

Law, Debt and Sustainability: Re-Thinking DSAs

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Issues Note

Background and premise

The sustainability of a country's public debt, an ever-relevant factor in sovereign debt, is faced with new-found questions. A looming debt crisis in emerging markets and developing countries—coupled with growing awareness of the impact of climate risk, human rights, and other economic, environmental, social, and governance factors on sovereign debt—calls for study on how debt sustainability is defined, analyzed, and acted upon.

A debt sustainability analysis (DSA) conducted by the International Monetary Fund (IMF) assesses how a country's current level of debt and prospective borrowing (based on indicative thresholds, projections and tests) affect its present and future ability to meet debt service obligations. The framework consists of two complementary components: analysis of the sustainability of total public debt and the total external debt. A country's public debt is considered sustainable if the government is able to meet all its current and future payment obligations without exceptional financial assistance or going into default. Notably, debt sustainability is confined to financial and macroeconomic sustainability.

There is a lack of clarity, certainty, predictability, and precision regarding the definition and the effects of economic, environmental, social, and governance (EESG) factors on the sustainability of sovereign debt. Incorporating these factors into DSAs would improve assessment of financial and macroeconomic sustainability as well as account for broader definitions of sustainability applicable to sovereign debt. To advance this proposition, this issues note makes three observations. First, the global financial system is increasingly addressing EESG risks and objectives, and the various standards and rules are applicable to sovereign debt. Second, a growing number of norms and standards are relevant to the conduct of various sovereign debt market participants and stakeholders. These legal considerations should be incorporated into DSAs. Third, law is a tool for defining and allocating the rights and obligations of sovereigns and other market participants, designing or revamping institutions, mandates and procedures that govern debt restructurings, and articulating fair and legitimate outcomes.

To advance the understanding of sustainability in sovereign debt and improve DSAs, this issues note addresses the observations as follows:

1. What is the meaning of sustainability in the global financial system?
2. What is the law applicable to the sustainability of sovereign debt?
3. Who should decide when a country's debt is (un)sustainable and what actions can be taken?

What is the meaning of sustainability in the global financial system?

Sustainability is a very broad and evolving concept that implicates important governance and ethical issues. The term sustainability encompasses economic factors as well as environmental factors (e.g., climate change, pollution, renewable energy, biodiversity), social factors (e.g., financial inclusion, socio-economic inequality, labor rights, economic, social, and cultural rights), and governance factors (e.g., transparency and accountability, rights of association, diversity and non-discrimination, management practices and decision making procedures). The [Sustainable Development Goals](#), adopted by the United Nations in 2015, include 17 goals that collectively work toward [“sustainable development that meets the needs of the present, without compromising the ability of future generations to meet their own needs.”](#)

COP26 and the UN Intergovernmental Panel on Climate Change (IPCC) highlight the urgent need for green investment and solutions. Climate risk and other EESG factors have spurred growing attention among regulators and market participants, leading to a proliferation of taxonomies, metrics, data providers, credit ratings, and accounting and disclosure standards from government regulators, intermediaries, industry associations, and civil society organizations. (See Appendix, Section 1.) This fragmented, rapidly evolving universe of governance and regulation is hindered by a lack of comparability and accountability.

What is the law applicable to the sustainability of sovereign debt?

IMF member states are required, pursuant to Article IV of the [Articles of Agreement](#), to endeavor to direct their economic policies towards promoting stability in their own economic and financial situations and in international financial and monetary arrangements.

There is relatively little international law that deals explicitly with debt sustainability. There are a range of hard and soft international legal instruments that are relevant to assessing the debt sustainability of a state. There are treaties that are applicable to the environmental and social aspects of debt sustainability. The treaties include the international human rights conventions and the Paris Climate Accord. In addition, there may be treaties between specific states or groups of states that include provisions dealing with social and environmental issues relevant to debt sustainability.

The soft international law standards that are relevant to debt sustainability range from those that deal explicitly with sovereign debt to those that deal with a broader range of environmental and social issues that are relevant to debt sustainability. These instruments tend to focus on the importance of due diligence and impact assessments in the planning and structuring of transactions. Such assessments would be relevant to assessing the sustainability of the debts of both individual institutions and, in aggregate, the national economy. In addition, there are principles that focus on the financial sector more generally that are relevant to debt sustainability. Finally, there are soft international law instruments that are applicable to the corporate sector more generally. These

instruments are relevant because they apply to all corporations including financial institutions. (See Appendix, Section 2.)

Who should decide when a country's debt is (un)sustainable and what actions can be taken?

The legal procedures and institutional design characteristics governing DSAs are important in several interrelated ways. First, process establishes *ex ante* expectations by sovereigns and other market participants. Second, the identity, roles and responsibilities, and authority of decisionmakers—including any constraints, flexibility, or exceptions thereto—affect the results of DSAs. Third, a process that is perceived to be fair and legitimate is likely to enhance the efficiency and durability of a debt restructuring.

DSAs are carried out by IMF staff with general oversight by the IMF's Executive Board. The IMF provides guidance to its staff on [how they should conduct DSAs](#) through frameworks for low-income countries and market-access countries. DSAs to low-income countries are governed by a [joint framework](#) with the World Bank. DSAs form part of the IMF's analysis in the context of [country surveillance and Article IV consultations](#) with individual member countries and provide critical input in decisions concerning balance of payments assistance.

To facilitate DSAs that incorporate broader definitions of sustainability, a range of institutional design considerations and reform options to this process may be considered. First, there is the question who is involved in DSAs, which may be expanded to include, *inter alia* (1) other development agencies (e.g., regional multilateral banks, UNEP and UNDP), (2) independent experts, (3) ad hoc expert panels (drawn from civil society, borrowing member governments, and creditors, among other parties), or (4) the creation of a standing sovereign debt workout mechanism or institution. Second, there is the question of the procedural rights enjoyed by entities other than the IMF (or the World Bank) in the DSA process, which may include (1) the right of such entities to initiate a DSA, (2) the right of a sovereign borrower country to conduct its debt sustainability analysis and dispute or amend the IMF's DSA, or (3) the right of civil society representatives in the borrowing country (such as commercial creditors, labor unions, and pension funds) or externally to participate in the DSA. Third, there is the question of the actions that may be undertaken to account for EESG factors. These actions may include (1) the extent to which the IMF's lending approach, debt limits, and conditionality incorporate these factors, (2) the extent to which the time horizon for EESG risks, such as climate change, are incorporated into the aforementioned considerations, or (3) the obligations of official and external private creditors to engage with the sovereign borrower consistent with a DSA that accounts for EESG factors. Finally, there is the question whether the IMF (or the sovereign borrower government or any other entity responsible for carrying out or implementing a DSA) should be held accountable for the way in which it implements the DSA and for any adverse impacts that may follow.

Appendix

1. Standards and rules

- The FSB has established the [Task Force for Climate-related Financial Disclosures \(TCFD\)](#) to provide guidance to market participants on disclosure of information on financial implications of climate-related physical, risks, and liability risks.
- [Central banks](#) are working on incorporating climate change to their mandates and functions. The [Network for the Greening of the Financial System \(NGFS\)](#) is a network of central banks and financial supervisors.
- The European Union’s [sustainable finance strategy](#) includes the [EU Taxonomy](#) (a classification system for sustainable economic activities) the [Sustainable Finance Disclosure Regulation \(SFDR\)](#) (for financial firms), and the proposed [Corporate Sustainability Reporting Directive \(CSRD\)](#) (amending and expanding the Non-Financial Reporting Directive (NFRD)). The European Commission defines sustainable finance as “[the process of taking account of environmental, social, and governance \(ESG\) considerations when making investment decisions in the financial sector, leading to increased longer-term investments into sustainable economic activities and projects](#)”. In addition, the European Commission has proposed a [Directive on corporate sustainability due diligence](#) on companies and directors.
- In the United States, the Securities and Exchange Commission (SEC) has [proposed rules](#) requiring disclosure of climate-related risks and metrics by reporting companies.
- The [International Sustainability Standards Board \(ISSB\)](#) was established at COP26 to develop a unified set of standards for sustainability disclosures in the capital markets. It is [supported by the International Organization of Securities Commissions \(IOSCO\)](#) and intended to work in close coordination with the International Accounting Standards Board. Its [proposed standards](#) build on the work of the Climate Disclosure Standards Board, the International Accounting Standards Board, the Value Reporting Foundation (which houses Integrated Reporting and SASB Standards), the TCFD and the World Economic Forum.

2. International soft law

- Sovereign debt sustainability principles include the [UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing](#) and the [IIF Principles on Stable Capital Flows and Fair Debt Restructuring](#)
- Broader financial regulatory standards that address sustainability include the [Principles on Responsible Investing](#) and the [Basel III: International Financial Regulatory Standards for Banks](#).
- Soft international law instruments broadly applicable to the companies (including financial institutions) include the [UN Guiding Principles on Business and Human Rights](#) and the [OECD Guidelines for Multinational Enterprises](#).