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Sovereign debt audit
A way to mitigate future sovereign debt crises

Contents

Taking responsibility

What more can be done to mitigate future sovereign debt crises? Should borrowers be more or less responsible than lenders in ensuring rigorous standards and transparent practices in sovereign debt? Or does the onus fall equally on both?

The answers to these questions have become increasingly important as sovereign debt-fueled economic crises within the last decade have revealed missteps on the part of both creditors and debtors. One could argue that the lack of documented, universally accepted principles for lending and borrowing increased the likelihood of these missteps. And that this lack of transparency hindered preemptive action, namely a rigorous auditing process of debt portfolios that could have precluded rescheduling and restructuring that resulted in disastrous economic, social, and political consequences.

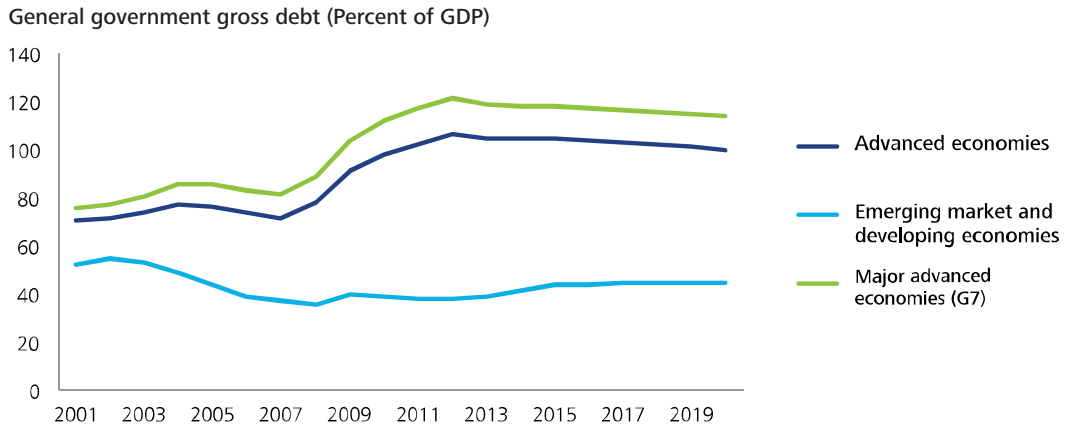
In response, the United Nations General Assembly in 2010 emphasized the need for creditors and debtors to share responsibility for preventing future debt crises by encouraging Member States, the International Monetary Fund (IMF), the World Bank, the regional development banks and other multilateral financial institutions and stakeholders to pursue ongoing discussions within the framework of the United Nations' Conference on Trade and Development's (UNCTAD) initiative to promote responsible sovereign lending and borrowing[1]. The result of this work resulted in the Principles on Promoting Responsible Sovereign Lending and Borrowing (the UN Principles).

Serious ramifications

In many ways, Greece is a poster child for what ails sovereign debt today and why the UN Principles and their execution are imperative. The seeds of the Greek crisis were planted long ago before 2009 when it became apparent that the country not only had an intolerable debt situation but also a lack of political will to implement economic reforms. Four other European sovereign states—Ireland, Portugal, Spain and Cyprus—reached similar situations, although the underlying causes varied. But in Greece's case, a perfect storm has revealed to the world how devastating unsustainable sovereign debt can be for a sovereign state, even one that is a full-fledged member of an economic union comprising some of the most developed economies in the world.

Unsustainable sovereign debt is today one of the most important economic and social issues. The size of the public debt market alone indicates this importance: global gross central government debt amounted to nearly US$43 trillion at the end of 2014, according to the World Bank[2]. Many sovereign states—especially those with developed economies—rely heavily on debt (Figure 1), a trend that has only become stronger since the global financial crisis, with government debt of developed economies growing from 70 percent of GDP in 2007 to over 105 percent in 2014.

Figure 1: Debt-to-GDP ratios, 2001-2019 (2015 and onwards are estimates[3])



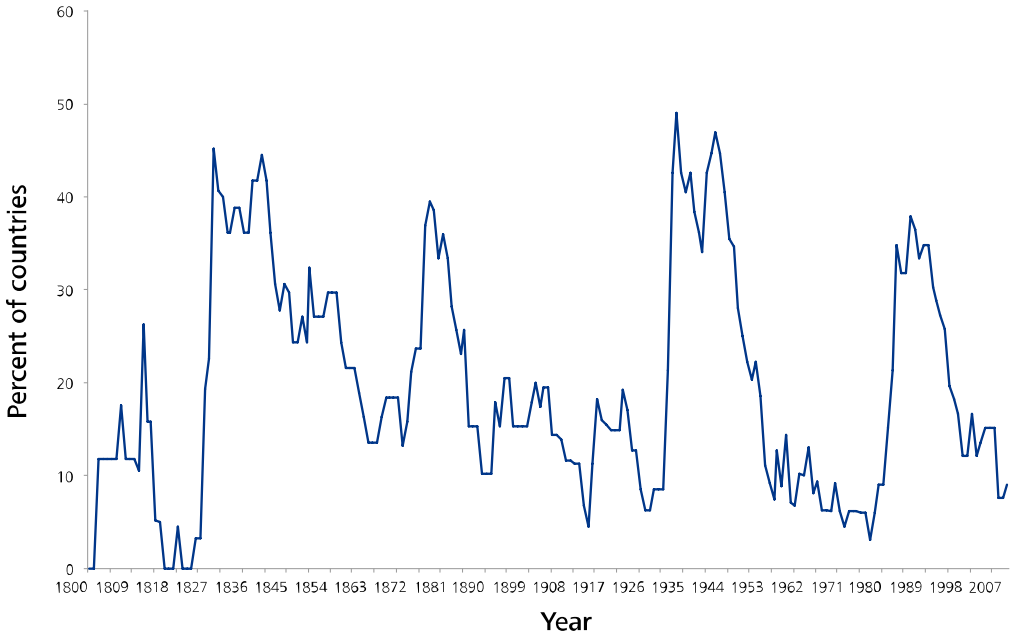
Source: IMF Data Mapper, IMF

[1] United Nations General Assembly, "Macroeconomic policy questions: external debt sustainability and development," A/65/434/Add.3, 3 December 2010.
[2] Quarterly public sector debt, World Bank, Q3 2014.
[3] Please refer to the IMF Data Mapper for definitions of advanced and emerging market/developing economies; http://www.imf.org/external/datamapper/index.php?db=FM

As with any kind of personal or institutional debt, sovereign debt, when acquired appropriately can boost the economic growth and stability of a sovereign state, hence contributing to global growth and stability. But, as has been seen in nations even numbering among the world's largest developed economies, such as Japan and Italy, high sovereign debt can also be a source of economic stress that contributes to stagnant growth. Or in the case of Greece, Cyprus, Argentina, and Puerto Rico, the nature and volume of sovereign debt can cripple an economy.

In addition to the domestic economic distress that sovereign debt crises induce, there are external consequences in the form of lender haircuts, political unrest, exclusion from global financial markets, and even the elimination of capital fusion and withdrawal of credit facilities by supranational institutions. Of course, sovereign debt crises are not novel news; history is full of them, such as in Europe in the late 1930s and 1940s, Latin America in the 1980s, and Asia in the 1990s (Figure 2).

Figure 2: History of sovereign default or restructuring



Source: Carmen M. Reinhart and Kenneth S. Rogoff, "This time is different", 2009

A report from the Bank of Greece succinctly reported some of the deep-seated structural ramifications of a debt crisis: "In the course of the fiscal crisis and the deep recession, some negative developments, primarily the dramatic rise in unemployment… are estimated to have contributed to an exacerbation of relative poverty and economic inequality in Greece"[4]. Indeed, Greece's unemployment rate skyrocketed from 7.2 percent in the second and third quarter of 2008 to 26.6 percent in the first quarter of 2015, and the youth (ages 15-24 years) unemployment rate is a staggering 51.9 percent and 57.0 percent for female youth alone[5].

But what makes Greece's case even more onerous is that it not only impacts the international community via the IMF, but it has systemic ties to the European Union, putting pressure on the other EU Member States and the European Central Bank (ECB). A large economy, such as Italy, would have even larger, and potentially disastrous, systemic ramifications that would likely affect the global economy.

Though many issues related to sovereign debt have received significant media coverage, it is the havoc, not the potential remedies, that receives most of the attention. This is understandable, especially when the problems, as in the case of Greece at present, are so overwhelming and the debates are highly contentious and politically fraught.

Need for better solutions

But the fact remains that the international community still does not have a mechanism for solving debt crises. There is no single entity that manages sovereign debt crises, and included with this void of a lack of a coherent and coordinated response is the disparity in mandates among funding institutions, such as the IMF and the state central banks.

[4] Mitrakos, T. "Inequality, poverty and social welfare in Greece: Distributional effects of austerity," Bank of Greece, 2014.
[5] Hellenic Statistical Authority, June 2015, Labour Force Survey, 1st Quarter 2015.

To be fair, the IMF has tried to implement a debt restructuring mechanism, and it has proposed remedies for improving the existing system that saw considerable weaknesses exposed in the course of handling the Greek and Argentinian defaults. Private investors have also had limited effect; a prime example is the lack of enforcement after Argentina lost in the district courts in the United States[6]. Hence, the international community has a distinct need for preemptive measures, which are encapsulated in the UN Principles, but which also require a concrete approach toward verifying their implementation. This approach will be identified and discussed shortly.

Sovereign debt restructuring

Restructuring has been a common solution to deal with sovereign debt crises for many years. In 2010 alone, there were over 600 cases of debt restructuring in 95 sovereign states in the previous 50-year period. Less than a third of these cases were with foreign private creditors, with the majority of them related to bank loans. Debt rescheduling (lengthening of maturities) was twice as frequent as debt reduction, although in all instances, a "haircut" in the form of reduced claims, was inevitable.

Of course, this method is typically employed when all other mechanisms have failed, and when the crisis has already taken its toll and the creditors are convinced that restructuring is the only way to recover some of their investment.

Responsible lending and borrowing

It is now commonly understood that both borrowers and lenders share responsibility for sovereign debt in that imprudent borrowing is begat by imprudent lending. Although seemingly obvious, the rights and obligations of borrowers and lenders have been approached differently depending on the entities and institutions involved.

Furthermore, the lack of acceptable legal frameworks have only exacerbated the situation with little clarity on the responsibilities of each party. Perverse incentives and risks flowing from "agency problems, time inconsistency, information asymmetries and moral hazard" are rampant in debt structuring[7].

Some rights and obligations of the lender that may be perceived as globally accepted are: verifying that the proper authority has signed the loan; assuring that the project it funds (if the debt targets a project) is solid; assuring that the borrowing country does not take on too much debt as a consequence of the new loan; adequately disclosing terms; and not lending to nations on the United Nations (UN) sanction list[8].

However, most, if not all, of these rights and obligations are applicable to borrowers. And lack of common understanding about the rights and obligations of a loan transaction has costs, the worst being debt-fueled crises that have cross-border effects and domestic effects ranging from financial instability to declining social cohesion that roll back gains of economic and political development. Hence, in response to the need to reduce the probability of these sovereign debt-fueled crises, an UNCTAD Expert Group created the aforementioned Principles on Promoting Responsible Sovereign Lending and Borrowing[9]. And thus far, the UN Principles have been endorsed by 13 Member States[10].

[6] Center for Economic Policy and Research, "Economists Call on Congress to Mitigate Fallout from Ruling on Argentine Debt," Press release, July 31, 2014 http://www.cepr.net/index.php/press-releases/press-releases/economists-call-on-congress-to-mitigate-fallout-from-ruling-on-argentine-debt.

[7] Anna Gelpern, "Hard, Soft, and Embedded: Implementing Principles on Promoting Responsible Sovereign Lending and Borrowing," Working paper, Institute for International Law and Justice, New York University School of Law, Volume 20, November 2012

[8] These sanctions are "intended to apply pressure on a State or entity to comply with the objectives set by the Security Council without resorting to the use of force." http://www.un.org/sc/committees/

[9] UNCTAD, Principles on promoting responsible sovereign lending and borrowing, 2012; http://www.unctad.info/en/Debt-Portal/Project-Promoting-Responsible-Sovereign-Lending-and-Borrowing/About-the-Project/Principles-on-Responsible-Sovereign-Lending-and-Borrowing/

[10] The following countries have endorsed the UN Principles: Argentina, Brazil, Cameroon, Colombia, Gabon, Germany, Honduras, Italy, Morocco, Nepal, Norway, Mauritania and Paraguay.

In accordance with the idea that lenders and borrowers share responsibility for sovereign debt, the UN Principles (summarized in the appendix) include seven principles for lenders and eight principles for borrowers, encompassing concepts such as fiduciary duty, accountability, transparency, due diligence, co-responsibility, debt monitoring, and good faith. Similar principles can be found in most domestic legal orders, but this codification at an international level is new.

The Principles strive to durably change the behavior of sovereign lenders and borrowers and bring about a resulting shift in sovereign borrowing and lending practices. According to the UNCTAD, "The normative contribution of these Principles lies not in the creation of new rights nor obligations in international law but in identifying, harmonizing and systematizing the basic principles and best practices applied to sovereign lending and borrowing and in elaborating the implications of these standards and practices for lenders and borrowers at the international level[11]."

In particular, the Principles pursue three aims:

- Provide a common conceptual framework on the law and practice of sovereign lending and borrowing
- Achieve consensus on responsible practices in sovereign borrowing and lending and disseminate such knowledge
- Create constituencies for implementation.

Sovereign debt audit as a preemptive tool

Most certainly, the global community needs better ways to address sovereign debt issues through stronger multilateral legal frameworks and effective mechanisms for debt restructuring. But these are ex-post solutions to address problems that, over time, become highly complex and intractable. And because any help that usually comes is "too little too late,"[12] as the IMF itself has pointed out, the distress that both borrowers and lenders have to endure is not offset with enough relief.

Yet, no matter how robust in concept the UN Principles are in preemptively addressing these sovereign debt issues, they require diligent application to be truly effective. This practical implementation must begin with an examination of existing practices of debt management. One potent tool for this examination is a sovereign debt audit.

Sovereign debt audits encourage a new preemptive discipline around lending and borrowing practices overall. This new approach has the potential to minimize future problems and, together with other initiatives currently being developed, possibly avert future crises.

Accordingly, the UN Principles inspired Supreme Audit Institutions (SAIs), through their global organization INTOSAI (International Organization of SAIs), to develop and roll out an expanded public debt audit framework. INTOSAI's decision to change and expand the public debt audit had already begun in late 2007, before the worst of the most recent public debt troubles, and before the drafting of the UN Principles, as there were already deep concerns about sovereigns having incurred too much, and rapidly increasing, debt.

Until recently, when SAIs audited public debt, they focused mainly on auditing the stock of public debt to comply with the particular rules of the sovereign they were auditing. The revised approach, building on the UN Principles, however, now extends to lending and borrowing practices, debt disbursements, and sustainability issues. Expansion into these new areas for SAIs signals a significant development in infusing a new discipline to public debt management. And as testament, over 20 sovereign borrowers were in the process of auditing their debt, with reference to the UN Principles, as of November 2015.

[11] UNCTAD, Principles on promoting responsible sovereign lending and borrowing, 2012.
[12] IMF, "Sovereign Debt Restructuring—Recent Developments and Implications for the Fund's Legal and Policy Framework," April 2013.

The Norwegian example

To test the application of the UN Principles, the Norwegian Government volunteered to be the first ever creditor country to undertake this debt audit, and it assigned Deloitte Norway (Deloitte) to carry out the Norwegian Debt Audit, the first debt audit based on the UN Principles. The United Nations and its Member States hope that Norway's effort will serve as a role model for responsible sovereign lending as well as the beginning of a larger international endeavor to promote a culture of responsibility in international finance, so frequently neglected by lenders (both sovereign and otherwise) and borrowers in recent history.[13] While the original UN Principles refer explicitly to the borrower, UNCTAD stated in a guidelines document that it released in 2014 that "as an exemplary practice, sovereign lenders may also audit the debt granted to sovereign borrowers."[14] It went on to refer to Norway as the first sovereign lender to have executed this "exemplary practice."

SAIs are national agencies responsible for auditing government revenue and spending. Their legal mandates, reporting relationships, and effectiveness vary, reflecting different governance systems and government policies. But their primary purpose is to oversee the management of public funds and the quality and credibility of governments' reported financial data.

"Anti-poverty campaigners are celebrating Norway's release of an external audit of outstanding public debts it is owed by developing countries, the first time any country has undertaken such a process," The Guardian, "Norway blazes a trail with audit of developing world debt," 20 August 2013.

The portfolio of debt that Deloitte audited comprised outstanding Norwegian export credits to emerging market sovereign states. Norway thus became the first sovereign state to conduct an independent and transparent investigation of its debt agreements to ensure that it was living up to its responsibilities as a creditor.

Under INTOSAI's new recommended approach, public debt audits have changed. Audit of public debt should address not only internal administrative issues, and determine and measure both the real and contingent public debt, but also take into account the budgetary and fiscal environment, and the interrelations between the public debt, financial markets and creditors.

The audit scope is thus not limited to verifying the regularity of government operations, as often was the case before the new framework, but also takes into account whether funding of public expenditure from borrowing is sound and borrowing costs are kept to a minimum.

One of the greatest improvements to the sovereign debt audit process is that it is now also a performance audit and not only a financial and compliance audit.[15] An audit employing all three of these approaches ensures that the examination is objective and robust.

[13] UNCTAD, "Norway to audit debt on basis of UNCTAD principles," Press release, August 22, 2012; http://unctad.org/en/pages/newsdetails.aspx?OriginalVersionID=231.

[14] UNCTAD, "Guidelines on Responsible Sovereign Lending and Borrowing," Draft Version, June 8, 2014; http://www.unctad.info/upload/RSLB%20Guidelines_for%20official%20consult.pdf.

[15] Performance audit refers to an independent examination of a program, function, operation or the management systems and procedures of a governmental or non-profit entity to assess whether the entity is achieving economy, efficiency and effectiveness in the employment of available resources.

How the Norwegian audit was done

The audit covered a portfolio of 34 debt agreements with seven emerging market sovereign states. While most of these are two to three decades old, their debt principals totalled nearly US$170 million. The audit assessed the compliance and performance of the portfolio based on both previous and present rules and regulations for the debt agreements, and the UN Principles for responsible sovereign lending and borrowing was used to inform whether the portfolio was on par with this newest standard. The previous and present rules and regulations included those established by the Organisation for Economic Cooperation and Development (OECD), of which Norway is a member. Accordingly, the audit team scrutinized a large amount of files and loan documents covering the 34 cases of debt agreements that were covered in the audit.

As *The Guardian* reported on 13 August 2013, "The report was written as a roadmap for future such exercises. Deloitte's auditors offered feedback on the UN Principles–in particular, they encouraged the Principles to become more explicit and suggested ways in which they can become more operational."

Principles for responsible lending and borrowing + sovereign debt audit = Responsible sovereign lending and borrowing

The Norwegian Debt Audit 2013 was a test and a first of its kind, and we believe that it signals a likely shift toward more sovereign debt audits. At first, the audits may be performed by SAIs but soon independent audits by private audit firms (as in the 2103 Norwegian Debt Audit) will be requested in which lenders and borrowers can have independent opinions on the quality and soundness of sovereign debt. Soon, the private sector institutions, such as banks and pension funds, must secure–through audits–that their portfolios, as well as new lending practices, adhere to the UN Principles.

There are particularly two aspects that we think will change the current situation:

- A shift in views regarding the responsibility of sovereign debt, both by lenders and borrowers: The UN Principles–finally–made it clear that both lenders and borrowers have a shared responsibility for responsible lending and borrowing. This clarification about shared responsibility is important as sovereign borrowing is uniquely unforgiving of mistakes. Unlike corporate or personal debtors, sovereigns do not have access to a formal bankruptcy process in which insupportable liabilities can be adjusted according to pre-established rules. From a legal standpoint, sovereign debts are therefore ineradicably absent from the consent and cooperation of the creditors. Unfortunately, the process by which that consent and cooperation must be sought–sovereign debt restructuring–remains, as we have discussed previously, unpredictable and disorderly.
- A tool for long-term public finance sustainability: Public debt audit could potentially be –as the United Nations General Assembly stresses–a tool for debt sustainability. The other present debt issues relate to solving short-term problems, such as those of debtor nations already having payment problems. Hence, there is definitely a need for robust long-term alternatives to support sustainable debt practices that reduce the dependence on the ad hoc, usually short-term reactive programs that include such solutions as rescheduling and restructuring debt.

In short, we believe that the UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing, combined with a rigorous sovereign debt audit practice, will strengthen and support sustainable borrowing and lending on a global scale.

Conclusion

While Deloitte's Norwegian debt audit 2013 report is the first sovereign debt audit, it may not be the last. Deloitte's experience suggests that sovereign debt audits potentially shed new light on a country's sovereign debt situation. The Norwegian debt audit 2013 report shows that debt audits are able, both technically and politically, to be a useful tool for long-term public finance sustainability.

Responsible sovereign borrowing and lending is hard work. One potent tool in implementing the UN Principles to mitigate sovereign debt crises in the future is the sovereign debt audit. As the Norwegian example shows, a rigorous, independent audit as a common practice is within reach.

It is a hope that debtor sovereign states in the future will be able to obtain debt that conforms to the UN Principles, thus potentially avoiding the huge economic and social cost of defaults and restructuring that severe sovereign debt problems have caused already in sovereign states, such as Greece. Sovereign debt audits in conjunction with the new global standards for lending and borrowing are a likely part of this solution.

Appendix

The UN Principles on Promoting Responsible Sovereign Lending and Borrowing
Summary of the Principles as developed by an UNCTAD working group. These Principles are still open for discussion and debate.

Responsibilities of Lenders
Principle 1 Agency
Lenders should recognize that government officials involved in sovereign lending and borrowing transactions are responsible for protecting public interest (to the state and its citizens for which they are acting as agents).

Principle 2 Informed decisions
Lenders have a responsibility to provide information to their sovereign customers to assist borrowers in making informed credit decisions.

Principle 3 Due authorization
Lenders have a responsibility to determine, to the best of their ability, whether the financing has been appropriately authorized and whether the resulting credit agreements are valid and enforceable under relevant jurisdictions.

Principle 4 Responsible credit decisions
A lender is responsible to make a realistic assessment of the sovereign borrower's capacity to service a loan based on the best available information and following objectives and agreed technical rules on due diligence and national accounts.

Principle 5 Project financing
Lenders financing a project in the debtor country have a responsibility to perform their own ex ante investigation into and, when applicable, post-disbursement monitoring of, the likely effects of the project, including its financial, operational, civil, social, cultural, and environmental implications. This responsibility should be proportional to the technical expertise of the lender and the amount of funds to be lent.

Principle 6 International cooperation
All lenders have a duty to comply with United Nations sanctions imposed against a governmental regime.

Principle 7 Debt restructurings
In circumstances where a sovereign is manifestly unable to service its debts, all lenders have a duty to behave in good faith and with cooperative spirit to reach a consensual rearrangement of those obligations. Creditors should seek a speedy and orderly resolution to the problem.

Responsibilities of Sovereign Borrowers
Principle 8 Agency
As to borrowers, governments are agents of the state and, as such, when they contract debt obligations, they have a responsibility to protect the interests of their citizens. Where applicable, borrowers should also consider the responsibility of lenders' agents toward their organizations.

Principle 9 Binding agreements
A sovereign debt contract is a binding obligation and should be honored. Exceptional cases nonetheless may arise. A state of economic necessity can prevent the borrower's full and/or timely repayment. Also, a competent judicial authority may rule that circumstances giving rise to legal defense have occurred. When, due to the state of economic necessity of the borrower, changes to the original contractual conditions of the loan are unavoidable, Principles 7 and 15 should be followed.

Principle 10 Transparency
The process for obtaining financing and assuming sovereign debt obligations and liabilities should be transparent. Governments have a responsibility to put in place and implement a comprehensive legal framework that clearly defines procedures, responsibilities and accountabilities. They should particularly put in place arrangements to ensure the proper approval and oversight of official borrowings and other forms of financing, including guarantees made by state-related entities.

Principle 11 Disclosure and publication
Relevant terms and conditions of a financing agreement should be disclosed by the sovereign borrower, be universally available, and be freely accessible in a timely manner through online means to all stakeholders, including citizens. Sovereign debtors have a responsibility to disclose complete and accurate information on their economic and financial situation that conforms to standardized reporting requirements and is relevant to their debt situation. Governments should respond openly to requests for related information from relevant parties. Legal restrictions to disclosing information should be based on evident public interest and to be used reasonably.

Principle 12 Project financing
In the context of project financing, sovereign borrowers have a responsibility to conduct a thorough ex ante investigation into the financial, operational, civil, social, cultural and environmental implications of the project and its funding. Borrowers should make public the results of the project evaluation studies.

Principle 13 Adequate management and monitoring
Debtors should design and implement a debt sustainability and management strategy and to ensure that their debt management is adequate. Debtor sovereign states have a responsibility to put in place effective monitoring systems, including at the sub-national level, that also capture contingent liabilities. An audit institution should conduct independent, objective, professional, timely and periodic audits of their debt portfolios to assess quantitatively and qualitatively the recently incurred obligations. The findings of such audits should be publicized to ensure transparency and accountability in debt management. Audits should also be undertaken at sub-national levels.

Principle 14 Avoiding incidences of over-borrowing
Governments have a responsibility to weigh costs and benefits when seeking sovereign loans. They should seek a sovereign loan if it would permit additional public or private investment, with a prospective social return at least equal to the likely interest rate.

Principle 15 Restructuring
If a restructuring of sovereign debt obligations becomes unavoidable, it should be undertaken promptly, efficiently and fairly.

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