

Responsible Finance Charter

Executive summary	1
Introduction	2
Financial inflows to and outflows from developing countries	3
PART ONE: Current political dynamics of responsible finance	7
How does responsible finance fit into the current political agenda?	8
Existing voluntary measures to promote responsible finance	9
Why current measures just don't make the grade	11
Towards a responsible finance framework	12
PART TWO: Technical components of Eurodad Charter	13
Endnotes	19

Main author of 2011 version: Nuria Molina

Acknowledgements:

Marta Ruiz, Eurodad

Bodo Ellmers, Eurodad

Gail Hurley, UNDP

David Spencer, Tax Justice Network

David McNair, Christian Aid

Jostein Hole Kobbeltvedt, Norwegian Church Aid

Mark Herkenrath, Alliance Sud

Jesse Griffiths, Bretton Woods Project

Burghard Ilge and Wiert Wiertsema, Both Ends

Tim Jones, Jubilee Debt Campaign

Antoine Heuty and Matthew Genasci, Revenue Watch

Antonio Tricarico, CRBM

Teresina Gutierrez-Haces, Universidad de Mexico

Nathalie Bernasconi, International Institute for Sustainable Development

And special thanks to Howard Mann at the International Institute for Sustainable Development.

Executive summary

The Charter aims to go beyond a do-no-harm approach by outlining standards to ensure that lending and investments actively deliver positive development outcomes.

The global financial crisis will leave lasting scars on the global financial system and will have protracted impacts on poor people across the world.

While financial inflows to developing countries after the crisis are increasing but so are outflows. In the absence of binding responsible financing and investment standards, private capital inflows to developing countries are still offset by debt repayments, foreign investment profit repatriation, and illicit financial flows.

In addition, access to external finance for developing countries is uncertain. The renewed search for financial returns means that there is currently an increase in short-term and volatile private capital flows. Without a framework of binding standards for sovereign and private investments, there is an increased risk that these lending and investment practices are irresponsible. Without the future implementation of such a framework, this risk will only increase.

In light of this, Eurodad's Charter on Responsible Financing – as tabled in Part Two of the paper – proposes contractual changes to loan and investment contracts to ensure that they contribute to a decent and equitable future for the people of developed and developing countries. These changes aim to help improve the

quality of lending and investments in developing countries, and prevent future illegitimate and unsustainable debt and harmful impacts of foreign investment.

The Charter covers standards that should apply to external lending and foreign investments in developing countries that have a developmental purpose. This comprises loans and direct investments by development institutions or private lending and investments that count on financial support or guarantees by development institutions. Most of the standards of the Charter could also apply to private lending and investments even when they are not backed by development institutions. Therefore, Eurodad invites private lenders and investors to align their practices to the standards of this Charter.

The Charter is also applicable to lending to and investments in developed countries. However, Eurodad has chosen to specifically focus on the responsibility of financial flows to developing countries, where legal frameworks and enforcement mechanisms for responsible external lending and foreign investments are often weaker than in developed countries.

The principles in the Charter aim to go beyond a do-no-harm approach by outlining standards to ensure that lending and investment actively deliver positive

development outcomes. To this effect, the essential components of a responsible loan and investment contract as outlined in the Charter aim to ensure that:

- the terms and conditions are fair, and the process is legal and transparent;
- the human rights and environments of recipient nations are respected,
- loans and investments contribute to the effective development of recipient nations,
- fair taxation rules are respected,
- procurement is transparent and effective for development,
- loans and investment count on public consent by affected populations, and that
- many possible future problems are pre-empted and that repayment difficulties or investment disputes are resolved fairly and efficiently.

More than ever a responsible finance framework is needed to ensure a decent and equitable future for the people of developed and developing countries. The principles, mechanisms, and proposals are out there. Putting them into practice just takes courageous and decisive political will.

Introduction

The global financial crisis will leave lasting scars on the global financial system and will have protracted impacts on poor people across the world. The staggering human cost will be paid by many millions who have fallen into poverty and who will take years to recover.

After the global crisis: Whither development finance?

The global financial crisis will leave lasting scars on the global financial system and will have protracted impacts on poor people across the world. The staggering human cost will be paid by many millions who have fallen into poverty and who will take years to recover. Sub-Saharan Africa, Eastern Europe and Central Asia will most likely fail to reach the first of the Millennium Development Goals (MDGs), which aims at halving poverty by 2015.

Recent forecasts by International Financial Institutions (IFIs) predict that the worst phases of the crisis are over and world economies are recovering. However, real recovery still faces a series of challenges. Firstly, economic performance is uneven between world regions and also between developing countries. Furthermore, economic growth is still below the rates previous to the global crisis and it is threatened by several short- and long- term challenges.² The looming debt crisis in Europe, the impending food crisis, and the patchy and unfinished re-regulation of the global financial sector threaten a sound recovery.

As well as having to battle with these challenges, developing countries face a situation where access to

external finance is plagued with uncertainties. In their search for higher returns, private financial flows are becoming ever more volatile by exploiting the loopholes of a still highly unregulated global financial system. Public development finance is also becoming unpredictable as high-income countries fail to meet their aid commitments and start blending scarce aid resources with loans or use them to leverage investments from the private sector. These trends indicate that in the years to come increasingly less access to good quality development finance will add new challenges to the old ones facing developing countries.

The price that citizens across the world will have to pay, and particularly poor people in poor countries, will be even more dramatic if ambitious regulatory measures to stabilise the financial system and to promote a framework to ensure responsible financing are not urgently taken. Agreements in this direction taken so far by the IFIs and the G20 fall short of what is needed to prevent future crises and to promote responsible finance which contributes to sustainable development.³

However, it is not too late. A responsible finance framework is needed to ensure a decent and equitable future for the people of developed and developing countries. The principles, mechanisms, and

proposals are out there. Putting them into practice just takes courageous and decisive political will.

External financial flows do not fill the gap

The relatively stronger recovery in some developing countries after the global crisis compared to that in developed countries is attracting an increasing share of global financial flows to the former.⁴ However, flows to developing countries are still lower than before the global crisis and they are expected to remain at these levels for the years to come.⁵ After two years of dwindling exports, profit remittances and international capital flows, and increasing financing needs to address the social and poverty impacts of the global crisis, external finance is unlikely to make up for the chronic financing deficit in many developing countries.

Financial inflows to developing countries after the crisis are increasing but so are outflows. In the absence of binding responsible financing and investment standards, private capital inflows to developing countries are still offset by debt repayments, foreign investment profit repatriation, and illicit financial flows.⁶

In 2009, financial flows from developing to developed countries increased sharply as debt service,

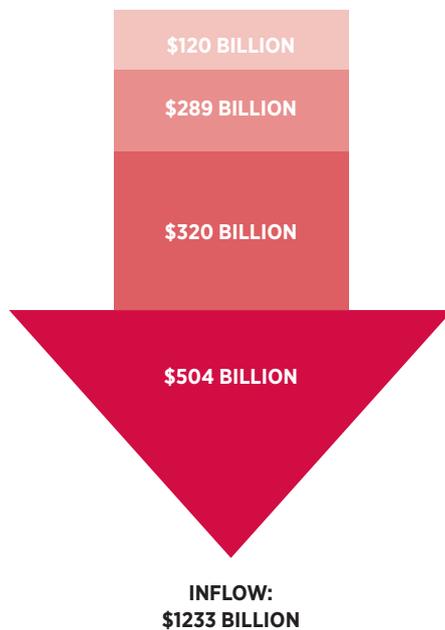
profit remittances and illicit flows increased from pre-crisis levels. Tax-related illicit flows amounted to more than \$US 700 billion in 2009. Private funds and companies investing in developing countries often breach responsible financing standards by resorting to aggressive tax planning practices. These practices undermine developing countries' abilities to raise and mobilise domestic resources,⁷ and have seriously detrimental impacts on developing countries' democratic governance. CSO research shows that every year developing countries lose \$US 160 billion in tax revenues⁸ due to abusive transfer pricing practices by multinational companies operating in the South, whereby private companies sell goods and services between branches of the same company at artificially low or high prices in order to shift profits out of the country and dodge taxes.⁹

Public flows are unlikely to make up for the gap left by private finance. OECD countries are failing to meet their aid commitments and many developed countries are even cutting their aid budgets.¹⁰ According to the World Bank, this may just be the beginning of a sharp decline in the world's ODA, which could hit rock bottom in 2019 with almost a 25% decrease in aid from developed countries.¹¹ In the meantime, European development policy debates are promoting blending aid with loans to stretch out ever more

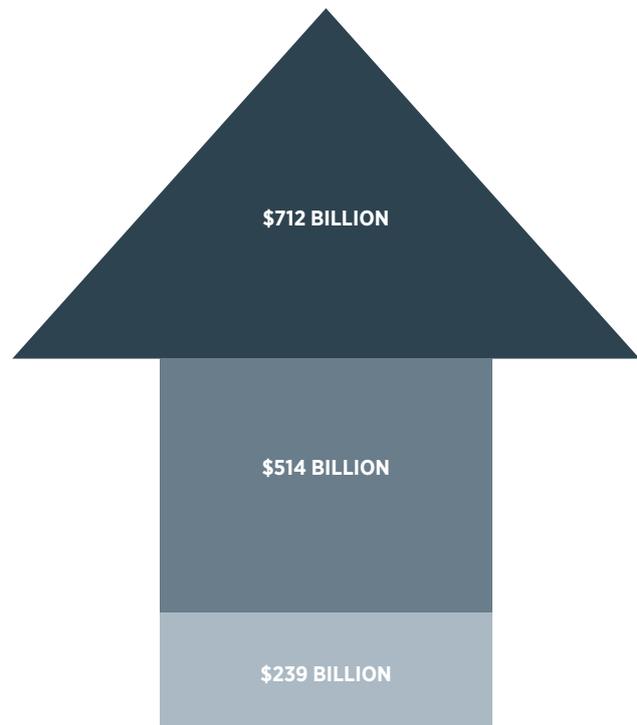
Financial inflows and outflows from developing countries: a hidden gap

INFLOWS 2009 (BILLIONS US\$)

- GLOBAL ODA
- DEVELOPING COUNTRIES' MIGRANT REMITTANCES
- NET FDI TO DEVELOPING COUNTRIES
- NEW LOANS TO DEVELOPING COUNTRIES



OUTFLOW:
\$1465 BILLION



OUTFLOWS 2009 (BILLIONS US\$)

- DEVELOPING COUNTRIES' DEBT SERVICE
- PROFIT REMITTANCES ON FDI
- ILLICIT FLOWS

A boom period of cheap, but unsustainable, debt financing in developing countries

Much of the financial flows during the boom years were driven by speculative and irresponsible behaviour. Lessons have not been learnt, and as investors regain confidence, they are starting to flood some emerging economy capital markets. This is posing renewed

risks of asset bubbles in middle income countries (MIC) if regulatory measures are not urgently taken.

The intensive use of financial innovation in the financial markets, such as securitisation or the use of off balance sheet vehicles, allowed a surge in lending during the past decade and increased the quantity of financial flows to developing countries, including to low-income countries. At the global level, international banking sector credits

grew twice as fast as nominal GDP.¹⁶

The sharp increase in financial flows to developing countries in the last decade was the result of easy and cheap lending: the value of syndicated bank borrowing and international bond issuance for the purpose of acquisition rose to almost US\$1 trillion in 2007 from \$131 billion in 2003. However, the main actors involved were those in the financial sector, rather than in the real economy; according to

the United Nations Conference on Trade and Development (UNCTAD), almost 30 percent of merger and acquisitions (M&A) deals between 2003 and 2008 were carried out by big investment banks, hedge funds and other private equity firms.¹⁷



scarce aid budgets, which may result in an increased use of loans instead of grants.

Harder conditions could limit access to external funds

The nature of external funds is worrying. Firstly, they are highly volatile and unstable fostering the risk of new financial bubbles in these countries if adequate measures to tame speculative capital flows are not taken in a timely manner.¹² Short-term debt, which is one of the most unstable types of external finance, experienced the largest increase of all international capital flows. In contrast, foreign direct investment (FDI), which is often longer-term and more predictable, is recovering at a much lower pace, particularly when considering the sharp declines observed during the global crisis. Moreover, FDI to the world's poorest countries is highly concentrated on the extractives sector which, according to the United Nations "seldom leads to the development advances that FDI is credited with."¹³ The geographical distribution of these flows is also highly uneven as the bulk of private capital flows is heavily concentrated towards only a few dynamic middle-income countries.

External borrowing for developing countries could also become much more expensive, as monetary easing in high income countries phases out, and real interest rates return to pre-crisis levels. Borrowing costs for developing countries could rise by 110 to 220 basis points compared to pre-crisis levels. In other words, borrowing would be 2 to 4 times more expensive for developing countries.¹⁴

Even more concerning are the borrowing terms for low-income countries, more dependent on external finance and with virtually no access to financial markets. As ODA decreases, concessional lending for low-income countries will fall very short of their external financing needs.¹⁵

In a context where global finance to developing countries is increasingly more unpredictable and volatile, it is ever more important to ensure that these flows will contribute to responsible and sustainable investment.

Public development finance going private

As high income countries fail to scale up aid, new winds in development policy are advocating for the use of aid to leverage other types of development finance. One of the

options currently under discussion in European development debates is to increase the use of limited public resources to leverage private sector funding, arguing that this will create a multiplier effect in funds available for developing countries.

This approach was rubberstamped by the G20 leaders in recent meetings, where they called upon MDBs to focus their poverty eradication intervention on four main areas, one of them being to "support for private-sector led growth and infrastructure to enhance opportunities for the poorest, social and economic inclusion, and economic growth."¹⁸ Multilateral Development Banks have already increased the share of their lending for the private sector in the decade of the 2000s. This trend is bound to continue: according to Eurodad estimates, by 2012 World Bank financial support to the private sector in low income countries will be a quarter of all World Bank development finance to the world's poorest countries.¹⁹

This "private turn" in development aid²⁰ could break the already fragile balance between the amounts of development finance channelled to the public and private sectors. It also creates serious challenges when trying to reconcile the for-profit rationale of private sector firms and private finance with the mandate of development

institutions. In order to ensure that for-profit entities deliver positive development results, a strong and binding framework for responsible lending and investment, as outlined in the second part of this document, should be urgently put in place. This is even more important for publicly subsidised or guaranteed private capital flows to developing countries as development institutions should act as standard setters by establishing the highest standards for responsible financing. Yet, the guidelines used by these institutions still overlook key elements such as the negative impact of using offshore financial sectors as a conduit for investing in developing countries.

Heightened risks of new debt crises in developing countries

Limited access to good quality development finance is even more worrying when coupled with heightened risks of debt distress. As a result of the global crisis, a greater number of developed and developing countries are at high risk of debt distress. To exacerbate the situation, development agencies – in particular European ones – are increasingly blending grants and loans to make ever more scarce aid resources stretch further.

In a context where global finance to developing countries is increasingly volatile, it is ever more important to ensure that there flows will contribute to responsible investment.

Whereas this increases funds available, it also means that new finance will effectively be in the form of loans. This is coupled with a sharp increase in IFI-lending in the wake of the global crisis, as the G20 leaders decided in April 2009 in London to massively increase the lending capacities of Multilateral Development Banks (MDBs) and the International Monetary Fund (IMF). Increased lending may put at risk the already fragile sustainability of several developing countries' debts.

According to the IMF, one quarter of countries that have already benefitted from debt relief under the Highly Indebted Poor Countries (HIPC) initiative are already at high risk of debt distress.²¹ In addition, sixteen Small Island Developing States (SIDS) registered public debt to GDP ratios in excess of 60 per cent (the broadly accepted threshold for sustainable levels of public debt).²² Debt-to-GDP ratios of 28 low-income countries also exceed the 60 percent threshold. This is twice as high as before the outbreak

of the global recession. UNCTAD's estimates are even bleaker: the United Nations agency highlights serious concerns over the debt burden of 49 least developed countries (LDCs).

Some of these are expected to qualify for debt relief; but several others are not eligible to benefit from debt relief under current initiatives – mostly, Caribbean countries and small vulnerable economies which are already suffering unsustainable debt burdens.²³

Renewed concerns about creditor co-responsibility and sovereign debt sustainability

Debt crises in Northern countries and companies that seemed sound and solvent just a few years (or even months) ago, have triggered new debates on debt sustainability and creditor co-responsibility.

At the end of 2009, the debt crisis of the Dubai World Holding company and the subsequent standstill²⁴ re-opened crucial debates on creditor co-responsibility. As Dubai's finance minister announced that his

government would not guarantee the company's debt, he said that creditors must take on part of the responsibility for their lending decisions."²⁵

The sovereign debt crisis in Europe, which comes on top of the 2008 Icelandic debt crisis, and has brought several Southern European countries to the brink of default, has put forward serious and legitimate concerns about sovereign debt sustainability. While debt sustainability has traditionally been assessed along strict macroeconomic criteria (the ability of a country to repay, given their

GNI and their exports), Eurodad and other civil society organisations claim that debt sustainability should also be a function of crucial human indicators. 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. If a country is strangled by a high debt service, this strangles its future financial and social viability with not only dramatic human consequences, but also back-firing on creditors' abilities to cash back on their loans.



Private capital flows will not deliver for the world's poor if ambitious regulatory measures to promote responsible finance are not urgently taken.

The return of the vultures

Vulture funds are one of the most condemnable examples of irresponsible development finance. Vulture funds are commercial entities which – on the secondary debt market – buy-up the debt of rapidly weakening companies or in the case of sovereign states, developing countries, usually for a sum far less than the face-value of the debt obligation. They then sue to recover the nominal full face-value of the debt plus interest, penalties and legal fees. Vulture funds also resort to other measures to recover the debt such as the seizure of assets overseas or political pressure. Practices by these predatory actors have proliferated over the last years following the improved solvability of HIPC

countries that benefited from debt relief programs.²⁶ Such actions raise serious concerns over developing countries' already tightened finances. For this reason, at the UN conference held in Doha in 2008, world leaders called on creditors not to sell claims on HIPC countries to creditors that do not participate adequately in the debt relief efforts.

According to 2008 estimates, vulture funds had 54 litigation processes with HIPC countries for an amount of over US\$ 2billion over these countries' debts. Although these figures went down in 2009, as some of the cases were solved out of court,²⁷ the problem remains extremely worrying as new lawsuits were initiated in 2008 against DRC, Zambia, Sudan and Sierra Leone.

One of the most recent examples is the case of FG Hemisphere, a private investment fund registered in Delaware - one of the most prominent tax havens according to CSO analysis, which in 2004 bought a total of US\$ 35.9 million worth of unpaid Congolese debt to the SNEL, a public electricity company in DRC. Following a lawsuit, filed by the vulture to the US courts, DRC was condemned in 2007 to pay back as much as \$151.9 million to FG Hemisphere. In 2008, FG Hemisphere tried to recover more money from DRC, filing another lawsuit to the Hong Kong courts, in order to recover DRC revenues stemming from new contracts with China. But the Hong Kong court declared itself incompetent for the case. Nevertheless the

vulture ended up winning the case. In January 2009 a South African court allowed FG Hemisphere to seize during the next 15 years the revenues stemming from SNEL's electricity export to South Africa, worth some \$105 million, some three times the amount that the Fund paid for the debt when they purchased it in secondary markets, and twice as much as the country's health budget for 2009.²⁸

The urgent need for an international responsible finance framework

The global economic and financial crisis is having a dramatic impact on the finances of developing countries. Despite rebounding growth in some developing countries, the global economy is still plagued with uncertainties which may constrain the ability of many poor countries to mobilise domestic resources to finance development in years to come. Many developing countries, and particularly low-income countries, will

continue to rely on external finance to fill in chronic financing gaps. Higher volatility of international capital flows and its concentration in a few middle-income countries will continue to constrain many poor countries' access to private capital flows. In this context, development institutions are channelling ever greater shares of ODA and public development finance to incentivise private sector investments in countries which have higher challenges in accessing capital markets. However, reconciling the development mandate of these institutions and the for-profit-rationale

of the private sector and private finance is not an easy task.

At this historical crossroad, it is crucial to learn the lessons taught by the global crisis: private capital flows will not deliver for the world's poor if ambitious regulatory measures to stabilise the financial system and to promote a responsible finance framework are not urgently taken.

Agreements taken so far in this direction by the IFIs and the G20 fall short of what is needed to prevent future crises and to promote

responsible finance which contributes to sustainable development.²⁹ The role of these political processes and institutions in setting the bar high for responsible finance standards cannot be overstated.

More than ever a responsible finance framework is needed to ensure a decent and equitable future for the people of developed and developing countries. The principles, mechanisms, and proposals are out there. Putting them into practice just takes courageous and decisive political will.

Current political dynamics of responsible finance

In the absence of a fair and binding framework for responsible finance, countries facing repayment difficulties or disputes with foreign investors, a “Wild West” type of system prevails where the fastest gun collects the money and there is little justice in who wins the draw.

The history of foreign capital flows to developing countries has been a double-edged sword. While in principle they could provide much needed resources to finance development, in practice these flows have at times done more harm than good.

External debt and foreign investments have sometimes generated financial outflows – debt repayments and profit repatriation – that are greater than the inflows to developing countries; short-term and speculative flows have at times destabilised vulnerable economies; social, environmental and labour standards have been bypassed; and all too often they have not “trickled-down” to generate positive development outcomes for the most vulnerable and the poor.

In the absence of a fair and binding framework for responsible finance at the international level, countries facing repayment difficulties or disputes with foreign investors have sometimes

been able to negotiate in an orderly and smooth manner. Sometimes they have not. A “Wild West” type of system prevails where the fastest gun collects the money and there is little justice (or certainty) in who wins the draw. This approach has not only proven costly in human and social terms for the poorest of the poor, in countries which have had to face the effects of harsh adjustments, and that are at the brink of default or facing the negative consequences of failed investments. A disorderly approach to resolving debt and investment disputes has also been more costly than warranted for all parties involved from a purely financial viewpoint.

The looming sovereign debt crisis in some peripheral Eurozone countries has shown, once again, that a haphazard approach to resolving sovereign debt crises remains. Almost 30 years after Mexico’s sovereign debt default in 1982, which many analysts view as the beginning of the

modern-day debt crisis, key issues related to who should be responsible for sovereign debts, how a country’s financial situation should affect the terms of repayment of outstanding debts, and who should decide on disputed debt claims and on the terms of repayment, remain unresolved.³⁰

Decision-makers have so far been reluctant to support a formal international procedure for fair and transparent debt resolution. Yet, sceptical views from official circles are detrimental to everyone’s interests, including those of the creditors. From a financial point of view, lengthy and disorderly negotiations increase uncertainty on the outcome of the process and encourage free riding behaviour by individual creditors. From a human point of view, sudden credit squeezes or repayment settlements which require too high a share of the GNI for servicing outstanding debts have dramatic effects on the country’s most vulnerable sectors and impose a high toll on future generations.

Unlike perceptions of debt flows, foreign investment – the biggest external financial flow to developing countries – is perceived to be risk free as it is expected to generate new productive capacities and it does not have to be repaid. Unfortunately, foreign investment does not always deliver on these expectations: it can have harmful social and environmental impacts, fail to create decent jobs or transfer technological capacities, and even generate massive outflows in the form of profit repatriation or through tax evasion and avoidance.³¹ Current

rules regulating foreign investment are heavily skewed towards protecting investor’s rights, which in the last 30 years have exponentially increased the number of investor-state arbitrations seeking massive compensations when they perceive their rights have been breached.³² When the rulings oblige the host state to compensate the investor, these payments become a massive financial liability for the host state, thus having direct consequences on the welfare of its citizens.

Civil society and many independent academics argue that responsible financing standards would provide a rules-based system which lays out the rights and obligations of lenders and investors, borrowers and host states, but most importantly which protects the rights and welfare of the citizens across the world. The very existence of such a rules-based framework would have a dissuasive effect on irresponsible flows and ensure that borrowed funds contribute to the well-being of citizens in borrowing nations. They would also ensure that investment delivers on the expected results, including by ensuring that all parties pay their fair share of tax dues and comply with international social, environmental and labour standards and human rights. When disputes arise, a fair and transparent debt arbitration mechanisms or international insolvency procedure could determine responsibilities over a certain debt claim, thus helping identify incidences of illegitimate debt, as well as legitimate creditor claims.

How does responsible finance fit into the current political agenda?

As the global economy rebounds, financial actors are re-engaging in highly speculative activities while political leaders fail to agree upon a fair and binding framework for responsible finance.

The global financial crisis has been a brutal wake up call for world leaders; they have learnt the hard way what civil society organisations have been saying for decades.

“Reckless and irresponsible risk taking by banks and other financial institutions, combined with major failures of regulation and supervision”³³ brought the world economy to its knees and caused major damages to citizens both in developed and developing countries.”

Yet as the global economy rebounds, financial actors are re-engaging in highly speculative activities while political leaders fail to agree upon a fair and binding framework for responsible finance which contributes to sustainable and equitable development. World citizens are paying for the reckless behaviour of the financial and private sector, while the same financial institutions makes hefty profits once again.

On other occasions, lenders have extended loans to developing country governments negligently, corruptly or under grossly unfair terms, commonly described as illegitimate and/or odious.³⁴ Even where loans have not promoted development or benefited the people of the recipient nation, they must be repaid under current international norms, which dictate that where the borrower is a nation-state, contracts must always be respected. This has triggered civil society debates around the legitimacy of certain debt claims.

International agreements on investment also focus to a great extent on the protection of foreign capital and investments, while failing to protect the rights of the citizens in the host country. In the absence of a binding framework for responsible investment, foreign investors all too often generate massive financial outflows from developing countries where they invest – and where legal frameworks are weaker – by engaging

in highly speculative activities, or simply by avoiding their tax dues.³⁵ In addition, arbitration mechanisms to settle investments dispute have failed to meet basic criteria of legitimacy, transparency and accountability and have sometimes led to hefty compensations to private investors which host states have had to pay.³⁶

Illicit financial outflows related to commercial activities and repayments originating from dubious debts have sometimes seriously compromised the ability of developing countries to carry out their basic duties of care towards its citizens. Corrupt and/or negligent behaviour by lenders and investors has in essence been rewarded.

Until now, creditors and investors have responded with an assortment of voluntary measures designed to reduce uncertainty or promote fairness (among creditors or investors) where debt crises do hit and investment disputes arise.

Existing voluntary measures to promote responsible finance

Public and private lenders have since 2001 promoted the broader use of 'collective action clauses' in sovereign bond contracts³⁷ and the private sector's 'Principles for Stable Capital Flows and Fair Restructuring in Emerging Markets' of 2004.

These Principles cover "voluntary, good faith negotiations," "transparency and timely flow of information" and "sanctity of contracts".³⁸ In 2003, the International Monetary Fund (IMF) tabled proposals for a 'Sovereign Debt Restructuring Mechanism' (SDRM) but these were soon shelved.³⁹

The World Bank and IMF's 'debt sustainability framework for low-income countries' approved in 2006 and reviewed in 2009 also takes up the issue of responsible lending although the framework takes a slightly different approach.⁴⁰ The framework is voluntary and creditors are 'urged' to take into account the Bank and Fund assessment of a debtor economy's "state of health." It does not enter into the qualitative aspects of the loan finance on offer nor does it propose sanctions for lending beyond so-called prudent limits.⁴¹ In 2009 the Bank and the Fund re-cast the debt sustainability framework for low-income countries to allow countries to take on more debt with greater flexibility, thus undermining to a certain extent its previous analyses of sustainable levels of debt.

With regards to principles that should guide foreign investment, the international community is not short of voluntary measures either. The Organisation for Economic Cooperation and Development (OECD) has a set of non-binding guidelines for multinational enterprises (MNE) in order to encourage MNEs to "not only reap profits, but also stimulate development and improved social conditions around the world."⁴² The United Nations also boasts a range of initiatives "to promote good corporate citizenship and to build a more stable, sustainable and inclusive global economy." In the year 2000, the UN launched the Global Compact which agreed upon 10 key principles on responsible and sustainable corporate policies and practices. In light of the growing weight of institutional investors in global private capital flows, the United Nations Secretary General convened in 2006 an initiative led by institutional investors to agree upon a set of global best-practices for responsible investment: the "Principles for Responsible Investment."⁴³

Bilateral development finance institutions (DFIs) that support private companies investing in developing countries sometimes count on investment codes or ethical guidelines aimed at regulating the behaviour of their client companies. Although these codes are mandatory for DFI investee companies, they tend to be rather general and aspirational thus failing to

discipline the behaviour of their client companies.

To help ensure responsible and sustainable project finance from official lenders and investors, multilateral institutions – such as the World Bank, International Finance Corporation (IFC) – have adopted a series of 'safeguard policies' or 'performance standards' applicable both to their loans and investments. These claim to offer a certain standard of protection to the peoples and environments of borrower countries.⁴⁴ Private banks have responded with their own set of (voluntary) financing standards as set-out in the 'Equator Principles' adopted in 2006.⁴⁵

The G8 and the G20 have also jumped on the bandwagon. In 2009, the G8 announced its "Lecce Framework of Principles and Standards for Propriety, Integrity and Transparency"⁴⁶, covering issues such as "corporate governance, market integrity, financial regulation and supervision, tax cooperation, and transparency of macroeconomic policy and data". Specific issues covered include, "accounting standards, the cross-border exchange of information, bribery, tax havens, non-cooperative jurisdictions, money laundering and the financing of terrorism, and the quality and dissemination of economic and financial data". In November 2010, G20 leaders issued the "Seoul development consensus for shared growth," which aims to "promote the

best existing standards for responsible investment in value chains and voluntary investor compliance with these standards."⁴⁷

The United Nations also seized the opportunity of the crisis to re-open debate on the issue of responsible finance. In March 2009, the UNCTAD launched a program for "Promoting Responsible sovereign lending and borrowing." This project involves, inter alia, the development of a set of guidelines to promote and foster mechanisms to enhance responsible sovereign lending and borrowing, including developing criteria for and assessing the legitimacy of sovereign debt.⁴⁸ The President of the UN General Assembly also established a Commission of Experts on Reforms of the International Monetary and Financial System, which issued a report calling for "a debt workout regime (which is) efficient, equitable, transparent, and timely in handling debt problems ex post (as problems become apparent, especially after default) while promoting efficiency ex ante (when the borrowing takes place. It also supports the creation of an "International Debt Restructuring Court," similar to national bankruptcy courts.

The table below summarises the existing major instruments to promote responsible lending and investment.

Major instruments to promote responsible lending and investments

Instrument	Year	Aim	Mandatory or voluntary	Official/private sector initiative
OECD Principles and Guidelines to promote Sustainable Lending practices in the provision of Official Export Credits to low income countries	2008	Encourage prudent lending	Voluntary	Export credit agencies
G20 Charter on Responsible Lending	2007 (ongoing)	Promote responsible lending	Voluntary	Official (governmental)
WB “free-rider” policy	2006	Promote ‘prudent’ lending and borrowing	Voluntary	Official
The Equator Principles	2006	Promote responsible lending	Voluntary	Private sector
Principles for Responsible Investment (PRI), UNEP and Global Compact	2006	Promote responsible investment	Voluntary	Private sector
WB/IMF debt sustainability framework	2005	Promote prudent lending and borrowing	Mandatory assessment, voluntary compliance	Official
Principles for Stable Capital Flows and Fair Debt Restructuring in Emerging Markets	2004	Deal with debt crisis, prevention and resolution problems	Voluntary	Private sector
Collective action clauses	More common from 2003	Deal with debt crisis	Voluntary (but now standard terms in contracts)	Official and private sector
OECD 2003 Recommendation on Common Approaches on Environment and Officially Supported Export Credits	2003	Promote responsible lending	Voluntary	Export credit agencies
IMF lending into arrears policy	1999 and 2002	Deal with debt problems	Conditional ⁴⁹	Private sector
OECD Guidelines for multinational enterprises (latest revision)	2000 (new revision ongoing)	Promote responsible investment	Voluntary	Official initiative with participation of private sector
UN Global Compact: 10 principles	2000	Promote responsible investment	Voluntary	Private sector
World Bank social and environmental safeguards/ IFC performance standards/ EIB environmental standards	Various	Promote responsible investment	Some mandatory, others discretionary	Official project loans

Why current measures just don't make the grade

Existing measures are focused on mitigating the potential harms of irresponsible financing practices, without paying enough attention on how external lending or investments can actually make a positive contribution to equitable and sustainable development.

There are a number of problems with the policy responses currently available at the international level. They are mostly voluntary in nature, they do not address the question of validity or legitimacy of creditors' and investors' claims, and they are mostly focused on mitigating potential harms done by lending and investment rather than promoting behaviour which can positively contribute to equitable and sustainable development pathways.

The most central concern is probably the voluntary nature of the measures currently at borrowers', lenders' and investors' disposal. The concern is

that those lenders and investors that are inclined to sign-up to voluntary codes of conduct are precisely those that are more unlikely to engage in irresponsible behaviour, leaving the door wide open to unscrupulous practices. No voluntary code of conduct can usefully be relied on to promote responsible financing or resolve repayments difficulties or investment disputes equitably where they do arise. Purely voluntary codes of conduct have no enforcement powers and therefore cannot impose any discipline on lenders, borrowers or investors.

Another important gap in current instruments centres on the fact that none question the validity or legitimacy of creditors' or investors' claims. While it is critical to secure as much ex ante certainty for potential lenders to sovereign states and foreign investors as possible, there is an urgent need to put in place mechanisms to address situations where a contract can no longer be enforced.

Indeed lenders and investors must be confident in the legal enforceability of their contracts before a loan or investment contract is made. The importance of this should not be underestimated: in the modern globalised financial environment, the importance of global capital flows to developing nations and emerging market economies is significant. Any reform measures should not discourage responsible, legitimate financing practices from taking place. But although 'pacta sunt servanda' (contracts must be respected) is an important economic and ethical principle, all domestic legal systems recognise that there can be disputes over contracts that need to be settled in a fair and transparent manner, taking

into account the rights and obligations of all parties to the contract.

These include situations 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 basic legal principles of lender or investor liability and shared responsibility have not been applied, thus undermining the nation states' obligations to meet the basic welfare of their citizens.

Last but not least, most of these measures are focused to a great extent on mitigating the potential harms of irresponsible financing practices (do-no-harm approach), without paying enough attention on how external lending or investments can actually make a positive contribution to equitable and sustainable development.

Towards a responsible finance framework

The renewed search for the return of global financial actors is boosting short-term and volatile private capital flows and increasing the risks of a race-to-the-bottom regarding the standards of responsible lending and investment. Without a clear framework of binding standards for sovereign and private lending and investment, there is a high risk that in the wake of the global crisis, lending and investing practices will become increasingly irresponsible.

To counter these potentially negative developments, Eurodad's Charter for Responsible Financing – as tabled in Part Two of the paper – proposes contractual changes to loan and investment contracts. These changes aim to help improve the quality of lending and investments

in developing countries, and prevent future illegitimate and unsustainable debt and harmful impacts of foreign investment.

Essential components of a responsible loan and investment contract as outlined in the Charter aim to ensure that the terms and conditions are fair, that the process is legal and transparent, that human rights and environments of recipient nations are respected, that many possible future problems are pre-empted and that repayment difficulties or disputes are resolved fairly and efficiently. It also aims to go beyond a do-no-harm approach by outlining standards to ensure that lending and investment actively deliver positive development outcomes.

The Charter moves away from institution or sector specific responses to concerns over responsible financing towards internationally recognised legal standards for responsible lending and investment. Many of the provisions outlined in Eurodad's charter are drawn from international treaties and conventions to which most world nations are signatories.⁵⁰

We argue that all lenders and investors that receive public support or guarantees, as well as borrowers, should be held accountable to the responsible financing standards outlined in this Charter. Eurodad also encourages private lenders and investors that do not count on public support to comply with the standards of the Charter.

If the standards in the charter are broken, the law is broken. This qualifies for the nullification of the loan or investment agreement and a stop in transfers to the loan party who broke the standard. Lender or home state and borrower or host state should make changes to national legislation to recognise – and agree to abide by – these responsible financing standards. National legislation will also ensure that private financiers are bound by the same framework. Our proposals will therefore encourage a race-to-the-top rather than a race-to-the-bottom that some financiers clearly fear.⁵¹

Technical components of the Eurodad Charter

The history of sovereign debt crises and disputes over foreign investments has shown that loan and investment contracts have often been signed with insufficient regard for the rule of law or citizens' welfare. Citizens around the world demand the productive and transparent use of financial resources for lending and investment.

In January 2008, Eurodad published its Charter on responsible financing outlining the key components that lenders should adhere to in order to prevent repeated rounds of unsustainable and irresponsible lending and borrowing. The 2011 version of the Charter goes a step further by proposing a set of principles to ensure that international lending and investment contribute to sustainable and equitable development and to citizens' welfare around the world.

Scope of the charter

The Charter covers standards that should apply to external lending and foreign investments⁵² in developing countries that have a developmental purpose. This comprises loans and direct investments by development institutions or private lending and investments that count on financial support or guarantees by development institutions.

Most of the standards of the Charter could also apply to private lending and investments even when they are not backed by development institutions. In particular, the Charter is relevant for private lenders and investors that are increasingly aware of the need to comply with principles of corporate social responsibility and responsible financing. Therefore, Eurodad invites private lenders and investors to align their practices to the standards of this Charter.

The Charter is also applicable to lending to and investments in developed countries. However,

Eurodad has chosen to specifically focus on the responsibility of financial flows to developing countries, where legal frameworks and enforcement mechanisms for responsible external lending and foreign investments are often weaker than in developed countries. Lending to and investments in developing countries have often come hand in hand with conditions to liberalise investment regimes and to undertake economic reforms which have weakened their resilience to external shocks or their ability to manage external flows in order to maximise their contributions to the country's sustainable and equitable development. Therefore, the standards of the Charter are, if possible, even more relevant for developing countries.

Public institutions are often party to lending and investment contracts in developing countries. Private financiers or investors can enter into contracts with host states, so-called "state contracts", which often underpin foreign investment or external lending to developing countries. Bilateral and

multilateral development finance institutions can also enter into loan contracts with governments or with private lenders or investors to support their operations in developing countries. In some instances, development finance institutions do not enter into direct agreements with the borrower or investor, but rather channel funds through financial intermediaries which lend or invest in developing countries. All these types of contracts have strong public policy considerations.

The standards in this Charter cover the contracts that regulate these lending and investments. In cases where public institutions are not direct party to the contract regulating the operation but provide some type of financial support or guarantee, they must ensure that the contract signed by private companies or financial intermediaries complies with the standards of this Charter.

A

Technical and legal terms and conditions

A. (i) LOANS

- 1. Purpose and amount of loan:**
The loan document must state clearly the purpose, amount and beneficiaries of the loan.
- 2. Mutual obligations and predictable disbursement:**
The borrower commits to spend the funds as stipulated in the loan agreement. The lender commits to deliver the funds predictably as stated in the loan agreement.⁵³
- 3. Compliance with national and international laws:**
The parties to the loan must comply with national laws and regulations in the borrower and lender nations. Loans should not be exempted from the responsibilities and accountabilities demanded by national law in the borrower or lender nation and by international law. Disregard for applicable laws can render any later claims invalid.⁵⁴
- 4. Legal authorisation to enter into the transaction:**
The loan document must be signed by authorised representatives of both borrower and lender. It must show that it has secured the necessary parliamentary and/or other administrative approvals in the borrower country (see F(I)).
- 5. Repayment assumptions:**
The borrower government and lender must make public the economic 'assumptions' they have made in relation to how the loan is to be repaid, such as the financial position of the borrower and where applicable the expected rate of return on activities financed.
- 6. Interest rates:**
The loan document must indicate clearly the type and level of interest rates charged (fixed or variable rates). If variable interest rates are chosen, rates must be given a reasonable and fair upper limit which must be stated in the contract. This offers more predictability and certainty to both parties to the contract.⁵⁵
- 7. Repayment profile:**
The contract must provide clear information on grace and maturity periods, and repayment profiles (date and amount of debt service).

- 8. Penalties:**
There should be no usurious penalty premiums. These should be a maximum rate as the original interest rate, for example if the original loan carries an interest rate of 3%, the penalty premium should be no more than 3%.⁵⁶
- 9. Side-letters:**
All details in relation to the loan must be contained within one document. Side letters are not permitted.⁵⁷
- 10. Fees and charges:**
The loan document must contain detailed figures and information of any fees charged as part of the transaction (including recipient(s) and purpose(s) of fees). Any such fees should be charged at no more than international market prices for such goods or services.⁵⁸
- 11. Conflict of interests:** The loan document should also spell out any additional role the lender has played in relation to the loan, e.g. if it has acted as advisor/consultant to the borrower in addition to its role as lender. The details of this advice should be public and available on demand.
- 12. Sale of loan on secondary market:**
To prevent aggressive actions by litigating creditors, the loan should restrict the creditor's right to assign the debt to another party, i.e. the lender cannot unilaterally sell or assign the debt to other entities. The lender must first obtain the free and informed consent of the borrower. In the event that the debt is sold-on, assigned, transferred, restructured or replaced with a successor loan, all provisions as outlined in the original loan agreement apply, such as the provision for independent arbitration and change of circumstance.⁵⁹ If the country has been granted debt relief through an international agreement (such as the HIPC Initiative), the litigating creditor should not be able to recover more than the amount of debt recovered by other creditors, i.e. if the country has benefited from an 80% debt reduction on bilateral and multilateral debt, the litigating creditor will also be obliged to take an 80% reduction on their debt claim. The sale of sovereign debt in the secondary market should be banned to creditors that have previously refused to participate in agreed debt restructuring.
- 13. Sovereign debt securitisation:**
in order to avoid speculation over sovereign claims, securitisation of sovereign debt should be prohibited.⁶⁰
- 14. Currency of the loan:**
Official lenders should offer the possibility of borrowing all or part of the loan in the local currency to help balance exchange rate risk.
- 15. Agreements between borrower and lender:**
The loan must contain details of any host government agreement, production-sharing

agreement, power purchase agreement or any other similar accord. It must also contain details of any agreement to repay the loan in goods or services provided by the borrower as well as state clearly the basis for the valuation of these goods or services. Similarly, if the purpose of the loan is the provision of goods or services by the lender, the loan document must clearly state how such goods/services have been valued.

A. (ii) INVESTMENT CONTRACTS⁶¹

- 1. Equality of treatment:**
The investment contract must address the interests of all parties to the contract and of affected communities if they are not party to the contract.
- 2. Applicable national and international law:**
The contract shall be governed by and construed in accordance with applicable national law and the international treaties to which the country is party, including human rights treaties (see B (i)). The investor shall provide relevant information on the international law which is applicable to their investments. In case of inconsistency between national and international law, the contract shall explicitly waive investors' rights or host state obligations which undermine host states' ability to harvest the maximum possible developmental benefit from the investment.
- 3. Compliance with national and international law:**
See A(I)3. The contract may include standards that go beyond those required under national law.
- 4. Legal authorisation to enter into the transaction:**
See A(I)4. In cases of investor to host state agreements, the government representative must show that it has secured the necessary parliamentary and/or administrative approvals in the host state, including by sub-national authorities where relevant.
- 5. Obligations of contractors, subcontractors, and affiliates:**
The investor must ensure that all contractors, subcontractors and affiliates involved in the project comply with the investment contract. The investor must include specific requirements in its contracts with subcontractors and suppliers and establish procedures to monitor compliance and sanction non-compliance. The contract shall provide for mechanisms to ensure these obligations are still met in cases where the investor is no longer in a position to fulfil them.
- 6. Contract management:**
The document must spell out the roles and responsibilities of all parties involved, sanctions and rewards. It must also include provisions that require the parties to regularly review

the state of play of the implementation of the contract. In cases of investor to host government agreements, host government representatives (including from revenue collecting agencies or environmental agencies) shall be granted a place in whatever management committees are established.

7. **Technical feasibility:**

The investor, prior to commencing the project or investment, shall have a feasibility study on the basis of sound economic and financial principles and in keeping with best industry practices. The investor shall provide an independent review of the feasibility study which certifies that the figures provided are accurate. The investor and host state must also have an independent needs and impact assessment (see clauses B3 and B4).⁶²

8. **Financial feasibility:**

The investor shall also have a financing plan which details how the investor will raise the financing necessary to successfully conduct the project or investment. The document must contain details on the expected return on the investment. Any contract related to the financing of the investment must be made public.

a. **Debt-to-equity ratio:**

The investment's debt to equity ratio must not at any time exceed the percentage agreed in the document. The debt-to-equity ratio of any

subsidiary in the host country shall not exceed the debt-to-equity ratio of the parent's company worldwide consolidated group.

b. **Lost profits (lucrus cesans):**

Investors' claims on lost profits beyond the expected return stated in the contract shall be forbidden. The host state shall not be liable for lost profits due to fundamental changes in social, economic or financial circumstances.

9. **Foreign currency remittance:**

Except in the case of generally applicable exchange controls imposed on a non-discriminatory basis, or emergency controls necessary to respond to a financial crisis, the state confirms that the interest, dividends and all other payments for goods and services are freely remittable, subject to contractual statutory withholding taxes (see section D).

10. **State financing and guarantees:**

The state is not obliged to provide any funds or credits, issue guarantees or otherwise become liable directly or indirectly for any financing of the project. The investors shall not aggressively promote schemes which require sovereign counter-guarantees.

11. **Financial records and statements:**

The investor is responsible for maintaining accurate accounting records and to support all fiscal returns or any other accounting reports required by the state in relation to the investment

(see D2 and D3).

12. **Changes in ownership of the investment or the investor:**

The investor must obtain the free and informed consent of the host country in order to undertake any legal transaction which may change the effective control over the investment. This includes the sale of investments on secondary markets. In the event the investment is sold-on, all provisions outlined in the original contract will continue to apply.

13. **Conflict of interests:**

See A(I)11.

14. **Review clauses:**

The contract may contain provisions for periodic reviews triggered by fundamental changes in circumstances which shall be objectively defined in the document. Either party to the contract can request revisiting the contract terms. Reviews of clauses shall be conducted transparently and shall be subject to due processes of approval under the host state's law. Contract renewals should not be automatic but subject to renegotiation which shall take into account changes in the law and in other circumstances at the time the contract expires. The government is entitled to require an independent assessment of the changes in circumstances claimed by an investor to support the renegotiation.

B

Protection of human rights and the environment

B. (i) LOANS⁶³ AND INVESTMENT CONTRACTS⁶⁴

- 1. Respect for human rights:**
Activities financed by the loan or conducted under the investment contract must not violate human rights and must not contribute to the violation of internationally recognised human rights treaties and conventions.⁶⁵
- 2. Respect for internationally recognised social, labour and environmental standards:**
The loan or investment must not support any venture that contravenes internationally accepted minimum standards on social, labour and environmental protection.⁶⁶ The contracting

parties recognise that it is inappropriate to encourage lending or investment by relaxing domestic labour, public health, safety or environmental measures and thus shall not waive or otherwise derogate from such measures as an encouragement for the establishment, acquisition, expansion or retention in their territories of a lending or investment.

- 3. Needs assessment:⁶⁷**
The parties to the contract should provide clear documentation or other evidence which identifies the need for the loan/ investment and how it contributes to the national development plan.⁶⁸
- 4. Ex ante impact assessment:**
The lender or investor has a fiduciary responsibility to ensure that activities financed are legal and viable, as attested by an independent ex ante long-term integrated impact assessment. The lender or investor, borrower/ host state and affected communities should jointly appoint someone who will carry out the ex ante assessment. The assessments shall be publicly disclosed and accessible to the affected local communities prior to the approval of the loan or investment contract in a language understood locally. The loan/ investment contract

should state who bears the costs of possible risks associated with the project as identified in the ex-ante assessment.⁶⁹ Comprehensive ex ante assessments of loans and investments are essential to promote responsible financing practices. However, there must be no explicit or implicit blanket legitimisation of any claim on a sovereign beyond a general presumption of innocence. Any standards set for guiding responsible lending and investment must serve as benchmarks for an ex-post consideration by an independent entity. This must not be ruled out by any ex-ante assessment of either the loan or the investment. In the case of loan contracts, the impact assessment should be either financed jointly, or through a grant and it should not be charged as part of the loan or financed by the investor only.

- 5. Precautionary principle:⁷⁰**
Investors, lenders and country authorities shall apply the precautionary principle to their ex ante poverty, social and environmental impact assessment and to decisions taken in relation to a proposed investment, including any necessary mitigating or alternative approaches to the investment.

C

Development effectiveness

C. (i) LOANS AND INVESTMENT CONTRACTS⁷¹

- 1. Alignment to national development goals:**
Loans and investments must be in-line with country-designed development strategies. They must also respect the key principles of Aid and Development Effectiveness such as recipient country ownership and the use of country systems. Loans and investment contracts should not be tied to the purchase of goods or services from the lender or investor. Lenders and development institutions supporting private

investments should not aggressively push loans or investments to promote vested commercial and/or political interests.

C. (ii) INVESTMENT CONTRACTS⁷³

- 2. Employment of local citizens:**
The contract shall contain specific local employment targets.
- 3. Local community development:**
The investor shall enter into agreements with communities impacted by the investment, to promote sustainable development and enhance the general welfare and quality of life of inhabitants.
- 4. Local business development:**
The investor shall cooperate with the host state in carrying out its governmental responsibilities to promote economic development and growth in the area of communities impacted by the investment. Where possible, contracts shall stipulate that a share of downstream activities be undertaken in the host country, and that joint-ventures are developed with local businesses.

Contracts shall also stipulate that a share of downstream activities undertaken locally are conducted by micro, small and medium enterprises.

- 5. Technology transfer:**
The contract shall include provisions for the local use of technology and know-how, including outside of the project.
- 6. Infrastructure development:**
The investor shall endeavour to plan and develop all forms of infrastructure in ways that facilitate its shared use by others and its contributions to the sustainable social and economic development of the area in which it is located.
- 7. Availability of products for domestic industry:**
Where relevant, the contract can include provisions to market a percentage of the produce in domestic markets. In times of national emergency or shortfall in domestic supply, the host government can request or purchase a share of the produce from the investor at discounted prices.

D

Tax related measures

D. (i) LOANS AND INVESTMENT CONTRACTS⁷⁴

- Public revenues:**
Contracts must contain provisions to ensure that companies financed by the loan or conducting the investment project comply with national tax legislation, including corporate income tax, value-added taxes, property taxes, withholding tax obligations, and any other relevant taxes or levies.
- Tax information exchange:** All jurisdictions through which the loan or investment funds flow must be committed to “on request”, spontaneous and automatic information exchange.
- Financial transparency:**⁷⁵ Lenders, borrowers and investors shall ensure that companies involved in the transaction do not avoid taxes or engage in abusive transfer pricing practices. To ensure that necessary information is available

to national tax authorities, companies involved in the transaction must disclose reliable annual information related to sales, employees, profits made and tax paid in the country.⁷⁶ They must also automatically disclose information regarding beneficial ownership of any legal structure directly or indirectly related to the company, including trusts, foundations, and bank accounts.

D. (ii) INVESTMENT CONTRACTS⁷⁷

- Transfer pricing:**
The contract should explicitly require that sales, services, loans, and other transactions between related parties of a company be at arm’s-length prices, and the contract should provide detailed evidence of:
 - How such prices were determined by the parties to the contract;
 - How such prices comply with arm’s-length pricing requirements;
 - Any difference between the prices in the contract and market prices for similar transactions between unrelated parties – if they exist and are available.
 - In the case of any payment for intangibles, the tax treatment in applicable jurisdictions and the legal/tax provisions of applicable law on

which such legal/tax treatment is based.

The contract should also give the government of each jurisdiction which has some relation to the parties the right to contest the prices in all transactions between related parties or affiliates.⁷⁸

- Minimum capitalisation:**

The contract must ensure minimum levels of capitalisation to prevent investor over-indebtedness being used as a mechanism to minimise the company’s tax liabilities. The contract must give the host government the right to scrutinise loans among affiliates and the extent to which project proposals rely on external lending for their implementation (debt-to-equity ratio; see also A9a).

- Tax competition:**

There should be no clauses in the contract which grant tax relief with the purpose of attracting foreign investment.

- Review of tax clauses:**

The contract must contain flexible mechanisms that enable the parties to the contract to review taxation levels in cases of fundamental changes in produce prices generating higher-than-expected profits (see A16). The reviews shall allow for alignment of taxation levels to national laws, in cases of changes in national tax law.

E

Procurement

E. (i) LOANS⁷⁹

- Public procurement:**
Procurement processes must be rules-based, transparent and accountable. The loan contract should carry clear details of tendering processes for those carrying out any work or providing any services. The document must require that all tenders, award criteria and contract awards related to the loan are publicly available in order to facilitate access to information by all interested

and eligible parties, create a level playing field, and support the efforts to curb corruption. See also articles F.1, F.2 , F.3 and F.4.

- Use of country systems:**

The contract shall state that, where feasible, the borrower’s country system will be used as the first option for all public financial management and procurement procedures related to the loan. To facilitate access for local socio-economic actors, including small and medium enterprises, loan contracts should contain provisions for local advertisement of tenders in accessible languages, as well as tailored eligibility criteria and smaller lot sizes.

- Loan tying:**

Loan contracts must not be formally or de facto tied to the purchase of goods or services from the lender. See also section C.1.

- Immunity:**

To ensure that service providers are fully accountable, there should be no clauses in

loan agreements which give legal immunity for violations of the law in borrower and lender nations to those carrying out any services or work as part of the contract.

E. (ii) INVESTMENT CONTRACTS⁸⁰

- Local preference:**⁸¹

In order to ensure that investment projects generate employment and business opportunities for the national economy, the contract must contain provisions to ensure investors or investments procure goods and services locally. Where possible, preference shall also be given to local micro, small and medium enterprises (MSMEs). Goods and services produced in the host country must be given first preference at comparable quality, delivery schedule and price. Preference can also be given if this increases the project’s costs only within a certain percentage.

F

Public consent and transparency

F. (i) LOANS AND INVESTMENT CONTRACTS⁸²

- 1. Parliamentary and citizen participation:**
The loan or investment contraction process must be transparent and participatory, i.e. parliaments, citizens and affected communities in the borrower or host country must be given adequate time and information to debate the loan or investment, including purpose, terms and conditions of the relevant contracts. All should comply with national laws and regulations based on democratic principles.⁸³ The lender or

development finance institution supporting a private investment must exercise due diligence, ensuring that the loan or investment contraction process is transparent and participatory.

- 2. Public disclosure of information:**
The loan or investment contract and any supplementary documentation must be available to the public in borrower/ lender nations or home/ host states (e.g. transmitted to parliament, available for consultation on request, published on the web, announced in the national press, radio and/or television as appropriate).⁸⁴
- 3. Financial transparency:**
The borrower or investor is responsible for maintaining accurate accounting records regarding activities financed by the loan or investment project and to support all fiscal returns or any other accounting reports required by the state. See also A10, D2 and D3.

- 4. Language:**
The contract must be available in the main national languages (including the language(s) of affected communities) of the debtor or host nation. Both original and translated versions should have equal validity in a court of law.⁸⁵
- 5. Adherence to integrity and anti- corruption efforts:**
Agencies and agents found to have violated anti-corruption guidelines should be debarred from contracts.

F. (ii) PROJECT LOANS

- 6. Progress reports and loan evaluation:**
For project loans, there should be regular (e.g. biannual or annual as appropriate) progress reports. There should be a clear timetable for completion of the project. There should be independent and timely evaluation and audit of project loans. Project reports and evaluations must be public.

G

Dispute settlement

G. (i) LOANS

- 1. Change in circumstance:**
The loan must recognise that there will be cases where a dramatic change in circumstances – beyond the will of either borrower or lender – means that the borrower is no longer able to meet its financial obligations on the loan. The contract should state clearly what happens in such circumstances and should allow for a modification of the terms of the agreement. The borrower must provide clear evidence which demonstrates that it is not able to meet its financial obligations on the loan.⁸⁶
- 2. Independent procedure:**
All public sovereign liabilities need to be subject to an impartial and independent assessment and adjudication, once conflicts over payability or legitimacy of an individual or a class of debt instruments arises⁸⁷. The loan document should provide a provision for an independent and transparent debt workout procedure in case of repayment difficulties or dispute (at the request

of the borrower)⁸⁸. There will be a stay on debt repayments while negotiations are underway. The borrower will also be protected from litigation while negotiations are in progress. Borrowers and lenders will abide by the decision of the independent arbitrator and there is a right to appeal.⁸⁹ Such independent debt work out procedure would allow the establishment of new debt sustainability criteria that take into account basic development needs. Eventually, it would lead to the establishment of the adequate level of loans to be contracted by borrower countries.

- 3. Legal authorisation to negotiate:**
Proof of legal power of attorney and negotiation must be provided by both sides of the contract before commencement of any negotiations on the loan.
- 4. Loan refinancing:**
The details of any restructuring/refinancing agreement must be made public. Any successor loan carries with it the properties of the original loan. Borrowers should not sign sovereign immunity waivers when debts are sold-on.
- 5. Cross-default:**
The loan document must not contain any cross-default or similar clause.⁹⁰
- 6. Collective action clauses:**
These clauses should be introduced in sovereign bonds with a strict reference to national law and jurisdiction.
- 7. Termination of the contract:**
There must be clear, fair grounds and requirements for nullification/termination of

the contract by either party. In the event of the loan being used for purposes other than those agreed, or in a manner that violates the principles stated in this Charter, the lender may decide to terminate loan disbursements after granting the borrower the opportunity to take corrective measures, and reasonable advance notice.

G. (ii) INVESTMENTS

- 1. Mediation:**
The contract shall contain clauses establishing dispute resolution mechanisms through mediation and amicable means.
- 2. Exhaustion of domestic remedies:**
Litigation before domestic courts of the host state shall be the default option. The contract shall state that international arbitration will only be sought if domestic courts are unable or unwilling to perform this function. Litigation shall be fully transparent and independent.
- 3. International arbitration:**
In cases where international arbitration is included, such arbitration shall be impartial, fully transparent and independent. The dispute settlement mechanism must take into account sustainable development considerations and the realisation of human rights of third-parties affected.

- 1 The types of foreign investment covered by the Charter comprise both public and publicly-supported or guaranteed direct investment and portfolio investment. The standards should apply to all contracts that IFIs and DFIs sign with investee companies and / or projects, regardless of the share of the investment owned by the DFI / IFI.
- 2 World Bank: Global Economic Prospects (GEP), 2011.
- 3 See Eurodad analysis on G20 measures "From London to Pittsburgh: assessing G20 action for developing countries" available at: www.eurodad.org/whatsnew/articles.aspx?id=3820
- 4 World Bank: Global Economic Prospects (GEP), 2011.
- 5 World Bank: Global Economic Prospects (GEP), 2011.
- 6 Bhinda, Nils and Martin, Matthew: Private Capital Flows to Low Income Countries: Dealing with Boom and Bust, Foreign Private Capital Capacity Building Programme, November 2009.
- 7 See briefing "Is the International Financial Corporation supporting tax evading companies?" Available at: www.eurodad.org/uploadedFiles/Whats_New/News/Is_the_International_Finance_Corporation_supporting_tax_evading_companies_updated%20february%202010.pdf
- 8 Christian Aid, « Death and taxes, the true toll of tax dodging », May 2008. Available at: www.christianaid.org.uk/images/deathandtaxes.pdf
- 9 For more information on transfer mispricing, see ActionAid's 2010 report *Calling time: Why SABMiller should stop dodging taxes in Africa* and evidence on how the Glencore subsidiary Mopani Copper Mine evades taxes in Zambia.
- 10 European Union ODA, which amounts to 60% of global ODA, decreased in 2009 to €49 billion from €50 billion in 2008.
- 11 Hai-Anh Dang, Steve Knack, and Halsey Rogers. 2009. "International Aid and Financial Crises in Donor Countries." Policy Research Working Paper 5162, World Bank, Washington, DC.
- 12 In this sense, interest rate differential between developed and developing countries is an important risk factor for carry trade speculative attacks on MICs currencies. These new asset bubbles could not only happen in currency but also in stock and real state markets.
- 13 Background paper for the United Nations ministerial meeting on Least Developed Countries' development: *Harnessing private capital flows to LDCs*, Lisbon, October 2010.
- 14 Op. Cit, GEP, 2010, P13.
- 15 Op. Cit, GEP, 2010, P 163.
- 16 Op. Cit, GEP, 2010, P6.
- 17 Op. Cit. GEP, 2010, P85.
- 18 Pittsburgh summit conclusions, point 24. See: www.pittsburghsummit.gov/mediacenter/129639.htm
- 19 Rzepka, Sylvi: The big post-crisis takeover: Trends in IFI lending to low income countries, Eurodad briefing, April 2010.
- 20 Powell, Jeff and Van Waeyenberge, Elisa: Whither development finance? Eurodad report, forthcoming.
- 21 International Development Association and International Monetary Fund: Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI): Status of Implementation, September 2010.
- 22 Hurley, Gail: Addressing unsustainable debt in Small Island Developing States, Poverty Group, Bureau for Policy Development, UNDP, January 2011.
- 23 See IMF paper : Preserving debt sustainability in LIC in the wake of the global crisis. April 2010. Available at: www.imf.org/external/np/pp/eng/2010/040110.pdf
- 24 Dubai World holding company asked its creditors for a six month stand still on debt payments. See more on this case at: www.guardian.co.uk/world/2009/nov/30/questions-dubai-world-debt. See also: <http://dealbook.blogs.nytimes.com/2010/03/24/bankers-meet-to-sort-out-dubai-worlds-debt/>
- 25 See : <http://news.bbc.co.uk/2/hi/8385164.stm>
- 26 For a more detailed analysis of vulture funds see Eurodad report "Taming the vultures. Are new measures enough to protect debt relief gains?" at: www.eurodad.org/whatsnew/reports.aspx?id=2752&LangType=1033
- 27 See iDA and IMF HIPC and MDRI status of implementation 2009.
- 28 See report by Plate- forme dette et développement and CNCI-11.11.11 « Un voutour peut en cacher un autre. Ou comment nos lois encouragent les prédateurs des pays pauvres » May 2009
- 29 See Eurodad analysis on G20 measures "From London to Pittsburgh: assessing G20 action for developing countries" available at: www.eurodad.org/whatsnew/articles.aspx?id=3820
- 30 For a detailed analysis of this case see "Who should pay for Iceland's debt? How a fair and transparent debt work-out mechanism could help settle the Icelandic case" at www.eurodad.org/whatsnew/reports.aspx?id=4043
- 31 For a literature review of the impacts of foreign direct investment (FDI) see Herkenrath, Mark: *Ausländische Direktinvestitionen und nachholende Entwicklung: ein Forschungsüberblick*, Sociological Institute of the University of Zurich, 2010. <http://www.suz.uzh>.
- 32 UNCTAD: Latest development in investor-state dispute settlement, UNCTAD/WEB/ITE/IIT2005/2, 2005.
- 33 G20: The Seoul Summit document, November 2010.
- 34 There is no universally agreed definition of illegitimate debt. However illegitimate debts can loosely be described as those loans which did not benefit the populations of borrower nations and in some cases did local communities and/or environments grave harm. Professor Alexander Nahum Sack, a Russian legal scholar developed the notion of odious debt in 1927. Odious debts are defined by three main characteristics: a/ the loan did not benefit the population of the debtor nation and indeed the funds may have been used to oppress the people(s) of that nation (absence of benefit); b/ the population of the debtor nation did not consent to the loan (absence of consent); and c/ the creditor was aware of these facts and yet proceeded to disburse the loan anyway (creditor awareness). Illegitimate debt however is a much broader category. It applies for example to ill-conceived development projects which no financier exercising reasonable due-diligence should ever have financed. More recently, the concept of ius cogens and its potential application in cases of illegitimate debt has been raised. This argues that any loans which contravened accepted international ius cogens norms such as torture, slavery or war of aggression should be deemed invalid.
- 35 Global Financial Integrity: Illicit financial flows from developing countries: 2000-2009, January 2011.
- 36 International Institute for Sustainable Development: Model International Agreement on Investment for Sustainable Development, April 2005.
- 37 A collective action clause (CAC) allows a supermajority of bondholders to agree a debt restructuring that is legally binding on all holders of the bond, including those who vote against the restructuring. Bondholders generally opposed such clauses in the 1980s and 1990s, fearing that they would compromise 'creditor's rights', although such clauses were long standard in bonds issued under British law. New York law bonds on the other hand, the most common, required unanimity to alter their financial terms, although a technique had been devised to indirectly change the terms with a smaller majority ('exit consents'). Bond-issuing governments generally feared that including CACs would raise their interest rates, if creditors demanded compensation for greater perceived risk. However, after Mexico experimented successfully with CACs in a New York bond in February 2003 without negative effect, they became the new standard. Whether they enable easier coordination of bondholders has not yet been tested.
- 38 See: www.iif.com/emp/principles/
- 39 In 2003, Anne Krueger, First Deputy Managing Director at the IMF developed proposals for a Sovereign Debt Restructuring Mechanism (SDRM). Some of the main features of the SDRM include: a supermajority of creditors could vote to accept new terms under a restructuring agreement, minority creditors would be prevented from blocking such agreements, negotiations should be based on good faith, there would be transparency requirements and sharing of information by the debtor and the creation of a dispute resolution forum. The proposals were abandoned in 2004 following objections by a number of creditor governments and private financiers. Proposals were also criticised by NGOs for, among other reasons, the exclusion of IMF debts from the process of orderly restructuring. For further information, see: www.imf.org/external/np/ex/ facts/sdrm.htm
- 40 For further information on the World Bank/IMF debt sustainability framework, see: <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTDEBTDEPT/0,contentMDK:20261804-men uPK:64166739-pagePK:64166689-piPK:64166646-theSitePK:469043,00.html>
- 41 In fact, the reverse is true. In 2006, the World Bank approved its so-called 'free-rider policy'. The policy, entitled 'Managing Risks Associated with Non concessional Borrowing' states that should low-income countries take-on too much non-concessional commercial debt for purposes the Bank does not agree with, it retains the right to reduce (or harden the terms of) that country's access to concessional International Development Association (IDA) resources. No sanctions of any kind are imposed on lenders for lending beyond prudent limits. And although the Bank recognises that "this does imply a somewhat asymmetric treatment of lenders and borrowers" it presents no potential policy measures which could be discussed to ensure a more equitable treatment between the two parties. For further information on the policy, see: <http://web.worldbank.org/WBSITE/EXTERNAL/EXTABOUTUS/IDA/0,contentMDK:21021578-p agePK:51236175-piPK:437394-resourceurlname :FY06grantimplementation%5E%5Epdf-theSitePK:73154,00.html>
- 42 OECD: The OECD Guidelines for Multinational Enterprises, 2000 revision.
- 43 UNEP Finance Initiative and the UN Global Compact: Principles for responsible investment, 2006. <http://www.unpri.org/files/pri.pdf>
- 44 See for example, the World Bank's safeguard policies at: <http://go.worldbank.org/WTA1ODE7T0> or the IFC's "performance standards" at: www.ifc.org/ifcext/enviro.nsf/Content/PerformanceStandards
- 45 See: www.equator-principles.com/
- 46 See: www.g7finance.tesoro.it/export/sites/G8/en/2009ItalianPresidency/Meetings/June/Communiqués/Documents/Comunicato_G8_Ministri_Finanziari__Lecce_13_giugno_2009.pdf
- 47 G20: Seoul development consensus for shared growth, November 2010.
- 48 See : www.unctad.org/Templates/WebFlyer.aspx?intItemID=5213&lang=1
- 49 The IMF will lend to countries in arrears to private creditors if the country shows it is making a 'good faith effort' to resolve its debt crisis.
- 50 Eurodad charter has contributed to a broader framework for Sovereign Democratic and Responsible Finance that has been put forward by a South- North platform of CSOs. See: www.eurodad.org/whatsnew/reports.aspx?id=4100
- 51 Most the provisions in Eurodad's Charter for Responsible Financing can be applied to a full range of lending, e.g. project loans, export-credit agreements, sovereign bonds, policy support loans (such as modernisation or privatisation loans) and balance of payments loans. There may be some cases however where a particular provision may not be relevant to this type of loan, e.g. the provision for an ex ante social and environmental impact assessment would not apply in cases of direct budget support or to sovereign bonds. The provision on the untying of loans to the purchase of lender goods or services would not be applicable to export credit agreements although we suggest ways to dramatically improve the quality of these transactions.
- 52 The types of foreign investment covered by the Charter comprise both public and publicly-supported or guaranteed direct investment and portfolio investment. The standards should apply to all contracts that IFIs and DFIs sign with investee companies and / or projects, regardless of the share of the investment owned by the DFI / IFI.
- 53 In cases where changes in circumstances may emerge, we refer to the cluster E: Repayment difficulties or disputes.
- 54 The loan should comply with relevant legislation in both borrower and lender nation. If the loan violates the constitution of the borrower nation in any way, it should be deemed null and void. Examples of relevant legislation in the lender nation include: the Spanish law of December 2006 entitled: "Act Governing the Management of Foreign Debt". This binds the Spanish Government as a lender to, among other things, tailor loans to "debtor countries' development requirements and [...] be proportional to their financial difficulties," and pay special attention to "reducing poverty levels, [...] pursuing sustainable economic growth, [...] as well as to preserving the environment."
- 55 According to Debt relief International, a reasonable upper limit for sovereign or publicly guaranteed lending would be 1% above the basic market rate in the lender nation.
- 56 EURODAD advocates for internationally agreed guidelines and limits on counterpart fees and interest penalties
- 57 Fees and other supplementary charges are often included in loan documentation by reference to a side letter to avoid disclosure. For this reason, side-letters should be avoided.
- 58 The loan should distinguish between types of fee, e.g. 'commitment' fees (which should have a maximum level of 0.5-1%), from fees for 'services rendered'. These should really be included in the overall loan amount as part of the project being financed. In case they are not, the loan document must contain clear and detailed information on the amount, purpose, recipient and interest rates charged.
- 59 If only a voluntary code of conduct is adopted as an immediate step on the way towards binding international standards, there could be a stipulation that loans can be assigned only to other creditors who have signed up to the Code of Conduct.
- 60 This proposal has been further developed in 2003 by Professor Eric Berr. See "La dette des pays en développement : bilan et perspectives "Centre d'économie du développement, document de travail n°82, Université

- Montesquieu, Bordeaux IV.
- 61 The provisions in this Charter focus specifically on investments fully or partially subsidised or guaranteed by public institutions with a development mandate, such as bilateral donor agencies, Development Finance Institutions (DFIs), and International Financial Institutions (IFIs).
- 62 Eurodad is aware that some of the standards outlined in the Charter may contradict international law under Bilateral Investment Treaties and WTO investment rules. These rules have often by-passed considerations which are fundamental to ensure that lending and investments contribute to sustainable and equitable development. Development institutions which support lending and investment must ensure that their practices are aligned with their development mandate thus enshrining principles for responsible lending and investment in all their contracts and agreements.
- 63 We recognise that there are some loans, e.g. balance of payments support loans, budget support etc. where best practice standards as they relate to ex-ante and ex-post social and environmental impact assessments would not be relevant.
- 64 The provisions in this Charter focus specifically on investments fully or partially subsidised or guaranteed by public institutions with a development mandate, such as bilateral donor agencies, Development Finance Institutions (DFIs), International Financial Institutions (IFIs), and Export Credit Agencies (ECAs).
- 65 Such rights are clearly laid-out in texts such as the United Nations Universal Declaration of Human Rights, 1948 (<http://www.un.org/Overview/rights.html>) which many experts argue has achieved the status of international customary law as well as the United Nations Covenant on Social, Economic and Cultural Rights and United Nations Covenant on Civil and Political Rights.
- 66 Such internationally recognised and accepted standards include – but are not limited to – the World Bank’s safeguard policies (<http://www.worldbank.org/safeguards>), the International Finance Corporation’s (IFC) Performance Standards, the Equator Principles (<http://www.equator-principles.com/>) and the International Labour Organisation’s (ILO) core labour standards (<http://www.ilo.org/public/english/standards/norm/>). The World Bank’s safeguard policies incorporate for example: environmental assessment; natural habitats; forestry; pest management; involuntary resettlement; indigenous peoples; cultural property; safety of dams; projects on international waterways; and projects in disputed areas. Important, please note– this paper does not suggest that in many cases these safeguard policies or principles could not be significantly strengthened. There is a large volume of literature available which points to the weaknesses of different institutions’ policies and safeguards and therefore efforts must constantly continue to improve on them. Instead, this paper suggests that they provide a minimum set of standards which enjoy broad-based sign-on and which can be used to hold financiers and borrowers accountable for their lending/borrowing decisions.
- 67 See endnote 13.
- 68 This document must be public (e.g. available for consultation on request, published on the web, announced in national press, radio and/or television as appropriate).
- 69 It is crucial to carry out ex ante impact assessments on all loans, not just project loans. This is because loans which are described as ‘policy support loans’ or loans to support ‘modernisation’ or privatisation’ in a borrower country can also have significant distributional or other impacts. It is therefore vital that these also be accompanied by independent (and positive) ex ante social and environmental impact assessments.
- 70 The precautionary principle states that if an action or policy has a suspected risk of causing harm to the public or to the environment, in the absence of scientific consensus that the action or policy is harmful, the burden of proof that it is not harmful falls on those taking the action. In some legal systems, as in the law of the European Union, the application of the precautionary principle has been made a statutory requirement.
- 71 See footnote in point B.
- 72 See the Paris Declaration on Aid Effectiveness, March/April 2005: www.oecd.org/document/18/0,2340,en_2649_3236398_35401554_1_1_1_100.html The 12 indicators donor countries have signed up to are: partners have operational development strategies; reliable country systems; aid flows are aligned on national priorities; strengthen capacity by coordinated support; use of country public financial management systems; use of country procurement systems; strengthen capacity by avoiding parallel implementation structures; aid is more predictable; aid is untied; use of common arrangements or procedures; encourage shared analysis; results-oriented framework; mutual accountability. See also the UN Millennium Declaration, 18 September 2000: www.un.org/millennium/declaration/ares552e.pdf
- 73 See endnote 13.
- 74 See footnote in point B.
- 75 A country by country reporting standard would oblige multinational companies to disclose information on the profits made in each country where they operate. This would make it easy for tax authorities to identify how much tax should be paid in that country. Transfer pricing abuse is largely used by multinational companies with the aim of shifting profits to low or zero tax jurisdictions and benefitting from tax exemptions in the country where they operate. For a more detailed analysis of transfer pricing and country by country reporting see: www.taxjustice.net/cms/upload/pdf/Country-by-country_reporting_-_080322.pdf
- 76 The companies must disclose reliable and detailed information regarding:
The name of each country in which it operates;
The names of all of its subsidiary companies trading in each country in which it operates;
Its financial performance in every country in which it operates, without exception, including:
Its sales, both with third parties and with other groups in the same company;
Purchases, split between third parties and intra-group transactions;
Labour costs and employee numbers;
- Financing costs split between those paid to third parties and those paid to other groups in the same company;
- Its pre-tax profit.
- The tax charge included in its accounts for the country in question;
- Details of the cost and net book value of its physical fixed assets located in each country;
- Details of its gross and net assets in total for each country in which operates.
- 77 See footnote in point B.
- 78 In view of the problems with the arm’s-length method, alternative methods should be explored, such as safe harbours (with or without rebuttable presumptions), formula apportionment, or hybrid methods, in order that transactions between related parties or affiliates be determined, and reported to all applicable tax authorities, more appropriately.
- 79 See footnote in point B.
- 80 See footnote in point B.
- 81 See endnote 13.
- 82 See footnote in point B.
- 83 Minimum standards of consultation to be respected can be drawn from internationally recognised social, labour and environmental standards.
- 84 Both lenders and borrowers should be encouraged at the end of the year to publish condensed annual reports of their lending and borrowing activities. This report should be widely distributed and made publicly available to anyone interested.
- 85 Often, even where loan contracts are available in translated versions, they carry no legal value. A clause contained within the agreement will state that in cases of dispute, only the original language version of the document has any validity (usually drafted in the language of the lender nation). This practice is routinely used by lenders although others have abolished the practice which shows that improvement is possible. Recent loan agreements between Belgium and Ecuador for example state that both French and Spanish language texts are equally valid in a court of law. Denmark, France, Germany and Italy however need to improve since loan agreements issued by these countries state that only the original texts are legally valid.
- 86 There are two broad categories of cases which could reasonably be deemed a dramatic change in circumstance which may require a modification of the terms and repayment profile of a loan. These include: a/ force majeure (dramatic changes which occur beyond the will of borrower or lender such as political or economic upheaval, war, natural disaster, a dramatic fall in the price of major export commodity prices, dramatic changes in real interest rates, dramatic currency fluctuations etc.); b/ état de nécessité (state of necessity: when repayments on the loan threaten the survival of the state and/or its peoples). The burden of proof lies with the borrower in these situations. The debt contract must state clearly the procedures should such eventualities arise. Possible resolution scenarios include: a/ GDP or commodity-price indexed loans to allow for GDP indexed debt service, i.e. a reduction in debt service in cases of external shock or ‘force majeure’. They could also allow for payments to be linked to the price of a ‘basket’ of the borrowing country’s main commodity/ies; b/ a moratorium on debt service payments (without penalties imposed) to safeguard a state’s vital expenditures and help it to recover more quickly; c/ an ad-hoc arbitration or other independent legal opinion/ decision under which both parties agree to share the consequences of such unforeseen circumstances.
- 87 This process would entail the realisation of an independent audit of the debt.
- 88 The ‘fair and transparent arbitration procedure’ or ‘FTAP’ was first proposed in 1987 by Austrian academic Kunibert Raffer who recommended the internationalisation of Chapter 9 of the US Insolvency Code. Chapter 9 protects national government municipalities in cases of bankruptcy. The key features of Raffer’s model include a neutral decision-making body which arbitrates and decides which debts need to be declared null and void, and which need to be repaid; the rights of both debtor and creditor to be heard by arbitrators; protection of the human, social and economic rights of the citizens of the debtor; the institution of automatic stay and transparency of process and decisions. Internationalisation of this procedure would ensure comparability of treatment between countries and between debts. In cases of financial difficulties or dispute, debtors and creditors should be able to turn to such an independent mechanism as a serious option should they so choose. According to Raffer’s model, arbitration may be heard on an ad-hoc basis. Meanwhile, Alberto Acosta, Ecuadorian economist and Oscar Ugarteche, Peruvian economist have also put forward not dissimilar proposals for the creation of a ‘tribunal internacional de arbitraje de deuda soberana’ or ‘TIADS’ (international tribunal for the arbitration of sovereign debts). Unlike Raffer’s model, the TIADS model would involve the institutionalisation of an arbitration court – possibly under the aegis of the United Nations or International Court of Justice – to hear sovereign debt related disputes and/or repayment difficulties. Acosta and Ugarteche argue for an ‘international financial code’ (código financiero internacional) which would codify the right to be heard before an arbitration tribunal. Eurodad’s charter does not indicate a preference for either model, but argues that borrowers and lenders should have the right to be heard before an independent panel in cases of repayment difficulties or dispute. This panel would also identify incidence of illegitimate debt (and legitimate debt of course). See also Eurodad paper: ‘A fair and transparent debt work-out procedure: 10 core civil society principles’ at www.eurodad.org/uploadedFiles/Whats_New/Reports/Eurodad%20debt%20workout%20principles_FINAL.pdf?n=13
- 89 See note on FTAP and TIADS proposals for further elaboration. During the arbitration procedure, the borrower would continue to make interest payments on the loan(s) at the standard level charged (i.e. penalty interests rates would not apply). These interest payments may be reimbursed to the borrower subject to the outcome of the independent arbitration.
- 90 A provision in a bond indenture or loan agreement that puts the borrower in default if he/she/the state defaults on another debt obligation.

Eurodad

The European Network on Debt and Development is a specialist network analysing and advocating on official development finance policies. It has 57 member groups in 19 countries. Its roles are to:

- research complex development finance policy issues
- synthesise and exchange NGO and official information and intelligence
- facilitate meetings and processes which improve concerted advocacy action by NGOs across Europe and in the South.

Eurodad pushes for policies that support pro-poor and democratically-defined sustainable development strategies. We support the empowerment of Southern people to chart their own path towards development and ending poverty. We seek appropriate development financing, a lasting and sustainable solution to the debt crisis and a stable international financial system conducive to development.

www.eurodad.org



european network on
debt & development

Eurodad
Rue d'Edimbourg 18 – 26
1050 Brussels
Belgium

Tel: +32 (0) 2 894 4640
eFax: +32 (0) 2 791 98 09
www.eurodad.org