



# The UNCTAD principles on promoting responsible sovereign lending and borrowing

## Explained and assessed from the perspective of Eurodad's Responsible Finance Charter

A briefing paper by Bodo Ellmers and Konstantinos Todoulos; May 2013

### Introduction

Irresponsible lending and borrowing are key reasons for high public debt levels in low, middle and high-income countries. The related debt service seriously threatens the ability of governments to finance the provision of public services and to achieve internationally agreed development goals. Irresponsible lending and borrowing have also been instrumental in causing financial crises in a large number of countries, as they have driven debt levels beyond a sustainable level, and continue to do so.

Both the public and private sector are involved in irresponsible lending and borrowing. The motivations for acting irresponsibly may differ between lenders and borrowers, and between different actors within these groups. On the lender side, motivations include - but are not limited to - greed for high yield investments, the lack of 'responsible' investment opportunities in times of sluggish growth, lax financial regulation, and moral hazards through implicit bailout guarantees. On the borrower side, motivations might include an overly easy access to loans, financial illiteracy, political costs of fiscal adjustment (i.e. tax increases or spending cuts), and moral hazards through implicit bailout guarantees.

The definition or 'scope' of responsibility as regards credit relations is not fully consensual among stakeholders. It may include economic aspects (e.g. not lending/borrowing beyond a certain level of debt to gross domestic product), procedural aspects (e.g. due authorisation of the lender/borrower, or the absence of corruption) and normative aspects (e.g. not lending/borrowing for harmful activities).

Cross-border lending is currently badly regulated. To date, international financial architecture does not contain an effective mechanism that could prevent irresponsible lending and borrowing covering all actors involved. Neither does it contain an effective debt workout mechanism that could tackle the consequences of irresponsible lending that took place in the past and is still taking place today. Consequently, citizens pay the price for irresponsible lending and borrowing as their tax payments finance the debt service rather than public services they should be benefitting from.

Consequently, citizen groups have put the issue of responsible lending and borrowing high on their agenda. Some of the key documents produced by civil society organisations (CSOs) include:

- *The Eurodad Charter on Responsible Financing* (published in 2008, updated in 2011)<sup>1</sup>
- *The South-North Platform “Transforming the International Financial System: Sovereign, Democratic and Responsible Financing”* (2009)<sup>2</sup>
- *The Afrodad Borrowing Charter* (2010).<sup>3</sup>

The global financial crisis that started in 2008 has increased awareness and understanding among governments and international organisations about the fact that the international loan provision and debt management systems are not working well. As a result, there has been increased political will to tackle some of the flaws and gaps. Responsible financing was put on the official agenda, through leadership taken by the United Nations Conference on Trade and Development (UNCTAD), which is traditionally the institution within the UN system that deals with questions related to debt and debt management.<sup>4</sup>

The Principles on Promoting Responsible Sovereign Lending and Borrowing (PRSLB) are the results of a three-year multi-stakeholder process including governments, CSOs, academia, the private sector, international financial institutions (IFIs) and the Paris Club Secretariat. Eurodad participated in the expert group that was consulted during the development of the PRSLB.

In January 2012, UNCTAD released the Principles. Thus far, they have been formally

endorsed by 13 of the 193 UN Member States. Among the 13 are three European nations – Germany, Norway and Italy. More states are expected to follow suit. However, the need to promote responsible lending and borrowing has also been reflected in three UN General Assembly Resolutions, and in the outcome document of the UNCTAD XIII Conference in Doha in April 2012.<sup>5</sup> Thus, there is already now a reason for all UN Member States to comply with the Principles. However, the indirect endorsement through UN resolutions should not be seen as an effective substitute for direct endorsements by nation states.

Additional practical relevance has been afforded because the government of Norway is currently auditing a selected share of its outstanding loans to developing countries, following the criteria set by the Principles.<sup>6</sup> The actual impact of the endorsement in the other 12 signatory countries remains largely unclear at this stage.

The political dimension is relevant, as the Principles are not legally binding. They are voluntary, and no sanction or enforcement mechanisms yet exist to ensure compliance – a situation that may limit their actual relevance and impact, as was flagged by Eurodad and other CSOs during the consultation process. But what do the Principles say?

### **Eurodad Assessment of the PRSLB**

<sup>1</sup> See <http://eurodad.org/13540/>

<sup>2</sup> See <http://eurodad.org/4100/>

<sup>3</sup> See <http://www.afrodad.org/site/Publications/Conference%20reports%20and%20Statements/afrodad%20borrowing%20charter.pdf>

<sup>4</sup> See UNCTAD’s debt portal: <http://www.unctad.info/en/Debt-Portal/>

<sup>5</sup> See the UN General Assembly Resolutions A/RES/64/191 (§3); A/RES/65/144 (§3) ; A/RES/66/189 (§3); and UNCTAD 2012: The Doha Mandate ; §28-30 and 31c;

[http://unctad.org/meetings/en/SessionalDocuments/t\\_d500\\_Add\\_1en.pdf](http://unctad.org/meetings/en/SessionalDocuments/t_d500_Add_1en.pdf)

<sup>6</sup> See <http://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=231>



The aim of the principles is, in UNCTAD's own words, *"to reduce the frequency and severity of debt crises by developing a set of voluntary guidelines that promote and reinforce responsible sovereign lending and borrowing practices. Lack of globally agreed rules and regulations guiding sovereign financing has contributed in many instances of irresponsible sovereign borrowing and lending to sovereign countries. The principles are meant to fill this gap."*<sup>7</sup>

Compared to Eurodad's own conceptual work – the Responsible Finance Charter – the aim is therefore relatively narrow, as it just intends to prevent debt crises. Eurodad's Charter goes further than this: Eurodad moved from a 'do no harm approach' to a 'do good approach'. It also intends to improve the development effectiveness of public finance in general, and to make sure that irresponsible lending practices and their costs do not undermine state capacities to fulfil other core state functions, such as public service provision and poverty eradication.

### **Narrow scope: relevant flows uncovered**

The scope of financial instruments covered is relatively narrow. While the Principles make clear that *"they are ... conceptualized in a holistic way and are thus meant to be applied to sovereign borrowers, developed or developing countries alike, as well as their lenders"*, it is obvious that the drafters had primarily project-type loans, and primarily developing countries' external borrowing in mind.

In contrast, Eurodad's Responsible Finance Charter goes beyond sovereign lending and borrowing. It covers investment contracts and addresses the risks of increased blending of public funds and private loans.

### **Significant gaps: taxation and procurement**

Eurodad's Charter covers additional areas that are closely related to lending and investment: taxation and procurement, which are fully neglected in the UNCTAD Principles. Taxation is of limited relevance for sovereign borrowing (in the Eurodad Charter, it addresses investment contracts and loans to companies), but the omission of public procurement is a striking gap, as many sovereign lenders attach harmful procurement conditionality to loans, or tie development loans to the purchase of goods and services offered by the lender countries' businesses. On the borrower side, many loans fund public procurement, which may be distorted by corruption or collusion. The Eurodad Charter asks for procurement to be transparent, accountable, fully untied and conducted through the borrower countries' own procurement system. Preferences for domestic industries or certain groups may be applied if it makes developmental sense.

### **Missing in action: illegitimate debt**

While the scope of the term 'responsible' was not clearly defined, UNCTAD picked a relatively narrow definition. One of the main points of criticism by CSOs was that the concept of 'odious' or 'illegitimate' debt was not clearly considered. The distinction between odious/ irresponsible/ illegitimate is also not clear in the Principles. Only the preamble mentions *"undisciplined, ineffective, abusive or non-cooperative behaviour on the part of both creditors and sovereign debtor"*.

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<sup>7</sup> See <http://unctad.org/en/pages/InformationNoteDetails.aspx?OriginalVersionID=20>

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Obviously, the sensitive issue of illegitimate debt was sacrificed during the consensus-building process, as this makes it easier for more UN Member States to endorse the Principles. The Principles could, however, contribute to a further operationalization and subsequent implementation of the debt legitimacy concept, which is thus far not fully acknowledged by the community of official lenders and borrowers. Implicitly, loans that do not comply with the Principles can be considered as illegitimate debt. Norway's debt audit shows that the Principles can also be applied to assess the legitimacy of existing outstanding debt, besides their important function of improving future lending relations.

The Principles are divided between lender and borrower, thus acknowledging a co-responsibility of both parties for credit relations. This analysis follows the structure of the UNCTAD Principles, which contain seven principles for lenders and eight for borrowers. These are:

### **Lenders' side obligations:**

**1. Agency:** The Principles make clear that lenders have to accept that borrowers' state officials act as agents of their nations and ultimately their citizens, whose tax payments are used to repay loans. However, the listed implications mainly focus on refraining from corrupt practices. What is missing is making explicit that lenders must not attach policy conditionalities to loans that would undermine democratic decision-making processes and/or influence policy outcomes in other directions than the ones intended by citizens.

**2. Informed decisions:** This principle obliges lenders to disclose sufficient information

about the financial products in order to enable borrowers to assess the actual risks and benefits involved. They also make clear that 'unsophisticated governments' need more user-friendly information. This is a step forward, as financial products are increasingly complex and the implications are often not clear to the borrowing parties. However, it was useful to state more clearly what kind of information lenders are supposed to disclose, how and where this information needs to be disclosed, and that citizens' right to access information needs to be respected, in both creditor and lender countries. This is the more important as principles developed by the financial industry themselves stress their desire for confidentiality.<sup>8</sup> The Eurodad Charter is more precise in this regard (Chapter F).

**3. Due authorisation:** The principles state that lenders have the co-responsibility to check if the borrower's officers are 'authorised under applicable law' to make the financing agreement, and to abstain from lending if this is not the case. Some CSO inputs had demanded much more: parliamentary or even civil society consent for all individual loans. The compromise of the Principles, however, follows the rationale that the legal framework for sovereign borrowing may differ from country to country, an approach also taken by Afrodad's Borrowing Charter. The Eurodad Charter

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<sup>8</sup> See Institute of International Finance: *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets*, Principle 1. (<http://www.iif.com/download.php?id=34pFJozFeMA> =)

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demands parliamentary and/or administrative approval of loan contracts and compliance with national laws in the borrower country. Parliaments and citizens must be given adequate time to debate the loan.

**4. Responsible credit decision:** This principle states that lenders should assess the borrower's repayment capacity, and should not lend beyond this capacity, including for cases that affect the lender's commercial or geostrategic interest (such as military exports). One gap is that there is no specification about what constitutes debt sustainability. In fact, the term is fully avoided. The Eurodad Charter addresses debt sustainability in the context of debt workout mechanisms and stresses that the concept must pay attention to the development needs of a borrower country (Chapter G.2). It also gives guidance on credit terms, for instance, that variable interest loans should have an upper limit for their interest loans.

**5. Project financing:** In project financing, lenders have a responsibility to conduct ex ante and post-disbursement impact assessments. Explicitly mentioned are financial, operational, civil, social, cultural and environmental implications. In addition, CSOs had asked for human rights impact assessments, and to make explicit that responsible lending cannot fund activities that undermine core labour standards. The Eurodad Charter devotes a whole chapter to protection of human rights and the environment (Chapter B).

**6. International cooperation:** This principle simply says that lenders should not lend when there are UN-imposed sanctions on a certain nation.

**7. Debt restructuring:** This principle states that "all lenders have a duty to behave in good faith and with cooperative spirit to reach a consensual rearrangement". For many CSOs, the lack of a debt workout mechanism is the weakest point of the UNCTAD principles. Eurodad explicitly raised this in the consultations, pointing to the civil society position debt workout.<sup>9</sup> However, the Principles state that, "To date, no universal sovereign debt restructuring mechanism has been established". It concludes that seeking consensual restructuring with lenders is a borrower's only option. Some CSO contributions contested this. For example, the Latin American Network on Debt, Development and Rights (Latindadd) advocated for unilateral debt repudiation of illegitimate debt.

The Principles do not explicitly address the problems of vulture funds. However, they do phrase diplomatically that such types of creditors are acting 'abusively'. The Eurodad Charter goes much further when stating that the borrower's consent is needed when the lender wants to sell on a loan, and that sales to parties that refused

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<sup>9</sup> See Eurodad: *A fair and transparent debt work-out procedure*. 10 civil society principles ([http://www.eurodad.org/uploadedfiles/whats\\_new/reports/eurodad%20debt%20workout%20principles\\_final.pdf](http://www.eurodad.org/uploadedfiles/whats_new/reports/eurodad%20debt%20workout%20principles_final.pdf)).

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or refuse to participate in debt restructuring are forbidden (A.12).

### **Borrowers' side obligations:**

**8. Agency:** As with lender side obligations, the Principles make clear that government officials are agents of states and citizens, including future generations. They should have a Code of Ethics and should not break national law or international conventions. What is missing is a clear statement on what the agency principle implies for how officers deal with lender-imposed conditionality and other 'accountability dilemmas' – for instance, when debt service competes for limited public resources with financing other core state functions. The UNHCR had made clear that states have a primary responsibility for ensuring human rights, and should ensure that obligations arising from external debt agreements do not undermine this responsibility.<sup>10</sup>

**9. Binding agreements:** Loan contracts are generally binding, but there may be cases of 'economic necessity' or cases where "competent judicial authority may rule that circumstances giving rise to legal defence have occurred". This is the main principle that alludes to the fact that unsustainable and illegal debt may exist; it refers to the two principles on debt restructuring for solutions. A practical challenge might be that cases of illegal debt should "be raised in a court of competent jurisdiction", as the

reach of national courts beyond borders is in practice very limited, and international debt arbitration courts do not yet exist.

**10. Transparency:** Governments have a responsibility to put in place and implement a legal framework that clearly defines procedures, responsibilities and accountabilities. The Principles state that taxpayers' representatives should 'ideally' be involved and outline what form of engagement should be taken. However, the participation of parliaments and citizens should be clearly defined. In fact, this principle neglects the central role of parliaments in the legislation process.

**11. Disclosure and publication:** The citizens' right of access to information is recognised as follows: "relevant terms and conditions ... should be universally available and freely accessible in a timely manner through online means to all stakeholders, including citizens". However, the implications just refer to the need/right of information of the creditor to assess credit risks, and do not specify the citizens' right to access information further, and what it means concerning the way information is presented. The Eurodad Charter, for instance, states that key documents should be available in the languages of both borrower and lender party, and both should be equal before the law. Progress reports for loan-funded projects should be made public too.

**12. Project financing:** The principle mirrors those for lenders, outlining that the borrower has to carry out ex ante and post-

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<sup>10</sup> See UNHCR's *Guiding principles on foreign debt and human rights*, in particular §18; [http://www.ohchr.org/Documents/HRBodies/HRCouncil/RegularSession/Session20/A-HRC-20-23\\_en.pdf](http://www.ohchr.org/Documents/HRBodies/HRCouncil/RegularSession/Session20/A-HRC-20-23_en.pdf)



disbursement assessments, including for projects where the lender took the credit risk but where the burden may ultimately end up on the borrowers' balance sheets. Again, there is no reference to human rights impact assessments. It does, however, point at the responsibility for borrowers to investigate lender-funded projects independently in order to avoid harmful projects.

**13. Adequate management and borrowing:**

While the principle states that borrower countries should have debt management and sustainability strategies, independent audit institutions and debt management offices, it contains little clarity on the role of citizen participation and democratic institutions. The statement that, "Audits should follow commonly agreed principles in this field" should have been complemented by a clearer outline of the scope of audits, the audit process and the stakeholders involved, and the use of audit findings, i.e. the actual consequences. CSOs had asked for audits to assess the legitimacy of lending too, and for the cancellation of illegitimate and unsustainable debt that was identified in audits.

**14. Avoiding incidences of over-borrowing:**

This principle gives an economic rationale for the amount of borrowing: it is to avoid borrowing for chronic fiscal deficits, borrow just for activities that yield sufficient returns to cover the repayment obligations. Exceptions for implementing countercyclical policies and in situations of national emergency are permitted, however. While the Principles in general build on the spirit of

co-responsibility, they lack a similar principle for over-lending that would equally hold the lender side to account.

**15. Restructuring:** When debt restructuring is needed, borrowers are supposed to propose an agreement with the supermajority of creditors to modify the original contractual terms. Collective action clauses can facilitate sovereign debt restructuring; therefore, it is recommended that debtors and creditors should include them in multi-party debt instruments. "The borrower should avoid opportunistic behaviour and arbitrary discrimination among creditors; and it should respect the voluntary basis of the process and the seniority of debts. The restructuring should be proportional to the sovereign's need and all stakeholders (including citizens) should share an equitable burden of adjustment and/or losses."

While it is laudable that the concept of a sovereign's needs are acknowledged in the Principles, this needs further definition in terms of what a sovereign's need and equitable burden-sharing might look like. In the best case, along human and developmental indicators, the Eurodad Charter states that "determining the ability of a country to repay should take into account the fundamental rights and needs of citizens, as well as the country's needs to invest in future sustainable development". Eurodad also specifies that, while the default approach is that loan contracts must be respected, this is not the case "where the lender or the investor has not exercised due-diligence or has engaged in illegal behaviour; where the terms of the



*contract are considered unfair; where coercion has been involved; or where the borrower's or host state's circumstances change so dramatically that to force them to honour the contract would lead to inhumane distress or a violation of human rights".*

The Eurodad Charter also specifies that loan contracts should state clearly what happens in cases where borrowers find themselves unable to repay a loan, and the contract should allow for a modification of the terms. Loan documents should offer provision for an independent and transparent debt workout, an automatic stay would apply and borrowers must be protected from litigation during debt restructuring processes. Loan documents should not contain cross-default clauses. Similar to the UNCTAD principles, Eurodad supported collective action clauses as one useful instrument to facilitate debt restructuring. Latindadd rejected them because they favoured unilateral debt repudiation, at least for illegitimate debt.

## Conclusion

The UN's Principles on Responsible Sovereign Lending and Borrowing represent a first step towards reforming cross-border finance in the direction of more responsibility and thus indirectly towards greater sustainability and development effectiveness. This is the first time an international organisation has identified, harmonised and systematised good practice in this way. Although the Principles are a step in the right direction, they fall short of what CSOs had expected from the process. Compared with the self-regulation principles by the private sector<sup>11</sup> (the IIF principles), the

UNCTAD Principles' main added value is perhaps the clarification that borrower countries' officials act as agents of their nations and citizens, including future generations. Relatively high requirements for due authorisation, transparency and accountability follow from this acknowledgement.

In other areas, the Principles lack the clarity that is needed to hold borrowers and lenders to account and to actually improve lending and borrowing, to do no harm and make finance work for all. For instance, this includes more precision on democratic authorisation processes, details on data disclosure, or what 'mutually satisfactory solutions' in debt restructuring are. A human rights-based definition of 'economic necessity' could also be expected from a set of UN principles. The vague phrasing of the Principles, however, also allows their further strengthening as the implementation process proceeds. Many steps need to follow to make financing work for development. The most important shortcomings at this stage are as follows:

- The scope is too narrow, as it just covers sovereign lending and borrowing, while in practice the share of sovereign debt in total debt shrinks when compared to private debt.
- The scope is too narrow, as the aim is simply to prevent cases of debt crisis and contagion, not to increase the development effectiveness of lending. Also missing is a clear statement on who is being held to account for the consequences of irresponsible lending and borrowing, and how.
- The principles do not contain clear guidelines for implementation that limits their effectiveness to drive behavioural

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<sup>11</sup> See: Institute of International Finance: *Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets*  
[http://www.iif.com/download.php?id=34pFJozFeMA=\)](http://www.iif.com/download.php?id=34pFJozFeMA=)



change. So far, Norway seems to be the only signatory government that has actually taken action after endorsement.

- The fact that the Principles are not legally binding and no sanction or enforcement mechanism exists may lead to practical irrelevance, unless such mechanisms are to be introduced in future, or 'soft' accountability mechanisms – such as regular peer reviews or civil society watchdogs – fill the gap. The Eurodad Charter calls on national governments to enshrine responsible financing principles into national law, given that the effectiveness of voluntary guidelines in this and other areas of development finance has been very limited.

As the Principles leave much room for interpretation, there is still space for the international community to further strengthen and deepen responsible financing during the implementation process. UNCTAD has taken a first step, but very obviously there is a long way to go to fill the gaps and ensure the practical relevance, full compliance by all actors, and thus ultimately the effectiveness of financial regulation towards responsibility. The Eurodad Responsible Finance Charter provides valuable guidance and inspiration for decision-makers in this process.

### **Eurodad**

Eurodad (the European Network on Debt and Development) is a network of 48 non-governmental organisations from 19 European countries who work together on issues related to debt, development finance and poverty reduction. The Eurodad network offers a platform for exploring issues, collecting intelligence and ideas, and undertaking collective advocacy.

More information and recent briefings are at:  
[www.eurodad.org](http://www.eurodad.org)



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