

# 11<sup>th</sup> UNCTAD Debt Management Conference

13–15 November 2017

Palais des Nations , Geneva

## Responsible Financing: The role of «soft law» in promoting sustainable lending and borrowing practice

by

**Prof. Rosa Maria Lastra**

Queen Mary University, London

*The views expressed are those of the author and do not necessarily reflect the views of UNCTAD.*



● ● ●

## Responsible Financing: The role of 'soft law' in promoting sustainable lending and borrowing practice

*Prof. Rosa M Lastra, CCLS, QMUL, London*



UNCTAD Geneva  
14 November 2017





## Subject of this panel: Soft law in sovereign finance

- In recent times, ‘**responsible** financing’ has been a rising ‘slogan’ whose meaning and role in the discussion on how to finance development in the current global economic environment is not always clear. Essentially, however, this refers to attempts to embed international ‘soft law’ on how national debt should be contracted and negotiated between debtors and creditors. Debtor-creditor relations of sovereigns have been immensely complicated in the wake of global financialisation. A number of attempts have been made to provide a workable framework of rules and norms, including the UNCTAD Principles on Responsible Sovereign Lending and Borrowing, and more recently the G20 Operational Guidelines for **Sustainable Financing**.
- On 10 Sep 2015 the UN General Assembly adopted resolution [69/319](#) declaring that sovereign debt restructuring processes should be guided by nine Basic Principles, including the right to sovereign debt restructuring, good faith, transparency, equitable treatment, sovereign immunity, legitimacy, sustainability and principle of majority restructuring.



# Framing the debate

- There is no coherent international law framework dealing with sovereign financing. Absent such a system we rely on arbitration, national law and national courts of justice, ad hoc solutions and negotiations and international soft law.
- National law and national courts of justice are not equipped nor designed to deal with the broader public policy considerations (poverty alleviation, sustainability, human rights) that are at stake in sovereign debt crises. **MLG and soft law.**
- Talking about sovereign responsible financing we are of the concept of state sovereignty, a concept anchored in constitutional & administrative law and, on the other hand, of the workings of the financial markets (debt instruments)
- With the restrictive theory of sovereign immunity, it is financial markets rather than sovereigns that provide the framework for understanding sovereign debt.
- **At stake is the interaction between the public interest of sovereign governments as well as broader policy consideration and the private interests of financial market participants.** By definition contractual approaches (like CACs) are limited to contractual issues and thus are not suitable to deal with policy issues. **No SDRM**
  - Sovereign bonds – under English law or under New York Law are not *acta iure imperii*, they are commercial transactions, subject to private contract law



# National courts

Hayk Kupelyants in *Sovereign Defaults before domestic courts* (OUP 2018) refers to the sanctity of contracts and the limited role that judges should have. He talks about **distributive fairness and procedural fairness**.

“From a distributive point, it might seem unfair to some that creditors enrich at the expense of seriously indebted countries. Conversely, from the point of procedural fairness, the compensation of creditors who acquired their debt in a legal and procedurally valid manner is beyond doubt (...). Courts should never consider broader policy arguments to override contractual language and established legal rules’. “Rendering a decision by reference to vague policy reasons, bordering on judicial legislation, would defy the commercial predictability of English and New York laws”.

Lee Buchheit articulated the problems facing national judges - *Sovereign debt in the light of eternity* (OUP 2015)

- *“To say that sovereigns should be accountable in municipal courts for their debt contracts, however, is not to say that municipal courts are an appropriate forum for administering a sovereign debt crisis. Judges, powerful as they may be within the four walls of their own courtrooms, are ill-equipped and ill-positioned to decide how the discomfort of a financial crisis should be apportioned among the citizens of the debtor country and the various classes of its creditors. Judges can only hand down judgments saying that, as a matter of law, the sovereign is bound to pay. They cannot prescribe the nature or the degree of the sacrifices that the sovereign would need to impose on its other stakeholders in order to make those payments or satisfy those judgments.(...) [W]e have thus established a framework that makes sovereigns accountable to the judiciary for the performance of their sovereign debt contracts even **though everyone recognizes that the judiciary is wholly irrelevant in the face of a large sovereign debt problem** (...)”*



## Framing the debate in terms of soft law

- UNCTAD principles on promoting **Responsible** sovereign lending & borrowing
  - Principle No. 1: 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)
- G-20 Operational Guidelines for **Sustainable** Financing.
  - The Addis Ababa Action Agenda on Financing for Development recognizes that “borrowing is an important tool for financing investment critical to achieving sustainable development, including the sustainable development goals (...) However, borrowing needs to be managed prudently.
  - In this regard, UN member states “reiterate[d] that debtors and creditors must work together to prevent and resolve unsustainable debt situations”, that “maintaining sustainable debt levels is the responsibility of the borrowing countries; however [...] acknowledge[d] that lenders also have a responsibility to lend in a way that does not undermine a country’s debt sustainability”, and agreed to “work towards a global consensus on guidelines for debtor and creditor responsibilities in borrowing by and lending to sovereigns, building on existing initiatives.”



## Understanding soft law

- Soft law can be defined as rules or standards that are not legally binding, but which in practice are adhered to by those to whom they are addressed or to those who observe them for a variety of reasons (moral suasion, fear of adverse action and other ‘incentives’).
  - ‘Soft law’ cannot be enforced by formal legal means because it is not legally binding. While ‘hard’ law is characterised by formality, ‘soft’ law is characterised by informality. Soft law is observed in a voluntary, self-imposed way. Hard law is binding in a coercive, externally-imposed way. Enforcement is the key element to distinguish between hard and soft law.
- Globalization has challenged the traditional law-making process. The need for international soft law in finance is a logical response to the ‘vacuum’ in this important area of economic regulation.
- The growth in ‘soft law’ is one of the most relevant developments in the field of international financial law in recent years. With a few exceptions (IMF Articles of Agreement), most of the international standards, rules, principles, guidelines, codes of conduct, best practices, and other arrangements governing cross-border financial relations can be characterised as ‘soft law’.



## Soft law as a method of Law Reform

- Harmonization and other techniques of regulatory convergence (EU – mutual recognition)
- Importation/reception of foreign laws ('legal transplants') – wholesale or piecemeal
- Local adaptation of a foreign legal regime (domestication)
- Development of a home grown regulatory regime
- Adoption of a model law or treaty, model clauses, model contracts and uniform rules. Examples: UNCITRAL model law on Electronic Commerce and Electronic Signatures, EBRD model law on secured transactions, ICC rules and standards
- Adoption of standards (soft law) set by 'international standard setters' and professional groups





# The actors

- While most of the entities involved in the process of international financial standard- setting are inter-governmental or official entities, and their principles or recommendations can be characterised as 'top down' rules (typically 'public law', rules that emanate from official entities (formal inter-governmental institutions and groupings created at the initiative of governments), the work done by professional associations and market entities such as ISDA (uniform rules and standards, voluntary 'codes of conduct', 'codes of practice', etc) can be characterised as 'bottom up' rules, an exercise in self-regulation.
  - As regards the harmonization of international commercial law ('private law' governing cross-border transactions), the work of **UNIDROIT** (the International Institute for the Unification of Private Law) and similar efforts such as **UNCITRAL** (United Nations Commission on International Trade Law), offer a 'set of rules produced and agreed by scholars representative of the main legal families of the world'.



# Taxonomy

- From the point of view of their effect standard range from professional practices at the lowest end of the legal scale (best practices, gentlemen's agreements) to uniform rules, codes and guidelines, and progressively more 'forceful' arrangements with various degrees of actions (sanctions) in the event of 'non-observance'.
- From the point of view of their scope they can be classified into sectoral standards (eg banking, securities, insurance), functional standards (disclosure and transparency, governance, accounting) etc.
- From the point of view of their 'degree of specificity' they can be divided into 'principles', 'practices', and 'methodologies/guidelines'.
- With regard to the contents of the rules, a distinction can be made between 'substantive rules' and rules that allocate regulatory jurisdiction
- With regard to the sources of international soft law - 'top-down' rules and 'bottom-up' rules.



# Advantages and disadvantages of soft law

## ○ ADVANTAGES

- Flexibility, informality and pragmatism. While international-treaty making is a formal and time-consuming process, which lacks flexibility for the purposes of revision or amendment, international standards provide flexibility and informality
- The *modus operandi* of many 'international standard-setters' (the technical expertise of those involved, the commonality of knowledge and interests, and the relatively small size of the working groups) fosters pragmatism and mutual trust.

## ○ DRAWBACKS

- Concerns about legitimacy and accountability. Treaty-making is slow, but formal and legitimate. In a democratic system, this is a very important consideration.
- Self-imposed standard-setting responsibilities Erosion of national sovereignty
- Concerns about 'country ownership', with regard to developing countries - related to the 'ownership of financial law reform' projects; under-inclusiveness of the process
  - incompatibility with the domestic legal culture
  - level of sophistication of some standards.
- Since implementation remains at the discretion of national authorities, problems of legal certainty and predictability may arise. Problems of protection for the parties concerned in the absence of formal legal remedies if the rules are not followed.
- The proliferation of standards may lead to complexity, inconsistency, overlaps or gaps



## Implementation and Monitoring Observance

- Implementation of international standards is typically done at the national level, through appropriate legislation or regulation. Once they are incorporated into national law, standards become 'hard law' and thus enforceable. While enforcement is a legal concept, implementation is a 'factual' concept. The word 'compliance' is a term typically in the case of hard law and 'observance' (or adherence to) in the case of soft law.
- Soft law rules are not 'legally enforceable' and yet they have often proven to effective in finding their way into national law or into EU law
- Voluntary observance is often driven by regulatory competition which induces national jurisdictions to adopt and implement the latest 'must have' set of rules, lest they be frowned upon by the international community and international business.
- Assistance for implementation. Setting out detailed guidelines for the assessment of compliance with the core principles. For each principle, there is a set of criteria (essential and additional) against which compliance can be assessed.



# Monitoring observance

- ROSCs and the FSAP are an indication of a truly worldwide interest in aligning national legal and regulatory frameworks with international best practices, ensuring consistency and comparability in the implementation of standards.
- The only other organization producing ROSCs and solely in the area of anti-money laundering and combating the financing of terrorism, is the FATF, Financial Action Task Force, including its FATF-Style Regional Bodies.
- The ‘good practices’ identified through ROSCs can, in turn, generate more standards and codes. For instance, the IMF Statistics Department has proposed that the examples of good statistical practices identified through the ROSC process could be brought together a Compendium of Good Statistical Practices to serve as a guide to countries in improving their statistical system.



# Incentives to promote observance of soft law rules

## ○ OFFICIAL INCENTIVES

- ‘name and shame’ – a practice associated eg.g, with the list prepared by the Financial Action Task Force on Money Laundering (FATF) regarding non-cooperating jurisdictions or OECD list of offshore financial centers responsible for harmful tax competition act as deterrents against ‘non observance’.
- Institutionalised peer review is another official incentive to promote observance, often as a complement to financial sector surveillance.
- Use of IMF conditionality and surveillance when the country’s adherence to a particular set of standards is made a ‘condition’ for the disbursement of IMF funds under a stand-by or extended arrangement.

## ○ MARKET INCENTIVES/DISCIPLINE

- credit risk weightings, private ratings, borrowing spreads, differentiated interest rates, inter-bank exposure. These forms of market discipline are typically voluntary and require a developed framework of transparency or disclosure.
- The success of standardized clauses and model rules in private contracts developed by trade and financial industry associations (International Swaps and Derivatives Association, ISDA) has demonstrated that markets are capable of spreading existing standards across jurisdictions and developing common rules (self-regulation).



## Soft law, informal law and the ‘lex mercatoria’

- Formal law has often been born out of the development of informal law. A recurrent feature in the history of law.
  - Soft law has proved to be a precursor of emerging hard law. The relation between soft law and legally binding rules (statutory law in domestic jurisdictions, formal treaties at the international level) often appears to be an evolutionary process
- The primary sources of international law are conventional law (treaty law), customary law and the general principles of the law, as recognised by Art 38 of the Statute of the International Court of Justice.
  - Customary international law, however, can evolve into conventional law. Indeed, important principles of customary international law have become codified in the Vienna Convention of the Law of the Treaties, thus acquiring the characteristic of ‘conventional law’.
- The birth and development of commercial law was influenced by the medieval *lex mercatoria*, ie by the mercantile codes and customs which reflected the usages of trade, the maritime and commercial practice. Many of the uncodified usages of trade that constituted the *lex mercatoria* eventually became formal law.



## Relationship between soft law and hard law

- Soft law sometimes complements or supplements hard law.
- The evolution of law provides evidence of the formalization of rules over time. Many legal rules that are today binding were at some point customs, usages or practices. Since financial law and, in particular, international financial law is a rather novel field of law, its dynamic and evolving character is unsurprising. The process of law creation still continues.
- Law has progressed throughout time, both with regard to its substance and with regard to the way it is created (the process or procedures).
- International financial soft law is often well suited to the changing needs and rapidly evolving structures that characterise the workings of financial markets. It would be wrong to dismiss it because of its 'softness'. It is 'soft' from the perspective of traditional mechanisms of enforcement (international standards are not international obligations), but in many instances it is or it can become as compelling as 'hard law'.
- There is **hard 'soft law'** (e.g. international standards on money laundering and countering the financing of Terrorism) and **soft 'hard law'** (eg treaties dealing with economic integration in West Africa, such as the 1975 and 1993 ECOWAS Treaties, notorious for their lack of enforcement).





# G-20 2017 operational guidelines

- 5 dimensions: **adequacy, transparency, consistency, coordination and resilience.**
  - 1. Adequate financing for sustainable development to help developing countries access long-term financing and bolstering potential growth, while preserving sustainable debt levels.
  - 2. Information-sharing and transparency -Sovereign creditors and debtors should build a common understanding of the macroeconomic and financial situation of the borrower country, based on the most recent estimates of the international financial institutions (IFIs), including the latest IMF Debt Sustainability Analysis (DSA).
  - 3. Consistency of financial support - Consistency of borrowing and lending practices with debt limit policies as a shared responsibility of debtors and creditors
  - 4. Coordination of stakeholders - Ensuring a regular dialogue between sovereign creditors, debtors and international financial institutions. The IMF, the Paris Forum and Paris Club meetings, and UNCTAD are examples of venues where such a dialogue can take place. Interaction and policy coordination on a regular basis between the IMF, the World Bank, the regional development banks, and other financial and development institutions
  - 5. Promotion of contractual and new financial instruments and minimizing litigation issues to strengthen resilience - GDP-indexed contracts, local currency bond markets, modified pari passu, enhanced collective action clauses – CACs). Minimize aggressive litigation by non-cooperative minority creditors in debt restructuring processes, especially for the poorest countries that lack the technical capacity to face such a legal challenge. **Problem is how?**