

How Law Can Contribute to a More Holistic Assessment of Debt Sustainability

Daniel D. Bradlow¹, Rosa M. Lastra², Stephen Kim Park³

¹ Centre for the Advancement of Scholarship, University of Pretoria, Pretoria, South Africa

² Centre for Commercial Law Studies, Queen Mary University of London, London, UK

³ University of Connecticut, Storrs, USA

*Correspondence to Daniel D. Bradlow. Email: danny.bradlow@up.ac.za

Abstract

The IMF has acknowledged that climate change and other environmental and social factors issues should be incorporated into its analytical work and the surveillance, financial, and advisory services that it provides member countries. However, the IMF's current approach to these issues hinders its ability to accurately and equitably assess the nature, diversity, scope, and magnitude of these issues. In this article, we argue that the IMF can draw on existing international and transnational law to develop operational policies and procedures that more effectively address financial, economic, environmental, and social (FEES) factors.

Keywords: International monetary fund; Sustainable finance; Financial, Economic, Environmental, and Social (FEES) factors

The International Monetary Fund (IMF) Managing Director and its former General Counsel have said that in order to continue complying with its mandate the IMF needs to evolve. They acknowledge that the IMF must incorporate the 'macro-critical' aspects of such 'new' issues as 'climate change, gender, inequality, governance, anti-corruption, and social protection' into its operations (Georgieva and Weeks-Brown 2023). While it is encouraging that the IMF recognizes the need to pay more attention to environmental and social issues in addition to its traditional focus on financial and economic issues, it is doing so in ways that are often opaque, vague and difficult for many of its stakeholders to understand.

In fact, in June 2024, the Independent Evaluation Office (IEO) of the IMF issued a report assessing the IMF's evolving application of its mandate (IEO 2024). It concluded that there were problems with the IMF's approach to these 'new' issues. According to the IEO report, the Fund's decision-making process was ad hoc and lacked a longer-term strategic anchor. In addition, its approach to assessing the policies, resource needs and the risks associated with these new issues was being developed and implemented in a piecemeal manner. The report also raised concerns about the transparency of the IMF's decision-making process and about how inclusive it was of all relevant stakeholders.

In this article, we offer some suggestions on how the IMF can address these shortcomings. We propose that the IMF draw on various hard and soft sources of international and transnational law to develop FEES (finance, economics, environmental and social factors)-based operational policies and practices that are more consistent and predictable than its current approach and

ensure that the IMF is accountable for the way in which it engages with environmental and social issues.

To make this case, this article is divided into four sections. The first section describes how the IMF has expanded its operations and the implications that arise therefrom for the transparency and predictability of IMF operations. The second section focuses on the hard and soft international standards that the IMF should utilize in developing its policies. The third section discusses the importance of accountability to the IMF in regard to these new areas of focus and proposes an independent accountability mechanism for the IMF. The fourth section provides concluding observations.

Dealing with the Environmental and Social Factors in FEES

In recent scholarship on the sustainability of sovereign debt (Bradlow et al. 2024), we argued that despite the lack of formal legal authority over the transactions between sovereigns and their creditors, the IMF plays a significant and unique role as a catalyst, advisor, and monitor in sovereign debt management and restructuring and that its debt sustainability assessments (DSAs) are integral to this role. And, notwithstanding their shortcomings, DSAs provide a framework, known *ex ante* by creditors and debtors, that primarily utilizes financial and economic (FE) factors in developing its DSA of the debtor country. In our aforementioned work, we suggested ways in which the environmental and social (ES) factors could be incorporated into FEES-based DSAs in a more coherent and transparent way.

The IMF acknowledges that it has the authority to interpret its existing legal mandate in a way that allows—indeed requires—the Fund to incorporate the ‘macro-critical’ aspects of issues such as climate change, gender, inequality, governance, anti-corruption, and social protection into the Fund’s operations (Georgieva and Weeks-Brown 2023). While we agree that dealing with the ES in FEES does not require the Fund to exceed or alter its mandate, we contend that it does require the Fund to adjust its functions in a way that is more predictable and understandable.

ES issues do not affect the macro-economy in the same way as FE issues like balance of payment and budget deficits, interest rates and exchange rates. The latter impact the whole society and economy, albeit affecting different parts in different ways. ES issues impact specific geographic areas and economic sectors but with sufficient force to be macro-critical either in the short or medium term. Understanding these impacts and responses to them requires consultations with a broader range of actors than is usual for the IMF because the information cannot be gained only from government interlocutors. Thus, they require the IMF:

- to engage in wider and deeper interactions with the residents of its member states;
- to make judgements about the scope (in terms of space and time) of the specific financing, surveillance and advisory services they offer each individual member state; and
- to make judgements about which aspects of the FEES issues that it is seeking to address in the specific financing, surveillance and advisory service it is offering to an individual member country are macro-critical and about their likely impacts on macro-economic and financial stability.

The complexity and novelty of these ES issues for the IMF and their interaction with FE issues suggests that the risk of mistakes is extremely high and that they raise potentially systemic risk

considerations. Unless the IMF has transparent and easily understood operational policies and procedures to guide staff in assessing these ES issues and in exercising discretion, IMF staff will be called upon to make their own judgements, which may appear opaque and unpredictable, and even arbitrary, to external stakeholders.

It is relatively easy for the IMF to correct this situation. For example, it can use existing international ES norms, standards and codes and can engage in fruitful dialogue with climate experts and scientists to develop its own set of ES operational policies and procedures. These norms, standards codes and consultations with experts, for example, can help make the IMF's surveillance of ES factors more predictable and transparent. It can also make the IMF's Climate Macro-Economic Assessment Program (CMAP),¹ a diagnostic assessment of the macro-fiscal impacts of climate change on a country, more transparent and understandable to all stakeholders. These assessments can then be incorporated into other IMF assessments such as the Financial Sector Assessment Program (FSAP) and the associated Reports on the Observance of Standards and Codes (ROSCs). ROSCs summarize the extent to which countries observe certain internationally recognized standards and codes and constitute benchmarks for the IMF and World Bank when they assess a country's financial stability and its vulnerabilities and crisis prevention protocols in the context of its FSAP, which is conducted every five years. The objective of the ROSCs is to encourage IMF members to adopt global best practices relating to the resilience and soundness of their financial systems.²

The IMF is already making modifications to its FSAP protocols. We are encouraged that these modifications include an effort to incorporate ES factors (with an emphasis on the E) into FSAPs. For example, in the recent FSAP for the Netherlands in June 2024, there is a technical note assessing the supervision and disclosure of climate-related risks,³ which builds on the principles for the effective management and supervision of climate-related financial risks issued by the Basel Committee on Banking Supervision in 2022.⁴ In the summary of this technical note, it is noted:

The Netherlands is exposed to both physical and transition risks from climate change. Due to unique geographic factors, about 60 percent of the land surface in the Netherlands is vulnerable to flooding from the sea and the large rivers, with nearly 26 percent of the land surface below sea level. Also, the Netherlands has high levels of nitrogen depositions from agriculture and transportation, exceeding the critical value set by EU Directives.

This note and similar ones prepared in other recent FSAPs (for example, for Sweden in 2023)⁵ can be seen as IMF pilot exercises in the area of climate change and risks to nature. It is important to note that these FSAPs were concluded before the publication in April 2024 of the revised Basel Core Principles for Effective Banking Supervision.⁶ The revised Basel Core Principles include, for the first time, climate-related risks as a driver of material risks that banks are required to identify, measure, evaluate, monitor, report, and control or mitigate. In addition, the revised version of the Core Principles refers to the need for bank supervisors to pay attention to emerging risks, which should pave the way for similar treatment of nature-related risks beyond climate, which is already standard practice in the European Central Bank's (ECB) banking supervision (Elderson 2024a).⁷

The IMF needs to expand these efforts to include a rigorous and principle based assessment of the risk and uncertainty associated with ES factors and to integrate this information into the combined assessment of all relevant FEES factors in all the functions of the IMF: the

surveillance function (also for the regular Article IV consultations in addition to the quinquennial FSAPs), the advisory function (technical assistance) and the lending function (programmes of conditional financial assistance) (Lastra 2015: chap. 13). This also means that the IMF will need to rethink conditionality in light of a comprehensive and integrated FEES-based approach.

For this to happen, the IMF needs to develop formal operational policies and procedures. These should be based on the relevant science. As the most senior ECB official working on ES issues, Frank Elderson, noted in June 2024:

[T]he exact mechanisms of mapping actual hazards to risks need to be analysed further to fully capture climate and nature-related factors in quantifiable regulatory and supervisory requirements (Elderson 2024b).

An analogous exercise will be required for social factors. In addition, the IMF's guidelines, policies, and procedures should be consistent with applicable international law and standards, as we explore in the next section.

Using Legal Rules and Standards to Enhance Transparency and Predictability

How can the IMF address ES issues in a manner consistent with its legal mandate and commensurate with the scope of the challenges that its members face? To address the shortcomings and limitations of its current approach, the IMF can draw on existing international and transnational legal instruments. It can use these instruments to inform its review and revision of operational policies and procedures in accordance with a FEES-based approach.

These legal instruments range from environmental and human rights treaties, international soft law norms and standards, and national and supranational financial regulation. They include, for example, international treaties such as the UN Framework Convention on Climate Change,⁸ the UN Convention on Economic, Social and Cultural Rights,⁹ and soft law instruments such as the Principles on Responsible Investing,¹⁰ the UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing,¹¹ and standards developed by the Network on Greening the Financial System (NGFS).¹²

None of these instruments are legally binding on the IMF, even though it is a creature of international law established by its member countries. However, despite its unique role in the international financial system, the IMF should not ignore the sources of legal innovation that have emerged to enable countries, companies, and communities to identify and respond to ES issues. By referencing and incorporating existing norms, standards and laws in the global financial system, the IMF can more effectively undertake FEES-based surveillance, lending and advisory services. Moreover, in doing so, the IMF is more likely to implement reforms that will be widely accepted by the public, as well as being principled in practice.

Legal instruments can enhance the IMF's treatment of ES issues in various ways. First, it will help improve financial decision-making. Standards and rules prescribing the disclosure of ES issues enable investors and other financial market participants to better ascertain the risks to which a given company, asset or fund may be exposed.¹³

Second, disclosure as a governance and regulatory strategy is not confined to identifying ES risks. ES disclosure can also make known to external parties how such risks are assessed and addressed. The collection, analysis, and dissemination of ES risks may have a catalytic effect on the ability to address them. That is, a company or a government that discloses ES-relevant information gains deeper understanding of its operations through the internal process of disclosure as well as its interactions with users of this information (e.g., investors) (Hess 2019: 5).

Third, the scope of ES disclosure should extend beyond financial market participants to include impacted communities and other stakeholders. The concept of impact materiality and its embrace by the European Union (EU) in the form of double materiality takes into account ES information that is relevant to the well-being of parties that do not have a financial stake in a company. The question about the users *qua* beneficiaries of ES information underscores an important inquiry that the IMF should undertake in the context of FEES issues: who are the constituencies that the Fund's operations should consider in assessing the impact of its surveillance, lending and advisory services? In this respect, international human rights and environmental treaties can help the IMF devise policies and procedures that reflect states' obligations to their citizens.

Fourth, related to, but distinct from, enhancing transparency is ensuring the veracity and accuracy of ES information and the means by which countries and companies address them. In the financial sector, regulation of ratings providers and other informational intermediaries serves this purpose as well as requirements on auditing, certification and other external assessments.

For the IMF, there is the opportunity to consider standards-based global governance frameworks, such as those issued by the Task Force on Climate-Related Financial Disclosures (TCFD) and the International Sustainability Standards Board (ISSB), as well as domestic regulatory frameworks, such as those developed by the EU and other capital market regulators. These standards and regulations can provide guidance on measuring, classifying and verifying ES issues that are accessible and consistent across countries facing different FEES challenges.

Finally, another objective of international and national legal instruments is to bolster procedural legitimacy. One component is reason-giving, which requires that decisions made by governments or companies affecting the welfare of individuals and communities be accompanied by explanations and justifications. Another component is participation, which requires that stakeholders be consulted and given the opportunity to provide input during the decision-making process (United Nations 2011). Laws mandating that companies conduct environmental and human rights due diligence, such as the EU's Corporate Sustainability Due Diligence Directive (CSDDD), can provide a template to the IMF on conducting stakeholder consultations.

Enhancing IMF Accountability

The IMF faces a formidable challenge in both identifying the macro-critical dimensions of ES issues and their macro-economic impacts. Unlike the case with the FE issues on which the IMF has traditionally focused, not all aspects of ES issues are macro-critical. Moreover, the macro-economic implications of these new issues can take longer to fully manifest themselves and they can affect different regions and economic sectors in a member country differently. As a result of these spatial and temporal differences, the actual macro-economic impacts of these

factors can be influenced by the environmental and social impacts of the relevant policies and/or by the responses of the directly affected individuals, households, businesses and communities to these policies and their impacts. For example, the actual macro-economic impact of a policy designed to promote a national shift from a coal-based energy network to one based on renewable energy will depend on how the local businesses, communities and households that depend on the coal-based energy sector will respond to the shift away from a coal-based energy sector as much as on how effectively the policy encourages the shift to renewable energy. The government itself is unlikely to have all this information. The IMF, therefore, will only be able to fully understand the macro-economic impacts of the government's policy initiative if they consult these local businesses, communities and households and these actors have sufficient confidence in the IMF that they are willing to share with it their planned responses to the policy changes.

The IMF can only hope to gain this level of confidence if its operations comply with certain criteria. The first is that it must have operational policies and procedures that are clear, understandable and consistently applied. Such policies will inform the conduct of IMF staff and management in regard to these issues. They will also help all external IMF stakeholders understand why the IMF is engaging in particular activities relating to its surveillance, financing, and capacity-building operations and how it plans to achieve its objectives for these activities. These policies will also help external stakeholders understand when and how they can engage with IMF operations.

It is important to note, in this regard, that the IMF undertakes these FEES-based activities in complex and dynamic situations whose precise characteristics vary depending on the conditions in each member country. Thus, the IMF will be taking decisions and designing operations with imperfect knowledge about the context in which they are operating and how it is likely to evolve over time. The risk that IMF staff make mistakes in these operations is therefore high, regardless of how skilled, committed and knowledgeable the staff are. This risk is further exacerbated by the fact that global knowledge about how to integrate all FEES factors into one coherent macro-economic approach is still limited and very much a work-in-progress.

The second criterion is that the IMF should create a mechanism that allows it to receive information on the impact of its operations from the individuals, households, businesses and communities that are most directly affected by its new operations. This is necessary for two reasons. First, the IMF does not have any formal mechanism through which these non-state actors can convey information to the IMF. Thus, the IMF runs the risk that its operations will have unintended and adverse impacts on these groups and that it will have no mechanism to learn about these adverse impacts in time to mitigate them.

Second, the mechanism will fill a gap in the IMF's current accountability regime. The IMF currently can be held accountable for its actions by its member states, through its boards of executive directors and governors. The IEO offers it a technocratic way to learn about the strengths and weaknesses in its operations after they are completed. However, it has no formal mechanism that allows non-state actors—communities, households, civil society, business—to communicate to the IMF in real time about how they are being affected by the IMF's actions. This means that the IMF is deprived of learning lessons that will enable it to either mitigate the risk of its operations causing unintended and adverse impacts or reduce the risk that it will repeat the same mistakes in other operations.

The only mechanism that can meet both these accountability objectives is an independent accountability mechanism. This would ensure that the IMF is complying with best practice in multilateral financial institution governance. Currently, it is the only such institution that does not have an independent accountability mechanism whose activities are initiated by complaints from adversely affected communities or individuals.

Given that the IMF, unlike the multilateral development banks, is not a project lender, the form and mandate of an IMF mechanism will necessarily be different. The most appropriate mechanism for the IMF is for the IMF's Executive Board to appoint an external ombudsman that is independent of IMF management and that reports directly to the IMF's Executive Board (Bradlow 2005; 2021).

Such an official should have the authority to receive and investigate complaints from external stakeholders who claim they have been harmed by the failure of IMF staff and management to comply with the IMF's own operational policies and procedures. After completing the investigation, the ombudsman should submit to the Executive Board a publicly available report documenting its findings. The ombudsman should also issue an annual report that includes, when appropriate, discussion of the lessons it has learned about IMF operations from its investigations.

It should be stressed that the ombudsman's remit would be to investigate the conduct of the IMF and its compliance with its own policies and procedures. It would not have any authority to investigate or comment on its member states' policies or actions.

An ombudsman offers the IMF three benefits. The first is an immediate uplift to its reputation. No one can expect an institution engaged in the complex operations normally undertaken by the IMF to have a perfect performance record. However, all institutions that have the power and authority to directly affect the lives of communities and individuals ought to be accountable to any communities or individuals that may be or have actually been harmed by their decisions. This is particularly important for an organization such as the IMF, which is effectively immune from being sued in any court in the world.

Second, it would help correct a serious blind spot in IMF operations: the lack of any formal mechanism for receiving or investigating complaints from affected communities and other non-state actors. As it stands, the IMF often makes lending decisions without the full knowledge of how its policies and practices impact households, communities and small businesses in these communities.

Lastly, an ombudsman would offer the IMF an opportunity to better learn from its mistakes. It would be the only IMF unit whose activities are initiated by outside stakeholders, uncovering new insights about how the lender's policies and operations are impacting countries and individuals. Its findings would then, one hopes, help the IMF improve its operations.

Conclusion

The IMF's surveillance, lending and advisory services can provide important support to its members as they grapple with the myriads of challenges posed by climate change and other environmental and social risks (Ahmad 2024). In this article, we propose that ES issues should be addressed in an integrated manner with the financial and economic factors that are indisputably central to the Fund's mandate. An integrated FEES-based approach is the only

way that the Fund can deploy its resources to respond to the threats to the international financial system. Procedural reforms to the IMF's operations, informed and guided by long-established and emerging international and transnational legal instruments, will equip the IMF to address the demands of its member states, identify the responsibilities of different actors, and bolster the fairness and legitimacy of the IMF's work.

Notes

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2. International Monetary Fund, Reports on the Observance of Standards and Codes (ROSCs), <https://www.imf.org/en/Publications/rosc>. The IMF has recognized so far 12 areas and associated standards as useful for the operational work of the Fund and the World Bank. These comprise: (1) accounting; (2) auditing; (3) anti-money laundering and countering the financing of terrorism (AML/CFT); (4) banking supervision; (5) corporate governance; (6) data dissemination; (7) fiscal transparency; (8) insolvency and creditor rights; (9) insurance supervision; (10) monetary and financial policy transparency; (11) payments systems; and (12) securities regulation.
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13. See, for example, the standards developed the International Sustainability Standards Board (ISSB). The EU has also been active in developing a taxonomy of sustainable activities and related legal instruments.

Conflict of interest

This article is free from any conflicts of interest, including all financial and non-financial interests and relationships.

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