "debt restructurings have often been too little and too late, thus failing to reestablish debt sustainability and market access in a durable way".

Case study

Private creditors blocking Zambia's debt restructuring

Zambia defaulted on payments to foreign currency bondholders in November 2020 when private creditors refused to suspend debt payments. In contrast, China agreed to the suspension under the G20's Debt service Suspension Initiative. In February 2021, Zambia applied for a debt restructuring through the G20 Common Framework, but little progress has been made on the negotiations as large private creditors including BlackRock have so far refused to cancel the amount of debt the IMF has said is needed to make it sustainable. BlackRock is the largest of the group of bondholders who are refusing to cancel Zambia's debt, despite lending to the country with interest rates as high as 9%. Private companies will need to take a significant haircut to get Zambia's debt down to a sustainable level as defined by the IMF. Currently 46% of Zambia's external debt is owed to private creditors.

The UK has a unique opportunity to strengthen the legal framework to ensure the participation of private creditors, as 90% of bonds issued by countries eligible for the Common Framework are governed by English law, including all bonds of Zambia and Ghana, as well as other countries needing debt restructuring such as Pakistan. There is a precedent for UK legislation to facilitate debt restructuring processes: the Debt Relief (Developing Countries) Act 2010 prevents a private creditor from suing a borrowing government for more than it would have received if it had taken part in the Heavily Indebted Poor Countries process, the previous major debt relief initiative.

3. What reform would look like

The UK could pass legislation to incentivise private creditors to take part in debt relief. Two possible legislative options are:

a) Replicate the Debt Relief (Developing Countries) Act by stating that no creditor can sue for more than they would have got if they had taken part in the Common Framework for debt restructuring, or any other internationally agreed debt restructuring the UK government is party to, including all restructurings agreed by the Paris Club.

b) Extend existing UK corporate law on debt restructuring so that governments can restructure their debts in a similar way to companies. Part 26A of the Companies Act 2006 allows companies in financial difficulty to restructure their debts without undertaking insolvency. Similar provisions for sovereign debt could enable the courts to require disruptive private lenders to take part in debt relief if other creditors, such as governments, have agreed to the debt relief deal, or if a certain proportion of creditors have voted in favour.

The legislation should also establish a debt moratorium once the borrowing country has applied for a debt restructuring, meaning that they would not be required to service debt repayments while negotiations are taking place. This would prevent creditors under English law from accelerating payments once the debtor applies for restructuring.

4. Benefits of introducing legislative reforms

The key benefits of introducing new legislation would be to:

- Ease the debt restructuring process by undermining the ability of minority creditors to hold out on an agreement;
- Ease financial settlements for debtor governments in distress;
- Increase the speed of restructuring processes, reducing uncertainty for debtor countries and creditors and enabling borrowing governments to access capital markets again more quickly;
- Address the power imbalance between the single debtor country and often large number of creditors.

Legislation would ideally be passed alongside similar legislation in New York, to minimise the risk of lenders avoiding contracts under English law. Similar proposals are being advanced in the New York Assembly.

About Debt Justice

We are a UK charity working to end poverty caused by unjust debt through education, research and campaigning.

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