CHAPTER 5

Debt Management

We recognise that the debt burden constitutes a major obstacle to allocating resources to key socio-economic sectors in developing member countries.

Aso Rock Commonwealth Declaration on Development and Democracy, Abuja, Nigeria, 2003

The lawsuits faced by HIPC countries highlight the difficulties they face caused by debt. Most debt shocks are also the result of globalisation and developments in international financial policy. Public debt management is a way to make indebted countries less vulnerable to financial crisis and shocks in the international financial market.

This chapter looks at the ways in which a sovereign country interacts with the international market and can implement effective debt management at national level. A sound debt management process is one which follows government policy and operates within the right institutional and regulatory framework. Effective debt management can stop unsustainable debt, and hence lawsuits by vulture funds.

Lawsuits brought by vulture funds are slowing down the progress made by many HIPC countries in obtaining debt relief and achieving the MDGs, in spite of strong support from the international financial institutions. One example is the recent case brought against Liberia in the UK courts,[47] where judgment was given against Liberia in the sum of US$20m to be paid to the vulture fund creditors, Hamsah Investments and Wall Capital Ltd. Liberia recently entered into an agreement with the World Bank to buy back some of its commercial debt at a discounted rate.

Litigation is of course a legal problem, but vulture fund lawsuits are nurtured by the unsustainable debt positions of sovereign countries. The financial, economic and political issues that determine a country's debt position play a crucial role in determining whether a lender will become dissatisfied and have recourse to a vulture fund creditor.

An examination of the historical reasons for the rise of vulture funds (Chapter 1) shows the opportunities for profit arising from indebted countries' failure to repay their loan obligations and their dire need for debt restructuring. Shortcomings in the debt restructuring process have inevitably been exploited by vulture funds through court proceedings against the HIPC countries. It is essential to understand that the manner in which a country manages its debt is important, as it can make it harder for a vulture fund to pry into the country's level of indebtedness. In the case of *Donegal International Ltd v Republic of Zambia & Anor*,[48] Donegal director Michael Sheehan indicated in court that he knew more about some countries' debts than did people within those countries. For example, he knew about Zambia's inability to repay and was able to bargain with Romania.

The Commonwealth Secretariat Legal Debt Clinic, with its brief to investigate vulture fund lawsuits, has looked into the root causes of the problem and adopted a holistic approach to reaching a solution. Its research has concluded that methods of contracting loan agreements in HIPC countries and related laws are out of date. Officers working in public debt management offices do not have the best tools or an understanding of how to implement loan repayments. In addition, economic and political issues play a very important part in a country's ability to repay. The experience of the United Nations Conference on Trade and Development (UNCTAD) and the World Bank, which have participated in debt rescheduling over several decades, have shown the weaknesses of debt management systems in nearly all indebted countries.

Being poor is not a sin, nor is it a sin for a sovereign state. However, managing poverty in a way that best avoids paying for costly litigation is an important option. This chapter aims to give lawyers and others who are not familiar with the topic of public debt management a background understanding. It should enable them to evaluate better the context of the loan agreements on which they are often called to give legal advice.

In a global financial world which is constantly evolving and which can have a serious impact on heavily indebted countries, the need to strengthen and update the functioning of public debt management is very important. For more than a decade, the World Bank has been offering services and products, providing global expertise and supporting countries in strengthening their debt management capacity and institutions. It considers that legal, structural and institutional reforms are needed to strengthen public debt management, particularly in relation to objectives, co-ordination, transparency, accountability and institutional frameworks.

The chapter outlines:

- What sound public debt management is;
- Why it is important in reducing a country's external vulnerability, and the likelihood of its defaulting on payments and ultimately incurring lawsuits;

- Ways of achieving effective debt management; and finally
- How effective debt management can be used to identify loans which may be vulnerable to vulture funds.

5.1 What is public debt management?

Public debt management, according to the World Bank, is 'the process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding, achieve its risk and cost objectives and to meet any other sovereign debt management goals the government may have set, such as developing and maintaining an efficient market for government securities'.[49]

Public debt management covers two types of debt: external and domestic. External debt is the amount of borrowing (government and private) whether guaranteed by government or not. It also has two levels – macroeconomic and micro administrative. On the macroeconomic level, debt management is an integral part of a country's overall macroeconomic management. On the micro administrative level, it is part of a broader process of public administration and management. To perform well on these two levels, both the execution of policy and the operational aspect must be effective and form part of a proper framework for public debt management.

Historically risky debt management practices make economies more vulnerable to economic and financial shocks, as in the Asian crisis of 1997. As a result, the creditworthiness of a country is also affected. Countries, especially low-income countries, depend on debt. Excessive reliance on these debts, which are mostly in foreign currencies, bring monetary and exchange rate pressures that are felt when a country is unable to pay or when creditors do not wish to refinance the debt.

When repayment of debt becomes difficult, various long-term and short-term solutions must be adopted. Possible remedies include: lengthening the maturities of borrowings and paying the associated higher debt servicing costs (assuming an upward sloping yield curve); adjusting the amount, maturity and composition of foreign exchange reserves; and reviewing criteria and governance arrangements in respect of contingent liabilities. However, once the creditor is dissatisfied or gives up, and sells the debt on the secondary market, vulture fund creditors step in. Servicing the debt is thus a necessity. To achieve this aim, there should be effective follow-up of payment schedules and checks that there is an adequate budgetary allocation every year.

Who deals with payments and how this is done, and who is responsible for managing this structure will be discussed next.

5.2 Why is public debt management important?

The following quotation from the World Bank explains the need for good public debt management. The World Bank advocates that

> *... effective public debt management can reduce financial vulnerabilities, contribute to macroeconomic stability, preserve debt sustainability and protect a government's reputation. Volatility of interest rates, exchange rates and debt flows require debt managers to properly assess possible risks and to mitigate them by relying on a diverse range of financing sources, while maintaining borrowing costs at prudent levels. The current financial crisis has made the tasks of debt managers even more complex by increasing financing needs at a time when conditions in financial markets are severely constrained. Moreover, the cost and risk characteristics of many financing options have changed, requiring a re-evaluation of existing debt management strategies.*[50]

Debt management is essential to reduce the risk of financial vulnerability. The experiences of the Asian crisis have shown the extent of the difficulties a hugely indebted country has to face. International bail-out becomes a necessity.

Whilst it is true that most developing countries suffer from changes in the international policy framework and are tied to the conditions imposed by most IFIs, nevertheless a huge external debt does not help an economy achieve sustainable economic growth.

At a time when the world is working together to reduce unsustainable debt in most of the HIPC countries, lawsuits from vulture funds are hindering progress. In the cases of Liberia, Zambia and DR Congo discussed above, money obtained from debt relief has been channelled to repay an outstanding loan after court rulings.

For instance, Liberia has been plagued by commercial debt of US$38m. In 2009, the World Bank agreed to assist Liberia and helped cancel its commercial debt, which was bought back by Liberia at 3 per cent of the total value.[51] Later, in November 2009, the UK courts were approached by the vulture funds Hamsah Investments and Wall Capital Ltd to recognise a default judgment that they had obtained against Liberia in the US courts in 2002. The UK court had no alternative but to make a judgment against the Liberian Government, ordering it to pay US$20m.

With sound debt management (which of course would not have been possible in Liberia as it was in the throes of civil war), this kind of scenario would have been avoided.

5.3 How to achieve effective debt management

Seven basic functions are needed in order to achieve effective debt management policies. They can be grouped into two major categories:

Executive (referred to below as the executive unit), which covers the policing, regulating and resourcing functions;

Operational, which covers the recording, analysing, controlling and operating functions. All these functions are dealt with either by one ministry (the ministry of finance, sometimes with a debt division) or by various ministries, depending on how the country's government is organised.

A strong institutional set-up is essential in order to achieve a meaningful debt management system. This responsibility lies with the executive unit. But many indebted countries have suffered in this respect because of a lack of adequate resources, both financial and human.

In the past decades, many organisations have provided capacity building training and workshops (for example the World Bank, IMF, regional banks, Commonwealth Secretariat, MEFMI, WAIFEM, UNCTAD and Debt Relief International (DRI)). However, it appears that the situation is often too complex and that change requires strong political will.

With ongoing lawsuits targeted against sovereign debtors, the Legal Debt Clinic argues that the executive aspect of debt management is where the fault mainly lies. Lack of robust will could be indirectly responsible for the lawsuits faced by a sovereign debtor. Governments need to set out appropriate rules and new regulations are needed. The operational division only follows, working within the limits set by the executive unit. It suffers from inherent difficulties, even if it has the best possible technical support and capacity building facilities.

The Legal Debt Clinic conducted an assessment of the need to update the laws governing sovereign borrowing in many of the indebted countries. It found that most of the participants identified a need for new or updated laws to support existing legislation.

The executive unit deals with the formulation of policies in terms of its debt strategies in accordance with the government's overall socio-economic objectives. It is the sole responsibility of the executive unit to formulate policies that determine debt strategies and the level of external borrowing, and to plan payments accordingly.

By way of illustration, at the workshop held by the Legal Debt Clinic in Ghana, Uganda's debt officers explained that in spite of several debt strategies to cope with indebtedness in their country over the years, they felt that a cap on borrowing was essential and should be implemented annually.

The executive unit therefore also becomes responsible for the type of laws required so that it can properly fulfil its policing function. The executive unit needs to be independent, well co-ordinated and centralised. It needs a well-defined operational unit, which is usually comprised of high-ranking officials and ministers, the governor of the central bank, economists and government auditors. It also needs effective reporting and data collection systems to provide transparency. The Legal Debt Clinic therefore decided to prepare a framework for fiscal responsibility law that was presented to the Commonwealth Law Ministers Meeting held in Edinburgh, Scotland in July 2008 (see Chapter 9, Ways Forward).

The executive unit is also responsible for proper resourcing of the operational unit. Indebted countries frequently suffer from a huge turnover of staff in their debt divisions because staff are not properly paid and can easily obtain better paid jobs in the financial services industry. There is a continuing need for most of the international institutions, such as the Commonwealth Secretariat, MEFMI and WAIFEM, to continue capacity building in debt management. Governments should investigate this constant staff turnover, which hinders countries in dealing effectively with unsustainable debt. Mistakes are inevitable with high staff turnover and the country suffers.

This chapter does not describe in detail the operational aspect of debt management, except to highlight that it involves different levels of functions. Each level has varying degrees of importance, but strengthens the whole debt management system.

The two most important operational levels which have an impact on the number of lawsuits are the units dealing with the negotiation of the loan and the servicing of debt thereafter.

The unit responsible for servicing the debt works closely with the third level, recording, for which a computerised system is recommended. The Commonwealth Secretariat has developed software, known as the Commonwealth Secretariat Debt Recording Management System (CS-DRMS), which is supplied to most Commonwealth countries, together with ongoing training and support. UNCTAD has also developed similar software since 2000; this has been adopted in 54 countries and is known as the Debt Management Financial Analysis System (DMFAS). Installing specialised software to record government debt has proved to be very helpful in establishing a good environment for debt management.

It is essential to know the key points of the World Bank guidelines that are relevant to avoiding vulture fund lawsuits. Further information is available on the World Bank website.[52]

5.4 Identifying loans which are targets for vulture funds

Effective debt management can offer a means of identifying existing loans that are targets for vulture funds. An effective debt management system will allow a country to:

- Know when it is defaulting on the servicing of its debts;
- Monitor creditors effectively, assess their mood and keep in close contact with them;
- Identify if they are willing to restructure or want to dispose of the debt agreement;
- Know how much money is owed and what steps to take, for example whether to buy out, restructure or reschedule the debt;
- Study those loan agreements and check assignment clauses, law that is applicable to the contract, sovereignty issues, *pari passu* clauses, and other terms and conditions of the contract as identified in Chapter 2, Loan Agreements;
- Identify terms and conditions under the agreement that will enable the country to ask for comparable treatment or similar treatment with other creditors or to obtain relief comparable to the Multilateral Debt Relief Initiative (MDRI) terms;
- Assess the risk, especially in terms of the default clauses and the amount of interest or penalty the country will have to pay;
- Consider at that juncture any other options available to the debtor, including a 'name and shame' campaign (Chapter 6, Responding to Lawsuits).

The following quotation illustrates how this monitoring system will help a country. In the case of *Donegal International Ltd v Republic of Zambia & Anor*,[53] Michael Sheehan of Donegal International stated that he used to have more extensive records of government debts than anybody in the market. Donegal routinely called on ministries of finance around the world and was aware of Romania's debt profile. He was in close contact with officials at the Romanian Ministry of Finance's External Debt Department. He stated: '... if a debt hits the market, we know about it within hours'.

Last but not least, if the above options are not successful, it is imperative to negotiate and even to lobby, using a 'name and shame' campaign.

Conclusion

A poor debt management structure can be a major factor in creating economic crises, as seen during the Asian crisis of 1997. In indebted countries, the government's debt portfolio is usually the largest financial portfolio in the country. It often contains complex financial structures which can generate substantial risk to the government's balance sheet and the country's financial stability. It is only through a prudent debt management system, with sound policies for managing risk, that a government can achieve stable economic status and avoid eventual lawsuits.

This chapter has considered areas where capacity building may be needed in order to strengthen public debt management, particularly in relation to policy decisions and institutional and legal frameworks. Finally, it has pointed to situations where effective debt management and risk management strategies can be used to identify loans which may be vulnerable to vulture funds.

The chapter has again drawn on the experiences of the Commonwealth Secretariat Legal Debt Clinic, which have shown that debt management issues are crucial in dealing with vulture fund lawsuits. The important lessons that emerge from this chapter are:

- Sound debt management practices and structures help governments to minimise risks. Debt management needs to be linked to a clear macroeconomic framework and should be linked to countries' monetary and fiscal policies.
- A fiscal responsibility law can help bring stability to the system.
- There is a need for capacity building in strengthening public debt management infrastructure. The World Bank guidelines clarify areas where reform can reduce a country's vulnerability to international financial shocks.
- There are many organisations that deliver capacity building in strengthening public debt management infrastructure. These programmes should be used until the government decides to introduce measures to stabilise high staff turnover in the sector.
- When it comes to identifying loans that are targets for vulture funds, effective debt and risk management processes are essential to check the profiles of loan agreements and the behaviour of creditors. Software should be used to keep track of all loan repayments.
- Negotiation again comes to the fore and is important for the formulation of clauses in the agreement during the refinancing or renegotiating of loans.

Further reading

- IMF-World Bank Guidelines for Public Debt Management, http://treasury.worldbank.org/bdm/htm/guidelines_publicdebt.html
- Commonwealth Secretariat Debt Management Recording System, http://csdrms.org/
- UNCTAD, Debt Management-DMFAS Programme, http://r0.unctad.org/dmfas/