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Market Trends: Sovereign Bonds

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Overview

In order to finance their budgets, raise funds for infrastructure projects, or otherwise raise needed resources beyond tax revenues, governments throughout the world turn to the local and international capital markets. The sovereign bond market for both local currency and foreign currency denominated instruments includes both traditional, stable issuers with investment grade ratings and more volatile emerging markets issuers. Sovereign issuers are typically active in the beginning of the calendar year as finance ministries begin to address their funding needs. Thereafter, sovereigns typically analyze market conditions throughout the year to identify the optimal time for issuance based on trends in their yield curve against U.S. treasury bonds (U.S. Treasuries) or other benchmark securities.

Throughout 2016, although yields on sovereign debt were historically low based on continuing low U.S. Treasury benchmarks, sovereigns carefully accessed the markets according to developments in their local economies, including continued low oil prices for oil producing nations, and with an eye to internal political developments. A number of sovereigns, including Colombia, Chile, Peru, and Mexico, issued in euros or other non-U.S. dollar currencies, taking advantage of liquidity in those markets and also tapping other non-traditional currency markets as the U.S. Board of Governors of the Federal Reserve System (Federal Reserve) considered increases in the federal funds rate in the second half of the year.

This article describes current trends and developments during 2016 in the sovereign bond financing market. It explains the process for issuance of a sovereign bond, notable transactions, and regulatory changes that may affect certain aspects of the sovereign bond market in the coming year. For additional information, see Sovereign Entities Practice Guide and Getting the Deal Through: Debt Capital Markets.

Notable Transactions

The year 2016 started off with Argentina's massive offering of $16.5 billion, used to fund its settlement with the hold-out creditors from its prior restructuring. The offering included four series of bonds with maturities from three to thirty years, with the largest series being a $6.5 billion benchmark 10-year bond due 2026 at a coupon of 7.5%. Although the country was required to pay higher spreads against U.S. Treasuries than issuers with arguably similar credit quality, the transaction enabled the sovereign to open a fresh chapter with investors. Argentina then returned to the sovereign bond market in July issuing $2.75 billion in 12 and 20-year bonds as well as a $7.0 billion issuance in the first quarter of 2017 of five and ten year bonds. For additional information on debt restructurings in general, see An Overview of Debt Securities Restructuring Options.

The year ended with Saudi Arabia issuing an inaugural Rule 144A/Regulation S dual tranche offering of five and ten year bonds in the aggregate amount of $17.5 billion, the largest inaugural issuance in the history of the sovereign bond market, as the Kingdom announced plans to diversify its economy in light of the current decline and projected trends in the international oil markets.

The Argentine and Saudi Arabian issuances bookmarking 2016 reflected a trend towards larger sovereign offerings. While typical sovereign offerings in past years have tended to range from bookmark size of $500 million (or equivalent) up to $2.5 billion, the markets were able to digest these and other larger transactions without having any adverse effect (from the issuer's perspective) on pricing.

Deal Structure and Process

Deal Process

A sovereign bond offering is typically commenced by the sovereign seeking proposals for an offering. In some cases, public bidding laws of the issuer require that the sovereign undertake a full procurement process to select underwriters. In others, a more informal process, based on the issuer's prior relationships and desire to retain a wide list of market makers and create competition among them, will result in a selection process with a rotating group of lead banks. The principal global investment banks typically act as lead underwriters on transactions throughout the world, with regional underwriters taking roles as part of the underwriting syndicate in the regions in which they are more prominently known. International counsel (i.e., New York or UK counsel, depending on whether the bonds are to be issued pursuant to New York law or UK law and whether the bonds are registered with the Securities and Exchange Commission (SEC)) may also be selected pursuant to such rules, either on an issue-by-issue basis or for a multi-year period. Underwriters generally also retain local counsel (i.e., of the country issuing the bonds), with the sovereign issuers either using in-house counsel (typically from the sovereign's finance ministry) or both in-house and external counsel. Any requirement or preference for a selection process for advisors is likely to add significant additional time for completion of a transaction, as discussed below.

Timeline

Once the sovereign selects financial and legal advisors, the parties will hold the kick-off for the offering. For seasoned repeat issuers with an effective shelf registration statement already on file with the SEC and updated public disclosures, including an annual report on Form 18-K, a transaction may be effected in a matter of days. For additional information on shelf registration statements, see Shelf Registration and Market Trends: Shelf Registrations and Takedowns. For sovereign issuers who access the market more intermittently and whose disclosures may not be updated as frequently, a timeline of six to eight weeks is more common (longer if the debt securities will be registered with the SEC in circumstances where a new registration statement is required and SEC staff review is possible). For additional information on SEC review, see Understanding the SEC Review Process.

For inaugural issuers, a transaction may also include a road show for targeted investors in financial centers or in cities with a concentration of institutional investors in the United States, Europe, and Asia, which may add an additional week or more to the execution timeline. For additional information on road shows, see Preparing for a Road Show and Before Your Road Show Hits the Road Checklist.

Due Diligence

For first time or very infrequent issuers, a due diligence trip to the country of the sovereign issuer may be scheduled to visit with officials from the principal governmental ministries of the issuer (ministry of finance, central bank, ministry of foreign affairs, ministry of commerce and trade, and office of attorney general) to conduct a review of the issuer's economic and political condition. For repeat issuers, such due diligence is most often held telephonically with a smaller set of governmental officials (narrowed to ministry of finance and central bank).

Deal Structure

Global sovereign bond transactions are typically offered either publicly pursuant to an SEC registration or privately on a Rule 144A/Regulation S basis to institutional investors in the United States and offshore. The issuer will enter into an underwriting agreement with underwriters (for SEC registered offerings) or a purchase agreement with initial purchasers (for Rule 144A/Regulation S offerings). For repeat issuers, standard documentation will typically be used and will be subject to modification only to reflect changes in law and regulation or to address particular aspects of an offering. For additional information on SEC registered offerings, see Initial Public Offerings Resource Kit and Follow-On Offerings Resource Kit. For additional information on Rule 144A/Regulation S offerings and forms used in these transactions, see Understanding the Requirements of Rule 144A and Regulation S, Indenture (Rule 144A and/or Regulation S Debt Offering), and Purchase Agreement (Rule 144A and/or Regulation S Debt Offering).

Starting in 2014 with the adoption of International Capital Market Association (ICMA)-recommended aggregated collective action clauses (CACs), most sovereign issuers have opted to issue using a New York (or English) law indenture, rather than the historical fiscal agency agreement. Proposed as a result of the legal and procedural stale-mates occasioned by the Greek and Argentine restructurings, these clauses, which permit voting on fundamental amendments to the terms of affected debt securities on an aggregated basis among different series of bonds in a manner similar to the requirements of Chapter 11 under the U.S. Bankruptcy Code, are intended to make it harder for a hold-out creditor to frustrate an agreed resolution for a debt restructuring by acquiring a veto position in a single series of debt securities and voting those securities against a global restructuring. By using a trustee structure in which the trustee has fiduciary rights on behalf of the noteholders as a whole and is authorized to act with exclusive authority upon the instruction of a majority of noteholders, the ICMA form trust indenture seeks to make it more difficult for minority "vulture" noteholders to pursue remedies at odds with the majority creditors.

Deal Terms

Transaction terms for sovereign bond offerings are comparatively standardized under either New York or English law, both as among various issuers and as among an issuer's outstanding series of bonds. This structure helps issuers to go to market quickly and for investors to make investment decisions based on their view of the particular sovereign's credit characteristics and outlook and not on any particular or unique provisions in the transaction terms of a particular bond series. Covenants and events of default are minimal, with a negative pledge on other external public indebtedness being the sole negative covenant and events of default typically limited to payment and non-payment defaults, cross-acceleration or payment default on other external debt of the issuer, unsatisfied judgments, illegality, or repudiation. For investment grade sovereign issuers, issuer call provisions (at a make-whole premium against U.S. Treasuries for the majority of the outstanding tenor, reduced to par as the debt securities near maturity) have become another standard feature of sovereign bond issuances. More recent changes in standard documentation include the January 1, 2016 adoption of provisions addressing the European Union (EU) bail-in regulation for underwriters subject to EU regulation.

The offering will typically be listed and eligible for trading on a non-U.S. stock exchange, often either the Luxembourg Stock Exchange or the Irish Stock Exchange, due in part to those exchanges offering exchange regulated markets outside the scope of certain EU regulations.

Disclosure Trends

The prospectus/offering circular used for the issuance and sale of the securities will include political, economic, and financial information covering the sovereign issuer consistent with the requirements of Schedule B under the U.S. Securities Act of 1933, as amended (the Securities Act), (which sets forth the minimum requirements to be included in a registration statement filed by foreign governments seeking to register debt securities for sale in the United States), Form 18-K under the rules of the U.S. Securities Exchange Act of 1934, as amended (the Exchange Act), and the rules of the stock exchange upon which the bonds are to be listed. Compared to the detailed, technical requirements of the U.S. securities laws covering private issuers included in SEC regulations such as Regulation S-K or Regulation S-X, the express requirements under Schedule B and Form 18-K are minimal. However, market practice and other applicable legal provisions, such as Section 17(a) of the Securities Act and Rule 10b-5 under the Exchange Act, have the practical effect of standardizing disclosures and inducing sovereigns to include important legal and political developments in their countries along with macroeconomic information concerning their budgets, Gross Domestic Production, balance of payment and foreign trade information, international reserve levels, and outstanding debt. Where a sovereign issuer's economy or budget is particularly dependent on a commodity, such as oil or minerals, or on remittance flows from expatriates, additional, detailed disclosures may be included. This information, almost always prepared and reported using International Monetary Fund approved methodology, substitutes for the audited financial statements of private companies required under the U.S. or EU securities laws and regulations.

For seasoned issuers with shelf registration statements filed with the SEC and filing annual reports on Form 18-K, the SEC will typically review a sovereign's annual report and/or Schedule B registration statement once every three to five years, with such review often tied to the filing of a new Schedule B shelf registration statement. Sovereigns considering a need to file a new registration statement to register additional debt securities should plan such filing in advance to take into consideration the likelihood of SEC review and potential delay in the declaration of effectiveness of the new registration statement.

Legal and Regulatory Trends

In 2016, there were few new legal or regulatory provisions in the United States directly applicable to sovereign bond issuers, although there was heightened attention to diligence questions and representations concerning economic sanctions, terrorism financing, and corruption. There was greater activity in the EU in 2016 in terms of new regulations applicable to sovereign bond issuers. As noted above, the EU bail-in rules became effective on January 1, 2016, and the provisions added to transaction documents typically require all counter-parties to contracts with EU-regulated banking institutions to acknowledge such rules and to agree to treatment of any obligations of such regulated institutions as determined by the applicable resolution authority. Under the EU bail-in rules, the applicable financial regulator can reduce, annul, or modify the obligations of an EU financial institution set forth in any agreement signed by such financial institution in order to address financial sector shocks affecting the EU or local jurisdiction. Other than the obligation to pay for securities on closing at settlement (typically three to five business days once a deal prices), the only obligations running from EU-regulated underwriters to sovereigns (or private) issuers under a standard underwriting or purchase agreement generally relate to underwriter indemnities concerning material misstatements or omissions in information supplied by the underwriters for use in the prospectus/offering circular. Notwithstanding, for sovereigns not closely following the progress of the EU bail-in rules, the sudden inclusion of such provisions required consultation and consideration. (These provisions are likely to create greater potential effects in the sovereign loan market, where EU-regulated lenders' commitments and future obligations to the sovereign or state-owned entity may be affected in unanticipated ways.)

The EU brought its Market Abuse Regulations (MAR) into force in July 2016. The potential application to sovereign issuers is not clear yet. In general, the MAR extended EU measures to combat market abuse to EU markets not previously subject thereto, including the unregulated segments of the Irish and Luxembourg Stock Exchanges, where many sovereigns list their bonds. Although EU members and the central banks and finance ministries of specified non-EU sovereigns were exempted from the extension of MAR, any sovereign not so exempted is now required to take certain actions regarding the identification and prompt dissemination of inside information (i.e., material non-public information) and to maintain written records of persons who have access to such information. While corporate issuers may be grounded in the procedures for identification and treatment of such information (consistent, for example, with similar SEC concepts), the application of such rules to sovereigns, which regularly compile and update macroeconomic data before it is made public, is uncharted. The MAR rules also require persons discharging managerial responsibility (PDMRs) to notify the issuer of their transactions in the debt securities of the sovereigns and for the sovereigns to make such information public. Similarly, while such a concept and the public reporting thereof may be commonly understood and applied in the case of Section 16 reporting for officers and directors of SEC registered U.S. issuers under the Exchange Act, the coverage and application of such rules to a broader sector of governmental officials of a sovereign are less clear. Finally, the MAR rules place certain restrictions on dissemination of inside information during market soundings (i.e., non-deal road shows or deal road shows prior to the public filing or dissemination of a prospectus/offering circular). The EU has not published follow-up interpretations of the rules or indicated means to comply with the rules or means by which other sovereigns can be added to the exempted list of issuers. These rules will need to be monitored by non-exempt sovereigns in the coming year. For a discussion of these regulations in another context, see Reverse Yankee Bonds and the New EU Market Abuse Regime.

Market Outlook

Sovereign issuers are typically active in the beginning of the calendar year as finance ministries begin to address their funding needs, and 2017 has been no exception. Although recent actions taken or anticipated to be taken by the U.S. Federal Reserve to raise the U.S. federal funds rate have not yet had a pronounced effect on the sovereign bond market, market participants will study the direction of the market in determining timing of issuances and effects on the overall market.

One area to which some sovereigns may turn in 2017 and the coming years is an effort, through liability management transactions or otherwise, to extend the new ICMA aggregated CACs to their outstanding bond issuances. While the continuing low interest rate environment may make liability management and cash tenders or redemptions impractical or overly expensive for such transactions, some sovereigns may wish to further standardize their debt issuances in advance of the next challenging event, whatever it may be.