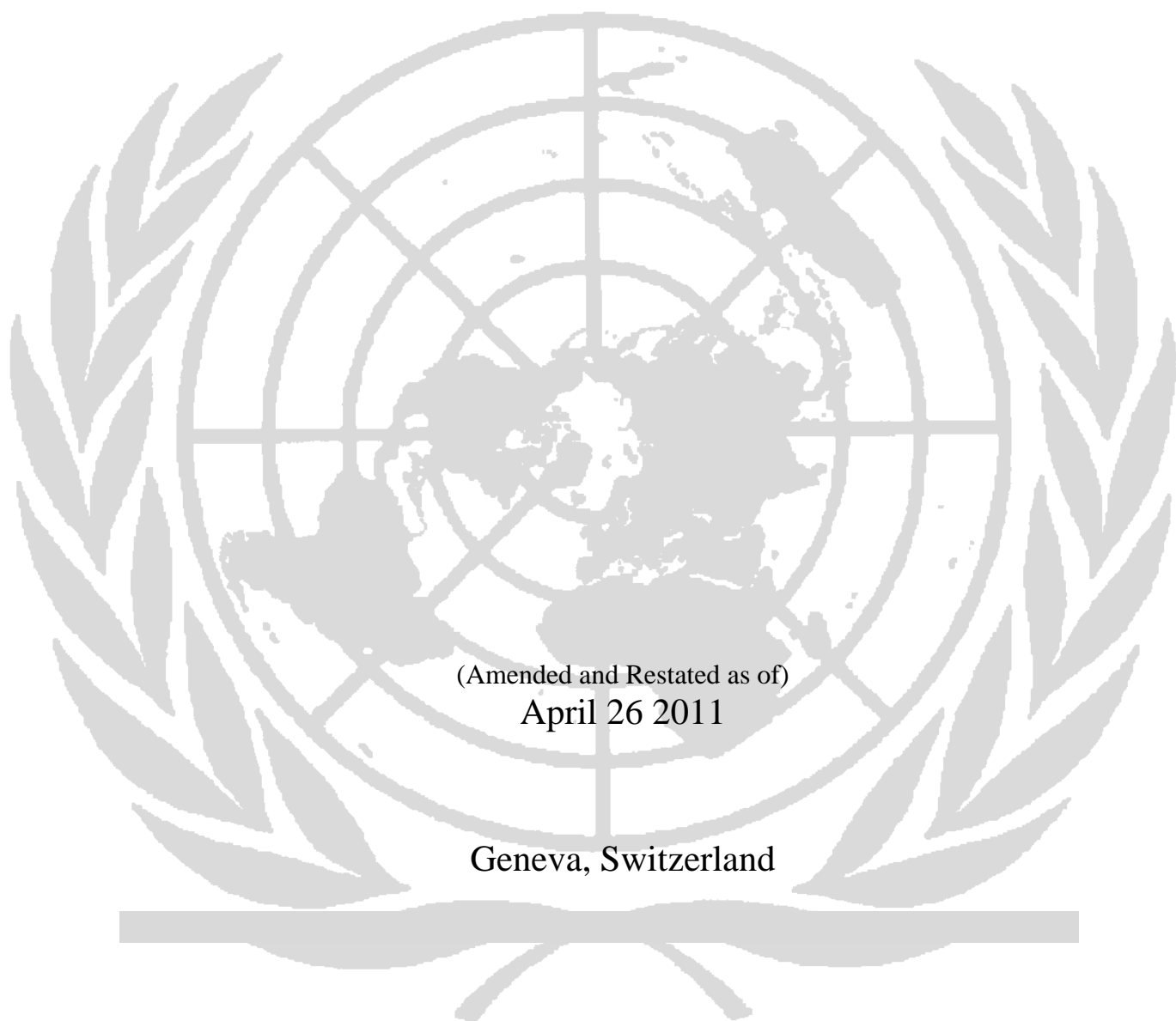


**DRAFT PRINCIPLES ON PROMOTING
RESPONSIBLE
SOVEREIGN LENDING AND BORROWING**

UNITED NATIONS CONFERENCE ON TRADE AND
DEVELOPMENT

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(Amended and Restated as of)
April 26 2011

Geneva, Switzerland

Draft Principles on Promoting Responsible Sovereign Lending and Borrowing

UNCTAD Project on Promoting Responsible Sovereign Lending and Borrowing

Background of the UNCTAD Initiative

The causes and widespread negative effects of the global financial and economic crisis prompted UNCTAD to launch an initiative in 2009 to promote responsible sovereign lending and borrowing practices. The purpose of UNCTAD's initiative is to provide a forum for debate on responsible practices and to develop a set of commonly accepted principles and practices relating to sovereign debt issues.

The annual United Nations General Assembly resolution on external debt has repeatedly stressed the importance of promoting responsible sovereign lending and borrowing. In December 2010, it emphasized the need for creditors and debtors to share responsibility for preventing unsustainable debt situations and encouraged Member States, the Bretton Woods institutions, regional development banks and other relevant multilateral financial institutions and stakeholders to pursue the ongoing discussions within the framework of UNCTAD's Initiative to promote responsible sovereign lending and borrowing, while taking into account the work on this issue that is carried out by other organizations and forums.

Identifying agreed principles to guide sovereign lending and borrowing is the first step in this process. Thus, UNCTAD aims to build consensus around a set of internationally agreed principles to prevent irresponsible sovereign financing.

These Principles are presented as a document to fuel discussion and debate. The process of converging towards agreed principles aims to be transparent and inclusive in a multi-stakeholder forum. The current draft is intended to be a point of departure for international discourse and will be subject to further discussions and revisions, including the possibility of introducing additional Principles. Further comments and feedback are welcome.

An expert group was established to contribute to the process of drafting these Principles. The group is composed of world renowned experts in law and economics, private investors and NGOs. Senior representatives from the IMF, the World Bank and Paris Club participate as observers of this group. After several formal meetings and exchanges of ideas, this draft of the Principles emerged.

UNCTAD is grateful for the contributions provided by members and observers of the Expert Group, external consultants and UNCTAD staff who worked in their professional capacities. The views expressed here do not necessarily represent the views of their institutions or organizations. UNCTAD is also grateful for the generous financial support from the Government of Norway

Preamble

Sovereign insolvencies occur due to systemic and/or extraordinary reasons and due to lenders' and/or borrowers' behavior. Both developing and developed countries—as well as bilateral, multilateral, and private lenders—have been involved in or affected by sovereign defaults.

Undisciplined, inefficient, abusive or non-cooperative behavior on the part of both creditors and sovereign debtors should be prevented in order to minimize sovereign insolvencies and their negative consequences. Sovereign lending and borrowing conducted in a prudent and disciplined manner can promote growth and development; but irresponsible financing can have baleful consequences for the debtor country, its citizens, its creditors, its neighbors and its trading partners. These effects can extend well beyond the territory of the sovereign debtor itself.

Encouraging responsible sovereign borrowing and lending practices is therefore a matter of truly international concern. Sovereign lending and borrowing are intrinsically linked to the feasibility of the Millennium Development Goals. Each side of a sovereign lending transaction – the borrower and the lender – is accountable for its own conduct in these transactions. Neither side can wholly shift to the other the duty of ensuring that the agreement is financially sound, legally authorized, appropriately documented and carefully monitored.

The normative contribution of these Principles lies not in the creation of new rights nor obligations in international law but in identifying 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.

The responsibilities of lenders and borrowers are presented separately in these Principles. Each Principle is accompanied by bullet points that clarify its meaning and highlight some relevant implications of the Principle.

I. RESPONSIBILITIES OF LENDERS TO SOVEREIGN BORROWERS

1. Agency

Lenders should recognize that government officials involved in sovereign lending and borrowing transactions owe a strict fiduciary duty to the State (including its citizens) for which they are acting as agents.

Implications:

- Lenders to sovereign borrowers are dealing with agents (the government officials directly involved in the borrowing process) who owe fiduciary duties to the State and its citizens for which they act.
- Any attempt by a lender to suborn a government official to breach that duty is wrongful (for example, instances of bribes or corruption).

2. Informed Decisions

Lenders should ensure that their sovereign customers are making informed credit decisions.

Implications:

- The due diligence standards that financial institutions recognize in dealing with private sector customers should be equally applicable to sovereign counterparties. Among other things, this requires the lender to take reasonable steps to ensure that the sovereign understands the risks and benefits of the financial product it is being offered. In addition, the lender should form an independent assessment of whether the product is suitable for the sovereign.
- The level of financial sophistication among sovereigns differs widely. Some are well informed about markets and financial techniques, others less so. The lender's duty increases when dealing with an unsophisticated sovereign counterparty.

3. Due Authorization

Lenders should determine whether the financing has been appropriately authorized and whether the resulting credit agreements are valid and enforceable under the laws of the sovereign borrower's jurisdiction.

Implications:

- A lender has an independent duty to ensure that the government officials are authorized under local law to enter into the transaction and that the arrangement is otherwise consistent with local law.

4. Responsible credit decisions

A lender is responsible for making a realistic assessment of the sovereign borrower's capacity to service a loan based on the best available information and following established technical rules on due diligence.

Implications:

- Lending beyond a borrower's reasonable capacity to repay not only risks a default on the loan in question, it adversely affects the position of all other creditors of that sovereign debtor.
- In a transaction in which a lender is motivated solely by commercial considerations, the lender should have a direct economic interest in assessing the borrower's repayment capacity.
- Credits extended to sovereign borrowers as a means of enhancing a bilateral (government-to-government) lender's geopolitical influence, however, will involve other motivations. The financing of military exports from the creditor country falls in a similar category. The desire to realize these ancillary benefits from a financing transaction should not alter a bilateral lender's duty to perform a sober assessment of the borrower's repayment capacity.
- Lending decisions are critically dependent on the willingness of the sovereign borrowers to provide timely and accurate information (see Principle 11 below).

5. Project financing

Lenders financing a project in the debtor country should perform their own investigation into the likely effects of the project, including its financial, operational, civil, social, cultural, and environmental implications.

Implications:

- In the context of project financing, a lender carries some of the responsibility for determining the reasonably foreseeable effects of the project and the host government shares a corresponding responsibility.
- This investigation will normally include post-disbursement monitoring of the use of the proceeds of the loan (see Principle 12 below).

6. International Sanctions

All lenders have a duty to comply with United Nations sanctions imposed against a governmental regime.

Implications:

- UN sanctions are imposed against a state in order to maintain or restore international peace and security. In instances of serious misconduct where sanctions are deemed to be necessary, lenders should not participate in financial transactions that violate, evade or hamper such sanctions.

7. Debt Restructurings

In circumstances where a sovereign is manifestly unable to service its debts, all lenders have a duty to behave in good faith and with cooperative spirit to reach a consensual rearrangement of those obligations. Creditors should seek a speedy and orderly resolution to the problem.

Implications:

- To date, no universal sovereign debt restructuring mechanism has been established. A sovereign borrower facing severe financial distress therefore has no choice but to approach its creditors for a consensual rearrangement of its debt burden.
- Although the presumption is that contracts will be performed according to their terms, lenders should recognize the possibility that circumstances may arise in the future that may require the restructuring of sovereign debt. The sovereign debtor's responsibilities in this situation are summarized under Principle 15 (below).
- A creditor that acquires a debt instrument of a sovereign in financial distress with the intent of forcing a preferential settlement of the claim outside of a consensual workout process is acting abusively.

II. RESPONSIBILITIES OF SOVEREIGN BORROWERS TO LENDERS

8. Fiduciary Relationship

Governments are agents of the State and stand in a fiduciary relationship to their present and future citizens when they contract debt obligations.

Implications:

- Sovereign debts that are contracted by governments bind the continuing legal entity of the State, including its future administrations and future generations of its citizens. The government officials who authorize and execute such borrowings therefore carry fiduciary responsibilities vis-à-vis the people who must ultimately repay the money.
- This fiduciary status makes wrongful any form of self-dealing or peculation on the part of government officials involved in the borrowing. National laws as well as international and regional conventions against corruption are relevant in assessing the legality of this behavior.

9. Binding Agreements

A sovereign debt contract is a binding obligation and should be honored unless the economic circumstances of the borrower prevent its full and/or timely repayment or a competent judicial authority rules that circumstances giving rise to legal defense have occurred. When changes to the original contractual conditions of the loan are unavoidable, Principles 7 and 15 should be followed.

Implications:

- A sovereign's inability to continue normal debt servicing is typically caused by acute financial distress. Sometimes the sovereign will have been the author of its own difficulties (for example, by pursuing imprudent macroeconomic policies); occasionally a sovereign predicament will have been abetted by reckless creditor behavior. In other cases the crisis may have been precipitated by events beyond the sovereign's control (natural disasters or a general deterioration in international markets).
- In some cases the circumstances surrounding the incurrence of a sovereign loan may give rise to a legal defense pertaining to the performance of that contract by the sovereign borrower. Creditor complicity in the corruption of government officials in the borrowing process is one. Transactions that hamper or directly imply violations of sanctions imposed by the United Nations is another case. Where such legal defenses are available to a sovereign debtor, these should be raised in a court of competent jurisdiction.

10. Transparency

The process for obtaining financing and assuming sovereign debt obligations and liabilities should be transparent. Governments should put in place arrangements to ensure the proper approval and oversight of official borrowings and other forms of financing, including guarantees made by State-related entities.

Implications:

- Because the taxpayers of a country will ultimately be responsible for the repayment of the sovereign's debt, their representatives in the legislature should ideally be involved in the decisions about whether and how to incur the debt. This may take the form of legislatively-specified debt ceilings, legislative oversight of government finances, the ability to conduct post-disbursement audits of specific transactions, or any other kind of legislative intervention.
- Transactions or accounting techniques that have the effect of misrepresenting the true nature or extent of a sovereign's debt picture are inconsistent with a sovereign's duty of candor to its citizens and its creditors.

11. Disclosure

Relevant terms and conditions of a financing agreement should be disclosed by the government, be universally available, and be freely accessible in a timely manner through online means to all stakeholders, including citizens. Sovereign debtors should disclose complete and accurate information on their economic and financial situation that conforms to standardized reporting requirements.

Implications:

- If investors are expected to bear the risk of their sovereign investment decisions, it is necessary that they be given the information required to analyze that risk properly before making the investment. A sovereign borrower that does not provide full disclosure –subject only to a very limited category of exceptions involving national defense- or misrepresents its information at the time it incurs a debt, will be ill-positioned to argue that its creditors have a moral responsibility to participate in any necessary workout of the loan down the road.
- In the same spirit, the material terms (financial and legal) of a sovereign's outstanding debt issuances should at least be made publicly available in the official language(s) of the country.
- Debtors should make public disclosure of their financial and economic situation, providing among others the following information: (i) accurate and timely fiscal data; (ii) level and composition of external and domestic

sovereign debt including maturity, currency, and forms of indexation and covenants; (iii) external accounts; (iv) the use of derivative instruments; and, (v) details of any kind of implicit and explicit sovereign guarantees. Sovereign borrowers may wish to consider disclosing information by way of international norms, such as the IMF's Special Data Dissemination Standard.

12. Project Financing

In the context of project financing, sovereign borrowers are responsible for conducting a thorough investigation into the financial, operational, civil, social, cultural and environmental implications of the project and its funding.

Implications:

- The debt incurred to finance a project will remain payable even if the sovereign borrower comes later to regret the design or commissioning of the project.
- Traditional project financing (where the lenders take the credit risk of the project, rather than that of a sponsor of the project such as the host State) is often kept off the balance sheet of the host State. Ill-designed or underfunded projects, however, must often be taken over by the State before completion which then results in unexpected public sector liabilities.
- A sovereign borrower's responsibility to investigate a project that is being funded with public monies does not relieve the lender of its independent responsibilities in this regard. Recent history offers many examples of lenders that have tempted sovereigns to commission unnecessary or even harmful projects merely to access the hard currency loans on offer to finance the project.

13. Adequate Management and Monitoring

Debtors are responsible for designing and implementing a debt sustainability and management strategy and for ensuring that their debt management is adequate. Debtor countries should put in place effective monitoring systems, including at the sub-national level. The debtor should conduct independent, objective, professional, timely and periodic audits of their debt portfolios to assess quantitatively and qualitatively the recently incurred obligations. The findings of such audits should be publicized to ensure transparency and accountability in debt management.

Implications:

- Many countries have suffered from undisciplined practices with respect to the incurrence of debt obligations by sovereign and other public sector borrowers.

In the absence of a centralized approval and monitoring process, loans can be contracted without regard to the country's overall debt sustainability. As a result, the application of the proceeds of such loans may remain opaque and the terms – both legal and financial – of such borrowings may be inconsistent and ill-advised.

- The establishment of an efficient debt management office (DMO) can address many of these concerns. DMOs exist in many countries, both developed and developing, and technical assistance is available from international financial institutions to help countries in the establishment of a DMO.
- A DMO should be involved in both the pre- and post-disbursement aspects of any credit for which the State or one of its instrumentalities will be liable.
- A thorough knowledge, understanding and publication of the current and future implications of the sovereign debt portfolio are keys to both the fiduciary relationship between governments and their citizens and the financial relationship between States and their lenders. Audits should follow commonly agreed principles in this field.

14. Avoiding Incidences of Over-Borrowing

Governments should weigh costs and benefits when seeking sovereign loans. They should seek a sovereign loan if it would permit additional public or private investment, with a prospective social return at least equal to the likely interest rate.

Implications:

- Sovereigns should borrow if the alternative would involve cutting back investment with a return greater than the interest rate.
- A sovereign can legitimately borrow to finance consumption (i.e. a cut in saving) rather than an increase in investment where macroeconomic stability and private investment is endangered.
- The calculations described above should be performed after internalizing relevant social and environmental costs and benefits.
- Engaging in borrowing to solely cover large chronic budget deficits could eventually erode the debtor country's credit standing, impair its ability to obtain loans on favorable terms in the future and effectively impose a tax on subsequent generations of citizens. Borrowing for this purpose, when not justified by a national emergency, could therefore be inconsistent with a sustainable economic policy.
- In calculating prospective social returns and likely interest rates one should take account of the danger that outcomes may not be favorable as expected ex ante.

15. Restructuring

If a restructuring of sovereign debt obligations becomes unavoidable, it should be undertaken promptly, efficiently and fairly.

Implications:

- Although debt servicing should be a high priority for governments, there may be occasions when the need to devote public resources to other purposes will leave insufficient funds to normally service its debt.
- The sovereign borrower's first responsibility in this situation is to move in a timely fashion to communicate with its creditors and commence the process of a consensual debt rearrangement. Protracted debt restructurings are generally injurious to all concerned parties, both the debtor and its creditors. The sovereign debtor should therefore seek to conclude the operation as efficiently as possible.
- If the sovereign has proved that a debt restructuring is in fact necessary, the debtor should seek 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.

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