

UNITED NATIONS DEVELOPMENT ACCOUNT PROJECT



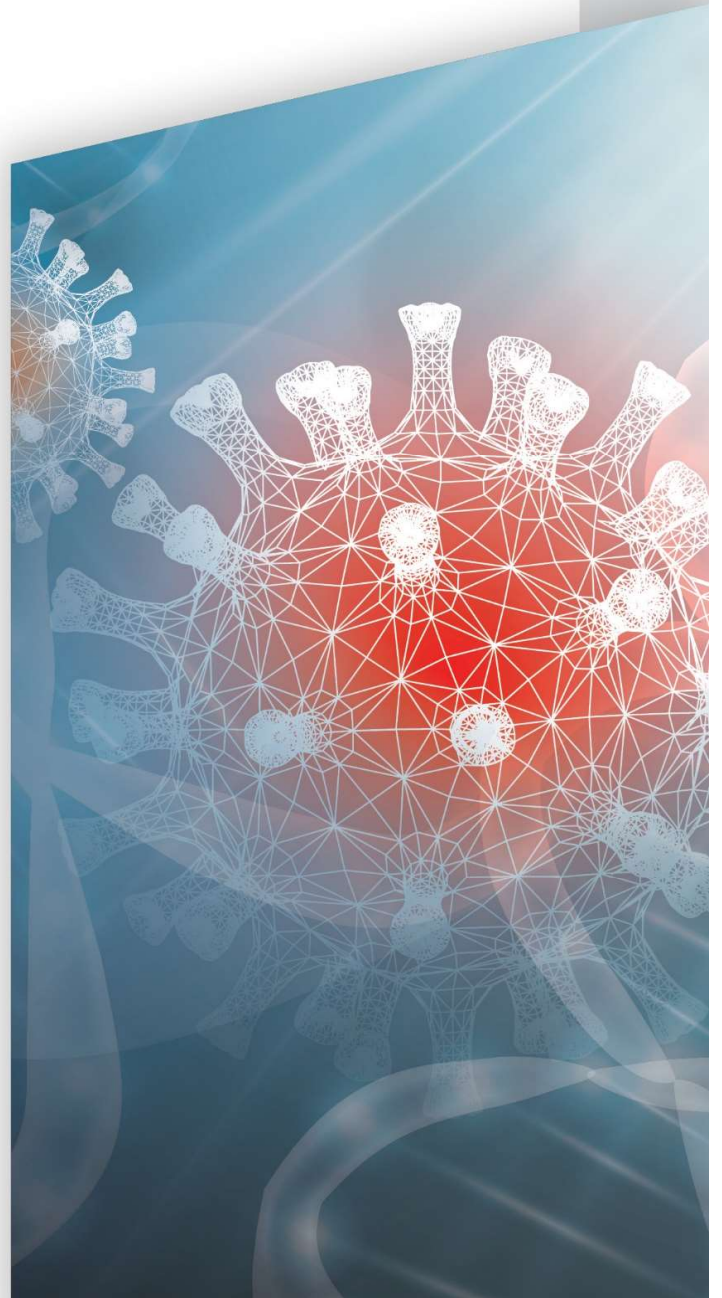
JUNE 2022

COVID-19

Response and Recovery

Mobilizing financial resources for development

DA-COVID-19 project led by Debt and Development Finance Branch, Division on Globalization and Development Strategies (DDFB/DGDS)



Soft law on sovereign borrowing and lending to sovereigns: Revitalizing UNCTAD Principles on the Promotion of Responsible Sovereign Lending and Borrowing

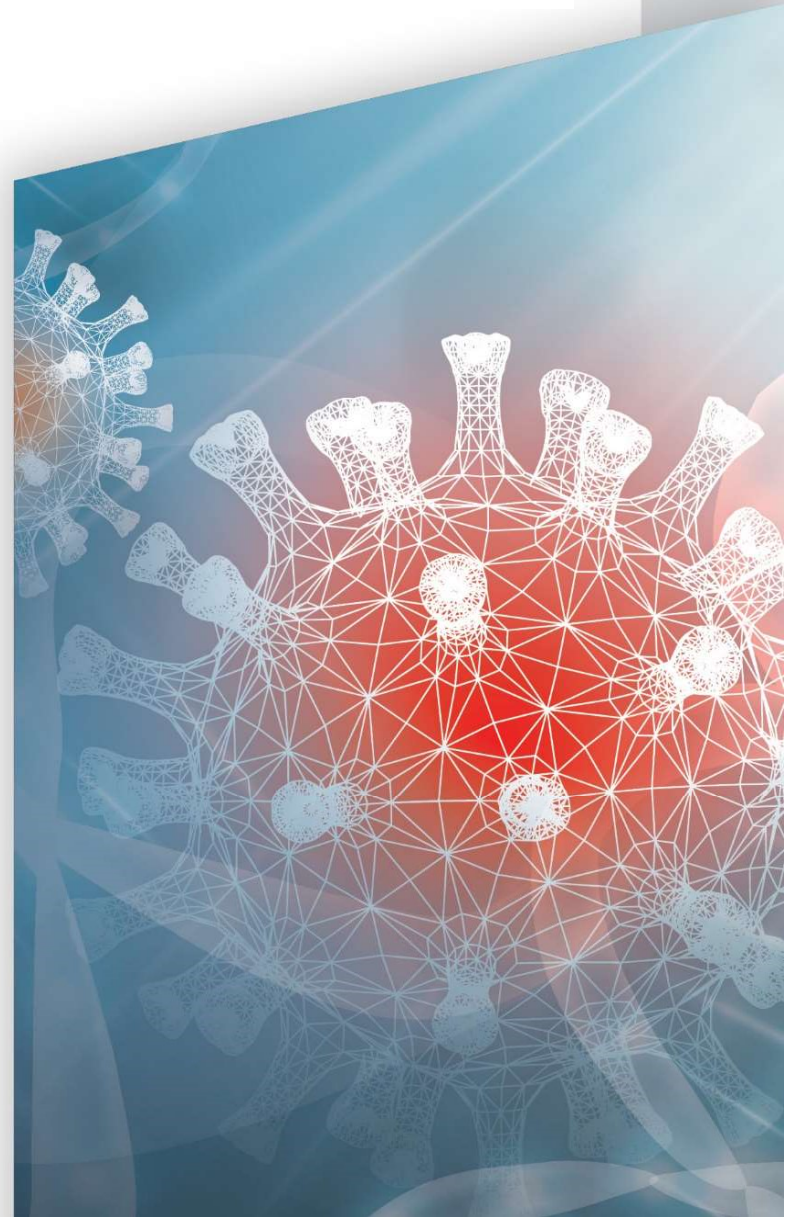
JUNE 2022

Short Policy Paper

Yuefen LI

Senior Advisor on
South-South Cooperation and Development Finance

This document has not been formally edited and does not necessarily represent the views of the UN, UNCTAD, ECA, ESCAP or ECLAC



About the COVID-19 Response and Recovery project

This paper is an output from the project “Response and Recovery: Mobilising financial resources for development in the time of COVID-19”, which is co-ordinated by the Debt and Development Finance Branch of UNCTAD and jointly implemented with ECA, ECLAC and ESCAP. This project is one of the five UN Development Account short-term projects launched in May 2020 in response to the COVID-19 crisis.

In this work, a framework to assess external debt and financial sustainability and public sector sustainability through the lens of the achievement of the Sustainable Development Goals (SDGs) is presented. The approach differs in some key areas from the International Monetary Fund’s (IMF) Debt Sustainability Analysis (DSA), placing the external constraints and the resulting possible growth rate at centre stage. This in turn provides information on the fiscal space available to policy makers with which to achieve the SDGs through public investment.

Sovereign financing is one of the most underdeveloped areas of international law as sovereign debts are mainly governed by domestic laws¹. As a result, there are no clear boundaries relating to creditor and borrower behavior - or indeed expectations as to such behavior. This legal void has contributed to insufficient deterrence to irresponsible or sub-optimal sovereign lending and borrowing. As attempts to introduce hard international law and regulations which are binding on countries have suffered repeated setbacks and international consensus has been difficult to reach, past decades have witnessed efforts to develop soft laws or norms² for the purpose of introducing behavioral change and set clear boundaries for appropriate conduct. The *Principles on the Promotion of Responsible Sovereign Lending and Borrowing* (the UNCTAD Principles) developed under the auspices of the United Nations on Trade and Development (UNCTAD), which was launched in 2012, have been acknowledged for the comprehensive coverage of debt instruments; inclusiveness in the formulation, validation and consensus building processes; and solid backstopping by scholarly research and analysis. The UNCTAD Principles set out clearly the co-responsibilities of both lenders to sovereigns and sovereign borrowers, covering all debt instruments used by sovereigns and by all categories of countries. Though soft law instruments are non-binding in nature, it carries legal effects and has a compliance pull for various reasons including the reputational costs of non-compliance³. Currently, against the backdrop of increasing debt vulnerabilities in developing countries caused mainly by spiking debt servicing costs, risk of stagflation, accumulation of public and private debt and widening development finance gaps, the efforts to revitalize the UNCTAD Principles could guide developing country policy makers to adopt more optimal ways in their efforts to mobilize new external and domestic financing, minimize and resolve debt crisis.

¹ Espósito C, Li Y, and Bohoslavsky JP (2013). Sovereign Financing and International Law, *The UNCTAD principles on responsible lending and borrowing*. Oxford University Press.

² United Nations (2015), “*Addis Ababa Action Agenda of the Third International Conference on Financing for Development*” para 97 available at https://sustainabledevelopment.un.org/content/documents/2051AAAA_Outcome.pdf

³ Lastra, RM. and Bodellini, M. (2018), “*Soft Law and Sovereign Debt*”. See also, Brummer, C. (2015), “*Soft Law and the Global Financial System*” 2nd Ed. Cambridge University Press.

1. The value of principles for guiding sovereign borrowing and lending to sovereigns

Developing countries are facing multiple challenges. The concern of a new debt crisis is getting more pressing and worrisome. Debt crisis always makes people think about what could have done better to avoid or mitigate the crisis.

To borrow or lend money is not a sin. Actually, raising debt can be a way to get needed financing to boost economic growth, increase investment and also roll over old debt. However, not to borrow or lend responsibly could land borrowers in debt crisis, could make lenders lose the expected returns from lending.

As there is no international consensus on rules to guide sovereign financing, both lenders and borrowers have approached the issues in the ways they deem appropriate or serve their objectives, which ultimately may not be responsible or optimal to the extent that the consequences of their actions create global problems. We have seen many instances of serious lack of good judgment, and many instances of *“undisciplined, ineffective, abusive or non-cooperative behavior on the part of both creditors and sovereign debtors”*- to quote the preamble of the UNCTAD principles.

More specifically, there has been borrowing for the purpose of “kicking the can down the road” and lending without proper scrutiny of credit and market risks⁴. History shows that irresponsible behavior has sometimes landed countries in default⁵. As there is no international consensus on rules and laws to guide sovereign financing, both lenders and borrowers have approached the issues in the ways they deem appropriate or serve their objectives, which ultimately may not be responsible or optimal - sometimes to the extent of creating and increasing debt vulnerabilities and financial instability. Responsible practices from both the lenders and borrowers are starting to be seen as the first line of defense to prevent future debt problems. Ideally this should take place before the debt is contracted so as to prevent and solve problems before they explode.

Meanwhile, the debt market has become more complex and riskier over the past decades. With the development of technology, debt changes hands more quickly, in just a few seconds on the computer keyboards. There have also been more debt instruments and more actors in the debt market. The changing composition of debt from mainly syndicated bank loans to bonds, both foreign and domestic, has made the capital market more volatile

⁴ Li Y, Olivares-Caminal R & Panizza U (2010), Avoiding Avoidable Debt Crises: Lessons from Recent Defaults, in Sovereign debt and financial crisis, edited by C Graga and G Vincelette, World Bank.

⁵Ditto.

⁶. Two of the most salient anomalous characteristics of modern financial markets include both overzealousness and excessive risk-taking,⁷ which have been prevalent in the banking, shadow banking sectors and for some sovereigns during the booming years before the global financial crisis⁸. Lack of financial sophistication of most of the LIC borrowers is another notable characteristic of sovereign financing⁹.

With globalization and a more interdependent world, and digitalisation of financial operations, debt crises hit the world harder and contagion spreads much faster than before. Debt crises are increasingly becoming more costly and damaging for countries, leading to major reversals of hard-won economic gains.

Building consensus around a set of well-grounded principles could lead to the establishment of criteria to assess whether the contracting of sovereign debt has been performed in accordance with internationally accepted principles.

The UNCTAD Principles aim at filling the international legal gap through systematizing best practices and promoting general principles for sovereign financing by proposing a coherent normative framework.

2. To revitalize UNCTAD Principles would be an international public good

UNCTAD started to work on the principles in 2008 when the global financial crisis was still evolving. The crisis generated widespread concern about the lack of international rules and weak regulation of the financial sector. As the global financial system was and still is dominated by the post-World War II power structures, maintaining the status quo is attractive to major market players. The introduction of hard law to overcome systemic problems would not be easy as vested interest and inertia are abounding. Besides, it takes time for hard law to emerge. With the financial support of Norway, UNCTAD started to work on the soft law approach to formulate the UNCTAD Principles. Before the UNCTAD principles, two sets of principles attracted some attention at that time. One was the “Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets” drafted in 2004 by the Institute of International Finance (IIF). The principles were welcome but have been viewed as lacking balance in terms of distributing responsibilities between lenders and borrowers, as they are

⁶ Cecchetti S, Mohanty M & Zampolli F (2010). “The future of public debt: prospects and implications,” BIS Working Papers No.300, Bank for International Settlements.

⁷ Bhattacharyya S, Purnanandam A (2011). “Risk-Taking by Banks: What Did We Know and When Did We Know It?”, AFA 2012 Chicago Meetings Paper, November 18, 2011, available at <http://ssrn.com/abstract=1619472>.

⁸ Georgiou. A , “Excessive Lending, Leverage, and Risk-Taking in the presence of Bailout Expectations,” IMF Working Paper WP/09/233, International Monetary Fund, 2009, p. 3.

⁹ Caruana J, Lay K & Leipziger D (2007). “Strengthening Debt Management Practices: Lessons from Country Experiences and Issues Going Forward”, IMF and the World Bank.

generally meant to regulate borrowers' behaviors and lack major references to how the lenders should minimize debt crises¹⁰. Besides, unlike UNCTAD Principles, no country (developed or developing) subsequently committed to abide by the IIF principles¹¹.

Another set of principles was developed by the OECD in 2008 entitled "Principles and Guidelines to Promote Sustainable Lending in the Provision of Official Export Credits to Low Income Countries". As the name suggests, it only relates to Export Credit Agencies and only their loans to low-income countries, thus with very narrow coverage, limiting to one category of countries and to one type of debt instruments.

Compared to these principles, the UNCTAD Principles are much more holistic and comprehensive, covering all debt instruments used by sovereigns and all countries. UNCTAD is well positioned to provide the Principles, as unlike OECD or IIF, UNCTAD, being a department of the United Nations, enjoys the universality and also the equal basis of its membership. As UNCTAD is the focal point for debt issues in the United Nations system, it has the mandate and acknowledged expertise on debt issues. Moreover, UNCTAD is not a financial actor in global markets, UNCTAD was and still is in a unique institutional position to promote a set of principles to introduce financial behavioural changes.

UNCTAD's ambition was reflected in how the Principles were formulated. The process of formulation was inclusive, transparent, scholarly, solid, authoritative and elaborate. The previously mentioned two sets of principles did not receive the national and international endorsement that the UNCTAD Principles did.

To be inclusive and authoritative, UNCTAD established an expert group in order to have open, transparent and inclusive dialog among all stakeholders. The Expert Group composed of prominent world-renowned specialists in law, finance and economics. The expert group was like a who's who in the sovereign debt world. Senior representatives of non-governmental organizations; the private sector and its representative IIF, multilateral financial institutions including the IMF, World Bank, the Paris Club secretariat were observers. After more than a year's in-depth exchange of views, UNCTAD had the second draft of the principles. Each principle had an analytical piece by famous scholars, eventually the Oxford University press published a book including all these studies. Extensive dialogues were conducted, and validation was undertaken in earnest and at ministerial level. During 2011

¹⁰ Helleigner E (2009), *The Contemporary Reform of Global Financial Governance*, G24 paper. Herman B (2010), "Why the Code of Conduct for Resolving Sovereign Debt Crises Falls Short."

¹¹ Herman B (2010), "Why the Code of Conduct for Resolving Sovereign Debt Crises Falls Short," in Herman, Barry; Ocampo, Jose A. & Spiegel, Shari (eds.), *Overcoming Developing Country Debt Crisis*, Oxford University Press, New York, 2010, pp.396, 412.

and 2012, five regional consultative meetings with national officials at ministerial level took place in Buenos Aires, Bangkok, Geneva, Jeddah and Punta Cana in order to get governmental feedback on the design and the possible implementation process¹². Around 75 countries provided their views on the draft principles. After a series of bilateral and high level regional governmental consultations, the Expert Group introduced further refinements to the draft principles in line with the feedback obtained. The consolidated version of the Principles was launched on the occasion of UNCTAD XIII ministerial conference in Doha in 2012, inaugurating the project's phase of endorsement and implementation. The inclusive and transparent process of drafting and endorsing the principles is actually a source of legitimacy for the UNCTAD principles.

A unique feature of the UNCTAD principles is that none of the other soft-law versions have had the national and international endorsement of the UNCTAD Principles. Thirteen developed and developing countries have endorsed the UNCTAD principles since their release for endorsement in 2012: including Germany, Norway, Brazil, Argentina, Italy, Nepal, Morocco, Cameroon, Columbia, Gabon, Honduras, Mauritania, and Paraguay. The annual United Nations General Assembly resolution on external debt for many years stressed the importance of responsible lending and borrowing, emphasizing that creditors and debtors must share responsibility for preventing unsustainable debt situations. UN member states committed, in the Addis Ababa Action Agenda in 2015, to “work towards a global consensus on guidelines for debtor and creditor responsibilities in borrowing by and lending to sovereigns, building on existing initiatives.” UNCTAD also addressed the principles in its 6th, 7th and 8th Debt Management Conferences respectively.

The strength of the UNCTAD principles lies in its comprehensive and holistic treatment of all debt instruments and all actors in the process, both lenders and borrowers, the emphasis of co-responsibility of lenders and borrowers corrected the misconception that borrowers are the only party to be blamed in the case of unsustainable debt.

Out of the set of 15 principles, 7 principles are for lenders and 8 principles are for

¹² May 4 2011, available at <http://www.unctad.info/en/Debt-Portal/News-Archive/Our-News/UNCTAD-Launches-Principles-on-Responsible-Sovereign-Lending-and-Borrowing-3052011/>
August 19 2011, available at <http://www.unctad.info/en/Debt-Portal/News-Archive/Our-News/UNCTAD-and-MOF-of-Argentina-Regional-Consultative-Meeting-19082011/>
October 3 2011, available at <http://www.unctad.info/en/Debt-Portal/Events/Our-events/High-Level-Regional-Consultative-Meetings/UNCTAD-organises-a-meeting-for-Asia-3102011/>
November 22 2012, available at <http://www.unctad.info/en/Debt-Portal/News-Archive/Our-News/MEFMI-countries-support-the-second-draft-of-the-Principles-on-Responsible-Sovereign-Financing-Luanda-22112011/>
November 14 2011, available at <http://www.unctad.info/en/Debt-Portal/News-Archive/Our-News/-Second-Draft-of-Principles-on-Responsible-Financing-is-released/>
February 25 2012, available at <http://www.unctad.info/en/Debt-Portal/News-Archive/Our-News/Arab-countries-support-the-Consolidated-Principles-on-Responsible-Sovereign-Lending-and-Borrowing-Jeddah-250212/> .

borrowers. The normative contribution of these Principles lies not in the creation of new rights nor obligations in *international law* but in identifying, harmonizing and systematizing the basic principles and best practices applied to sovereign lending and borrowing and in elaborating the implications of these standards and practices for lenders and borrowers at the international level.” The Principles do not aim to directly change domestic or international law but strive to durably change the behaviour of lenders to sovereigns and sovereign borrowers, with a resulting shift in sovereign borrowing and lending practice.

The UNCTAD principles comprise such important legal concepts as fiduciary duty, accountability, transparency, due diligence, co-responsibility, debt monitoring, good faith, etc. They can be found in most domestic legal orders¹³ -but are missing at the international level. This means that the principles are rooted in well-grounded and already successfully tested rules at domestic level. The principles are meant to bring major benefits for both sovereign borrowers and lenders.

3. How to implement and revitalize the principles in the national and international context

To facilitate implementation of the principles, UNCTAD published the Guidelines for Responsible Sovereign Lending and Borrowing in (2013). These Guidelines are designed to increase the understanding of and ultimately adherence to the UNCTAD principles.

At the national level, both general codes and specific legislation could be major vehicles for implementing the Principles.

Over past years, realizing international hard law or international treaty are difficult to emerge, countries have tried to find an alternative through enacting national legislation to introduce change. For instance, Belgium passed law in 2015 which limits creditor ability to recover claims which are disproportional to the price they paid for the debt. The UK Parliament passed the Debt Relief (Developing Countries) Act 2010, designed to ensure that all creditors provide their share of debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative. Ecuador and Bolivia passed their national laws relating to debt issue. While piecemeal, this approach has impact, especially if more countries to follow. So, the tactic is that if you cannot do it through wholesale, do it through retail.

To follow this approach, countries can adjust their own legal (regulatory or administrative) orders to incorporate the UNCTAD principles into their normative universe. However,

¹³ Goldmann, Matthias, “Responsible Sovereign Lending and Borrowing: The View from Domestic Jurisdictions,” UNCTAD Working Paper, Geneva, 2012, available at http://www.unctad.info/upload/Debt%20Portal/RSLB_MGoldmann_02-2012.pdf.

adoption of the principles does not correlate perfectly with compliance, so countries could also elaborate more specific guidelines and enforcement mechanisms so that debt managers understand and respect the framework of their work. Also, private sector lenders will benefit from enhanced national borrowing frameworks as well as improved practices on the side of the private sector.

The UNCTAD principles can be incorporated into capacity building programs on debt management, at sub-national, national, regional and multilateral levels, such as the UNCTAD's Debt Management and Financial Analysis System (DMFAS) and the World Bank's Debt Management Performance Assessment (DeMPA). Debt management agencies can also explore the possibility of incorporating the UNCTAD principles in their operational practices

Domestic and international courts could benefit from the UNCTAD principles by using them to interpret hard law instruments in ways that encourage parties involved in sovereign debt contracting to adopt more responsible behavior. Arbitral tribunals might also take advantage of the interpretation of the UNCTAD Principles. The Principles could also contribute to fostering good governance through the design and oversight of public policies on sovereign lending and borrowing at both the international and national levels.

There are many ways to implement and revitalize the UNCTAD Principles. Not to do so would be a huge waste of the international efforts, financial and human resources used to develop and endorse the UNCTAD Principles, and neglect the opportunity they present to improve soft-law. There has already been strong national and international support for the UNCTAD Principles, to revitalize and implement them would benefit the world and contribute to debt crisis prevention and resolution. Ultimately this would benefit global financial stability.