



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



UNITED NATIONS

(Amended and Restated as of)
10 January 2012

CONSOLIDATED 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.

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 still open for discussion and debate. The endorsement process aims to be transparent and inclusive of all UN member states. The consolidated version is a result of extensive international consultations, but may still be subject to finer refinements.

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, these Principles emerged.

UNCTAD is now reaching out to get national and regional feedback on the design and the possible and voluntary implementation process from UN Member States, essentially through Consultative Regional Meetings.

UNCTAD is grateful for the contributions provided by members and observers of the Expert Group, UN member states, 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, ineffective, 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 harmful 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 economically beneficial, financially sound, legally authorized, appropriately documented and carefully monitored.

These principles aim to promote more responsible behavior and provide economic benefit to both sovereign borrowers and their lenders. They are also 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.

Principles identified in this document are already followed by some sovereign borrowers and lenders. 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. This set of principles should apply without prejudice of other international rules concerning the action of lenders or borrowers..

The first step of this Initiative has been to shape a robust and well grounded set of principles and build consensus around them respecting the sovereigns' priorities and preferences.

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

1. Agency

Lenders should recognize that government officials involved in sovereign lending and borrowing transactions are responsible for protecting public interest (to the State and 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 responsibility 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 have a responsibility to provide information to their sovereign customers to assist borrowers in making informed credit decisions.

Implications:

- Applicable due diligence standards should be followed by lenders including taking reasonable steps to ensure that the sovereign understands the risks and benefits of the financial product being offered.
- The level of financial sophistication among sovereigns differs widely. Some are well informed about markets and financial techniques, others less so. The lender's responsibility increases when dealing with an unsophisticated sovereign counterparty.

3. Due Authorization

Lenders have a responsibility to determine, to the best of their ability, whether the financing has been appropriately authorized and whether the resulting credit agreements are valid and enforceable under relevant jurisdiction/s.

Implications:

- A lender has an independent duty to ensure to the best of its ability, that the government officials are authorized under applicable law to enter into the transaction and that the arrangement is otherwise consistent with such law.
- Should the lender determine that these conditions do not exist, it should desist from concluding the agreement.

4. Responsible credit decisions

A lender is responsible to make a realistic assessment of the sovereign borrower's capacity to service a loan based on the best available information and following objective and agreed technical rules on due diligence and national accounts.

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.
- When assessing the borrower's situation, lenders should consider the broad and real financial scenario, including direct and contingent liabilities according to the System of National Accounts adopted by the United Nations Statistical Commission.
- 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 this category. The desire to realize such benefits from a financing transaction should not replace a serious 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 have a responsibility to perform their own ex ante investigation into and, when applicable, post-disbursement monitoring of, the likely effects of the project, including its financial, operational, civil, social, cultural, and environmental implications. This responsibility should be proportional to the technical expertise of the lender and the amount of funds to be lent.

Implications:

- In the context of project financing, a lender carries some of the responsibility for the reasonably foreseeable effects of the project and the host government shares a corresponding responsibility.
- When applicable, this investigation will normally include post-disbursement monitoring of the use of the proceeds of the loan (see Principle 12 below). This monitoring should be transparent and not affect any sovereign's faculty to decide on its developmental priorities.

6. International Cooperation

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 re-arrangement 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).

- Lenders should be willing to engage in good faith discussions with the debtor and other creditors to find a mutually-satisfactory solution.
- 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

8. Agency

Governments are agents of the State and, as such, when they contract debt obligations, they have a responsibility to protect the interests of their citizens. Where applicable, borrowers should also consider the responsibility of lenders' agents toward their organizations.

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 responsibilities vis-à-vis the people who must ultimately repay the money.
- This status makes wrongful any form of self-interest 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.
- Codes of Ethics applicable to the circumstances of debt management that address the significant risks in this area should also be adopted and enforced.

9. Binding Agreements

A sovereign debt contract is a binding obligation and should be honored. Exceptional cases nonetheless can arise. A state of economic necessity can prevent the borrower's full and/or timely repayment. Also, a competent judicial authority may rule that circumstances giving rise to legal defense have occurred. When, due to the state of economic necessity of the borrower, 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 Security Council 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 have a responsibility to put in place and implement a comprehensive legal framework that clearly defines procedures, responsibilities and accountabilities. They should particularly 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, borrowing objectives, legislative oversight of government finances, the ability to conduct post-disbursement audits of specific transactions, or any other kind of legislative intervention.
- Transparency should operate at the level of specific transactions and at the

aggregate government sector level. The reporting standards to be followed depend on the type of stakeholder for whom the report is made.

- 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 and publication

Relevant terms and conditions of a financing agreement should be disclosed by the sovereign borrower, be universally available, and be freely accessible in a timely manner through online means to all stakeholders, including citizens. Sovereign debtors have a responsibility to disclose complete and accurate information on their economic and financial situation that conforms to standardized reporting requirements and is relevant to their debt situation. Governments should respond openly to requests for related information from relevant parties. Legal restrictions to disclosing information should be based on evident public interest and to be used reasonably.

Implications:

- If lenders 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 their actual market value; (v) amortization schedules and, (vi) 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 have a responsibility to conduct a thorough ex ante investigation into the financial, operational, civil, social, cultural and

environmental implications of the project and its funding. Borrowers should make public the results of the project evaluation studies.

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. Project assumptions should be based on an honest and careful technical assessment.
- 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.
- Borrowers should ensure that project funds are not used for purposes other than those agreed upon.
- When applicable, lender's responsibility to investigate a project that is being funded with public monies (see Principle 5) does not relieve the sovereign borrower 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 to access the hard currency loans on offer to finance the project.

13. Adequate Management and Monitoring

Debtors should design and implement a debt sustainability and management strategy and to ensure that their debt management is adequate. Debtor countries have a responsibility to put in place effective monitoring systems, including at the sub-national level, that also capture contingent liabilities. An audit institution 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. Audits should also be undertaken at sub-national levels.

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.
- Federal and unitary constitutional structure of the country should be considered when carrying out an audit. Auditors should have the power to duly access to all

information needed to perform debt audits according to the standards established in this Principle.

- 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. DMO should have sound processes in place to develop an effective medium-term debt strategy (including procedures to review the strategy periodically, to monitor emerging risks, to monitor interest costs, to take into account other liabilities that could impact on the government budgetary position, to monitor performance and to report clearly and transparently the outcome of the strategy).
- A thorough knowledge, understanding and publication of the current and future implications of the sovereign debt portfolio are keys to both the public interest 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 have a responsibility to 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. When necessary, preventive and defensive countercyclical measures should be allowed.
- 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.

- This principle should allow countries to design and implement adequate medium and long term debt strategies.

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 in which, by state of economic necessity, the sovereign borrower will be left with insufficient funds to normally service its debt.
- The sovereign borrower's first responsibility in this situation of substantive financial troubles is to move in a timely fashion to communicate with its creditors and commence the process of finding and implementing a transparent and 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.
- The sovereign borrower should provide the necessary information which would demonstrate that the sovereign is unable to normally service its debt.
- If the sovereign has proved that a debt restructuring is in fact necessary, the debtor should seek and 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.