Financial institutions and developing countries' debt cancellations: How to get rid of moral hazard?

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Abstract The purpose of the paper is to shed light on the looming risk of developing country debt defaults for financial institutions in the wake of the pandemic crisis. There are mounting calls to delink debt relief and conditions on developing countries so that debt cancellations should be delivered immediately without performance criteria or record of accomplishment. To date, however, debt cancellations have not sufficiently distinguished developing country beneficiaries according to their performance in sustainable development policies, neither have cancellations taken into account commitments towards improved governance trajectories, despite the requirements of poverty reduction programmes involving civil society. International financial institutions thus face the risk of large write-offs at a time of portfolio fragility due to an environment of low interest rates, meager profitability and weak economic growth. This paper argues that much of the resistance of private creditors comes from deeply rooted skepticism as to whether debt relief and write-offs lead to sustained improvement in creditworthiness. Accordingly, prudent risk management requires resisting calls for blanket debt relief when there is little scope for improved governance. Financial institutions should insist on strict criteria regarding inclusive development policies. As new legislation to facilitate debt-restructuring agreements, likely at the expense of private financial institutions, is currently being discussed, the insistence on 'fair burden sharing' between official and private creditors should be a wake-up call for banks. A range of financial risk management instruments could link debt relief with enhanced governance commitments, including debt swaps, recapture clauses and the monitored recycling of debt-servicing relief into high-priority projects. The pandemic crisis provides financial institutions with an opportunity to transform debt relief into a leverage for improving sustainable development prospects, hence better creditworthiness.

Keywords: *financial crisis, debt cancellations, governance, corruption, developing countries, capital flight (JEL Cl.: F34, F35 F63, H63, 055)*

INTRODUCTION: ANOTHER FULL-BLOWN DEBT CRISIS IS LOOMING

A spectre is haunting the global financial system — the spectre of an upcoming chain reaction of debt defaults in developing countries. Following waves of debt accumulation since the 1990s, a number of debt-servicing crises are about to occur due to a combination of headwinds. The challenges comprise the pandemic-related global recession, a fall in trade volume and commodity prices, capital flight, global risk aversion and a retreat in private funding, and a decline in workers remittances. A rising number of sovereign debt downgrades can precipitate debt moratoria. At end-2020, 38 governments have a credit rating that denotes a 'material' risk of default or worse, twice the number at the end of 2009.[1] Headwinds might also appear for several emerging market governments due to rising US interest rates and a stronger-than-expected dollar. Rising US yields coupled with a stronger dollar can trigger abrupt capital outflows while generating tensions for servicing dollar-denominated bonds.

Once again, the consensus to tackle debt crises calls for implementing debt cancellation programmes. During the peak of the pandemic crisis, G20 countries agreed to a 'debt service standstill' from all official bilateral creditors, providing direct liquidity support to the poorest countries. In the words of David Malpass, the World Bank president, 'Kicking the can down the road should not be an option – greater transparency and debt relief are needed now. The G20 governments should instruct and create incentives for all their public bilateral creditors, and forcefully encourage the private creditors under their jurisdiction, to participate fully in debt relief efforts.'[2] International financial institutions (IFIs) thus are expected to follow suit.

Pandemic-related debt relief would come on top of a number of restructuring programmes that emerged during the debt crisis of the mid-1980s. Since then, private financial institutions have been deeply involved in debt restructuring through various London Club negotiations with developing country governments. Debt negotiations often resulted in private creditors bearing large losses (so-called haircuts) partly offset by regulatory incentives. Increasingly, however, negotiations have become more complex and protracted due to 'write-off fatigue' as well as declining homogeneity within the community of private creditors. Diversity of client interest and of regulatory frameworks stems from the growing importance of nonbank financial institutions, such as bondholders and investment funds. Consequently, negotiations have more frequently involved lawsuits and holdouts, especially by so-called 'vulture funds' which resist large write-downs.[3]

THE UNFOLDING OF DEBT CRISES IN DEVELOPING COUNTRIES

Since the 1970s, developing countries have generated an impressive number of balance of payments, currency, banking and debt crises. The triggers of financial turbulence have been a blend of exogenous shocks, such as global recessions and rises in interest rates in the global markets, and often policy missteps. Overvalued exchange rates and inflation, as well as runaway deficits and uncontrolled banking credit, are the usual ingredients of financial crises. One can observe waves of debt accumulation over the last 50 years, each one leading to a financial crunch. External debt in developing countries started to rise again in 2009 after two decades of stabilisation, thanks to debt-restructuring transactions with both public and private creditors, mainly international banks. In the wake of the global financial crisis, emerging market countries took advantage of ultra-low interest rates and investors' search for yield to issue massive amounts of Eurobonds, hence in a period narrowing spreads, particularly in Latin American countries. But frontier markets in Africa also took advantage of an environment of substantial global liquidity. In the beginning of 2021, Benin's government issued €1b, in two tranches, at an interest rate of 4.8 per cent with a maturity of between 11 and 31 years, to refinance a previous bond issue, hence benefiting from a rising appetite of investors for African debt. In November 2020, Côte d'Ivoire issued a €1b Eurobond oversubscribed five times, for an interest rate of 5 per cent, the lowest in the country's history.

In the meantime, however, 11 frontier market sovereigns ended 2020 with worse ratings than the previous year. Angola, Zambia, Sri Lanka and Suriname underwent multiple downgrades during that period and ended up either defaulting (Zambia and Suriname) or at high risk of default. According to Fitch Ratings, 'downgrades could herald a series of sovereign defaults in Sub Saharan Africa, where several rated sovereigns face acute liquidity pressures and very high debt levels, and where the

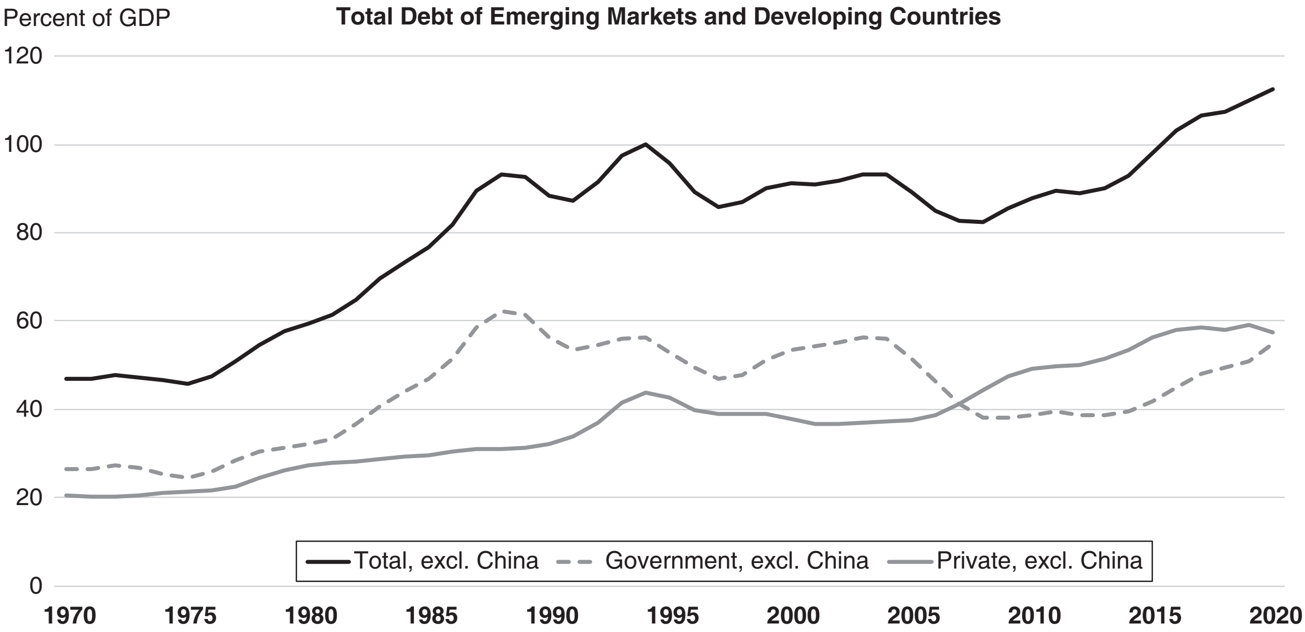

Figure 1: Emerging markets debt in % of GDP[5]

debt burden has risen sharply across most sovereigns over the last decade'.[4] One can observe the rising share of local currency debt, notably in the Brazil, Russia, India, China, and South Africa (BRICS) group and in a number of Association of Southeast Asian Nations (ASEAN) countries. Developing countries' local currency-denominated debt has increased sharply after the global financial crisis, to reach over 60 per cent of gross domestic product (GDP) in 2019, with the issuance of local currency bonds by corporate and sovereign borrowers. Demand for local currency debt is primarily domestic, leading to risks of crowding out between public and private borrowers.

Overall, developing country debt (excluding China) increased to around 112 per cent of GDP in 2020, up from 82 per cent of GDP in 2008. Moreover, a growing share of this external debt is short term and private, worsening debt-servicing prospects. Private debt in emerging and developing countries (excluding China) has increased by more than ten percentage points of GDP since 2010, to reach roughly 75 per cent of GDP at end-2020. The recent debt increase foreshadows a number of developing country debt defaults. The global pandemic currently provides all the trigger elements for a wave of debt turbulences. Any spark could bring about protracted financial crises in the current global environment of higher debt ratios, declining trade and secular stagnation. Figure 1 illustrates the emerging markets' cycles of debt accumulation since 1970, with an abrupt rise after 2008. The stabilisation of debt ratios between 1985 and 2010 owes much to a number of debt reduction transactions with both official creditors and IFIs.

FOUR DECADES OF DEBT RELIEF PROGRAMMES FOR DEVELOPING COUNTRIES

Developing countries have benefited from wide-ranging debt reduction programmes. Regarding higher-income emerging markets, their debt overhang benefited from the framework of the Brady Plan since 1989, in the wake of a sharp increase in interest payments due to a combination of rising Libor and falling exports.

The plan provided for debt relief through a menu of debt-restructuring options, including the conversion of bank loans into long-term discounted bonds, guaranteed by Organisation for Economic Co-operation and Development (OECD) government securities (mostly US and French). Accordingly, financial institutions suffered from heavy haircuts and write-offs, while bank portfolios did not benefit from the expected improved creditworthiness due to better debt-servicing prospects. Overall, 18 countries benefited from Brady deals forgiving US$60bn of debt and representing about US$190bn in international bank claims. On average, the debt reduction transactions led to about 35 per cent forgiveness of a country's bank debt. Arm-twisting between official and private financial institutions, yesterday as much as today, illustrates different agendas across creditors. As Vasquez summarises, 'The Brady Plan was driven by political, not market, considerations. Washington saw the issue as a security and geopolitical concern'.[6]

Regarding low-income countries whose GDP per capita is below US$1,025, four programmes have been implemented. A group of 37 low-income countries is eligible for massive multilateral debt reduction since the mid-1990s. These countries have resorted to the 'Highly Indebted Poor Countries' (HIPC) initiative and the 'Multilateral Debt Relief Initiative', under the auspices of the World Bank, the International Monetary Fund (IMF), and the Paris Club. In addition, highly indebted low-income countries benefited from a major turnaround in the treatment of their debt due to the Paris Club of developed countries. First, in 1994, the Paris Club shifted the debt relief to a stock treatment, meaning that the creditors cancelled a large part of the country's debt, which brought about a sharp improvement in solvency ratios (debt/GDP or debt/exports) as well as in liquidity (debt-servicing profile). Secondly, the enhanced debt relief measures include the possibility for creditor countries to conduct debt swaps, cancelling claims in exchange for sustainable development projects in the debtor countries.[7] Thirdly, in November 1999, the Paris Club creditors joined the HIPC initiative, thereby raising the level of debt cancellation for poor countries 'up to 90% or more if necessary', providing US$76bn in debt-service relief over time. Overall, the Paris Club governments renegotiated nearly US$600bn in debts, combining the granting of time (rescheduling) and money (refinancing) with outright cancellations, affecting their national budgets. Developing countries that benefited from exceptional debt reduction measures include Cameroon, Ivory Coast, Democratic Republic of Congo, Guinea, Togo, Congo, CAR, Afganistán, Haití, Honduras, Gambia, Nicaragua, Chad, Zambia, etc.[8] Fourthly, developing countries have borrowed heavily in the Eurobond market, taking advantage of the fall in interest rates since 2009. Debt has started to rise after a prolonged period of decline, thanks to the aforementioned debt relief measures. Consequently, the debt relief impact was so short-lived that the multilateral agencies decided to write off over US$40bn in debts from 18 developing countries during the 2005 G28 meeting in Gleneagles. Most recently, in the Spring 2020, the IFIs (i.e. the IMF and the World Bank) pushed the G20 to endorse the Debt Service Suspension Initiative to bring additional debt relief to 73 of the poorest countries, whose total external debt climbed to a record US$744bn in 2019. Following a steep fall between 2000 and 2010, low-income countries' total debt increased to roughly 69 per cent of GDP in 2020, up from 51 per cent of GDP in 2010. That trend coincides with growing current account deficits, reaching roughly 3.5 per cent of GDP in Africa and Latin America.

Figure 2 illustrates the 'turtle curve' of low-income countries' debt-to-GDP ratios. In 2020, the level is back to where it was in 1985; hence, the recent rising trend much limits the effectiveness of 35 years of debt restructuring, eliminating the benefits of 35 years of debt restructuring.

Overall, the mechanisms for cancelling official and private (especially banking) debts have had little lasting impact on the weight of indebtedness in budgets, balances of payments and national wealth, and even less on the nature of public policies. Regarding sub-Saharan Africa, the graph here (Figure 3) illustrates the decline in debt service-to-export income ratios since 1997, and

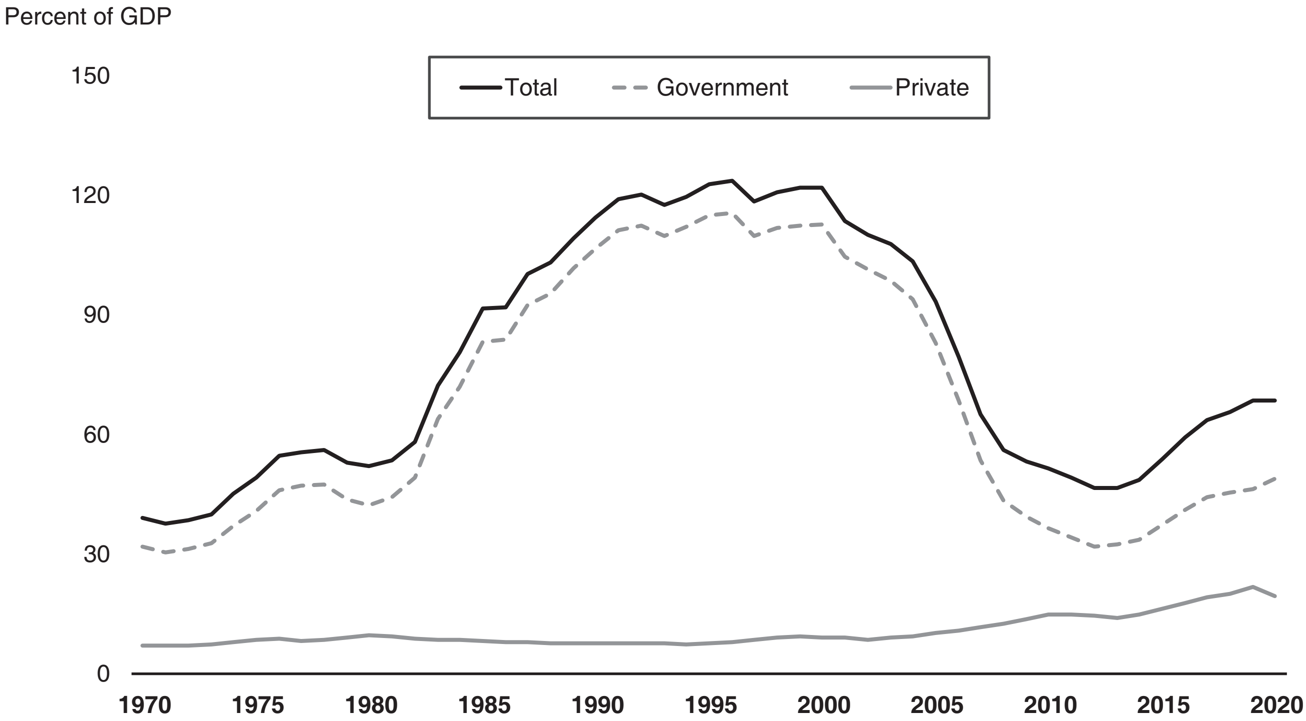

Figure 2: Low-income countries' total debt in % of GDP[9]

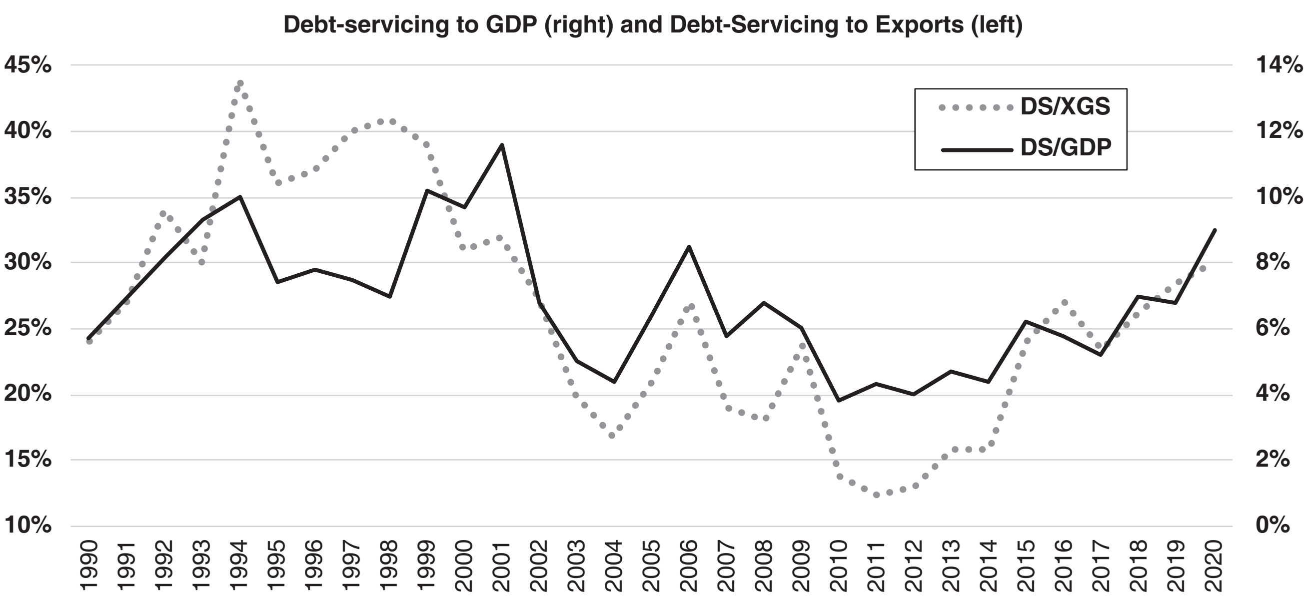

Figure 3: Liquidity (left axis) and solvency ratios (right axis) for sub-Saharan African countries
Source: World Bank Report December 2019 and author's estimates for 2020.

their rapid rise in 2011, despite a long period of low interest rates. Their level in 2020 returned to that of 1991. The ratio of debt-servicing burden to GDP is back to its 1994 level, erasing two decades of debt reduction programmes by both official and private creditors.

INTERNATIONAL BANKS' REGULATORY INCENTIVES FOR SOVEREIGN DEBT REDUCTION

Financial crises generate a nexus between creditor banks and sovereign debtors. This mutual dependence between bank risk and sovereign risk creates additional risk endogenously, sometimes termed a 'doom loop'. The objectives of debt reduction programmes are as much to finance the current account deficits of the debtor countries, to stimulate growth, to stabilise the debtors' socio-political systems and to maintain their trade flows, as to protect the balance sheets of banks. Indeed, back in the mid-1980s, international banks were both undercapitalised and overexposed to developing countries, particularly in Latin America. Bank claims to capital ratios were such that a chain reaction of defaults could have endangered the very solvency of financial institutions.

Forced solidarity between creditor banks and debtor countries led to endless rounds of refinancing, rescheduling and ultimately, debt reductions with a view to enhancing the creditworthiness of the countries holding less debt, hence with higher market value. Regulators developed incentives to protect banks' balance sheets and to mitigate the cash-flow consequences of debt write-offs. A number of regulatory incentives provided banks with equity relief, such as loan-loss reserves included in regulatory capital as well as various tax exemptions for charge-offs.[10]

Since the late 1990s, for sovereigns, the standardised approach in the Basel accord on banking capital regulation prescribes risk weights as a stepwise function of credit ratings, ranging from 0 per cent for sovereign bonds and assets rated at least AA (double A is a risk rating category) to 150 per cent for bonds rated at most B. Bank regulators, however, accept a lower risk weight for exposures denominated and funded in domestic currency. In practice, bank regulation treats domestic currency sovereign debt as risk-free. Consequently, banks are able to purchase high-quality sovereign bonds without funding them with any equity.[11] Banks, however, still need to meet leverage ratios where bond purchases would need to be funded with equity.

More recently, since the global financial crisis, regulatory incentives coincided with accommodative monetary policy in OECD countries. The exposure of private financial institutions to sovereign debtors shifted from loans to bonds. Banks have invested exceptionally in Euro-area bonds, which require low-capital backup but generating little profit, while diversifying in high-risk developing country bonds, which require larger capital but generating higher profit. Meanwhile, bank loans to the private sector kept increasing after the 2009 financial crisis, reaching more than 110 per cent of the countries' GDP in 2020 (Figure 4).

Despite an environment of economic and social fragility in Africa, financial institutions kept increasing exposure to the private nonbank sector, particularly during two periods of rising commodity prices, 2004–2008 and 2015–2020. It is striking that while bank loans steadily increased, private nonbank deposits in international banks kept increasing at the same pace, sometimes exceeding the volume of loans. Although these deposits might comprise 'legitimate' deposits by private companies, a large share comes from the recycling of capital inflows, namely capital flight. Academic research confirms that external borrowing is positively related to capital flight due to corrupt elites, therefore depriving the economy of sources of financing for development.[12] Econometric analysis concludes that capital flight is debt-fuelled.[13]

The scissor effect between capital flight on the one hand, and ongoing debt increase on the other, clearly exposes developing countries to the risk of defaults and, hence, creates liquidity risk for private financial institutions. Figure 5 illustrates the continuous rise in Africa's private deposits in international banks from the mid-1980s through 2020. Since the mid-1990s, private deposits of residents in Africa-Middle-East have always been

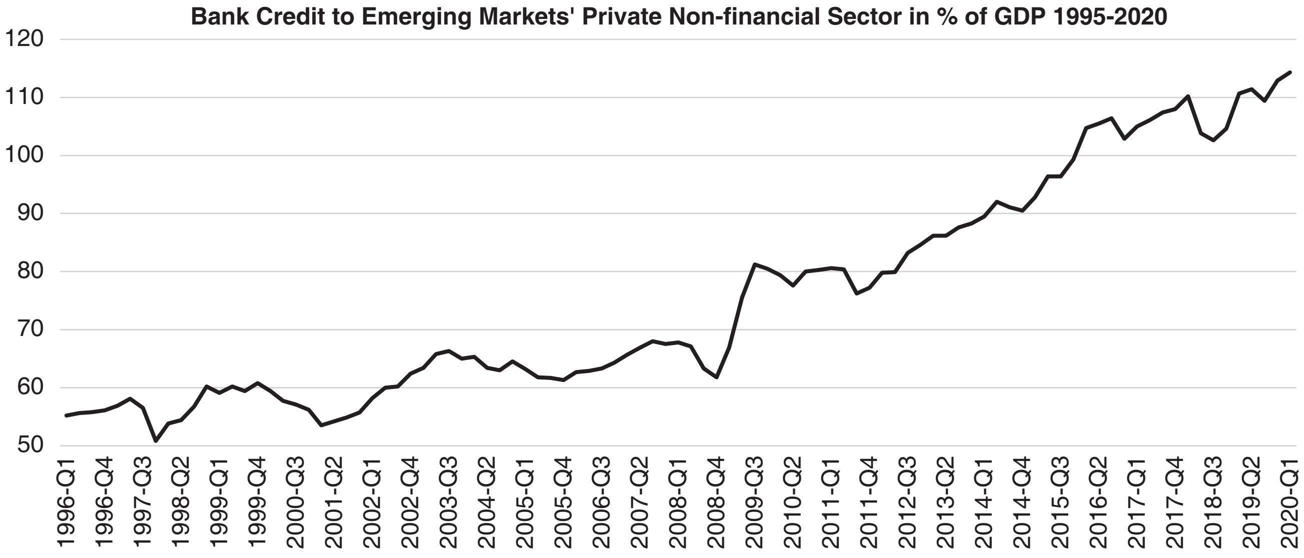

Figure 4: Bank loans to the private sector of emerging market countries in % of GDP
Source: World Bank Report 2019.

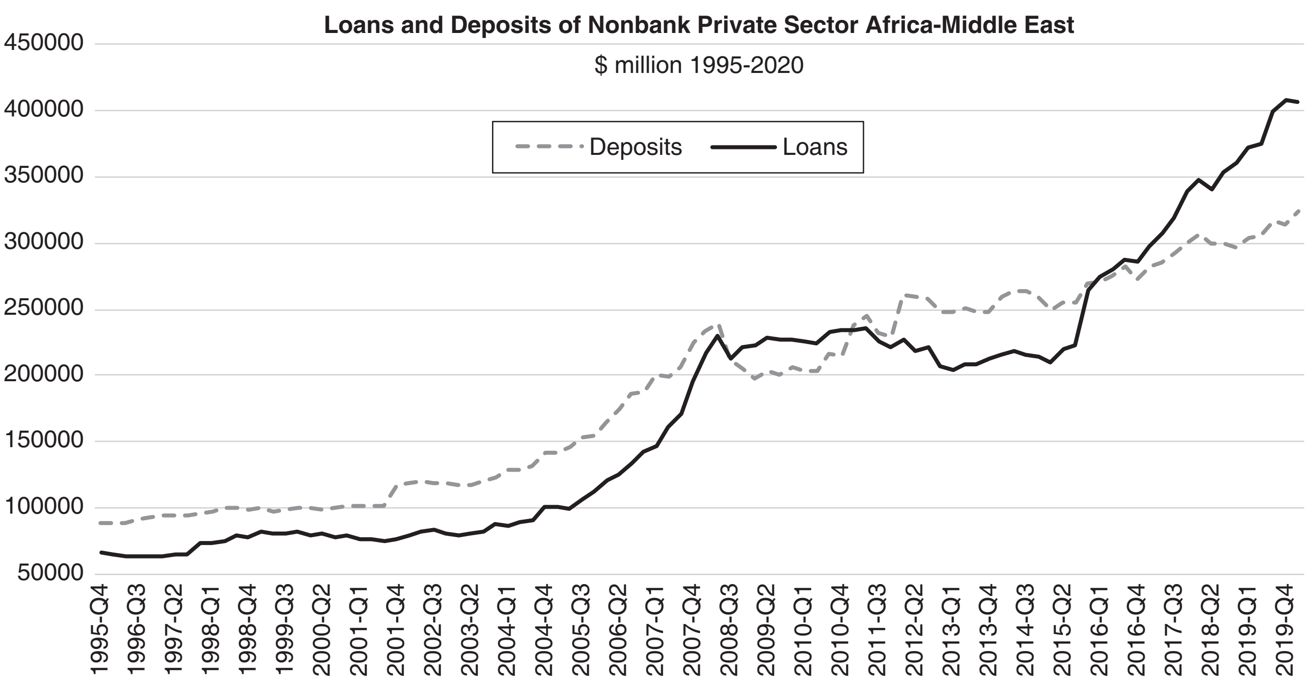

Figure 5: Flows of bank loans and deposits of the private sector from Africa and Middle-East countries (excluding Saudi Arabia)
Source: Bank for International Settlements (BIS)

larger than bank loans, with the exception of a short period during the global financial crisis and since 2017.

FINANCIAL INSTITUTIONS' FRAGILITY WITH REGARD TO THE RISK OF FOREIGN DEBT MORATORIA

The likelihood of developing country debt defaults in the wake of the pandemic crisis threatens the balance sheets of financial institutions worldwide. In Europe, the Association for Financial Markets has successfully pressed policymakers to grant an exemption for sovereign debt from a rule that mandates banks hold a certain amount of capital against all assets on their balance sheet. This exemption does not apply to developing countries' external debt; hence, capital is allocated to developing country exposure at the expense of other more beneficial alternatives. In case of defaults, capital is affected. In November of 2020, Zambia became the sixth country to default on its bonds this year — after Argentina, Belize, Ecuador, Lebanon and Suriname.

Growing bank exposure to developing countries coincides with rising fragility due to nonperforming loans (NPLs), which remain large, particularly in European banks where NPLs still reached €616b, the equivalent of roughly 4 per cent of bank claims as of 2019, compared with only 1.5 per cent in US banks.[14] Bank fragility is particularly acute in the south of Europe, including Greece, Cyprus, Portugal, Italy and Spain, with worse NPL ratios than the EU average.[15] Spanish banks have large exposure in Latin American countries, Portuguese banks in Angola and Mozambique, Italian banks in Central and Eastern Europe as well as in Eastern Africa, while banks in Greece and Cyprus hold large exposure in Eastern Europe. Despite robust capital adequacy and leverage ratios, bank fragility is also impressive due to meager return on equity (ROE). The ROE of European banks was 5.4 per cent in 2019 for EU 28, down from 6.1 per cent in 2018, reaching only 2 per cent in 2020. The decline is striking compared with levels of nearly 11 per cent registered in the outset of the financial crisis. Only Scandinavian and Eastern European banks still boast comfortable ROE ratios above 10 per cent. Falling profitability and socio-economic headwinds due to the impact of Brexit and COVID-19 have pushed banking valuations to the lowest levels since 2002. Low interest rates and the risk of deflationary pressures could further destroy net interest margin at European banks. The US banks face similar risks with an average ROE that dropped to only 5 per cent in 2020 from roughly 15 per cent between 1984 and 2006.[16]

In such an environment, worsening debt-servicing prospects in developing countries, with the threat of debt moratoria and outright defaults, would affect financial institutions' resilience. Figure 6 casts light on the declining trend in banking profitability in both European and US banks.

THE DEBT CANCELLATION IDEOLOGY AND MORAL HAZARD

The pandemic crisis has revived the issue of debt cancellation, placing debt relief on the front burner of multinational institutions and OECD governments. Often debt cancellation is promoted in the name of morality or the political interest of creditors. The argument is that social justice should lead to forgiving debts to break the subordination of poor countries with the purpose to 'reset the counters'. In the Torah, Deuteronomy and Leviticus invite the cancellation of debts every seven years and then during jubilees every 50 years, a continuation of the Assyrian-Babylonian tradition of remission of debts by the monarch between 2500 and 1500 BC.[18] The Quran also calls on creditors to show understanding towards their debtors when they have difficulty honouring their commitments.

At the forefront of the militant call for the cancellation of debts is a number of non-governmental organisations (NGOs) (Oxfam, Attac, CADTM, FONDAD). The Committee for the Cancellation of Illegitimate Debt reviles the IMF and the World Bank for using 'external debt as an instrument of debtor subordination. . . by violating international human rights covenants and by supporting dictatorships'.[19] Public debt is considered an instrument of enslavement involving a massive transfer of wealth from the peoples of the South to globalised capitalists and local ruling classes. Debt would boil down to an instrument

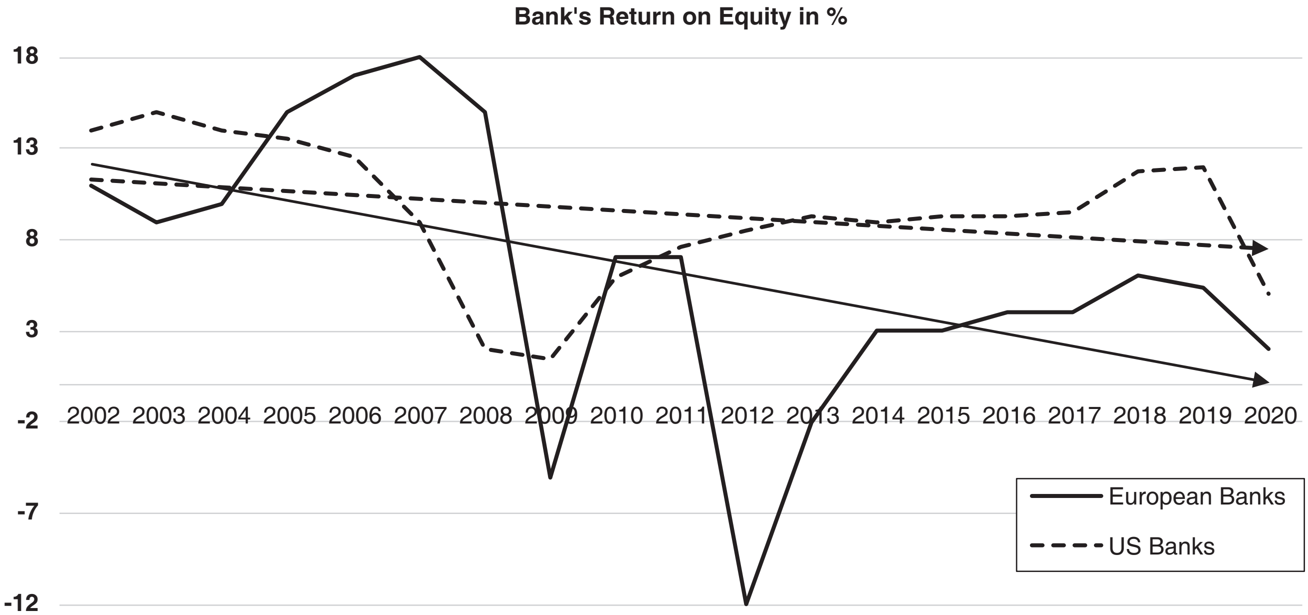

Figure 6: Declining banking profitability ratios 2002–2020[17]

of political and economic domination through a new form of colonisation: 'The peoples of the South are bled dry'.[20] The operational conclusion of these arguments is that the 'odious debt' doctrine, formulated in 1927 by the Russian jurist Alexander Sack, invites states to default because of 'debts contracted by despotic governments, contrary to the interests of the population, and with the complicity of creditors'. [21] The 'odious debt' concept has been raised during the Arab Spring revolution in Tunisia and its neighbours, as well as in Lebanon, a country plagued by decades of deeply rooted corruption. Faced with the global sanitary threat, in April 2020, Pope Francis called *Urbi et Orbi* for international solidarity 'by reducing or canceling the debt which weighs on the budgets of the poorest countries'.[22] The World Bank and the IMF urge OECD governments to participate fully in debt relief efforts while forcefully encouraging the private creditors under their jurisdiction to follow suit.

The pandemic crisis thus increases the risk for private financial institutions to be drawn into IMF-driven rounds of debt cancellations in a context of financial fragility without a meaningful improvement in creditworthiness or sustainable growth in the debtor countries. The reason is that poorly designed debt-restructuring programmes have failed to link debt relief and good governance policies. Moral hazard is the perverse effect that tends to occur when a party has an incentive to take unusual risks because it does not bear the full costs of that risk. All too often, complacent promises of debt cancellation to developing countries have created just such moral hazard, encouraging corruption and freewheeling indebtedness. William Easterly, senior adviser at the World Bank, warns policymakers about the risk of moral hazard in debt relief operations: 'By transferring scarce resources to corrupt governments with proven track records of misusing aid, debt forgiveness might only aggravate poverty among the world's most vulnerable populations'.[23]

NGOs and official creditors bring forward the equation between poverty and foreign debt without deeply investigating the links between poverty, debt and corruption. The perverse effect of debt cancellation policies stems from the lack of connection between debt relief and good governance policies. Debt relief programmes have not influenced unabated corruption in the governments of the debtor countries. In the wake of substantial improvement in debt ratios, at the expense of foreign creditors, bold borrowing tends to fill the black hole of balance of payments and budget deficits without boosting development prospects. Remarkably, the countries that benefited from debt relief kept borrowing enough funds in the 1980s and 1990s to more than offset the past debt cancellations.[24] The most corrupt countries have obtained access to debt cancellation programmes despite no improvement in governance nor any credible commitment towards sustainable development. What is more, debt reduction negotiations have often benefited unscrupulous investment banks combining all possible conflicts of interest, ie both traders and advisers.

DE-LINKING BAD GOVERNANCE AND DEBT CANCELLATION

The issue of governance and corruption is complex due to the challenge of comparative analysis of countries of diverse institutional structures and traditions. One can distinguish four sources of corruption and governance data. One is the annual Corruption Perception Index, designed by former World Bank economists back in the late 1990s; a second is the World Bank Governance Indicators that break down governance into four subindices; the third one is the measure provided by the International Country Risk Guide since 1984; and the fourth, the most disaggregated, is provided by the Ibrahim Index of African Governance, a tool that measures and monitors governance performance in 54 African countries since 2007 with 79 indicators.[25] Another useful index that indirectly measures the quality of governance is Oxfam's Commitment to Reducing Inequality Index, which ranks 158 governments' policies and actions in key areas that are directly related to reducing inequality, including public services (health, education and social protection), taxation and workers' rights.[26] Whatever the measure of the components of governance, these various methods converge to list the debt relief eligible countries among the most corrupt worldwide. Corruption remains constant before, during and after debt cancellation. The 37 countries of the HIPC Initiative are among the most corrupt in the world in their vast majority, whatever the criterion of measurement.

Corruption is closely related to the degree of accountability and transparency in a political regime. The larger the corruption, the weaker the institutional system, adherence to the rule of law, as well as civic checks and balances. Figure 7 illustrates that correlation in Africa for countries that benefited from debt relief programmes.

Exceptional debt cancellation measures have not targeted those poor countries that have suffered from exogenous headwinds, such as a sudden and protracted fall in export revenues or a natural disaster. In many eligible countries, however, corruption has been a social disaster that has engineered deeply rooted poverty and institutional fragility. Ivory Coast benefited from a debt reduction of more than 90 per cent in 2012 following the end of its Civil War, and from additional relief as part of the global initiative to fight the pandemic, while facing renewed threats of turmoil in the wake of controversial presidential elections in November of 2020. On the front burner in 2021 is also Zambia, one of the most corrupt countries worldwide, in default on over US$3bn Eurobonds and with poor relations with its bondholders. Mauritania is also negotiating debt relief in 2021 while showing persistent bad governance. Angola, Gabon and Mozambique, as well as Sri Lanka, Tunisia, Lebanon, Ecuador and El Salvador, all have a high probability of debt distress.[27] This group of countries with unabated bad governance combine high debt-to-GDP ratios (namely, Lebanon, Mozambique and Tunisia) with solvency ratios well below 100 per cent (namely, El Salvador, Sri Lanka and Angola). These countries that exemplify bad governance consistently show low scores on Oxfam's Commitment to Reducing Inequality Index. As the following graph shows, the larger the corruption, the poorer the population in nations that benefited from debt relief (Figure 8).

Poverty is not inevitable, however. Sub-Saharan Africa, for example, shows examples of 'relative success' in development and good governance in Mauritius, Sao Tome, Ethiopia, Rwanda, Ghana, Botswana or Namibia for that matter a list without

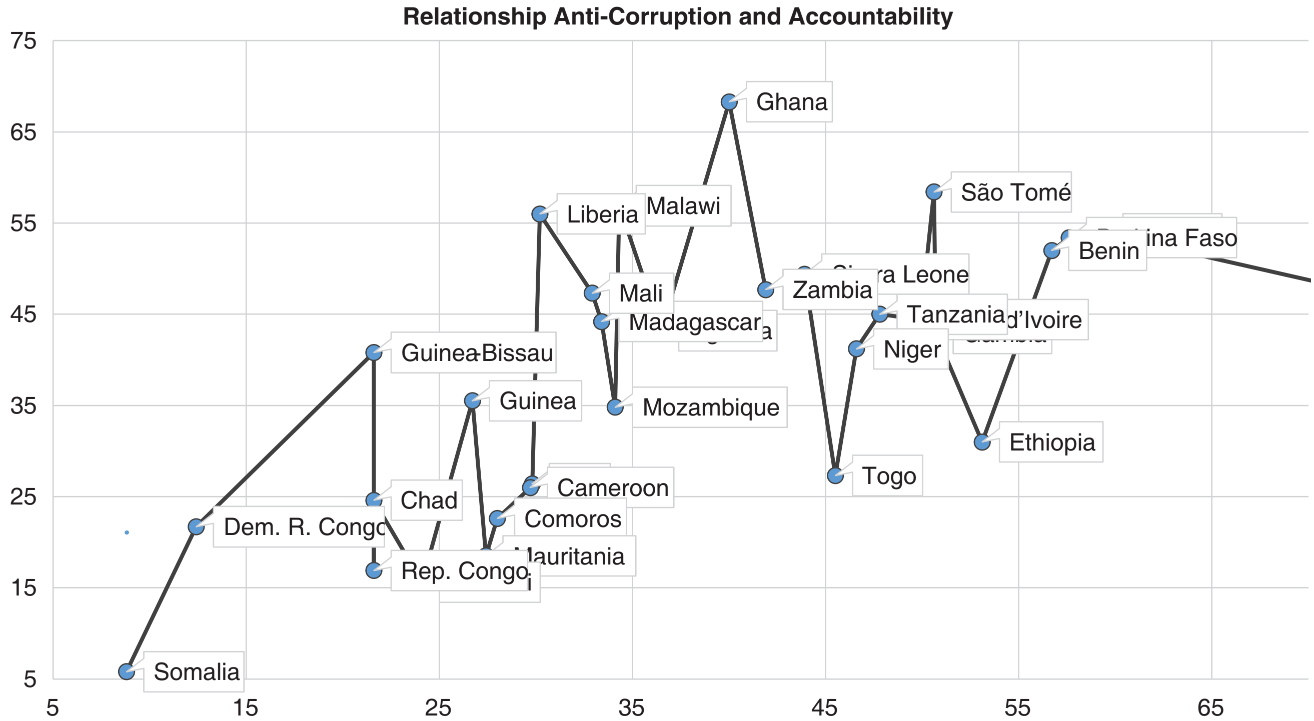

Figure 7: Relationships between corruption (left) and transparency and accountability (bottom)
Source: Ibrahim Index of Governance in Africa.

any former French colony.[28] Today as 10 or 20 years ago, the relationship between the criteria of the United Nations Development Program (UNDP) Poverty Index and corruption remains strong. This is particularly the case of countries whose growth depends on hydrocarbons and mineral wealth which combine corruption, poverty and inequalities, due to the triple concentration of power, economic, financial and political. This is the case of Cameroon, Gabon, Niger, Bolivia, Mali, Togo, Uganda, Mozambique, Angola, Zimbabwe and the two Congos.

Overall, debt relief did not make countries less poor or less corrupt. The countries that have remained poor despite debt cancellations are also the most corrupt and politically instable. There are those that show a persistent institutional fragility, according to an index backed by some 15 criteria (Figure 9).[29]

Not only does debt relief show little impact on poverty and sound economic policies, but generous debt cancellations maintain unabated capital flight. Corrupt governments engage in new borrowing to replace the forgiven loans, while shifting national resources to foreign bank accounts. The combination of corruption and capital flight can be observed in the close relationships between two major components of governance, namely, transparency and accountability, and large private deposits held in international banks. The graph illustrates that the lower the transparency (and the larger the corruption), the higher the ratio of private deposits to bank loans in sub-Saharan African countries eligible for debt cancellation (Figure 10).

Capital inflows often are either poorly invested at home or redeposited in tax havens abroad. The following graph illustrates the relationship between private deposits in international banks and debt to Paris Club creditor governments (Figure 11). The vast majority of developing countries in Latin America and Africa that benefited from debt relief

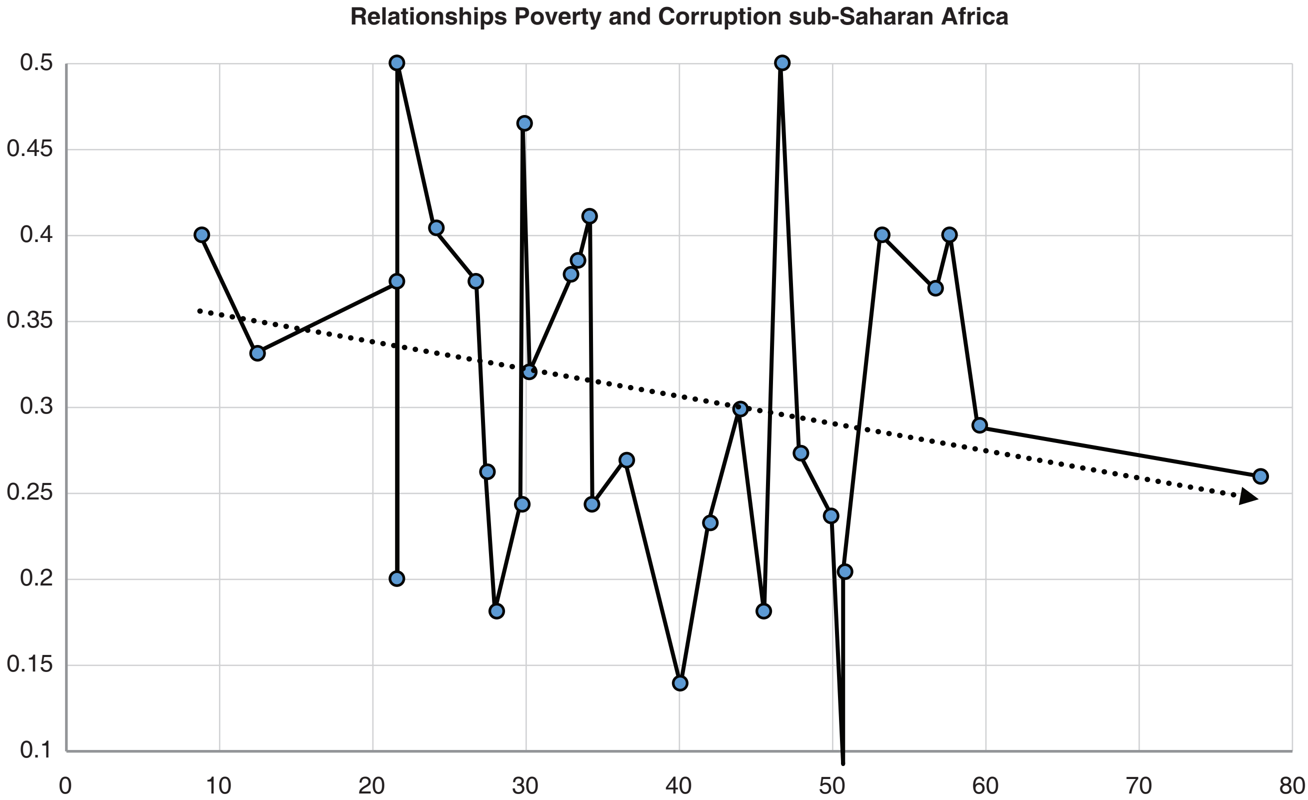

Figure 8: Relationships between poverty (left) and corruption (bottom) indices in 31 sub-Saharan African countries eligible for debt cancellation programmes

operations could repay their debt by repatriating capital flight.[31]

CONCLUSION AND POLICY IMPLICATIONS FOR RISK MANAGEMENT IN FINANCIAL INSTITUTIONS

Public sector pressure on financial institutions to participate in debt cancellations could have plausibly been justified by ex post observation of resulting marked improvements in healthcare, education, social housing and employment for nations crippled by debt. Seasoned risk management could justify a *quid pro quo* between loan losses and better creditworthiness in the wake of debt reduction. Debt cancellations, however, distinguished beneficiaries according to neither their performance in governance and sustainable development policies nor improved good governance trajectories despite the conditions of poverty reduction programmes involving civil society. The latter is to be a cornerstone of the IMF's debt reduction objectives with the support of official creditors: 'Governments, even the most generous, take seriously their role as trustees of their citizens' money. They therefore need assurances that debt relief will be used effectively for poverty reduction with strengthened governance and accountability'.[32] Actually, the populations have not benefited from the budget expenditure alleviation.

Despite the perverse effects of debt cancellations, which in no way encourage the promotion of inclusive development, demands have multiplied, such as a right inherent to low and stagnant GDP per capita. Poverty measured by GDP per capita threshold has been used as both a necessary and

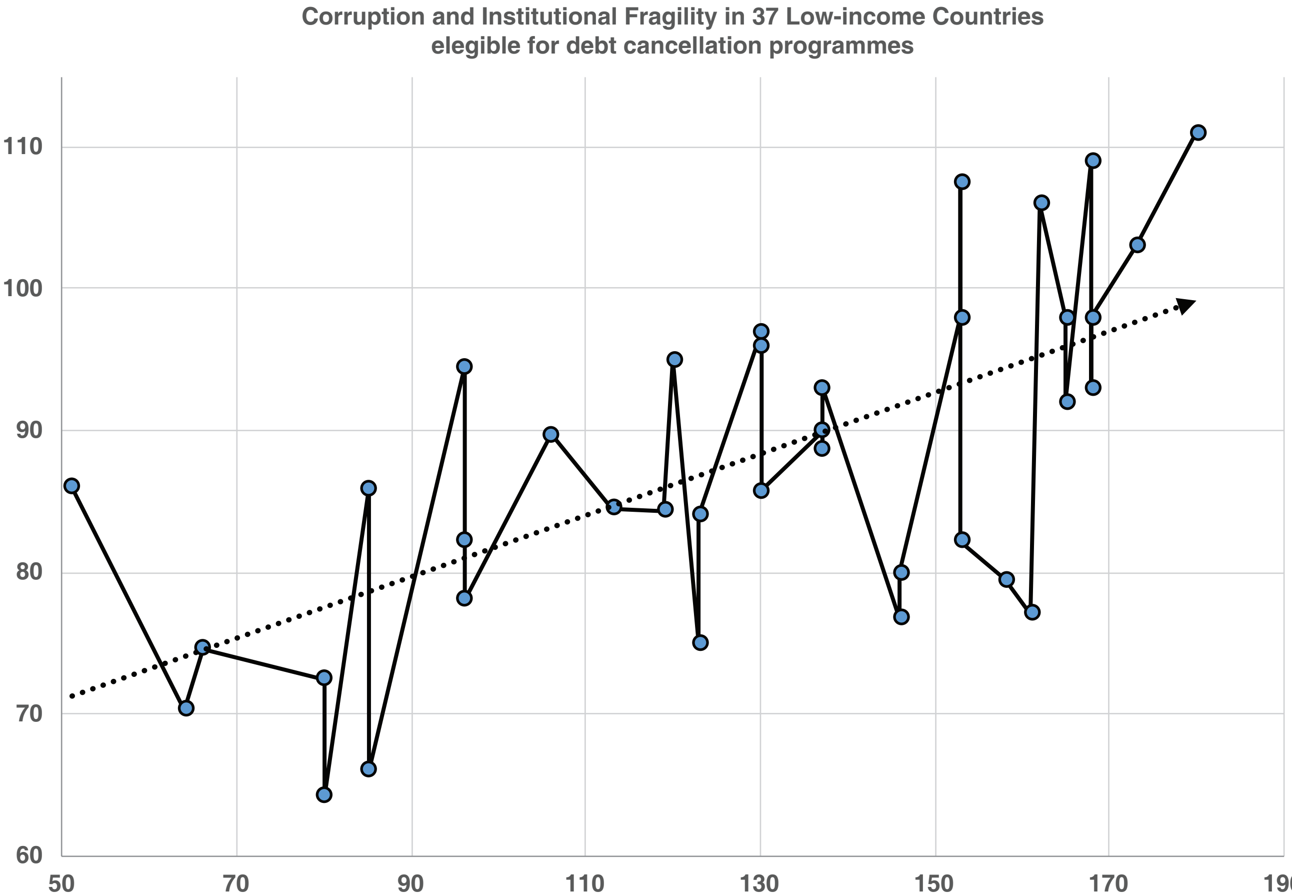

Figure 9: Relationships between corruption and institutional fragility indices (37 low-income countries in Africa and Latin America)[30]

sufficient condition for eligibility without enough attention devoted to governance and inclusive development policies. Poverty should never be a sufficient condition for debt relief. The pandemic crisis and the prospects of a number of demands for debt relief open a window of opportunity for risk management in financial institutions. They could implement risk management policies aimed at combining debt relief, good governance and better economic prospects. The objective of seasoned risk management in debt-restructuring operations is to benefit from the debtor countries' improved creditworthiness in the wake of reduced debt-servicing obligations. Six conditions could mitigate financial risk and reduce moral hazard:

a) First, debt default countries require a case-by-case approach and so does debt relief. Private creditors should resist calls to alleviate a country's debt burden unless a credible plan is presented that allows a convincing and monitored improvement in governance and development prospects. Debt relief must be linked to the unyielding fight against corruption and capital flight and to the reorientation of debt payments towards social and sustainable development purposes. This is the spirit of the debt conversion transactions implemented in the 1990s with UNICEF, USAID or WWF for countries such as Senegal, Morocco, Bolivia, Vietnam, Poland, Mexico, Chile, Costa Rica, Zambia or Brazil. Debts were reduced and converted into local currency to fund development projects.

b) Secondly, financial institutions should distinguish between countries with liquidity problems and those with solvency problems to determine the most appropriate financial relief instruments. The

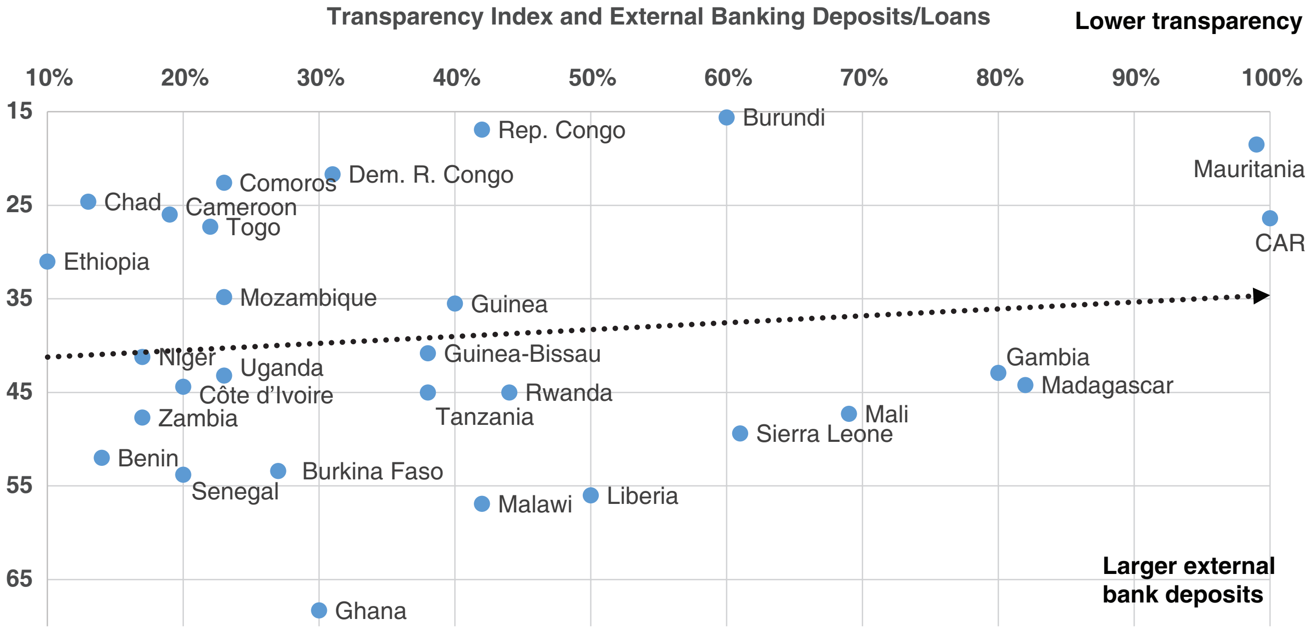

Figure 10: Relationship between transparency (left) and ratio of external private deposits/bank loans
Source: Ibrahim Governance Index and BIS.

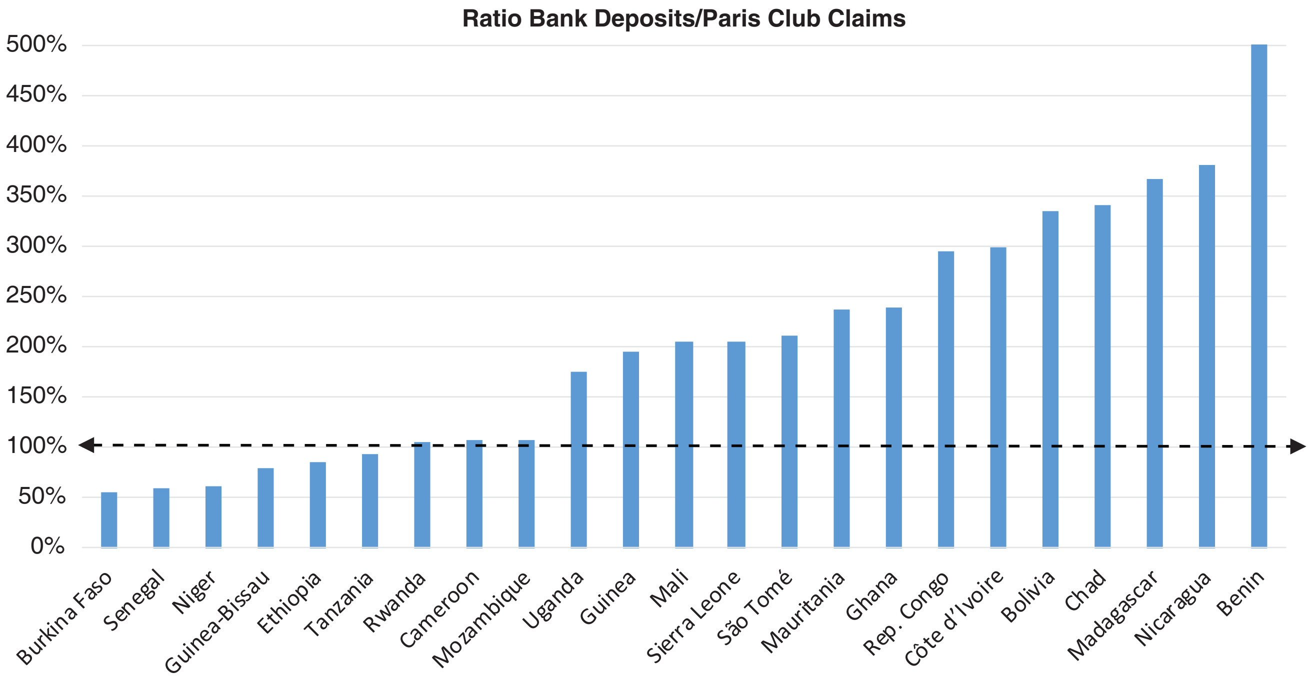

Figure 11: Ratio of private deposits in international banks to Paris Club claims
Source: BIS and Paris Club.

analytical demarcation could be provided by the IIF (Institute of International Finance). This is a missing element in the Debt Service Suspension Initiative. Financial institutions can benefit from official liquidity programmes in debt-distressed countries. An example is the IMF's liquidity facilities that provide financial support to keep countries out of an imminent default. Another example is the Liquidity and Sustainability Facility of the UN Economic Commission for Africa that aims to lower borrowing costs by ensuring that short-term debt obligations can be met.[33] Enhanced liquidity then can reduce financial institutions' risk of maintaining credit lines and implementing loan or bond refinancing.

c) Thirdly, private creditors can mitigate the risk of maintaining or even expanding exposure to local banks and private corporations in the framework of official credit guarantees, including those provided by Coface: Compagnie Francaise d'Assurance Credit Export (COFACE) and other official export credit agencies. Financial risk can also be reduced when bank loans support private investment in relation with guarantees from US International Development Finance Corporation (IDFC) or from Multilateral Investment Guarantee Authority (MIGA).

d) Fourthly, under the aegis of the IIF, private creditors should unite with the IFIs and the Paris Club to refuse that a public creditor such as China maintains opacity both on debt data and on relief measures, while representing more than 25 per cent of loans to African countries, often in transactions pledged on natural resources (e.g. Angola, Kenya, Zambia, Tanzania, Mozambique, Ghana, Cameroon, and Ethiopia).

e) Fifthly, financial institutions could promote debt relief and inclusive growth when the country demonstrates a commitment to good governance in an environment of economic fragility. One solution is to link the interest rate and the repayment profile to the economic performance of the country or to its export earnings, in the spirit of Islamic finance, which combines the destinies of creditors and debtors. Sovereign bonds can be structured so that they pay less when commodity prices tumble, terms of trade deteriorate or natural disasters strike. Conversely, bonds might incorporate recapture clauses so that they pay out extra when GDP growth or export income exceed a threshold. Another tool worth exploring is 'bendy bonds', which already exist in the corporate debt markets. The borrower would stretch the maturity (and defer interest payments) in return for extra interest at the end of the bond's extended life.[34]

f) Finally, private creditors could negotiate the gradual and conditional switch of bank loans into long-term zero-interest bonds that can be converted at a discount into local equity in the spirit of the Brady Plan. Swaps would take place at regular intervals when governance indicators unequivocally point towards a lasting improvement. Banks could also accept discounted debt buybacks when loan-loss provisions are large enough, within the framework of the World Bank's IDA Buyback Facility.

In conclusion, debt remains primarily a contract between two parties, and the concept of 'odious debt' is only an alibi to exonerate debtors from their social responsibilities and for creditor countries to conceal complacency and geopolitical as well as commercial interests. Public creditors and private financial institutions have diverse agendas that should respect the rights of their respective stakeholders. Banks and funds should resist calls for blanket debt relief which boils down to maintaining poverty and corruption in developing countries. Debt relief can be a leverage for improving sustainable development prospects. The pandemic crisis offers the perfect opportunity for seasoned risk management.

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