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Considerations for Designing Sovereign Insolvency Procedures

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Abstract

The idea to emulate domestic insolvency for over-indebted sovereigns, first suggested by Adam Smith, is no longer considered utopian. One may therefore focus on how to implement an appropriate insolvency mechanism for sovereigns. This paper discusses which domestic insolvency model can and should be emulated, whether a statutory approach enshrining such a mechanism in the Fund's Articles of Agreement is needed as the IMF claims, and whether granting international financial institutions (IFIs) preferred creditor status is justified and economically defensible. It will be shown that it is neither legally nor economically feasible. The de facto preference secured by IFIs is a grave shortcoming. The lack of any legal responsibility of IFIs, the IFI-privilege of being allowed tortious actions, theoretically even actions wilfully causing damage to their clients, not only with impunity but even with financial gain must be redressed. It has encouraged IFIs to violate their own statutes, causing damages to their members. Illustrative examples are provided, which would not be conceivable under the Rule of Law. My proposal to treat all creditors equally when it comes to a sovereign insolvency procedure would achieve a considerable change to the better. This paper concludes that emulating the essential features of US municipal insolvency (Chapter 9, Title 11 USC) is the only appropriate procedure for sovereigns. It would uphold the rule of law, respect for human rights, and the most fundamental legal principles. Using traditional ad hoc arbitration and the basic elements of municipal insolvency, it could technically be implemented at once.

Keywords: Debtor Protection, Human Rights, International Financial Institutions, International Financial Architecture, Sovereign Debts, Sovereign Insolvency, Tort Theory

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1. Introduction

The proposal to emulate features of domestic insolvency in order to solve the problem of sovereign debts, which dates back to Adam Smith, is no longer as controversial as it once was. Oechsli (1981) was apparently the first to analyse this issue in detail after the emergence of the Euro-market. Emulating domestic insolvency was strongly opposed when it was suggested immediately after 1982. Until the International Monetary Fund (IMF) proposed its own model as a 'new approach' (Krueger, 2001) this idea was virtually anathema. Krueger's speech finally broke the taboo of discussing sovereign insolvency. As if touched by Harry Potter's wand, even the strong reservations of IMF staff have disappeared.

As the idea or Adam Smith's economic aptitude need no longer be defended, this paper can focus on issues that are considered of particular interest to jurists. Before doing so, my

Chapter 9 proposal is sketched very briefly for readers unfamiliar with it. For details. I refer to other publications (Raffer, K, 1990, 1992). This paper also presents the main differences between the IMF's Sovereign Debt Restructuring Mechanism (SDRM) and my proposal, elaborated in details elsewhere (Raffer, K, 2001, 2003b).

It discusses which domestic insolvency model can and should be emulated, whether a statutory approach is needed as the IMF claims, and whether granting the IMF and other international financial institutions (IFIs) preferred creditor status is justified. Finally, a grave shortcoming in IFI-debtor relations is discussed: the lack of any legal responsibility of IFIs, the IFI-privilege of being allowed to commit tortious acts, not only with impunity but even with financial gain. This defect would be corrected, at least for insolvent debtors, by my proposal.

2. Essential Elements of an International Chapter 9

Domestic Chapter 9 in the United States (US) deals with debtors having governmental powers, and protects those affected by the composition plan, giving them a right to be heard. Both the indebted municipality's employees and taxpayers expected to pay more have the opportunity to object. Creditors are to receive what can be reasonably expected under the circumstances. The living standards of the indebted municipality's population are protected. The jurisdiction of the court depends on the city's volition, beyond which it cannot be extended. This demonstrates the appropriateness for sovereign debtors.

In my model, a panel of arbitrators, not national courts, would chair procedures. As is established practice in international law, each side (creditors/debtor) nominates one or two persons, who elect another person to achieve an uneven number. People affected by the solution would be represented by organisations speaking on their behalf, such as trade unions or employees' associations (as in domestic US cases) or international organisations, such as the United Nations Children Fund (UNICEF), religious or non-religious non – governmental organisations (NGOs), or grassroots organisations of the poor.

The principle of debtor protection, indisputable element of all modern and civilised legal systems, is also part and parcel of my model. In analogy to the protection granted to the population of an indebted municipality within the US, the money to service a country's debts must not be raised by destroying basic social services. Subsidies and transfers necessary to guarantee humane minimum standards (basic health services, primary education etc) to the poor must be maintained. Funds necessary for sustainable economic recovery ('fresh start') must be set aside. This can be done by establishing a transparently managed fund financed by the debtor in domestic currency as suggested by Pettifor (1999). Its management would be monitored by an international board or advisory council consisting of members nominated by governments (including the debtor country's) and NGOs. A legal entity of its own, checks and discussions of the Fund's projects would not concern the government's budget, which is an important part of a country's sovereignty. Aid could also be channelled through the fund, changing its character of money just set apart from the ordinary budget towards a normal fund for the poor.

Debt service payments have to be brought into line with the debtor country's capacity to earn foreign exchange. Where the removal of protectionist barriers can be expected to lead to higher export revenues, a trade-off between more repayments and less protection or higher debt reduction without reduced protection is necessary. Doubtlessly, a need for reform within debtor countries exists. These reforms would be proposed by the debtor in the plan. This is a fundamental difference to the SDRM in which it is the IMF that would, in fact, produce the plan. Here, the IMF should adjust debtors to the real international environment, not to a textbook illusion of 'free markets'. Realistic strategies have to drop ideological predilections, such as unilateral liberalisation by debtors. They must be based on carefully researched forecasts.

Another important feature of my proposal is that official creditors, including the IFIs must be treated in the same way as the private sector. All debts must be reduced by the same percentage. It is argued in detail below why this is legally and economically mandatory.

2.1. 9 or 11?

When Krueger (2001) eventually proposed to ‘mimic’ domestic insolvency — a ‘new approach’ the IMF should have been familiar with as it had opposed it ferociously before — she did not specify which domestic procedures should be followed. Her speech differed from some G7 finance ministers’ proposals a while before, explicitly calling for an international Chapter 11 (cf Raffer, 2001). But it was soon clarified that she had thought of Chapter 11, not Chapter 9, which grants public debtors a much stronger status legally.

Later, Krueger (2002, pp 12 - 14) referred briefly to Chapter 9 as ‘[i]n many respects ... of greater relevance in the sovereign context because it applies to an entity that carries out governmental functions.’ She draws attention to differences to the corporate model, suggesting ‘[a]ll of these features could be appropriately integrated into a sovereign debt restructuring mechanism.’ However, she sees important differences between municipalities and sovereigns that would have implications on the design of the SDRM:

‘Chapter 9 legislation acknowledges—and does not impair—the power of the state within which the municipality exists to continue to control the exercise of the powers of the municipality, including expenditures. This lack of independence of municipalities is one of the reasons why many countries have not adopted insolvency legislation to address problems of financial distress confronted by local governments.’

Krueger’s conclusion may be doubted on historical grounds. As European governments have operated on the doubtful premise that public authority cannot go bankrupt, special proceedings would therefore not be necessary. Experience, such as the present case of the City of Berlin, proves this optimism unfounded. Krueger presents the point that municipalities are subject to constitutional rights of states in a totally misleading way. It appears to be based on section 903 (Reservation of State power to control municipalities):

‘This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise, but —

(1) a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition; and

(2) a judgment entered under such a law may not bind a creditor that does not consent to such composition.’

Section 903 simply ‘sets forth the primary authority of a State, through its constitution, laws, and other powers, over its municipalities.’ (USC, S 903, Misc.1, Title 11 USC). Thus, section 103(c) specifically demands the authorisation to be a Chapter 9 debtor by state law (cf Raffer, 1990, p 302; Raffer, 1992, p 399). Given the need to reconcile constitutional rights of the federation and states (Kupetz, 1995) section 903 simply states that insolvency procedures do not invalidate state laws and state rights regarding a ‘political subdivision or public agency or instrumentality of a State’ (Section 101(34) 11 USC) deriving all its rights and powers from the State. Section 903 does not disturb but preserves constitutional arrangements (Kupetz, 1995, p 582). Filing for insolvency does not void the Constitution, or the law. As laws on the subject of bankruptcy are constitutionally reserved to Congress (Article I, Section 10), and states are prohibited to pass laws impairing the obligation of contracts, a state can basically suggest a method of composition. If creditors agree, this might be useful. Since the US Constitution is not the constitution of every country, it is

unlikely that US constitutional concerns will be the reason for the lack of municipal insolvency procedures in nearly all other countries. Advised by private western consultants, Hungary adopted an insolvency law for public debtors after the demise of communism — quite possibly the only other country with public insolvency procedures. These are, however, too specifically tailored to the country's institutions to lend themselves to international adoption.

Like municipalities, corporations are subject to the law. If justified, Krueger's reservation would also be valid against Chapter 11. Furthermore, if the argument were right, national laws could not be a source of international norms, as they usually address non-sovereign actors. International treaties could not draw on the principles of national contractual laws because these clearly address non-sovereigns. Her rather short passage on Chapter 9, which quotes no legal source and no academic literature on the topic, apparently expresses a certain dislike against Chapter 9, which she does not mention again later.

The difference between the two variants is fundamentally important. Chapter 9 is the only procedure protecting governmental powers, and thus applicable to sovereigns. Section 904 ('Limitation on Jurisdiction and Powers of Court') states with utmost clarity:

'Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with —

- (1) any of the political and governmental powers of the debtor
- (2) any of the property or revenues of the debtor; or
- (3) the debtor's use or enjoyment of any income-producing property.'

The concept of sovereignty does not contain anything more than what section 904 protects. The court's jurisdiction depends on the municipality's volition, beyond which it cannot be extended, similar to the jurisdiction of international arbitrators. Unlike in other bankruptcy procedures, liquidation of the debtor or receivership is not possible. No trustee can be appointed (Section 926, avoiding powers, if seen as an exception, is very special and justified). Section 902(5) explicitly confirms: "trustee", when used in a section that is made applicable in a case under this chapter ... means debtor'. Under Chapter 9, a US municipality cannot go into receivership. Change of 'management' (that is, removing elected officials) by courts or creditors is not possible — nor should this be possible in the case of sovereigns. Obviously, similar guarantees are absent from Chapter 11. Public interest in the functioning of the debtor safeguards a minimum of municipal activities. While debtors might be required to increase taxes, legal limits exist. In the 1930s, when some creditors insisted on higher payments by the City of Asbury Park to be financed by tax increases, the US Supreme Court clearly stated that '[a] city cannot be taken over and operated for the benefit of its creditors' (Malagardis, 1990, p 68).

To avoid misunderstanding, it is important to repeat that my proposal has always been adapting the main principles, 'the essence' (Raffer, K, 1990, p 304), of Chapter 9, not all details. Obviously, the complicated relationship between the union and states within the US and its legal repercussions are irrelevant internationally. So are other domestic details, such as the need to authorise the status of a Chapter 9 debtor. Domestic US Chapter 9 proves conclusively that an efficient and fair insolvency procedure for public debtors can be implemented easily. Its main principles — public interest in the functioning of public debtors, safeguarding a minimum of public activities, the right to be heard of the affected population, the transparent procedure and the protection of the debtor's governmental sphere as well as the best interests of creditors — need be applied internationally.

3. The Statutory Approach and Institutional Self-Interest

The IMF claims that a statutory approach is needed to assure functioning of any sovereign insolvency mechanism. It proposed to enshrine the whole mechanism down to surprisingly small details in the IMF's Articles of Agreement. From an institutional point of view, the statutory approach is vitally important to the Fund, giving it the sole mandate on sovereign insolvency, also ending what is officially described as joint 'debt management' by the International Bank for Reconstruction and Development (IBRD) and the IMF, and, thus, the long turf war between the two about which is in charge.

The problem of 'vulture funds' was used as the argument for a statutory approach. The IMF argued repeatedly that it would be necessary to change the laws of all countries, because 'vulture funds' could otherwise interfere with the mechanism, picking countries where they can enforce their claims successfully. The 'statutory approach' would oblige all member states to change their domestic laws in a way that the opposition of creditor minorities can be overruled. The IMF's argument is altogether flawed. Not all countries and territories are IMF members. The Cayman Islands, for example, are not members but enjoy enough autonomy to offer themselves as places for creditors shopping for jurisdictions where unanimity is required and any single hold-out creditor can try to get more than accepted by all other creditors. It should be recalled that these three minuscule islands have routinely been used to oppose the Tobin Tax by the IMF, arguing that it could not be introduced because universal acceptance could not be assured. 'Tobin Tax paradises' such as the Cayman Islands would preclude implementation. The same concern would logically hold with regard to Krueger's 'shopping for jurisdictions'. Conveniently, though, this point has not been raised.

Meanwhile, the IMF (2002b, p 33) contends: 'For the unsecured creditor, its ability to disrupt the process though legal action immediately following a default is limited.' In the following footnote, the Fund advises how 'the sovereign debtor may be able to further limit its vulnerability to creditor litigation.' (ibid, p 34) The Fund appears to admit now that the problem is not insurmountable. In fact, there is an easier way to stop disruptive litigation than changing the IMF's statutes (Raffer, 2003a). Changing sovereign immunity laws in the very few jurisdictions stipulated by loan agreements by inserting a clause voiding or suspending waivers of immunity during sovereign insolvency proceedings would solve the problem of disruptive litigation. 'Vultures' are equally bound by existing contracts, including clauses stipulating which law applies in the case of disputes. If the US and the United Kingdom (UK) changed their laws governing sovereign immunities by inserting one short clause, vulture funds would be put out of business in most cases. This clause could, for example, read: 'Starting international insolvency procedures voids/suspends all waivers of immunity relating to this case'. In the UK State Immunity Act 1978, Chapter 33, this could, for example, be inserted into Part I. More elegant formulations than mine are certainly welcome. If those few 'exotic' places whose laws are occasionally agreed on, such as in Frankfurt, followed, disruptive litigation would be impossible. This small change in sovereign immunity laws would have the advantage of preserving sensible and tested solutions in domestic contexts, such as the US preference for excluding majority action clauses to protect small investors.

Although it has been assured from the start that the process should be in the hands of creditors and the debtor (cf Krueger, 2001, p 5), the whole process is in fact wholly under IMF control. The arbitration mechanism proposed, meanwhile called Sovereign Debt Dispute Resolution Forum (SDDRF), would have no authority to challenge decisions made by the IMF's Executive Board regarding, inter alia, the adequacy of a member's policies or the sustainability of the member's debt. The most important decisions would, thus, be made by the IMF, a creditor in its own right and controlled by a creditor majority. Obviously, the IMF is not financially disinterested in the outcome. Formally, the SDRM would exempt all multilateral claims. However, lower sustainability levels (that is, higher losses for discriminated creditors) protect the viability of multilateral debt service. Smaller reductions by the private sector (and creditor governments should bilateral claims be included, an issue on which the IMF has remained opaque) would negatively affect the debtor's capacity to service

multilateral claims. More generous debt reductions by discriminated creditors would make multilateral debt service more viable and easier. Legal exemptions are only enforceable if debtors have sufficient money. Economic logic is not invalidated. The IMF has thus an economic interest in 'erring on the safe side', by demanding relatively larger reductions from others to protect its own claims. Deciding on sustainability the IMF would decide on the economic soundness of its own exposure.

The SDDRF would be an IMF organ. While it has no authority over the IMF and its authority over public creditors is unclear, its decisions resolving disputes between the debtor and its creditors or among creditors are binding irrespective of what creditor 'super majorities' might decide. They could not be challenged (IMF, 2002a, p 28). The panel's powers over private creditors and debtors would not be limited. It would also verify claims, thus deciding on whether to recognise them with full authority to strip creditors of their claims. To establish the SDDRF complicated, clumsy, and unnecessary procedures dominated by the IMF are proposed. Even details are to be written into the Fund's statutes (Raffer, K, 2003a; 2005). The fact that ad hoc arbitration as well as institutions that could be approached, for example, the International Court of Justice (ICJ), already exist proves that another IMF organ is not needed.

4. Preferred Creditor Status: Attempts to Legalise Improper Practice

Most, if not all, domestic insolvency laws differentiate between classes of creditors, preferences granted to certain claims (for example, unpaid taxes) or liens on specific assets. My proposal to treat all creditors equally is therefore not technically mandatory. Insolvency models privileging public or multilateral creditors can as easily be designed as mine. My demanding symmetrical treatment is based on economic sense, considerations of equity, and the basics of any legal system.

As present debt management efforts, including the Heavily Indebted Poor Country (HIPC) initiative and notably the SDRM, prove that IFIs are trying to gain recognition as preferred creditors. While other creditors should cut their losses, the IFIs are making themselves exempt from losing money. Under the HIPC initiative, IFIs only reduce the debt if and after reductions by all other creditors have proved insufficient. Economically, this preference is only possible if other creditors lose more. One strategy in this distributional battle between creditors is to argue against the claim of 'preferred creditors', as IFIs enjoy no such status by law or under their own governing statutes. The statutes of multilateral development banks foresee procedures for debt reduction in the case of debt overhang. All have built up loan loss provisions as demanded by their statutes, but refuse to use them as intended and when needed in spite of statutory obligations.

Checks on the IBRD, inter alia, by Canada's auditor-general, have concluded that it has no preferred creditor status. Under pressure from private business, the IBRD has even waived the negative pledge clause in its loans in 1993, which would have guaranteed that no creditors' claims will have preference over the Bank's (Caufield, 1998, p 323). If the IBRD has already been given preference, de jure, there would have been no need for such clause. Its Articles of Agreement does not provide for any preference but stipulate the IBRD's legal obligation is to grant debt relief if and when needed. The fact that private creditors are under no similar obligation logically supports the idea that its founders may even have wanted the public entity of the IBRD to ease debt pressure first when indicated. Article IV, section 6 of the Agreement obliges the IBRD to provide a special reserve in order to cover what Article IV, Section 7 calls 'Methods of Meeting Liabilities of the Bank in Case of Defaults'. Detailed rules are stipulated on how to proceed. As the IBRD is only allowed to lend either to members or to other borrowers if member states fully guarantee repayment (Article III, Section 4 of the Articles of Agreement), the logical conclusion is that this applies to sovereign default.

Multilateral development banks mirror the IBRD's constitution. All have the authority to modify the terms of loans other than the currency of repayment. The Agreement Establishing the Inter-American Development Bank provides for 'Methods of Meeting Liabilities of the Bank in Case of Defaults' (Article VII, Section 3). Charges should first be made 'against the special reserve provided for in Article III, Section 13,' which are required to meet the Inter-American Development Bank's liabilities in the case of debtor default. The Agreement Establishing the Asian Development Bank similarly demands a special reserve to meet liabilities in the case of default (Article 17). Article 18 provides a detailed description of how to proceed.

The case of the African Development Bank is slightly different (Raffer, 2004, p 69). The last revision of its statutes in July 2002 is available on its website. Article 20 (Special Reserve) was completely deleted, apparently in reaction to the Bank's downgrade from its triple-A status by rating agency Standard and Poor in the 1990s, and during its reform. No obligation to reduce debts is found in the present statutes. The European Bank for Reconstruction and Development (EBRD) writes off losses and submits debts to arbitration (also foreseen for the IBRD), which proves that multilateral development banks, if properly managed, can survive financial accountability and market risk.

IDA's Articles of Agreement are somewhat vague. Pursuant to Article V, Section 3, entitled 'Modifications of Terms of Financing', IDA may 'agree to a relaxation or other modification of the terms on which any of its financing shall have been provided'. In the case of maturities of 35, 40, or even 20 years with ten-year grace periods and 'no interest charge' (IDA prefers to call its 0.75 percent interest rate a service charge), this leaves little realistic alternatives but for outright grants.

Trying to find arguments in favour of preference, the IMF cannot deny that it enjoyed no legal or contractual status as a preferred creditor (Boughton, 2001, p 820). Its own Executive Directors emphasised a need to treat the IMF 'in practice' preferentially — a legally irrelevant view to which it is, of course, entitled. The Interim Committee endorsed this view and 'urged all members, within the limits of their laws, to treat the Fund as a preferred creditor' (*ibid*, p 821, emphasis added).

When the IMF was established, conditionality did not exist. Loan loss provisions were considered unnecessary. Acting as an emergency source of finance providing short-term liquidity on a comparatively small scale without strings attached justified unconditional repayment. Nevertheless, no preferred creditor status was enshrined in its statutes. Before the Second Amendment, the IMF's Articles of Agreement 'contained a provision suggesting that others would have preference on the Fund' (Rutsel Silvestre, 1990, p 825). According to the author, the 'intention' of this change by the Second Amendment 'was not to repudiate the underlying thought that it was beneficial to encourage bank lending by giving banks and other a preference in repayment' (*ibid*, p. 814). Unfortunately, rather than making the IMF financially accountable when conditionality was introduced, as economic reason would demand, initial intent was blurred.

Economic facts assert themselves. Facing repayment problems of its clients, the IMF had to accumulate loan loss reserves. This term or provisioning are anathema, presumably because the Fund thinks that such terms might lead to the conclusion that even the IMF thinks losses unavoidable in spite of its attempts to exempt its own claims. All IFIs have provided for losses. Their 'precautionary balances' ranged from slightly less than ten percent (IMF) to over 30 percent (Asian Development Bank) of credit outstanding as of end of October 2003 (IMF, 2004a, p 26).

One has to concur with Rutsel Silvestre (1990, p 814) that the IMF's statute contains 'a presumption against a preferred creditor status', and that 'general international law contains no compulsory standard of conduct requiring the preferential treatment of any external

creditor, including the Fund' (ibid, p 825). However, the IMF has no explicit statutory obligation to grant debt relief. Important multilateral development banks violate their own constitutions by not giving members their default relief as stipulated. This open breach of their statutes makes meaningful and sustainable solutions of over-indebtedness more difficult, inflicting damages on borrowing members. The fact that members' statutory rights have repeatedly been infringed on is a big problem unless one accepts a global system of legal double standards.

5. Liability, Tort, Fault, and Equity

One further, and very powerful, argument for not treating the IFIs better than other creditors is the IFIs' substantial involvement in debtors' economic decisions. The argument that the IFIs charge interest below the debtor's market rate, is generally (but not always) true, but it is economically flawed and legally irrelevant.

Commercial banks have usually not interfered with their clients' economic policy. Bond holders even less so. The IFIs have strongly influenced the use of loans, exerting massive pressure on debtors — to the extent of provoking questions over whether countries actually 'own' their economic policies. The IFIs have routinely taken economic decisions but refused to participate in the risks involved. They insist on full repayment, even if damages negligently caused by their staff have occurred, repayment which have to be made by borrowers. A high rate of IFI failures therefore renders adjustment programmes, which are administered by IFIs, necessary, just as failed programmes are likely to result in new programmes, as long as unconditional repayment to IFIs is upheld. This logical mechanism might be described somewhat cynically as 'IFI-flops securing IFI-jobs' (Raffer, 1993, p 158) It is at severe odds with the role of jurisprudence as the *ars boni et aequi*. No protection granted by contract or tort law to anybody else applies to the poorest of the world. Even wilfully and unlawfully inflicted damage does not presently confer any right to compensation. In spite of official declarations on human rights and equality of human beings, there exists one law for the rich in OECD countries and another law for the poor. Minds more critical than mine might be tempted to speak of a juridical apartheid. This perverted incentive system is also a severe market imperfection, totally at odds with any market economy.

Without any legal basis, and even in violation of their statutes, the IFIs have shrugged off legal liabilities that are part and parcel of the business of finance. If consultants fail to respect professional standards or to work properly, they can be taken to court. Those who have suffered damages unlawfully have a right to be compensated. The only exception of this generally accepted rule is development cooperation, an area where damage can still be inflicted with impunity and even financial gain. If normal accountability standards applied to southern debtors, there would be no multilateral debt problem.

As discussed, the IFIs have largely abolished the risk of insolvency by making other creditors lose more. But the statutes of most IFIs foresee legal liabilities comparable to private consultants, and indeed a necessary part of any civilised legal system: whoever causes damages by negligent or tortious action must provide financial redress. The IBRD's General Conditions Applicable for Loans and Guarantee Agreements 1985, Section 10.04 foresee arbitration as the means to resolve '[a]ny controversy between the parties to the loan agreement', and 'any claim by either party against the other' not settled by agreement. Actions may be brought against the Bank in courts of competent jurisdiction in the territories of members in which the Bank has offices, appointed agents for the purpose of accepting service or notice of process, or issued or guaranteed securities. Its Articles of Agreement (Article VII, Section 3) allow for actions against the Bank, except by members or persons acting for or deriving claims from members, who are supposed to use the arbitration mechanism. Property and assets are 'immune from all forms of seizure, attachment or execution before the delivery of final judgment against the Bank' (emphasis added). The Bank's founders had no intention to exempt and protect it from all legal, and economic

consequences of failures. Accountability was not initially meant to be removed. Suing the Bank before national courts was therefore considered technically feasible. Foiling the intentions of its founders and its own statutes, the IBRD has actively influenced members not to allow lawsuits against it. The principle that anyone suffering or alleging to suffer damages due to another's fault or because of failures to observe an equitable duty must be able to seek redress is firmly established in OECD countries and was thought to be appropriate for the IBRD as well. Apart from equity concerns, this is necessary to provide economic incentives for proper work.

Several telling examples demonstrate the difference between normal market actors and the IFIs. In 2003, a German court at Muenster ordered a bank to compensate a client whom it had advised to buy Argentine bonds as the bonds were considered high yielding yet safe investments as the Argentine newspaper Clarín (2003) reported. The court agreed with the plaintiff's argument that the bank did not explain Argentina's difficulties adequately and ordered the bank to indemnify its client fully because of the advice it had given. In Britain, an even stronger claim of liability was upheld. A British couple that had borrowed money from Lloyds sued the bank successfully because its manager had advised and encouraged them to renovate and sell a house at a profit. The High Court ruled that the manager should have pointed out the risks clearly and should have advised them against the project. By giving advice while lending, the bank went beyond mere lending, and Lloyds had to pay damages when prices in the property market fell and the couple suffered a loss (Gapper and Gourlay, 1995).

Some illustrations are necessary to show the stark difference between the IFIs and normal, decent legal practice. Stiglitz (2000) had heard about an IMF country team that had copied large parts of the text for one country's report into another country's report, forgetting to remove the original country's name in a few places. In 1982, the German expert Erwin Blumenthal, seconded by the Bretton Woods institutions to Zaire's central bank, warned most outspokenly, and in writing, that Zaire should not get any further money due to widespread corruption. In 1983, the IMF allowed Zaire the largest drawing that had ever been effected by an African government. Predictably, the money disappeared. Until 1989, the IMF trebled the volume of Zaire's drawings. Zairians had to pick up the bill.

The Asian financial crisis of 1997 revealed a more serious problem. Until the crisis, both Bretton Woods institutions encouraged further capital account liberalisation, although the IBRD, at least, was in possession of official documents warning that this strategy would lead to catastrophe. In 1999, the IBRD (1999, p 2; also Raffer and Singer 2001, pp 61 - 62 and p 151) acknowledged having known 'the relevant institutional lessons' since the early 1990s. An audit report by its Operations Evaluation Department on Chile's experience with precipitate capital account liberalisation warned expressly that proper sequencing and institution building were mandatory.

Encouraged by the Bretton Woods institutions and unhampered by democratic opposition, Chile's military junta liberalised around 1980. When the crash happened, authorities realised that 'practically no inspection or supervision of bank portfolios existed' (Diaz-Alejandro, 1985, p 8). Reserve requirements had been steadily reduced, and 'apparently little effort was spent on investigating the banking credentials of new entrants' when banks were privatised (ibid). The IMF's Director of the Western Hemisphere, E Walter Robichek, had assured Chileans that private borrowers — as opposed to governments — were very unlikely to over-borrow, even with official guarantees (ibid, p 9). This view is sometimes called the Robichek doctrine. Voluntary financial transactions between private agents were believed to be their own business only, and presumably pareto-optimal.

The IBRD (1999) pointed out that the lack of proper sequencing featured also prominently in Mexico's crisis 1994-95. The risks of quick capital account liberalisation had been recognised years before the crash, and the unfolding of the Asian crisis when these countries liberalised

in the Chilean way could be watched like a movie whose script is known. But instead of pointing out these risks clearly and warning Asian countries, the IFIs encouraged their Asian members to carry on policies that could be expected to produce a crash.

Brazil's Polonoroeste illustrates how failed projects produce additional income for the IFIs. An IBRD loan of USD 240 million had caused considerable environmental damage. Bank officials admitted that they had erred and lent another USD 200 million to repair the damage done by the first loan. Brazil's debts increased by USD 440 million, the IBRD increased its income stream (Raffer, 1993), earning nearly double as much as it would have if the project had succeeded.

The IBRD's lending targets have often put pressure on officials to disburse. Mosley et al (1991, p 72) cite examples. In the case of Bangladesh, although the whole division, including its chief, agreed that Bangladesh could not absorb any more money, the lending programme was not slowed. The Bangladesh division chief explained that if he advised slowing down he would be fired. This is by no means the only case. Quoting examples of pressure to lend, the Bank's Operations Evaluation Department (OED) had warned that the Bank 'needs to be more realistic about the borrowers' implementation capacities' (IBRD, 1989, p xvii; for more cases see Raffer, 1993).

The question of proper professional standards is especially pronounced with regards to the crucial role of the IBRD and the IMF in estimating debt sustainability. Their projections have served as the basis of debt reductions. The success of any debt reduction hinges on whether it is sufficient for a 'fresh start'. Granting too little might offer short-term comfort to creditors but it prolongs the problem, creating damages to debtor economies. For decades, overly optimistic forecasts have inflicted damages on member countries, rendering strategies based on such forecasts, especially debt reductions, useless. Attention was drawn to this undue optimism long ago. When the US General Accounting Office (GAO, 2000) was assessing HIPC II on congressional request, it found that debt sustainability depended on annual export growth rates above six percent in US dollar terms over 20 years — in four cases, including Nicaragua and Uganda, this was above nine percent. Understandably, the GAO doubted whether such rates can actually be maintained for that long, warning also about the volatility of commodity prices. It pointed out that additional money would be necessary. Like so many creditor initiatives before, HIPC II was apparently again built on fragile, optimistic assumptions and forecasts. With good reason, the Zedillo Report states that HIPC II has 'in most cases' (Zedillo et al, 2001, p 21) not gone far enough to reach sustainable debt levels, suggesting a 're-enhanced' HIPC III (ibid, p 54). Meanwhile, the IMF and IDA (2004, p 13) themselves had to admit:

'past experience suggesting a systematic tendency toward excessive optimism . . . a common theme behind the historical rise in low-income countries' debt ratios was that borrowing decisions were predicated on growth projections that never materialized . . . analysis of projections made by Fund staff over the period 1990-2001 suggests a bias toward over-optimism of about 1 percentage point a year in forecasts of low-income country real GDP growth. The bias in projecting GDP growth in U.S. dollar terms, however, was considerably larger, at almost 5 percentage points a year.'

The document called for 'well-disciplined projections, including by laying bare the assumptions on which they are predicated and by subjecting them to rigorous stress tests that explicitly incorporate the impact of exogenous shocks' (ibid). These are very basic requirements of projections, which IFIs have not observed so far. The same occurred in the Commonwealth of Independent States: 'overoptimism by multilaterals contributed to the high debt levels' (Helbling et al, 2004, p 1). Nevertheless, the IMF wants to continue with providing projections under the SDRM. As prolonged crises mean increased income and importance, economists could find economic explanations easily.

The establishment of the IMF's internal evaluation office and its frank reports are a huge and commendable step forward. Evaluating the Fund's role in Argentina, it found many cases of grave negligence at the least, if not worse (IMF, 2004b). It found that a 'program was also based on policies that were either known to be counterproductive ... or that had proved to be 'ineffective and unsustainable everywhere they had been tried' ... [A]s expressed by FAD [the IMF's Fiscal Affairs Department] at the time' (ibid, p 91). Another 'critical error' (ibid, p 75) which occurred in 2001 was, that there was no sufficiently clear understanding existed what to do should the approach fail. The Board supported 'a program that Directors viewed as deeply flawed' (ibid, pp 81- 82). The 'September 2001 augmentation suffered from a number of weaknesses in program design, which were evident at the time. If the debt were indeed unsustainable, as by then well recognized by IMF staff, the program offered no solution to that problem' (ibid, p 89). The IMF not only 'failed to use the best analytical tools' (ibid, p 109), but '[a]vailable analytical tools were not used to explore potential vulnerabilities in sufficient depth' (ibid, p 110). It goes without saying that the IMF was again unduly 'optimistic' in its forecasts, as the report documents. This is just a small selection from a limited part of the period evaluated. It should be sufficient to show that — if the IMF were a consultancy firm and Argentina its client — the plaintiff's lawyers would have a feast. But the IMF is not a consultant and Argentina has to pay for programmes that — as the IMF would must have known, judging from its own evaluation report — contributed to its ruin. The IMF gets more interest income from Argentina than it would have got if it had refrained from such strategies. One cannot but concur with the Statement of the Argentine Governor: 'Recognizing errors is, however, just the first step in a healthy self-criticism exercise. The second step is bearing responsibility for failures, namely sharing the burden of redressing their consequences' (ibid, Annex). Equal treatment of all creditors would be a first yet important step (for further corrective measures, see Raffer, 2004).

6. Conclusion

This paper argues that emulating the US Chapter 9 is the only appropriate procedure for international sovereign insolvency procedures which follow the rule of law and the most fundamental legal principles. By using long standing ad hoc arbitration practice and the basic elements of municipal insolvency, this could technically be done at once. Political opposition remains too strong, though, because the idea of abolishing legal double standards is still not widely accepted. Pronounced but unjustified institutional self-interest of multilateral creditors is another reason for opposing a fair procedure. To assure equal treatment and equity this must be overcome.

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