RESPONSIBLE FINANCING OR UNWARRANTED INTERVENTIONS:

FIDUCIARY OBLIGATIONS IN LOAN AND AID CONTRACTS BETWEEN DONORS, CLIENT STATES AND CITIZENS

Briefing Paper by Celine Tan

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About the Author:
Celine Tan is a doctoral candidate at the School of Law, University of Warwick where she held a postgraduate research fellowship from September 2002 to September 2005 and where she is currently lecturing part-time. Her thesis focuses on analysing the Poverty Reduction Strategy Paper (PRSP) framework as part of a larger shift in the regulatory framework of global economic governance and international law and her wider research interests include examining the nature, discourse and policy impact of the current architecture of international development financing and the interaction between development, trade, international finance and global governance. Prior to Warwick, Celine worked with the Third World Network in Penang, Kuala Lumpur and Geneva and with the Bretton Woods Project in London.

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About EURODAD:
The European Network on Debt and Development (Eurodad) is a network of 48 development non-governmental organisations from 15 European countries working for national economic and international financing policies that achieve poverty eradication and the empowerment of the poor.

About the process:
As part of its ongoing work on debt and aid, particularly in relation to debates around good governance and conditionality, Eurodad has begun to explore in greater depth issues of responsible financing and alternatives to conditionality. This work involves carrying out analysis, facilitating debates and consensus amongst members and building bridges with civil society groups working on development financing from different perspectives (e.g. those focusing primarily on transparency or on rights and standards).

Other papers that also contribute to this process include:

1) Eurodad, (2006), Overview of civil society positions on responsible financing standards, Discussion paper
2) Eurodad, (2006), Concept paper on responsible financing standards, Forthcoming for discussion

1 If you are interested in any of these papers, please email aidwatch@eurodad.org
Summary

This briefing aims to clarify the notion of fiduciary responsibility in development financing and unpack the complex box of fiduciary conditions associated with development loans, grant aid and debt relief agreements. Towards this end, this briefing draws on data from a review of existing academic and institutional literature on the subject as well as an examination of the operational policies of main financing institutions, with specific reference to the financing instruments of the World Bank and the International Monetary Fund (IMF). This briefing aims to serve as a background paper for discussions on the issues of fiduciary conditions in international sovereign lending from public institutions and forwards some issues to consider in and proposals for the design of fiduciary conditions in such financing agreements.

The issue of fiduciary responsibility in development financing has been gaining importance in the discourses on aid and development lending of late. The recent international focus on increases in official development aid (ODA) for poverty reduction and humanitarian crises and debt relief for developing countries have resulted in greater attention being paid to the issues such as transparency, accountability and legitimacy in the processes of aid allocation and in the contracting of development loans.

For donors or financiers, the concerns are that resources disbursed without due safeguards may be spent unwisely or illegitimately by the recipient government or individuals within the government. For citizens in countries contracting loans, the concerns are that loans contracted without due process and due diligence will saddle countries with an illegitimate and unproductive debt burden which has to be borne regardless of their lack of benefit to the general population. Meanwhile, grant aid and debt relief resources spent unwisely may also lead to a halting of aid flows for such countries, limiting future access to external resources for development.

Changes in the modalities of delivering development financing have also contributed to the call for greater scrutiny of the way in which resources from aid, development loans and debt relief are spent in client countries. In particular, the shift away from project-based loans and traditional adjustment loans to budget support mechanisms necessitates the implementation of different measures to ensure resources disbursed are accounted for and used for productive purposes and/or poverty reduction.

At the same time, these calls, particularly those from civil society, have been tempered by concerns that operationalising greater fiduciary conditions in loan or aid agreements will proliferate conditionality and create further onerous obligations on countries with little resources to implement them. There are also concerns that these conditions, used injudiciously and indiscriminately, may go beyond the constitutional mandate of the financing institution. This may lead to the erosion of policy autonomy and impinge upon the sovereignty of countries by imposing prescriptive interventions into domestic policy processes and which impact on the constitutional framework of the countries concerned.

This briefing examines the relationship between the fiduciary obligations of donors and financiers and the fiduciary conditions attached to development financing. A distinction is made between fiduciary obligations – obligations owed by financiers to the resources held on trust on behalf of shareholders or taxpayers – and fiduciary conditions – conditions designed to meet such fiduciary obligations in financing contracts. The briefing concentrates on the latter category, exploring the validity and/or viability of
imposing fiduciary or fiduciary-type conditions on client governments given the considerations outlined above.

The first section of this briefing considers the notion of fiduciary obligations in sovereign lending and focuses in detail on the fiduciary obligations of the World Bank and the IMF, examining both broad and narrow interpretations of these fiduciary obligations. The section thus classifies the Bank and Fund’s fiduciary obligations into a) fiduciary obligations relating to constitutional mandates – fiduciary duties to ensure that resources disbursed by the institutions conform with the purposes for which the institutions were established (broad interpretation); and b) fiduciary obligations relating to financial matters – fiduciary duties relating to the use of funds once they are disbursed and to ensure that the borrower has the capacity to repay the institutions (narrow interpretation).

The following section examines how these obligations are translated into terms and conditions of lending. The section details the content of fiduciary and fiduciary-type conditions found in Bank and Fund financing operations, notably through the conditionalities of programmatic or policy-based financing. Here, a cross-section of terms and conditions of financing are examined to discern how and if any or all of them serve to meet the fiduciary obligations of the Bretton Woods institutions.

It is suggested that when considering the content of fiduciary conditions in Bank and Fund lending, it is necessary to distinguish between two types of programme conditions: a) conditionalities with a fiduciary component but which serve a larger (and some would say) ideological purpose; and b) fiduciary conditions which are more technical in nature and which relate to aspects of domestic governance insofar as they serve to fulfil the financiers’ fiduciary responsibility to the benefactors and beneficiaries of the financial resources they hold on trust for. This is a crucial distinction as fiduciary responsibility should not be utilised as a covert means of introducing substantive conditionalities into financing agreements between the Bank and Fund (and other donors) and client governments.

The final section of this briefing outlines proposals for developing fiduciary mechanisms in development financing. The section highlights some issues to consider in the design of, and when campaigning for, responsible lending standards and fiduciary conditions, including the tension between state sovereignty and conditionality and considerations of institutional ‘mission creep’ in attempts to implement such standards through the leverage of Bank and Fund financing. The briefing concludes with a set of recommended policy proposals which may be utilised to develop a coherent set of guidelines for fiduciary oversight of resources disbursed for development financing. This includes mechanisms at the international and national levels which will hold financiers and donors as well as client governments accountable for financing disbursed for the benefit for persons and communities in countries in receipt of such financing.
Section 1: Definition of Fiduciary Obligations

1.1. Fiduciary Obligations in Sovereign Lending

A fiduciary relationship is established when one party is in a position of trust, power or responsibility over the rights, interests or property of another. Domestic law has strict rules governing the manner in which a person can create legal obligations for another. In an international setting, such provisions can also apply where governments create legally binding obligations on behalf of the state which includes its population (Khalfan et al, 2003: 4).

A fiduciary relationship in a sovereign loan agreement can therefore be established in two contexts:

a) between the financing agency or institution and the source of the financing that is to be loaned, for example, between the World Bank or the International Monetary Fund (IMF) and their shareholder governments for whom they hold money on trust, or between a donor government (through a bilateral aid agency such as the UK’s DFID) and its taxpayers;

b) between the client state in receipt of development financing and its citizens under whose authority it contracts the loan (see Figure 1 below).

Under domestic law, a third party can also be held liable for assisting in the breach of a fiduciary obligation by an agent to its principal (Khalfan et al, 2003: 4). Translated into an international setting, this could mean that donors and financiers have a corresponding duty to the citizens of countries to which development financing is disbursed to ensure that the fiduciary duties of the client state to its citizens are not breached. This applies to both loan and grant financing and applies to both policies advocated and implemented by the donors and financiers as well as by client governments.

Fiduciary obligations met through legal provisions built into standard loan agreements and negotiations for sovereign loans similar to those of domestic commercial contracts. These terms and conditions are aimed at ensuring that resources disbursed are utilised in an effective and responsible manner in accordance to the purpose for which the loans are issued and that the borrower has the capacity and commitment to repay the loans in the timeframe allocated. Financiers also exercise fiduciary oversight during negotiations for financing, notably through the conduct of various financial and institutional assessments of the finance.

It is important here to note the difference between fiduciary obligations and fiduciary conditions.

**Fiduciary obligations** are owed by financing institutions, such as the World Bank or the IMF, to their shareholding member states or taxpayers of member states and by financier and client governments to their citizens and/or taxpayers, for public funds held on trust by these institutions and agencies for specific financing purposes. The trustee is obliged to both ensure that the funds are invested and disbursed in accordance to the mandate accorded to it by its trustors or benefactors.

**Fiduciary conditions** are conditions imposed by the trustee on the use of trust resources, either on itself or the beneficiaries of the financial resources disbursed to
ensure that its fiduciary obligations are met. In the context of the World Bank and the IMF, these conditions could include either: a) fiduciary conditions imposed on the use of Bank and Fund resources to ensure that the fiduciary obligations of the institutions to their member states are complied with; or b) fiduciary conditions imposed on the use of such resources to ensure that the fiduciary obligations of the member state to their citizens or taxpayers are complied with (or in fulfilling their third party fiduciary duties).

Sovereign loans are governed by principles of public and private international law and a legal agreement between a sovereign entity, such as a state or representative of a state, gives rise to contractual obligations which must be adhered to just like any domestic contractual arrangement. These liabilities do not change even if there is a change in the government of the day which means that the obligations in any loan contracted by one government is automatically assumed by the successor government under the same terms and conditions.
However, there is currently significant support in international legal policy circles for a development of a doctrine of odious debt, odious debts being defined as debts ‘contracted against the interest of the population of a state, without its consent and with the full awareness of the creditor’ (Khalfan et al, 2003: 2, emphasis added). The doctrine provides for sovereign debts to be made unenforceable against the generally accepted rule of repayment of debt if the predecessor government had contracted the loan under those terms.

The provision for creditor awareness under this doctrine gives further rise to fiduciary obligations on the part of financiers in sovereign debt contracts. If applied, standards of creditor awareness will impugn a) actual knowledge on the part of the creditor of the odiousness of the debt contracted; b) ‘wilfully shutting one’s eyes to the obvious’ and/or c) ‘wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make’ (Khalfan et al. 2003: 5). This means, the onus is on the lender to establish mechanisms to ensure that the loans contracted are not contracted against the interest of the population and without its consent.

Furthermore, fiduciary obligations on the part of the lender/donor may also arise in the context of general international law, including international obligations arising from customary international law and treaty law. This broader interpretation of fiduciary obligations encompasses the obligation of the lender or financier to adhere to fundamental principles of international law, such as to obligations under human rights treaties binding upon the lender (for example, the International Covenant on Civil and Political Rights (ICCPR), the European Convention on Human Rights (ECHR)), or multilateral environmental agreements (for example, the Convention on Biological Diversity) or other internationally recognised norms when entering into financing agreements. Compliance with such norms would entail not just establishing fiduciary oversight mechanisms in financing instruments, such as those to track resource expenditure, but also establishing means to making normative judgments on the nature of the borrowing or financed entity, notably the government.

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3 These principles are drawn from common law on unenforceability of contracts in which contracts contracted in the absence of due process and through misrepresentation or fraud may be set aside and obligations nullified (see Khalfan et al, 2003: 5; Kremer and Jayachandran, 2003).
1.2. Fiduciary Obligations of the World Bank and the International Monetary Fund

The World Bank and the IMF financing activities are governed by their Articles of Agreement and their fiduciary obligations arise from specific provisions within these constitutional charters. Additionally, the IMF is also governed by the terms of the Poverty Reduction and Growth Facility (PRGF) the PRGF – HIPC (Heavily Indebted Poor Countries Initiative) Trusts as well as the newly established Multilateral Debt Relief (MDRI) Trusts for which the IMF acts as trustee³.

This means that the World Bank and the IMF owe fiduciary duties vis-à-vis their member states. These fiduciary duties may be divided into two categories:

³ This means that the IMF acts to mobilise and manage resources for the trusts on behalf of the donors in accordance with the terms of the trusts. See Section VII (1)(a) of the Instrument to Establish the Poverty Reduction and Growth Facility Trust (IMF, 1999).

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Box 1: Fiduciary Terms and Conditions in Legal Agreements

Fiduciary conditions in loan agreements may be said to fall into a series of contractual terms known as ‘protective clauses’ which ‘are designed to protect the lender and restrict the borrower’s future actions in order to enhance the likelihood that the borrower will repay the loan according to the agreed schedule’ (Bradlow, 2000: 18). According to Bradlow, these clauses include:

a) **conditions precedent** – conditions which ensure that ‘the borrower has the legal capacity to enter into a binding contract’, that all procedures for a ‘legally valid, binding and enforceable’ contract have been fulfilled and that ‘the borrower has the financial capacity to perform its obligations’;

b) **representations and warranties** – these are ‘factual statements that the borrower has made to the lender about its legal and financial situation to satisfy it that the borrower is capable of entering into this transaction and the assurances that the borrower gives to the lender about its financial and legal capacity to enter into this loan transaction’; and

c) **covenants** – ‘commitments that the borrower is required to make that it will do certain things or refrain from doing certain things during the term of the loan agreement’. These covenants serve two purposes: 1) to impose restrictions on the borrower’s future action and limit them ‘to those which the lender expected the borrower to perform when it entered into this transaction’; and 2) to ensure that the lender obtains certain information on the borrower, its financial condition and its activities over the life of the loan agreement in order to enable the lender ‘to detect any deterioration in the likelihood of the borrower being able to perform its obligations’ (Bradlow, 2000: 18 -19).

These ‘protective clauses’ are distinguished from ‘operational clauses’ in loan agreements which are defined as ‘clauses designed to make the financial agreement operational’, including statements on the purpose and amount of the loan, the repayment schedule, interest rate payable on the loan, period of loan maturity, disbursement schedule, tax fees and charges, currency provisions, etc (Bradlow, 2000: 18).

World Bank and IMF financing arrangements all contain such clauses in varying guises (see discussion below).
a) Fiduciary obligations relating to constitutional mandates: These are fiduciary duties to ensure that resources disbursed by the institutions conform with the purposes for which the institutions were established or with the purposes for which specific trust funds managed by these institutions were established. For the World Bank, this means ensuring that ‘loans made or guaranteed by the Bank shall, except in exceptional circumstances, be for the purpose of specific projects of reconstruction or development’ (IBRD Articles of Agreement, Article III, Section 4 (viii), emphasis added).4

For the Fund, this means that ‘authority to use the resources of the Fund is limited to use in accordance with its purposes to give temporary assistance in financing balance of payments deficits on current account for monetary stabilization purposes’ (IMF, 2004a, see also IMF Articles of Agreement, Article V, Section 3(a), emphasis added). The IMF also has to comply with fiduciary duties to provide loans and/or grants to eligible members who qualify for assistance under the terms of the PRGF and PRGF-HIPC Trust Instruments ‘in order to support programs to strengthen substantially and in a sustainable manner their balance of payments position and to foster durable growth, leading to higher living standards and a reduction in poverty’ (IMF, 2004b: Section 1, para 1; IMF 2004c: Section 1, para 2).

b) Fiduciary obligations relating to financial matters: These are fiduciary duties relating to the use of funds once they are disbursed and to ensure that the borrower has the capacity to repay the institution. They can be known alternatively as conditions of ‘due diligence’ requirements. When making or guaranteeing a loan, the Bank therefore is compelled to ‘pay due regard to the prospects that the borrower … will be in position to meet its obligations under the loan; and the Bank shall act prudently in the interests both of the particular member in whose territories the project is located and of the members as a whole’ (IBRD Articles of Agreement, Article III, Section 4(v), emphasis added).5 Similarly, the IMF is obligated to ensure that funds available to members are made under ‘adequate safeguards’ and this applies to both use of general resources as well as financing from the PRGF and PRGF-HIPC Trusts (IMF Articles of Agreement, Section 1(v) and Article V, Section 3(a); see also IMF, 2004b, Section VII, para 1; IMF 2004c, Section IV, para 1, emphasis added).

In effect, a broad interpretation of the World Bank and IMF’s fiduciary obligations encompasses all aspects of their work and provide a rationale for the imposition of all its financing conditions, including the heavily contested ‘first generation’ economic conditionalities and ‘second generation’ political and governance programme conditionalities. The World Bank and the IMF both justify their economic and, to a large extent, their political and governance conditionalities on compliance with their fiduciary obligations under their founding charters, although interpretations of such compliance are subject to debate. The Bank, for example, states that when it ‘conditions the release of funds, it is carrying out its due diligence on development effectiveness and financial and fiduciary responsibilities’ (World Bank, 2005d: para 5).

4 A similar provision is found in the IDA Articles of Agreement which states that: ‘Financing provided by the Association shall be for purposes which in the opinion of the Association are of high developmental priority in the light of the needs of the area or areas concerned and, except in special circumstances, shall be for specific projects’ (IDA Articles of Agreement, Article V, Section 1(a), emphasis added).

5 Corresponding provisions in the IDA Articles of Agreement state that the IDA ‘shall make arrangements to ensure that the proceeds of any financing are used only for the purposes for which the financing was provided’ and that ‘[f]unds to be provided under any financing operation shall be made available to the recipient only to meet expenses in connection with the project as they are actually incurred’ (IDA Articles of Agreement, Article V, Section 1 (g)(h), emphasis added).
However, a narrower focus of the fiduciary responsibility of these institutions would centre primarily on the technical financial aspects of their financing operations, i.e., the ‘due diligence’ aspects. This means ensuring that resources disbursed for the purposes stated, whether or not these objectives or the manner in which the institutions aim to achieve such objectives are contested, are utilised in accordance with the purposes for which they were disbursed.

For the purposes of our discussion here therefore, we are not focusing on whether or not the Bank or Fund comply with their fiduciary obligations under their respective mandates – for example, whether the Bank’s development policy (formerly structural adjustment loans) – are made in pursuit of the purposes of reconstruction and development and/or whether these loans and the policies contained therein are appropriate instruments for achieving such purposes. Instead, we are concerned with how the Bank and Fund establish mechanisms – whether through conditionalities, technical assistance, country profiling and assessments, etc. – necessary to fulfil their fiduciary obligations to account for resources disbursed.

In standard World Bank and International Monetary Fund (IMF) programme loans, the fiduciary obligations of the institutions are met through clauses in:

a) pre-financing assessments, including World Bank Country Assistance Strategies (CAS) and Country Policy and Institutional Assessment (CPIA)s and IMF safeguards assessments of central banks;
b) loan or other financing agreements;
c) programme documents, including the World Bank’s Letters of Development Policy and accompanying Policy Matrices and the IMF’s Letters of Intent or Memoranda of Economic and Financial Policy (MEFP).

The following section will discuss the fiduciary content of these clauses in detail. In doing so, we should bear in mind, two further constitutional issues.

Firstly, whether, as raised in the discussion in the previous section, the fiduciary duties of the Bank and the Fund should be confined to meeting obligations under their Articles of Agreement and institutional regulations as well as standard contractual norms where applicable, or should these duties be extended to include adherence to wider international norms and standards, including human rights and environmental and social safeguards.

Secondly, we need to consider whether in doing so, the instruments through which the Bank and Fund utilise to meet their fiduciary obligations are in conflict with their constitutional mandates, notably the Bank’s constitutional prohibition against interference in domestic political affairs of member states under Article IV, Section 10 of the IBRD Articles of Agreement and under Article V, Section 6 of the IDA Articles of Agreement.

\(^6\) Article IV, Section 10 of the IBRD states that ‘The Bank and its officers shall not interfere in the political affairs of any member; nor shall they be influenced in their decisions by the political character of the member or members concerned. Only economic considerations shall be relevant to their decisions, and these considerations shall be weighed impartially in order to achieve the purposes stated in Article I’. A similar provision is found in Article V, Section 6 of the IDA Articles of Agreement.
Section II: Content of Fiduciary Conditions

2.1. Fiduciary Conditions under Policy-Based or Programme Financing

Making sense of the World Bank and IMF fiduciary conditions is difficult as there are no clear demarcations in Bank and Fund literature and official documents as to what aspects of their lending constitute fiduciary responsibility and there is some overlap between their fiduciary oversight arrangements and their work on governance and institutional reform. This is especially true of policy-based or programme financing which constitute one-third of all Bank lending (World Bank, 2001: para 5) and all of Fund lending where the content of the policy-based operation or economic programme that is financed may include instituting fiduciary governance mechanisms in the client countries. For example, the Fund considers the improvement in the domestic management of public resources and public sector reform (such as treasury, central bank, civil service reform and reform of administrative procedures of budget management and revenue collection), including work on anti-corruption policies, as constituting part of its governance work (IMF, 1997: paras 5 – 6; 8 – 9).

Furthermore, the Bank and Fund have justified their increasing focus on public expenditure and public financial management in pre-financing and programme conditionalities as constituting ‘not merely a technical challenge but also fundamentally a deeper governance challenge’ (World Bank and IMF, 2001: para 5). The institutions view public spending as ‘a powerful tool of governments’ which requires guarantees ‘to ensure that decision makers make sound commitments and implement them’ (ibid). Thus, the emphasis in recent years has been on facilitating greater transparency and accountability in resource allocation and expenditure.

It is important to note here that this conventional understanding of fiduciary conditions or requirements in Bank and Fund financing remains geared mostly towards meeting the Bank and Fund’s obligations to account for resources disbursed under a loan agreement rather than to ascertain whether the decision to undertake a loan on the part of the country authorities is legitimate. The Bank and Fund are largely unconcerned with questions of whether the purposes for which the loans were undertaken and the policies agreed to under such agreements have been legitimately decided domestically.

In other words, these fiduciary mechanisms are aimed at protecting the financial integrity and, to a limited extent, the constitutional mandates, of the Bank and Fund and not to ensure that the client governments meet their own fiduciary responsibilities to their own citizens and adhere to their own constitutional mandates. This view has shifted slightly with the advent of the Poverty Reduction Strategy Paper (PRSP) framework (discussed below) which has reflected the Bank and Fund’s growing recognition of its fiduciary obligations towards citizens of client countries, although much of this remains driven by the institutions’ efforts to meet fiduciary obligations to their shareholders and donor governments by making sure that resources from loans, grants or debt relief are effective in meeting the objectives of poverty reduction, development and/or macroeconomic stabilisation.

Policy-based financing fit uncomfortably with the traditional legal framework for project lending which establish clear parameters for monitoring expenditure patterns and compliance with other financing terms post-disbursement. Although the World Bank formally defines its fiduciary policies as those relating to ‘rules governing financial
management, procurement and disbursement’ (World Bank, 2005i), these refer mostly to project-based loans. In the context of project or investment lending, the Bank’s fiduciary obligations are met through ‘specific legal covenants that require the borrower to carry out a project … with due diligence and efficiency’ (World Bank, 2005f: para 31). When formulating conditions for an investment project, Bank staff are guided by internal Operational Policies (OPs) on Financial Management (OP 10.02, 1997), Procurement (OP 11.00) and Disbursement (OP 12.00).

This includes requiring the borrower (or recipient in the case of grant aid) to ‘maintain financial management systems – including accounting, financial reporting, and auditing systems’ which are sufficiently ‘adequate to ensure that they can provide the Bank accurate and timely information regarding project resources and expenditures’ (World Bank, 1997a: para 1). These expenditures, in turn, ‘must fall within the project and category descriptions in the legal agreement and must be incurred for goods, works, and services procured in accordance with the [Bank’s] Procurement Guidelines and Consultant Guidelines’ as well as being subject to a negative list of expenditures7 (World Bank, 1997b: para 2) and a list of prohibited expenditures under the Bank charter, such as military expenditures. Most of these conditions are found in the loan or grant agreement between the Bank and the client country.

With policy-based loans, it is difficult to ascertain and monitor expenditures from the funds disbursed under the financing arrangement. Where in an investment project, the terms and conditions in the legal agreement refers the ‘project’ and expenditures incurred therein, agreements for policy-based loans refer to the borrower’s programme of action as set out in the borrower’s Letter of Development Policy (LDP) and/or the accompanying Policy Matrix (see Box 2).

Consequently, a large portion of the Bank and Fund’s fiduciary obligations are met through programme conditionalities rather than through the conditions of lending in the financing agreement and are therefore not considered ‘contractually enforceable’ (see Box 1; World Bank, 2005f: para 38). The Bank views such conditionalities as the ‘corresponding mechanism’ to the legal covenants for project loans discussed above: ‘Conditionality serves the role of a useful navigational aid to keep the borrower’s development program on course to ensure its productive outcomes and objectives are achieved’ (World Bank, 2005f: para 31).

Similarly, in the context of the Fund, the institutions’ fiduciary obligations for the disbursement of general resources are met through the conditions of a Fund arrangement which, while creating legal rights for the borrowing member by providing it with a set of criteria, compliance of which ensures disbursement, are not considered a contract between the IMF and the member state (see Box 2). Instead, the agreement is an ‘arrangement’ for financing in support of the programme of economic reform designed by the country authorities and set out in the country’s Letter of Intent (LOI) and/or its Memorandum of Economic and Financial Policy (MEFP) (IMF, 2002c: paras 20 – 22). This ‘arrangement’ is ‘a unilateral decision of the Executive Board’ not a contractual agreement (ibid: para 21).

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7 Such as ‘customs duties or taxes levied by the borrowing country, cost of land and late penalties imposed by suppliers’ (World Bank, 1997b: para 2)
Box 2: Distinction between ‘Conditionality’ and ‘Conditions of Financing’

When considering the content of fiduciary terms in World Bank and IMF financing, it is necessary to make a distinction between ‘conditionality’ and ‘conditions of financing’, particularly insofar as they relate to policy-based or programme financing:

1) **Conditionality** relates to conditions which regulate aspects of the economic programme or institutional or structural reform that is to be financed by the institutions. The borrower or grant recipient’s compliance with the conditions of financing will depend on whether the borrower has been judged to have complied with the fulfilment of these conditionalities to the satisfaction of the institutions. Conditionality therefore represents the ‘regulatory’ aspect of the programme being financed, to ensure that the objectives of the programme of reform, whether macroeconomic stabilisation or poverty reduction, are met. Programme conditionalities are not contained in legal agreements for financing but in the accompanying programme documents – the IMF’s Letters of Intent (LOI) or the World Bank’s Letters of Development Policy (LDP) - which are incorporated by reference into the legal agreement.

2) **Conditions of Financing** are the terms of the legal agreement between the financing institution and the client and will include a covenant referring to the ‘programme’ of policy reform or stabilisation which is being financed. Failure to comply with a programme conditionality does not necessarily mean a breach of a legal agreement as it is up to the institution to decide if this non-compliance can be waived. If the institution decide that the fundamental aspects of the programme, that is, key conditionalities, are not met, then this may constitute a breach of the legal covenant to comply with terms of the programme and this then represents a breach of a legal agreement.

This distinction however does not apply to Fund loans as they are not considered ‘contractual’ arrangements. Each programme is considered an Executive Board decision although these agreements take a similar form to conventional sovereign loans with a legal agreement containing most of the ‘operational’ and ‘protective’ clauses and a separate LOI and/or a Memorandum of Economic and Financial Understanding of the country authorities appended to the agreement and incorporated by reference.

When considering the content of fiduciary conditions in Bank and Fund lending, it is therefore necessary to make a distinction between two types of programme conditions:

a) **Conditionalities with a fiduciary component but which serve a larger programmatic (some would say, ideological) purpose:** These may be conditionalities which relate to the furtherance of either an economic policy reform prescribed under the financing arrangement (such as regulations pertaining to fair tender and transparency of divesture in the dismantling of state-owned enterprises under privatisation policies) or as a policy end in itself (such as legislative reform to facilitate a more enabling regulatory environment for the entry of foreign investment capital); and

b) **Fiduciary conditionalities which are more technical in nature and which relate to aspects of domestic governance:** These may include conditions which are aimed at improving accountability and transparency in public expenditure management systems, public procurement policies, and debt management strategies and debt regulatory frameworks. There may be some overlap between these conditionalities and
2.2. Modalities for Fiduciary Conditions

2.2.1. Pre-Financing Fiduciary Assessments

Pre-financing assessments are primary means through which the Bank and the Fund attempt to fulfil their fiduciary duties. These may or may not relate to the purposes for which the loan is disbursed, that is, whether it is for an investment loan or policy-based loan (in the Bank’s case) and whether the loan is for macroeconomic stabilisation purposes or poverty reduction or debt relief (in the IMF’s case).

These are the assessments that the Bank and Fund undertake prior to the design of a financing programme to assess the financial situation of a country to ensure that the client country is eligible for assistance under the respective institutional terms; that the country has the capacity to implement the project or programme financed and that the country has the capacity to repay the loan if it is a lending operation. Although the pre-financing assessments are not conditions of financing per se, they do inform the amount of financing, type of financing and portfolio mix of financing that the institutions allocate to client countries, particularly the World Bank. These requirements may also be translated into binding programme conditions if countries display ‘fiduciary weakness’ and the institutions deem it necessary to condition disbursement on reform of such areas.

a) World Bank Assessments

The World Bank’s Operational Policy (OP) 8.60 on ‘Development Policy Lending’ indicates that pre-financing assessments are critical to meeting the Bank’s fiduciary obligations. In particular, the guidelines state that the Bank should focus on ‘the borrower’s overall use of foreign exchange and budget resources’ through an assessment of the borrower’s central bank ‘control environment’ in conjunction with the IMF staff (for foreign resources) and a review of the country’s ‘public financial management and procurement arrangements’ (for budget resources) (World Bank, 2004a: para 19).

The Bank’s range of diagnostic instruments used to conduct these ‘expenditure reviews’ and ‘fiduciary assessments’ has grown considerably in scope and complexity with the increasing focus on institutional policy over the years. These fiduciary requirements overlap with the Bank’s work on governance reforms as was observed in the Bank’s 2001 ‘Adjustment Lending Retrospective’ report:

An important part of the increased developmental orientation of adjustment lending has been the explicit focus on good governance, with support for public sector management reforms accounting for a large share of the increase in adjustment lending in recent years. These developments put a premium on [economic sector work] to assess countries’ public expenditure, procurement, and financial management systems, and set out an action plan for addressing priority policy reforms and capacity building and for inclusion as appropriate in loan conditionality (World Bank, 2001: para 21).

These assessments accordingly ‘inform Bank decisions on the amounts of development policy loans, tranching, program content, conditionality, and risk mitigation measures’ (World Bank, 2004a: para 19). Such analytic work, in this case, those pertaining to ‘management, governance and public expenditure management, procurement, and financial accountability systems’ feed into both the design of the programme to be supported by the policy-based loan as well as the Country Assistance Strategies (CAS) for
each Bank member which sets the country’s lending portfolio. These assessments may also provide reasons for the Bank to compel countries to undertake stand-alone loans for institutional reforms, such as loans for governance projects to increase the viability of domestic fiduciary institutions (see World Bank, 2001: paras 88 & 91).

Furthermore, where such assessments identifies weaknesses in the countries’ institutions, such as in the area of public financial management, the Bank will determine if rectification of such weaknesses should be undertaken as conditionalities in the programme financed (World Bank, 2004a: para 17 & 19):

When the available analysis identifies weaknesses in the borrower’s central bank control environment or budget management system, or when an acceptable action plan to deal with identified weaknesses is not in place, the Bank will identify the additional steps needed to secure acceptable fiduciary arrangements for development policy lending (World Bank, 2004a: para 19).

The main pre-financing assessments of the Bank are:

- **Public Expenditure Reviews**: Public Expenditure Reviews (PERs) are regarded as a central aspect of the World Bank’s policy-based operations (World Bank, 2001: para 89). This assessment analyses the expenditure patterns and revenues of the client country’s public sector and evaluates ‘the quality of government spending and spending policies, covering a wide area, including reviewing the country’s fiscal and debt sustainability to examining the country’s ‘institutional capacity for public resource management’ (World Bank, 2001: para 90).

- **Country Financial Accountability Assessments**: The Country Financial Accountability Assessment (CFAA) analyses the ‘strengths and weaknesses of accountability mechanisms in the public sector and risks that these may pose to the use of Bank funds’ (World Bank, 2001: para 90). A full CFAA also addresses ‘public sector budgeting, accounting, and financial reporting; internal control systems and records management; auditing; legislative oversight; and public access to information’ as well as an examination of the regulatory aspects of private sector accounting (ibid). CFAAs (of less than five years old) underpinned 39 percent of the Bank’s adjustment operations in 1999 and 50 percent of those approved in 2000 (ibid).

- **Country Procurement and Assessment Report**: The Country Procurement Assessment report (CPAR) assesses the country’s procurement system and ‘initiate[s] a dialogue with the government on actions to improve the system’ (World Bank, 2001: para 90). This includes ‘an assessment of the legal framework, trade practices, the financial framework, procurement organization and procedures, decision-making authority, and anticorruption initiatives and programs’ (ibid).

The Bank considers the above ‘core fiscal and fiduciary products’ which have increased over time – from an average of 40 reports in financial year 2000 – 2001 to 60-75 reports in 2002 (World Bank, 2001: para 92). Aside from these assessments which feed into both programme conditionalities (including prior actions) and CAS triggers, the Bank also assesses client countries’ institutional and policy environment through the **Country Policy and Institutional Assessment (CPIA)** index which rate countries according their performance in key areas, such as economic management, such as fiscal and debt policy, and public sector management and institutions, including the quality of budgetary
and financial management, quality of public administration and issues of transparency, accountability and corruption in the public sector (see World Bank, 2003), and which feeds into the Bank’s country CAS. The CPIA index is drawn from the Bank’s analytic and economic sector work (ESW), including the assessments noted above, and when proposing remedies to the ‘weaknesses’ in the institutional and policy environment of countries reflected in CPIA scores, the Bank usually refers to the pre-financing assessments to draw up programme conditionalities.

The Bank may also conduct other assessments which may be considered part of their compliance with fiduciary requirements to member states, such as Poverty and Social Impact Assessments (PSIAs) and environmental safeguard assessments. However, these assessments are less likely to feed into or have their outcomes translate into binding commitments from client countries than the financial assessments, mainly for the political implications they may raise vis-à-vis issues of sovereignty and policy autonomy as well as issues of higher transaction costs for borrowing states – that is, the World Bank, particularly the IBRD, is always cognisant of the fact that they may lose core business if countries shy away from taking up World Bank loans due to excessive costs of lending which may be couched in both financial (interest rates, repayment terms) as well as non-financial (pre-lending conditions) terms.

b) IMF Assessments

The IMF conducts assessments of the country authorities’ macroeconomic framework and attendant fiduciary mechanisms prior to agreeing to a financing arrangement with a client country. These assessments are known generally as safeguards assessments and usually takes the form of negotiations between the Fund and country authorities on aspects of the programme to be financed, including negotiations on the design of the country’s LOI and/or MEFP. These assessments may be based on the IMF’s Article IV consultations with country authorities, the scope of which have broadened to encompass not only a focus on countries’ fiscal, monetary and exchange rate policies but also into structural and institutional policies, such as central bank independence, financial sector regulation, corporate governance, and policy transparency and accountability (IMF, 2005a).

Like the World Bank assessments, the outcome of IMF reviews not only informs the Fund’s decision to lend but also in the determination of programme conditionality. Issues of fiduciary governance have become increasingly prominent in Fund operations as the institution’s guidelines on governance issues state:

Weak governance should be addressed early in the reform effort. Financial assistance from the IMF in the context of completion of a review under a program or approval of a new IMF arrangement could be suspended or delayed on account of poor governance, if there is a reason to believe it could have significant macroeconomic implications that threaten the successful implementation of the program or if it puts in doubt the purpose of the use of IMF resources (IMF, 1997: para 16).

In concert with this increasing focus on fiduciary accountability for use of Fund resources, the IMF has adopted as a permanent policy the implementation of Safeguards Assessments of Central Banks in 2002. This policy, which was piloted in

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8 The IMF is mandated under Article IV of its Articles of Agreement ‘to exercise surveillance over the exchange rate policies of its members in order to ensure the effective operation of the international monetary system’ (IMF, 2005; IMF Articles of Agreement, Article IV, Section 3).
2000, is described as ‘an ex ante mechanism to help prevent the possible misuse of IMF resources and misreporting of information in a central bank’s control, accounting, reporting, auditing systems and legal structure that may impair the integrity of central bank operations’ (IMF, 2002). Therefore, all countries receiving new arrangements from the IMF after 30 June 2000 are subjected to a full safeguards assessment (ibid). The Fund defines these safeguards assessments as ‘a diagnostic exercise, carried out by IMF staff, to consider the adequacy of five key areas of control and governance within a central bank’ (IMF, 2005b). These five areas are denoted by the acronym ELRIC:

- **External audit mechanism**: assessment of the country’s practices and procedures for independent auditing and publication of financial statements
- **Legal structure and Independence**: assessment of central bank independence and degree of government interventions central bank operations
- **Financial Reporting**: assessment of adherence to internationally recognised good practices of financial accounting and publication, including reporting and disclosure of reliable financial information
- **Internal Audit Mechanism**: assessment of the effectiveness of internal central bank evaluation and auditing
- **System of Internal Controls**: assessment of policies and procedures to safeguard assets, prevention and detention of fraud and error and accuracy and comprehensiveness of accounting records.

If findings from the safeguards assessments warrant what the IMF term as ‘corrective measures’, these measures are implemented through programme conditionalities, either as prior actions or policy commitments in the country’s LOI. Commitments by country authorities ‘to implement safeguards recommendations’ will be monitored throughout the duration of the financing programme relying on regular reports by central banks to Fund staff of ‘their annual audited financial statements and related audit reports, including management letters and special audit reports’ (IMF, 2002d).

### 2.2.2. Loan or Financing Agreement Conditions

Standard technical fiduciary duties of the Bank and Fund are mainly met through the conditions of lending established in the financing agreement between the institutions and client countries. These agreements typically set out the purpose and amount of the loan (or grant), the financial terms and conditions of disbursement and repayment, such as procedures and dates for loan disbursement, loan charges, interest rates, currency provisions, procedures for loan withdrawal by the borrower, policies on cancellation and suspension of the loan, and enforceability of loan obligations and procedures for arbitration for breaches of these terms by either party (see Agarwal, 2000: 1-9; IBRD General Conditions for Loans; IDA, General Conditions for Credits and Grants).

Loan or financing agreements also contain clauses which ensure that the borrower has the legal capacity to enter into a loan agreement and that this authority has been met through due process in accordance with the client country’s domestic laws. These aspects are generally found in the loan’s ‘conditions precedent’ (see Section 1.1. above) and have to be fulfilled before the loans become operational. Both the IBRD and the IDA ‘General Conditions’ for Loans’ provide that legal agreements for loans, guarantees and

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\* The World Bank, like many other international financial institutions divide the documents of a loan agreement into two parts: 1) *general conditions* which are applicable to all loans and guarantee agreements and
grants do not become effective until evidence satisfactory to the Bank is produced by the client governments to prove the status of the borrower, that is ‘the document by which the Borrower has been constituted or by which it has come into existence’ such as charters, by-laws, or constitutional provisions in order for the Bank, as financier, to ‘satisfy themselves of the correct legal status and other particulars of the borrower’ (IBRD General Conditions for Loans, Article VIII, Section 8.01; IDA General Conditions for Credits and Grants, Article VIII, Section 8.02; Agarwal, 2000: 12).

The Bank’s General Conditions also provide that the loan agreement has been ‘duly authorized or ratified by all necessary governmental and corporate action’ (IBRD and IDA General Conditions, Articles VIII, Sections 8.01). This ensures that the borrower or grant recipient has such capacity to enter into a binding legal agreement, either for itself or on behalf of the state. It also necessitates the borrower proving that it ‘has obtained necessary authorizations from the appropriate bodies’ to borrow the money applied for (Agarwal, 2000: 13). The Bank thus ‘seeks assurance from the Borrower that it has a power to borrow and to execute, deliver and perform its obligations’ under the agreement (ibid: 12).

The capacity or competence of the borrower to enter into such agreements is determined by the laws which govern the borrowing country which means that the all domestic due process must have been adhered to prior to the signing of the legal agreement (Agarwal, 2000: 12). This capacity can be evidenced by the production of key documents by the country authorities establishing certain legal status and specific facts, such as a legal opinion by the borrower’s counsel and/or opinions by the legal counsel of the Bank or Fund resident in the country, or documents establishing performance of certain acts such as payment of fees (Agarwal, 2000, 10 & 14, IBRD and IDA General Conditions, Articles VIII, Section 8.02).

The purpose of much of these conditions precedent is for the lending institution to ‘ensure that all necessary legal and other formalities for coming into force of the Loan Agreement have been complied with by the Borrower in accordance with the laws of the Borrower’s country’ and that if the institution makes a disbursement under the legal agreement, the resources are safe and legally recoverable from the borrower (Agarwal, 2000: 10). The Bank, however, does not make normative assessments as to whether the due process undertaken by the country authorities is sufficiently legitimate for the purposes of compliance with the conditions of lending. In other words, as long as there is an official representation, such as from the country’s Attorney-General or General Counsel, that the government or other entity seeking to borrow has followed due process in accordance with the country’s laws and that this information has been verified by the Bank’s local counsel, the Bank will not question this authority to borrow.

The legal agreement for financing for both Bank and Fund lending will also contain covenants which are usually a series of undertakings by the borrower for its future conduct during the duration of loan. Through these covenants, the institutions monitor the activities of the client state with regard to implementation of the project or

which are incorporated by reference into individual loan agreements; and 2) loan or guarantee agreements which contain terms and conditions specific to the financing arrangement in question (Agarwal, 2000: 3, IBRD, 2005, Section 1.01; IDA, Section 1.01). In cases of conflict between the General Conditions and the Legal Agreement, both the IBRD and IDA General Conditions provide that the provisions of the Legal Agreement prevail (Agarwal, 2000: 6; IBRD General Conditions for Loans, Article I, Section 1.02; IDA General Conditions for Grants and Credits, Section 1.02).
programme for which the loan is granted. This is done through requirements to submit regular progress reports to the institution as provided for under the agreement (Agarwal, 2000: 24). The covenants will also include a covenant that the borrower maintain its authorisation to borrow and enact terms and conditions of the loan in conjunction with domestic law, for example, in compliance with ‘all authorisations, approvals, licences, exceptions, notarisations and consents required in or by the laws and the regulations’ of the country (Agarwal, 2000: 25). It is important to note here that these covenants do not prohibit the borrowing authority to enact legislation (in accordance with procedural requirements for law-making) to put into effect policies of the loan agreement.

With policy-based loans, specific covenants usually refer to an undertaking by the borrower ‘to implement the Program with due diligence to ensure that actions and policies adopted under the Program are put into effect’ (see Uganda Development Credit, Article III, Section 3.01(a)) and that proceeds of the financing are only used for agreed upon expenditures.

The expenditures made by the client state are monitored by the institutions through covenants in the legal agreement. This is where the Bretton Woods institutions depart from normal lending practice. In regular financing agreements, once the agreement is negotiated and pre-conditions met, the funds are made available to the client without further restrictions. With Bank and Fund financing\(^\text{10}\), the funds are retained in a special account within the institutions – for example, the Credit Account for IDA borrowing – and are only released when the client government incurs an expenditure either authorised by the project loan agreement or made in support of the programme of a policy-based loan that is not an excluded or prohibited expenditure under the agreement (Agarwal, 2000: 6 – 7; see also Uganda Development Credit, Article II, Section 2.02; IBRD and IDA General Conditions, Article V, Sections 5.01).

However, while there are stringent conditions regarding the release of funds under project lending, there are less controls on the release of funds for expenditures under policy-based loans and more so, with budget support loans, such as the Poverty Reduction Strategy Credits (PRSCs) from the IDA. As long as the borrower can prove that the funds are not utilised for purposes prohibited under the negative list of expenditures, the Bank will release the funds. If the proceeds of the financing agreement are used for unauthorised expenditures, the World Bank can request that the borrower return the said amount to the special account or reimburse the Bank for the ineligible expenditures.

Legal covenants are binding on the borrower and the lender. Breach of a covenant in considered breach of a legal agreement which may incur financial and non-financial penalties. Bank loans are considered international treaties and are deposited with the United Nations as such. The IBRD and IDA General Conditions for Loans provide for an arbitration mechanism for disputes arising from non-compliance with the terms of a financing agreement and not settled in-house (IBRD General Conditions for Loans, Article VIII, Section 8.04; IDA General Conditions for Loans, Article VII, Section 7.03). Although creating some legal rights for the financed member, an IMF financing arrangement is not considered a legal agreement per se but as ‘a unilateral decision of the Fund’ which does not give rise to contractual obligations (IMF, 2002c: para 22; see also

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\(^{10}\) This does not apply strictly to borrowing from the IMF’s general resources under the upper credit tranche facilities as this involves a complex purchase-repurchase process which does not fit in with the conventional framework for sovereign lending.
IMF, 2002a: para 9). Failure to meet a condition under an arrangement will only result in
ineligibility for future financing rather than be treated as a breach of a legal obligation

2.3. Programme Conditionalities

This is the most contentious area of fiduciary conditions and where there is most overlap
between the institutions’ governance work and their efforts to meet their fiduciary
obligations to their member states. Programme conditionalities are important in policy-
based loans for the Bank and in Fund financing as they represent the main mechanisms
through which the institutions meet their fiduciary obligations under their constitutional
mandates and their financial fiduciary duties to their member states. As mentioned
earlier, the Bank and Fund justify their use of conditionality on the need to fulfil their
fiduciary obligations under their constitutional charters and in their exercise of due
diligence therein.

Programme conditions serve as signposts to determine if a country has met its
obligations under the financing agreement. These conditionalities are not referred to in
the legal agreement but one of the main covenants of the agreement will refer to the
‘programme’ of economic reform undertaken by the client country and stipulate that the
borrower or financee undertakes to implement such programme ‘with due diligence to
ensure that actions and policies adopted under the Program are put into effect’ (see for
example, Uganda Development Credit Agreement, 2001, Article III, Section 3.01(a)).
Non-compliance with programme conditionality does not automatically mean a breach
of a legal obligation under the agreement as a judgment on non-compliance will rest will
the financing institution to determine. More often that not, the institution endeavours to
resolve the matter outside the arbitral mechanisms established in the agreement (see Box
2). Programme conditionalities include prior actions, benchmarks, tranche release
conditions, triggers, performance criteria and programme reviews.

The content of programme conditionalities, both at the World Bank and the IMF, have
broadened over the years to encompass more than the economic purposes that they were
originally designed to achieve. Over the past five years, particularly since the introduction
of the Poverty Reduction Strategy Paper (PRSP) framework and attendant new
modalities of financing, notably through the Poverty Reduction Strategy Credits (PRSCs),
there has been a significant increase in the use of fiduciary-type conditionality. This
increasing focus on governance and fiduciary conditionalities is related to the shifts in the
Bank and Fund’s conceptual approach to programme effectiveness, that is, the Bank and
Fund view domestic governance institutions as key to facilitating the implementation of
substantive economic policy reform (see IMF, 1997; World Bank, 2005h).

However, as discussed above, when considering conditionalities which fall into this
category, it is necessary to bear in mind the distinction between conditionalities which
contain a fiduciary aspect but which largely serve a more purposive, as opposed to
procedural, objective – that is, conditionalities which further economic or political
conditionalities – and conditionalities which serve a more technical purpose. There is
often an overlap and fiduciary-type conditions may serve as a conduit for furthering
more ideological reforms. For example, procurement conditions which purport to
institute more accountable and transparent government procurement systems may serve
as a mechanism for liberalising procurement regimes, opening up government
procurement processes not only to internal competitive tender but external competition from foreign firms as well. Such conditions may have the effect of curtailing the government capacity to utilise government expenditure as a means to stimulate the domestic economy by creating demand for domestic economic sectors.

a) World Bank Conditionalities

According to the Bank’s recent review of conditionality trends and practices, governance issues, including areas relating to domestic fiduciary mechanisms, such a public expenditure management systems, have become important priorities in the design of Bank policy-based financing and related programme conditionalities, moving away from short-term macroeconomic and structural programmes involving economic management, trade and agricultural issues towards public sector governance issues (World Bank, 2005g: para 25; World Bank, 2005h: paras 7 – 9). The type of governance and fiduciary conditionalities have also changed, moving away from merely technical aspects of financial accounting and reporting and fiduciary oversight, such as the preparation and execution of yearly public investment programmes, towards more complex medium-term policy and institutional reform of country financial management and procurement systems (World Bank, 2005g: paras 23 – 25).

These interventions are also more integrated than previous governance-type projects, ‘emphasizing a cross-cutting approach rather than stand-alone, discrete actions and shifting from supply-side reforms and technical advice to governments toward broader efforts to enhance domestic ownership and demand for reforms’ (World Bank, 2005h: para 9). As such, the Bank’s fiduciary and governance conditionalities have become central to its financing operations in which public sector governance reforms form an integral plank of the design of policy-based loans rather than being focused on ad-hoc, stand-alone policy reform projects, such as a sectoral adjustment loan on tax policy reform or a technical assistance loan for judicial reform. Instead, public sector governance conditionalities are now almost mandatory in all types of Bank policy support financing. Consequently, ‘the Bank is now reaching universal coverage of public sector governance issues in Bank loans’: in 1997, 60 percent of loans approved contained public sector governance conditions; by 2004, 93 percent of loans approved contained such conditions and by 2005, all loans had public sector governance conditions (World Bank, 2005g: para 25).

According to the Bank, public sector governance encompasses a range of interventions, for which the Bank’s Adjustment Lending Conditionality and Implementation Database (ALCID) distinguishes seven categories: public expenditure or public financial management (PEM/PFM) including public expenditure, financial management, procurement; tax policy and administration; administrative and civil service reform; other public sector governance, including parastatal reform conditions; anti-corruption measures; decentralisation policies; and debt management strategies (World Bank, 2005h: para 14). The first four categories account for 85 percent of programme conditions and benchmarks with PEM/PFM conditionalities accounting for over 40 percent of all conditions in the past five years, up from 20 percent in the early 1980s (ibid).

Public expenditure management conditionalities are considered important fiduciary areas for Bank focus with 75 percent of World Bank loans today involving PEM/PFM

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11 Known in normal parlance as reform of state-owned enterprises or privatisation policies.
conditions, up from 50 percent ten years ago (World Bank, 2005g: para 27). The Bank considers PEM/PFM conditionalities as conditions ‘designed to fight corruption, strengthen fiscal governance, enhance transparency in resource allocation, and improve overall management and accountability in public expenditures’ with such conditionalities focused more on financing in IDA countries (ibid). The share of PEM/PFM conditions in IDA countries in recent years has been 50 percent more than in IBRD countries, accounting for 27 percent of all conditions in IDA lending as opposed to 17 percent in IBRD countries in 2004 (ibid).

The increase in PEM/PFM and other fiduciary-type governance conditionalities in Bank financing is driven largely by the shift towards programmatic and budget support lending in which funds are disbursed without ring-fenced expenditure provisions to client governments in support of their expenditure priorities as spelt out in the PRSP, LDP or Policy Matrix. Poverty Reduction Strategy Credits (PRSCs), the IDA’s main instrument for disbursing budget support and programmatic lending, now constitutes a growing share of the Bank’s policy-based loans [insert percentage here]. In PRSCs, public sector governance conditionalities constitute 45 percent of all conditionalities as compared to 24 percent in non-PRSC policy-based loans, with upward of 64 percent of these conditions specifically addressing PEM/PFM weaknesses (World Bank, 2005j: para 66, Figure 13).

The Bank states clearly that improving or ‘modernising’ PEM/PFM systems is ‘a legitimate interest for donors’ particularly in low-income countries where there are ‘large donor resource flows’ and where assistance is provided through budget support ‘since it is critical to reducing fiduciary risks’ (World Bank, 2005j: para 71). As mentioned earlier, pre-financing assessments play a role in determining the content of programme conditionalities, particularly in the area of PEM/PFM. All PRSCs are underpinned by ‘ex-ante fiduciary assessment of the country’s PFM and expenditure systems’ which identify deficiencies and assesses fiduciary risk (ibid: para 72). In the event of weaknesses, implementation of ‘acceptable fiduciary arrangements’ may be made a programme conditionality, usually a prior action or trigger in the case of PRSCs and other programmatic operations (ibid).

The rise in PEM/PFM conditionalities have been accompanied by the decrease in economic management and trade conditionalities with less than 20 percent of loans currently carrying conditions in economic management, trade and rural/agricultural issues (World Bank, 2005g: para 25). However, where there have been economic management conditionalities, these have been increasingly focused on fiduciary-type aspects of economic management with half of all conditions focused on the institution of national debt strategies, prudential debt contracting and tracking/accounting of HIPC funds for IDA countries and subnational borrowing and spending rules for IBRD countries (World Bank, 2005g: paras 64 & 95).

b) IMF Conditionalities

IMF programme conditionalities have followed a similar trend to World Bank conditionalities with an increasing focus on institutional reform and fiduciary mechanisms in public sector governance. There has been, for example, an increase focus on economic management and debt strategies of client governments (IMF, 2005: Figure 1). For the IMF, fiduciary conditionalities are categorised as governance conditionalities which have been grouped into five categories: fiscal and public sector reforms, banking and
Fiduciary and governance conditionalities in IMF programmes fall under the category of structural conditionality, that is, conditionality related to the underlying structure of the economy of the client country as opposed to conditionality pertaining to macroeconomic performance. According to the IMF, until the mid-1980s, structural conditionality were mostly restricted to exchange rate and trade reforms with programmes occasionally addressing ‘selected fiscal and financial sector issues or general pricing policies’ (IMF, 2001c: para 25). However, since the late-1980s, the content of structural conditionality has broadened to include reforms in the fiscal and financial sectors, exchange and trade system and data collection (constituting close to two-thirds of structural conditionality and regarded as the core of IMF involvement in member states) and conditions related to the restructuring of public enterprises, privatisation and social security system reforms (accounting for 20 percent of structural conditionality) (IMF, 2001: para 25).

Over the years, reforms in the fiscal and financial sectors, most notably reforms in fiduciary oversight and regulatory frameworks of these sectors have become increasingly dominant in programme conditionalities. According to the Fund, 30 percent of structural conditions in the fiscal sector concern ‘expenditure and public sector management, including steps to introduce of strengthen systems of expenditure control’ (IMF, 2001c: para 28). However, conditionalities in this area also relate to policies which are more controversial governance reforms such as civil service reform and reorganisation of public sector employment (ibid).

The Fund’s involvement in governance-related conditionalities have therefore developed and increased considerably since the Fund’s 1997 ‘Guidance Note on Governance’ (IMF, 2001d: Box 3) which was adopted by the Fund’s Executive Board demonstrating the increasing importance of governance-related issues in Fund work. A survey by the Fund of governance conditionalities from 1994 – 1999 found that more than 80 percent of all Fund programmes in 1999 contained governance conditions (IMF, 2001d: Figure 3).

Most of these conditionalities are related to fiduciary aspects of domestic economic governance, similar to the Bank’s public expenditure management/public financial management conditions. The same survey found that the Fund’s engagement with fiduciary governance areas, such as transparency and accountability in public resource management and issues of poor governance and corruption, including issues of fraud prevention, were tackled through the use of programme conditionality, as were issues relating to accounting, auditing and capacity building in public sector reform (IMF, 2001d: Box 3 & Annex 1). Transparency and accountability policies consistently accounted for an average of 40 percent of governance conditionalities over the period surveyed, indicating the importance placed on fiduciary mechanisms (IMF, 2001d: Figure 4).

Like the World Bank fiduciary-type programme conditionalities, many of these programme conditionalities are derived from the ex-ante fiduciary safeguards assessments conducted by the Fund prior to implementation of a financing programme (see Section 2.1(b) above). Also, like the Bank, the Fund’s focus on fiduciary governance conditionalities has increased with the advent of the PRSP framework and the linking of PRGF access to the PRSPs. The Fund’s primary role in PEM/PFM reform under the PRSP-PRGF framework has been in budget planning and linkages to macroeconomic
policy. Consequently, the Fund’s work in this area ‘has focused on core areas essential for macro-fiscal management, including reforms in budget preparation, execution, and reporting and short-term expenditure rationalization’ (IMF, 2003: para 32). The IMF, has also worked closely with the Bank in developing public expenditure tracking mechanisms in low-income countries, notably the heavily indebted poor countries (HIPC’s) to ensure that funds disbursed from debt relief and the PRGF are utilised for the purposes of poverty reduction.

### 2.3.4. The PRSP Framework

Although obligations under the PRSP framework have been discussed above, it is worth considering the framework as a separate means of fiduciary compliance. As discussed above, most of the fiduciary conditions imposed by the Bretton Woods institutions have related to compliance with fiduciary obligations to their member states vis-à-vis the use of institutional resources for the purposes mandated by their Articles of Agreement and Trusts Instruments. The PRSP framework, however, represents an attempt by the Bretton Woods institutions, at least on paper, to meet assist member states, in particular client member states, meet their obligations to their citizens.

The framework’s provision for participatory decision-making and monitoring and evaluation systems enables citizens, at least notionally, to hold governments accountable for the expenditure of public resources by facilitating a mechanism by which citizens and civil society organisations may input into the policymaking process of their countries through the mandated establishment of a participatory policymaking process.

The Bank and Fund view the implementation of Poverty Reduction Strategy (PRS) processes in PRSP countries as located ‘within a framework of balancing accountabilities – including that of governments to both domestic constituents and to donors, as well as that of donors to developing countries’ (IMF and World Bank, 2005: para 21). The PRSP framework therefore attempts to build domestic accountability through the focus on framing ‘clear development goals that are coupled with programs of action; to link these to budgets and effective public financial management systems; and to monitor implementation in order to facilitate adjustments in policies and programs’ as well as to link these efforts with ‘institutionalizing participation’ and providing ‘greater space for participation and the involvement of key stakeholders (such as parliaments and poor people themselves’ in the process (ibid: para 25). The emphasis on social sector expenditure priorities is aimed at ensuring resources from the Bank, Fund and other donors are not utilised in wasteful government expenditure and which benefits the citizens while the transparency and accountability mechanisms is aimed at ensuring that citizens are kept informed of key budgetary and other economic decisions made by the executive and by legislatures.

The PRSP framework also attempts to ensure that the Bank, Fund and other donors meet their fiduciary obligations to their shareholders and domestic constituents, including taxpayers, by ensuring that resources disbursed are marginally ring-fenced to priority expenditure targets and that such expenditure is monitored and accounted for.

However, the PRSP framework also represents a caveat for efforts to design fiduciary mechanisms for development financing, particularly through an externally driven process in local settings. There have been numerous examples of how the PRS process have
failed to empower local citizens in decision-making and have, paradoxically, curtailed the policy autonomy of the executive and represented more intrusive interventions into a country’s domestic policymaking process.

Most notably are examples from many PRSP countries of how the participatory policymaking process has bypassed local legislatures in favour of a consultative mechanism for decision-making under the PRSP framework and how domestic priorities are now shaped by the contingency of meeting both procedural (for example, the participatory process) and substantive (for example, the focus on social sector expenditure) requirements of the PRSP process rather than fostering genuine local policymaking (see Rowden and Ocaya-Irama, 2004; World Bank, 2004e: 9 – 14; World Vision, 2005: 27 – 34). A recent World Vision report highlights what it calls a ‘key paradox’ in the PRS process in which accountability under the PRSP framework is no longer about ‘a national process connecting citizens and the state’ but rather represents a situation in which ‘the most important form of accountability outside the state is to international donors’ (World Vision, 2005: 33).

The Bank and Fund has acknowledged this in their recent review of the PRS process, stating that ‘[w]hile there is no inherent tension between domestic and external demands for better financial management and results-oriented performance, various factors can tilt the balance toward externally-focused requirements rather than domestic ones’ (ibid: para 95). These factors include the link between the PRS process and external financing with many countries perceiving ‘the PRS approach as an externally imposed requirement and [that] the focus was on a narrow aspect of an external compact’ with donors; the fact that in many instances,’ PRSPs were produced with processes that ran parallel to existing planning processes’ and where accountability for reporting has been focused on donor accountability rather than domestic accountability because of the bid for higher resources (ibid: para 97; 99 - 100). There can also be a ‘drive for the ‘wrong’ results’ through countries ‘cherry picking’ interventions which are preferred by donors and ‘where it is easier to show results’ as well as on policies which have a high international profile where internationally focused development indicators may influence the way policies are designed, ‘even if that particular intervention would not be a country-specific priority’ (ibid: para 102).

The experiences of the PRSP approach therefore offer valuable lessons when designing policy proposals for increasing oversight of development financing design and resource expenditure and in developing proposals for responsible lending standards.
Section 3: Proposals for Responsible Lending Standards

The need to develop a coherent set of internationally recognised responsible financing standards have never been greater in light of the current international economic and financial architecture and its impact on communities in large parts of the developing world. In particular, the lack of accountability and transparency in the sovereign loan negotiation process and in the contracting of development financing arrangements as a whole has led to countries sagging under the weight of greater indebtedness and being locked into a vicious cycle of debt servicing – a case of the ‘debt-tail’ wagging the ‘aid-dog’ so that aid inflows to developing countries are used to service old loans, loans that were never legitimately concluded in the first instance.

With increased attention on the issue of debt relief, poverty reduction and more bilateral commitments to aid resources for developing countries, the issue of fiduciary responsibility on the part of the financiers have become increasingly important. In particular, issues of due process in loan negotiation and accountability for the use of disbursed resources must be addressed in the context of the moral and legal duty of care owed by the financing institutions to the populations of the countries in receipt of such financing and member states on whose behalf the institutions hold resources on trust.

This includes not only considerations of due process in loan contraction and transparent and accountable debt management strategies of governments in receipt of financing but also the same considerations in relation to the policies and practice of donors and financiers. Fiduciary obligations of donors and financiers include not only ensuring the resources are disbursed and utilised in accordance with the purpose for which the resources are disbursed but also, especially in the case of programmatic lending, that the accompanying conditionalities do not further violate their institutions’ constitutional and fiduciary obligations.

Consequently, not only must care must be taken so as to not subvert local fiduciary mechanisms and substitute domestic processes with externally imposed instruments, but corresponding measures must also be taken to ensure that the same standards and mechanisms are established to account for the actions and policies of the donors/financiers themselves, including both procedural and substantive aspects of financing.

3.1. Issues for Consideration for Designing Responsible Financing Standards

There are several inherent tensions in the design of responsible financing standards which must inform any policy proposal and campaigning position.

Firstly, there is a tension between respecting the sovereignty of states and imposing fiduciary mechanisms through external loan conditions. While it is imperative that the disbursements of loan, grant aid and debt relief resources be subjected to stringent checks and balances to ensure that the targets of such resources – the population of the recipient state – receive the tangible benefits of such money, it is necessary to consider the impact of any prescriptive conditions to this effect on the wider global political economy.
Campaign calls for responsible lending standards must therefore ask the question of how specific policy prescriptions implemented through sovereign loan negotiation and contraction processes impact upon the wider issue of sovereignty of states and policy autonomy of states which, in turn, may impact upon the states’ ability to respond to other external governance pressures, such as negotiations under multilateral and bilateral trade treaties. Here, we must take into account the distinction, discussed above, between fiduciary-type conditions which further a particular purposive agenda, and purely technical fiduciary mechanisms, a distinction that is sometimes tricky to make.

Although it is widely acknowledged that sovereign states must accept some curtailment of their sovereign rights in the context of international negotiations and entry into force of international agreements and treaties, this is contestable in the context of sovereign loan agreements, especially loan agreements from international public bodies such as the World Bank, the IMF or regional development banks. As these are, to all extents and purposes, contractual agreements between financing institutions and sovereign states, states are only bound by negotiated terms and conditions in the agreements and sovereignty is only circumscribed insofar as the states undertake to carry out their obligations under these agreements.

However, as there is a significant imbalance in the bargaining power between the borrower and the lender in these negotiations, particularly in relation to low-income developing countries which lack access to commercial capital markets for external finance or for countries experiencing the effects of financial crises which need access to IMF stabilisation resources.

Given the unequal governance structure of the Bank and Fund, there is a danger that giving a carte blanche to these institutions to design internal fiduciary oversight mechanisms – including instruments which they are already currently engaged in designing, such as the Medium-Term Expenditure Framework (MTEF) – will be tantamount to endorsing forms of neo-colonialism in which external institutions are given the mandate to intervene in the restructuring of domestic institutions (see also discussion in Eurodad draft paper, Eurodad, 2005: 7).

In considering this tension, it is necessary to consider whether to advocate for developing internationally recognised standards and instruments, and if so, which organisations should be charged with their enforcement or if such standards should be implemented through financing conditions; or if there should be greater emphasis on the development of domestic or regional accountability mechanisms and supporting and building local and regional capacity for reform.

This issue is related to second tension inherent in designing and implementing responsible financing standards via international financing agreements, that is, the tension between extending the mandate of international financial institutions, particularly the BWIs, in the area of fiduciary oversight and that of limiting their interventions in other policy areas, notably in economic policy reform and some aspects of political governance. As discussed earlier, fiduciary mechanisms range from adherence to fiduciary guidelines in assessing applications for financing to instituting oversight mechanisms in financing agreements, compliance of which affects the continued disbursements as well as access to future financing. Implementing domestic fiduciary mechanisms also range from standard contractual requirements of financial reporting and auditing to complex restructuring of internal public expenditure management systems to
incorporate mechanisms such as participatory budgeting, transparency in procurement policies, anti-corruption instruments, and the restructuring of regulatory aspects of domestic debt management systems.

The question which arises here is whether proposals for policy reform will extend the current remit of work of the international financial institutions or, as discussed earlier, comply with the existing constitutional mandate, especially with the constitutional prohibition of the BWIs of non-interference in domestic political affairs. The World Bank and the IMF have already been criticised for ‘mission creep’, extending their work and control into areas outside their jurisdiction and basing such extended work programmes on a stretched interpretation of their Articles of Agreement.

Enabling greater interventions of the BWIs into domestic political processes through the leverage of financing further consolidates their control over domestic policymaking and has implications for countries’ negotiations with these institutions in the long term. Related to this is also the issue of competence – whether the BWIs, in particular the Fund with its narrow remit of macroeconomic stabilisation – are adequately equipped to facilitate institutional reforms of this nature. Currently, some conditions border on micro-management of state processes and are based on models of fiduciary oversight in industrialised countries with little regard for the capacity constraints of client states.

This leads us to the third tension inherent in the design of policy proposals for responsible lending standards which is the establishment of fiduciary standards in client countries administered by financing institutions and aid agencies whose processes and procedures are not subjected to external scrutiny. In particular, this raises the issue of transparency and accountability in the Bank and Fund’s internal governance structure and the basis upon which their decisions are made. Any proposal to implement responsible financing standards in client countries must also include proposals to oversee the activities of the Bank, Fund and other donors and hold these agencies up to greater public scrutiny in the use of public resources. In particular, the basis of financing should be made based on need (and to a limited extent, merit) and not linked to foreign policy objectives of donor counties. Imposing fiduciary mechanisms on client states for the purposes of furthering a larger geo-strategic and economic agenda should be prohibited.

A related issue is the complicity of private sector creditors in the construction of loan contracts and financing from international financial institutions. While there has been much focus on the odiousness of debt owed to international financial institutions and multilateral development banks, there has been much less focus on the debt owed to private institutions and the role played by creditors in the design of public financing agreements, notably the IMF in the design of stabilisation packages which prioritise repayment of debt to private external creditors over domestic creditors and at the expense of larger social and economic expenditure. Private creditors also need to be brought into the ambit of any policy proposal for responsible financing as loans entered into with private institutions tend to be on more onerous financial terms (such as higher interest rate, shorter repayment schedule and higher penalties for non-compliance) than from public institutions.

3.2. Recommendations for Policy Proposals
3.2.1. Supporting Institutional Structures for Accountability/ Holding Financing Institutions Accountable for Irresponsible Financing

a) Developing clear guidelines for responsible financing

It is clear from the discussion above that international financial institutions, in particular the World Bank and the IMF, owe fiduciary obligations to its member states and, to a limited extent, to the citizens of states to which they disburse their resources, to ensure that the resources disbursed are spent wisely, responsibly, and in accordance with the purposes for which the funds are disbursed. The Bank and the Fund institute fiduciary conditions to comply with this due diligence requirement, as illustrated above.

However, the discussion above also demonstrates that the content of such fiduciary conditions, particularly in respect of fiduciary aspects of programme conditionalities are unclear and the effectiveness of such conditionalities in meeting the fiduciary obligations of these institutions even less so. Developing a set of clear guidelines for responsible financing is therefore key to ensuring that resources disbursed through these institutions are spent in the manner that is transparent, accountable and beneficial for the target constituencies. This includes developing a set of defensible fiduciary conditions that can be advanced in policy proposals.

In doing so, it is worth bearing in mind the distinction made earlier between conditions which have a fiduciary component but which serve a larger programmatic (or ideological) purpose and conditionalities which are more technical in nature and which relates to aspects of domestic governance and compliance with due process of law. Making a distinction between these two types of conditions could help us develop a set of defensible conditions that must be tied to any sovereign financing agreement as conditions which are merely technical in nature and which reflect responsible financing standards which should govern any loan or grant aid contract. Separating out conditionalities with a purely fiduciary technical purpose as opposed to those which serve a larger economic policy or political governance purpose is a step towards holding financiers responsible for negligence in disbursing and monitoring development financing.

This is quite tricky but one could perhaps draw up the following table:

<table>
<thead>
<tr>
<th>1. Conditionalities with a fiduciary component with programmatic objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td>This can be further divided into two categories:</td>
</tr>
<tr>
<td>a) Conditions which are ends in themselves – ie conditions which serve an economic restructuring purpose, including liberalising government procurement to ensure greater transparency in government procurement but at the same time, opening government procurement up to external competition; reforming anti-competitive policies through the restructuring of monopolies and the divesture of state-owned enterprises; corporate governance reforms to create an enabling environment for private sector development and external investment; administrative and fiscal decentralisation to reduce the role of the central government in economic and financial planning; improving fiscal discipline by setting targets for fiscal austerity in macroeconomic planning; etc</td>
</tr>
<tr>
<td>b) Conditions which further substantive economic reforms, including competitive tender process for divesture of state-owned enterprises, deregulation of state-owned industries and monopolies</td>
</tr>
</tbody>
</table>
under privatisation policies, central bank independence to ensure that central banks are subject to
external market oversight rather than government direction in monetary policy, transparency in tax policy
to monitor compliance with trade and investment liberalisation (showing actual tariff reductions), legal
protection for investors and reform of commercial legal processes to facilitate formal channels of seeking
redress in commercial disputes, etc

2. Technical fiduciary conditionalities

These are conditions which may be purely technical in nature and does not further any
substantive economic or political objectives. This may include transparent and accountable
public expenditure management systems, including independent audits of budgets and public expenditure;
transparent and accountable budgeting; monitoring of government revenue and tracking of government
expenditure; fiduciary risk assessments of financial situation of borrower and capacity to repay,
transparency in government procurement policies – eg merely instituting a competitive tender process as
opposed to liberalising the process completely; institution of a debt management strategy, including the
instituting of policies to assess debt risk, capacity and limits on lending; central bank safeguards,
including provisions for financial reporting, audit mechanisms, safeguards against fraud and error.

3. Conditionalities which may straddle both aspects

These conditions are those which are possibly contentious – they serve some fiduciary
purpose but implementing them requires extensive interventions into domestic political
processes. They include policies for participatory monitoring and tracking of public expenditure and
for participatory budgeting (such as under the PRSP framework, constitutional and legislative reforms to
facilitate involvement of parliaments and citizen groups in loan contraction processes; anti-corruption
legislation to institute penalties for misuse of public funds and judicial reform to enable enforcement of
such laws.

Table 1: Proposals for Categorising Fiduciary Conditions

In developing this set of guidelines, we may want to consider broadening the scope of
the institutions’ interpretation of fiduciary responsibility, notably in fulfilling aspects of
their due diligence requirements relating to borrower’s capacity to borrow and other
protective clauses of loan agreements by making the financing assessments based on
substantive rather than procedural compliance with these requirements. For example, in
determining whether the borrower has the capacity and authority to borrow in fulfilment
of Article VIII, Section 8.01 and Article VIII, Section 8.02 of the IBRD and IDA
Articles of Agreement respectively, the assessment is not merely on whether the
government has fulfilled the due process requirements in order to borrow from external
sources but on whether such process is legitimate and not just legal – ie whether it has
sufficiently involved the legislatures, whether the amount borrowed and the purpose for
which it is borrowed is defensible given the social and economic circumstances of the
borrowing country.

This is the second part of developing responsible financing standards, that is, considering
how conditionalities which fall into the third category may be used effectively with due
regard for the sovereign autonomy of client states. In doing so, we are taking a broader
interpretation of the notion of fiduciary responsibility, holding the financing institutions accountable not only for the absence of due diligence in assessing borrower capacity and authority to borrow or grant recipient’s capacity to utilise resources accountably and in a transparent manner, but also for the absence of due diligence in assessing the purpose for which financing is granted and the nature of the government of the state which is in receipt of such financing. These reflect more normative assessments on not only whether states meet the minimum threshold of financial fiduciary safeguards but also if the states meet minimum standards of political governance, eg the level of corruption within a country.

b) Developing effective enforcement mechanisms to hold financing institutions accountable for fiduciary oversight

Most financing institutions, as demonstrated in the discussion in Section 2 above, have existing fiduciary requirements which they have to adhere to when designing financing programmes and contracting financing agreements. The institutions also have to comply with their fiduciary duties under their constitutional mandates and any deviation would theoretically constitute an action that is *ultra vires* or which has gone beyond the powers vested in the institution. The question here is how to hold these institutions accountable and to ensure that their fiduciary obligations are complied with.

The problem with institutions such as the World Bank and the IMF is that there is a lack of an enforcement mechanism and an absence of a legal/judicial process at the international level to oversee Bank and Fund compliance with their fiduciary obligations and to resolve disputes when they arise in these areas. Usually, any dispute arising from the Bank and Fund's failure to comply with their fiduciary oversight requirements is resolved at the level of the Executive Board with the General Counsel of both institutions sitting as arbitrator. When disputes do occur, it is often raised as a compliant by a major shareholding country against the disbursements of loans to a particular country with weak fiduciary records and as it is the Executive Board which has the power to approve loans to countries in the first instance, such incidences rarely occur as fiduciary issues would have arisen during the Executive Board deliberations on the loan application. Furthermore, as the institutions are often under pressure to lend for commercial reasons (such as the IBRD) and often engage in defensive lending to recoup debt, internal mechanisms are often not a viable option for holding the institutions accountable.

Furthermore, fiduciary programme conditionalities are not legal covenants per se (see discussion in Section 1 and also Box 2). They merely serve to ensure the programme of economic reform is complied with and compliance is judged by the Bank and Fund. If a country fails to comply with certain fiduciary conditions under the programme financed by the policy-based loan, eg implement certain financial reporting mechanisms, the institutions can, and have done so, waive that conditionality. Once that conditionality is waived, the country will not be judged as breaching its obligations under the legal agreement and will therefore not be subjected to legal sanctions, although they may be subjected to economic penalties, such as jeopardising access to future financing from the Bank. Therefore, one of the ways to encourage greater enforcement of fiduciary oversight requirements of the Bank and Fund is to place fiduciary conditions within the legal agreement rather than as a conditionality of the programme. Placing fiduciary conditions in the legal agreement rather than in programme conditionalities takes away the subjectivity in judgment, that is, making the condition a legally binding covenant, the
breach of which incur a legal penalty, such as the right of the lender to terminate the loan and financial penalties for default.

However, even though conditions in Bank lending may be made legally enforceable, a related problem is the issue of enforcement and pursuit of legal action by non-state actors, such as individuals and communities affected by the Bank’s non-compliance with their fiduciary obligations. Although Bank legal agreements provide a means for arbitration in cases of dispute, non-state actors have no legal standing or locus standi to institute proceedings. Public international law which governs the enforcement of these agreements do not generally recognise the rights of individuals, corporations or communities as having legal personality in international disputes. Furthermore, as the legal agreement for financing is between the Bank and the borrowing government, non-state actors are not regarded as having sufficient interest in the agreement to initiate proceedings for breach of contract. The action needs to be brought against the Bank by the borrowing country for failure to comply with fiduciary obligations, an option that is tricky if it is the country which is in breach of its own fiduciary obligations to its citizens vis-à-vis the use of funds.

Nonetheless, if fiduciary conditions are made a legal conditions of lending, citizen groups in the affected countries may be able to exert sufficient pressure on the Bank itself to terminate the agreement on grounds of the failure of the country to meet such fiduciary conditions, halt the disbursements and perhaps impose punitive penalties on the state in question.

3.2.2. Supporting External Mechanisms for Accountability and Fiduciary Compliance

1) Support the development of international legal norms on responsible financing

Supporting the development of international legal norms relating to responsible financing and internationally recognised standards for sovereign lending will move away from an institutional focus and place the responsibility for determining what constitutes a fiduciary duty away from individual financial institutions and into a community of nations. While the Bretton Woods institutions theoretically constitute a community of nations, their governance structure, as described above, is unduly skewed towards representations from developed countries in an outmoded post-war alliance and the development of rules within this narrow organisational structure is subject to the politics of the governance framework of these institutions. Support for truly international mechanisms for fiduciary oversight of loan resources and legal mechanisms for repudiation of debts contracted in bad faith, in the absence of due process and in violation of international human rights norms will bring all financiers, whether bilateral or multilateral, public or private, under the same umbrella of standards.

One concrete proposal is to lend support to the development of a doctrine of odious debt in international law which will confer duties upon all financial institutions, private and public, when lending to sovereign states to ensure that the loan contracted will have been consented by the population of the country involved and offers a benefit to

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12 This is known as the doctrine of privity in contract law which provides that a contract cannot confer rights or impose obligations arising from it to persons who are not party to the contract.
population as a whole (see Khalfan et al, 2003, 2- 4). If these standards are not adhered to, public and private creditors will risk the possibility of having their repayments repudiated by any successor government.

There are many ways and fora in which such a doctrine can be advanced. Khalfan et al set out various judicial and political approaches in their compendium on the odious debt doctrine, including infusing the doctrine through various legal jurisdictions and fora, including through international arbitration and the work of the International Court of Justice (Khalfan et al, 2003). Kremer and Jayachandran also offer a potential international framework for the development of such norms through the establishment of ‘an independent institution to assess a regime’s legitimacy and to declare any sovereign debt subsequently incurred by an illegitimate regime ‘odious’ and thus not the obligation of the successor governments’. In this manner, the authors argue that private and public creditors would have incentives to ‘curtail loans to regimes identified as odious, knowing that successor governments would have little incentive to repay them’ (Kremer and Jayachandran, 2003). The IMF should revise its policy of bailing out external private creditors in a financial crises because these creditors have failed to exercise due financial and fiduciary oversight when contracting a loan so that the country’s population is not saddled with debt from the IMF to repay debt from private creditors who failed to exercise due diligence and proper judgment.

2) Support for domestic mechanisms for fiduciary oversight

Supporting domestic mechanisms for fiduciary oversight delinked from financing agreements but which relate to scrutiny of finance contracting and resource disbursement process is another means of overcoming the problem of IFI ‘mission creep’. This includes supporting local groups in using and developing domestic means of fiduciary oversight and in developing a sound public debt management regulatory framework.

Southern groups are mostly in favour of such initiatives, of empowering local institutions and organising public interest in and around the issues of loan contraction and transparency and accountability in public expenditure management in order to enable greater scrutiny of the loan contraction and aid disbursement process. The African Network on Debt and Development, for example, advocates for the development of a ‘transparent, accountable and inclusive’ process of ‘procurement, utilisation and management of public loans and debts’ and for the development of domestic legal and economic framework for effective and inclusive debt management (Meja, 2005: section 1.0).

Development financing will only be disbursed if countries meet certain minimum standards of fiduciary oversight and governance. This may include ensuring that local loan contraction processes have been entered into through an inclusive and participatory process, designed in consultation with various stakeholders and in concert with an open and transparent debt management strategy and have sufficient safeguards for the auditing and accounting for resources disbursed (see Meja, 2005, section 9.0). Such efforts will force the World Bank and the IMF to make more normative judgments regarding the domestic loan contraction process and not just relying on the procedural aspects of the process when determining if the borrower has the capacity to borrow (see discussion in Section 2.2.2 above).
The Bank and some bilateral donors, such as the UK’s Department for International Development (DFID) already apply some of these principles in their disbursement of financing through the principle of ‘selectivity’. This approach, currently favoured by the World Bank when allocating PRSC and other programmatic loans, ‘implies channelling aid to countries that are committed to reform’, supporting countries ‘either on the basis of the policies they implement or on the results they achieve’ (World Bank, 2005e: para 69). The World Bank, for example, lends more to countries which score highly on the CPIA index. The DFID has a policy of targeting ‘high poverty/good policy’ countries’ in which ‘good governance’ is ‘a key criteria for influencing decisions about how aid is allocated’ (UK Government, 2003: para 24).

This is, nonetheless, a tricky area as it may lead to situations of effective prior actions if financiers insist only on financing countries with sound fiduciary oversight mechanisms. Rather than instituting home-grown fiduciary mechanisms, as proposed by domestic constituencies or local civil society and/or based on best practice guidelines of other international organisations such as the United Nations Institute for Training and Research (UNITAR), countries will feel compel to adopt the standards set by individual financiers, such as the World Bank, leading to a situation similar to that currently experienced by PRSP countries where accountability is directed upwards at the donors rather than downwards to the people. As the Bank itself has acknowledged: ‘if donors select the countries that follow good policies and simultaneously apply a predetermined list of such policies, the immediate effect is that recipients will face powerful incentives to adopt the prescribed policies [and] end up with polices they do not own’ (World Bank, 2005e: para 69).

However, some commentators, such as Piron and Evans, believe that ‘opting for the greater use of the state’s own financial systems’ in lending instruments can shift accountability domestically although this means the power resides with the financing agency through the ability to turn the resource tap on and off. Accordingly, the authors believe that enhancing accountability to donors can be a first step toward building domestic accountability’ as demonstrated in their case studies of PRS processes in Bolivia, Vietnam and Uganda (Piron with Evans, 2004: 31).

3. Support peer-review mechanisms

This is another means through which governments may be held accountable to citizens for use of resources gained from loans, grant aid and debt relief without necessarily compromising sovereignty or through extending the mandate of the international financial institutions. This can be achieved through making financing contingent upon satisfactory assessment by mechanisms such as the NEPAD Peer Review Mechanism or the African Union peer review mechanism. Southern groups, such as the African Network on Debt and Development (Afrodad), are in support of such mechanisms.

Supporting regional peer-review mechanisms delinks the institution of fiduciary oversight mechanisms in domestic loan contraction and aid disbursement processes from the financing instruments and financing agencies so that determination of a country’s compliance with certain governance standards is made by its own’s peers and financiers do not act as judge and jury and executor of such matters which will compromise the reform process.
4. **Support inclusion of responsible financing standards into other international treaties, such as United Nations treaties and other multilateral and bilateral agreements**

An obligation to adhere to responsible financing standards should be incorporated into other international agreements and treaties related to economic development and agreements for debt relief and additional aid, for example, through the UN Financing for Development process and bilateral and regional agreements for economic cooperation.
References and Further Reading


Legal Instruments

IBRD Articles of Agreement 1946
IDA Articles of Agreement 1946
IMF Articles of Agreement 1946
IBRD General Conditions for Loans, revised 2005
IDA General Conditions for Loans, revised 2005