

## **Input to the UN-DESA Elements Paper on Financing for Development**

### **Action area: Debt and Debt Sustainability**

#### **Reforming the Global Debt Governance System: Exploring Effective and Feasible Policy Solutions**

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By Kathrin Berensmann  
([kathrin.berensmannn@idos-research.de](mailto:kathrin.berensmannn@idos-research.de))

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### **1. Challenges of the current Global Debt Governance system**

The debt situation in developing countries has been further exacerbated by multiple and overlapping crises, such as the COVID-19 pandemic, the war in Ukraine, and the climate crisis. The International Monetary Fund (IMF) and World Bank have estimated that the proportion of low-income countries (LICs) that are at high risk of debt distress or already in debt distress has increased from 30 percent in 2015 to more than 50 percent in 2024 (IMF, 2024). About 25 percent of middle-income countries (MICs) are also at risk.

The above mentioned crises have created an urgent need for large-scale public spending, but at the same time have changed the macroeconomic environment in a way that has further worsened the debt situation, which was already difficult before these shocks. For example, the COVID-19 pandemic has led to higher government spending. The war in Ukraine has triggered rising inflation and higher interest rates in many countries, leading to limited access to international financial markets for developing countries. For developing countries, high interest rates increase their debt service payments (Berensmann et al. 2023).

The current Global Debt Governance system is unable to prevent over-indebtedness in developing countries. In addition, the current instruments of the Global Debt Governance system for resolving over-indebtedness are inadequate because they have often led to delayed, disorderly, inefficient, and therefore unfair debt restructuring processes.

## 2. Options to reform the Global Debt Governance system

Against this backdrop, it is recommended that policy solutions include the reform of existing instruments such as the Common Framework, which is currently the only instrument for comprehensive debt restructuring. Given the need for immediate action, it will be challenging to establish new comprehensive debt restructuring mechanisms, such as an international insolvency procedure<sup>1</sup>, which may not gain immediate acceptance from the international community. Secondly, new instruments must be created and combined with existing ones. We therefore propose the establishment of a universal code of conduct linked to the G20 Common Framework.

### 2.1 Reform of the G20 Common Framework for Debt Treatments

In 2020, the G20 introduced the Common Framework, which sets out the rules for future debt restructuring and debt relief (G20, 2020), with the aim of addressing the issue of highly indebted LICs in a systematic manner. One of the key aims was to ensure the involvement of both Paris Club members, representing the bilateral official creditors of Western industrialized countries, and G20 bilateral official creditors that are not members of the Paris Club. This latter group includes countries such as India, China, Turkey and Saudi Arabia that have become major creditors of developing countries in the past 15 years.

#### *Challenges of the Common Framework*

However, to date, only four debtor countries – Chad, Ethiopia, Ghana and Zambia – have adopted the Common Framework, nearly four years after its implementation. The primary reasons for this low level of participation are the typical challenges encountered with debt rescheduling mechanisms, including collective action problems, unequal involvement of different creditor groups and debtors in debt restructuring decision-making processes, the lack of a connection to climate risks and information asymmetries among stakeholders, which have resulted in socio-economic, political and intergenerational injustice. This example is representative of other debt rescheduling mechanisms within the global debt governance system.

#### *Reform proposals for the G20 Common Framework*

The reform proposals should contribute to making the Common Framework more effective, time-bound, and transparent with the following measures:

- ***Establish a ‘Comparability of Treatment’ formula*** (Serrate et al. 2024). A list of countries adhering to this formula could be put in place. To ensure the participation of all creditors, the IMF should include in its program conditions that the respective sovereign debtor should refrain from servicing hold-outs until they agree to provide comparable treatment (Henning, 2023).
- ***Create incentives for private creditors to participate in restructurings:*** Create legal safeguards for debt restructuring and limit the ability of holdouts to disrupt negotiation processes and outcomes, anti-holdout laws (Volz et al. 2022). Create Guarantee facility at the World Bank for green and inclusive reconstruction that would provide partial guarantees for restructured debt of private creditors, Brady-like credit enhancements for new bonds that would be swapped for old debt with a substantial haircut, facilitating negotiations with private creditors on debt cancellation (Volz et al. 2021).
- ***Involve of multilateral creditors on a case by case basis despite their preferred creditor status***

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<sup>1</sup> For further details on the various proposals for an international insolvency procedure, please refer to Berensmann and Herzberg (2009).

- ***Better link the Common Framework further instruments of the Global Debt Government system:*** Link the Common Framework with (i) a universal Code of conduct of creditors and debtors. The Global Sovereign debt Roundtable in collaboration with the FSB, should prepare a preliminary draft of the Code of Conduct for consideration by the G20 Working Group on International Financial Architecture (Serrate et al. 2024); (ii) include a provision for debt services, namely, the suspension of debt service payments for the duration of the negotiations. This would provide the debtor with much-needed relief at a time when they are under considerable pressure, and would also create an incentive for the faster processing of actual debt restructuring.
- ***Increase transparency of the debt agreements:*** Better coordinate information on debt agreement among international institutions as well as sovereign and private creditors and sovereign debtors by establishing an international debt registry at the Bank for International Settlements.
- ***Improve the link debt restructuring with development and climate goals:*** (i) Obligation of debtor countries to use debt relief to gain fiscal leeway for the achievement of SDGs (or specifically climate goals); (ii) Better include climate risks and the volume of investments in climate adaptation in WB/ IMF Debt Sustainability Analysis (DSAs) (Volz 2022); (iii) Integrate climate-resilient debt clauses in sovereign bond contracts, i.e. the deferral of debt payments in the event of a predetermined climate shock or natural disaster.
- ***Constitute Creditor Committees*** with all relevant creditors at the inception of the negotiation process, with the establishment of this committee being a prerequisite for initiating the aforementioned negotiation process.
- ***Promote dialogue among creditors:*** G20 and the international financial institutions should support creditor coordination and build trust and maintain dialogue with major creditors such as China and India. The new Global Sovereign Debt Roundtable, jointly led by the IMF, the World Bank and the G20 presidency, is a good initiative in this regard and includes public and private creditors (Serrate et al. 2024).
- ***Expand the Common Framework to MICs at least LMICs:*** Given that a number of MICs are also highly indebted, lower middle-income countries should also to be granted access to the Common Framework as well (Berensmann et al. 2022).

## 2.2 Design and implement a universal code of conduct

A code of conduct is a set of non-statutory rules of conduct that applies to all market participants. Such codes of conduct typically encompass provisions regarding to good faith negotiations, transparency with respect to the debtor's financial position and its agreements with other creditors, and equitable treatment of all creditors. These should be valid for all market participants, both before and during a debt crisis. In this regard, codes of conduct facilitate the resolution of debt crises by providing a framework for understanding restructuring and by fostering collaboration between creditors and debtors (Berensmann, 2022).

There are two main obstacles to the effective establishment and adoption of such codes of conduct. Firstly, a number of codes of conduct have been established with varying institutional settings and principles, some of which have already been implemented or proposed. These include those of the Institute of International Finance, the United Nations, the G20 and the OECD (Banque de France 2003; G20 2017; OECD 2018; UN General Assembly 2015; UNCTAD 2012 and 2015). However, the application of different codes of conduct by the relevant parties does not contribute to the prevention or effective resolution of debt crises in the context of differing institutional settings. Secondly, the current global economic governance structure does not provide sufficient and adequate incentives for creditors and debtors to adhere to codes of conduct (Berensmann, 2022).

## Design of a universal code of conduct

The new universal code of conduct should combine the elements of the various proposals made by the public and private sectors wherever possible. An aligned code of conduct should be set within the following general institutional framework (Berensmann 2022):

- **Objective:** the code of conduct should aim to ensure debt sustainability by preventing and promoting sustainable debt workouts.
- **Stakeholders:** All sovereign debtors and all public and private creditors should be included in the debt designing the code of conduct.
- **Principles:** A universal code of conduct should be based on the core principles of the various codes of conduct proposed or even implemented: (i) legitimacy, (ii) impartiality, (iii) negotiation in good faith, (iv) equal treatment, (v) fair creditor representation, (vi) dialogue between debtors and creditors, (vii) transparency, and (viii) restore debt sustainability (Banque de France 2003; G20 2017; OECD 2018; UN General Assembly 2015; UNCTAD 2012 and 2015).
- **Governance framework:** A monitoring system should be established with the objective of reviewing the implementation of the new code of conduct (Gelpern 2013). As is currently the case with the IIF principles, a Group of Trustees could oversee the implementation of the code of conduct and supervise the work of the Principles Consultative Group (IIF 2021). The latter group would be responsible for monitoring the principles and promoting the implementation of the universal code of conduct. The groups could comprise the debtor, public and private sector creditors, and representatives from non-governmental organizations and academia.
- **Secretariat:** Creation of a secretariat to facilitate the development of the code of conduct's institutional framework (Gelpern 2013).

The success of the code of conduct depends on achieving broad consensus among stakeholders on its design.

## Incentives for applying a non-statutory code of conduct

Incentives should be set in a way that encourages actors in the international financial markets to adhere to the code of conduct. If market participants view the implementation and adherence to the new code of conduct as a way to enhance their reputations and, consequently, gain improved access to international financial markets, it is in the best interest of a sovereign debtor to comply with this code. In this regard, peer and market pressure would be of significant importance.

- **Publication of a country list** indicating the countries adhering to the code of conduct (Banque de France 2003).
- **Role of rating agencies:** Encouraging rating agencies to consider adherence to the code of conduct in their macroeconomic analyses (Ritter 2009).
- **Link to sovereign bonds:** Incorporation of the code of conduct into sovereign bond contracts (Banque de France 2003).
- **Link to International Financial Institutions (IFIs):** Inclusion of codes of conduct in the lending policies of the IFIs, such as in the lending-into-arrears policy of the IMF (Banque de France 2003) or as a performance criterion at the IMF.

It is essential that all stakeholders actively participate in the development of a code of conduct if a cooperative process and ownership are to be achieved (Banque de France 2003). In addition, it is crucial that all relevant parties, including creditors, debtors, and the public sector, contribute to the design, approval, and implementation of a new aligned code of conduct. This can be achieved by establishing an expert group comprising representatives from all parties. The first step would be for the parties to agree on the composition and remit of the expert group. The

second step would be for the expert group to draft a proposal for a code of conduct, which would then be approved by all parties. It is essential that relevant public and private actors adopt the following tasks: the public and private sectors, including representatives of IFIs, should assume an active role in the governance body; in contrast, developing countries should demonstrate their commitment to applying the code of conduct by incorporating it into the documents for sovereign bond issues (Berensmann 2017 and 2022). Furthermore, it would be beneficial to incorporate this code of conduct into national and international legislation, as well as into the international cooperation infrastructure, including the G20, the G77, the Financial Stability Board (Gelpern 2013), and the Global Sovereign Debt Roundtable.

### 3. Conclusion

The Fourth International Conference on Financing for Development should make proposals to reform the Common Framework. Given that it is currently the only systematic instrument for restructuring/cancelling debt and that it would not be politically feasible to introduce another instrument in the short/medium term, reforming the Common Framework is the only viable solution in the short-term, albeit not the optimal one.

The Fourth International Conference on Financing for Development provides an excellent opportunity to discuss the potential for a universal code of conduct, given the inclusion of a diverse range of stakeholders. The lack of a universal code of conduct represents a significant gap in the Global Debt Governance Framework. The introduction of such a code could play an important role in preventing debt crises and facilitating debt restructuring. The prerequisite for this is that it is acceptable to the majority of debtors and creditors.

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