Market Trends 2017/18: Sovereign Bonds

A Lexis Practice Advisor® Practice Note by
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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 usually 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.

This article describes current trends and developments during 2017 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 Debt Capital Markets in International Jurisdictions.

NOTABLE TRANSACTIONS

Despite three increases in the benchmark interest rate by the U.S. Board of Governors of the Federal Reserve System (Federal Reserve) throughout 2017 and continued expectation of further interest rate increases in 2018, yields on sovereign debt continued their historically low trend based on ongoing low U.S. Treasuries benchmarks. Nevertheless, sovereigns carefully accessed the markets according to developments in their local economies, including volatile oil prices for oil producing nations, and with an eye to internal political developments and in some cases expanding anti-corruption scandals.

Among emerging market issuers, Argentina was one of the most active sovereign issuers in 2017, continuing the trend begun with its return in 2016 to international debt markets after resolving its long dispute with holdout creditors. Argentina began the year with a $7 billion five- and ten-year bond issuance in January 2017. In June 2017, Argentina issued $2.75 billion of a century (100-year maturity) bond, with reports that it was 3.5 times oversubscribed, following Mexico as the only other Latin American issuer of century bonds. Argentina returned to the markets in January 2018 with a $9 billion issuance in January which was 2.4 times oversubscribed, including a $1.75 billion five-year bond, a $4.25 billion 10-year bond, and a $3 billion 30-year bond, with yields that the sovereign stated were the lowest in its history.

Other transactions of note included Peru issuing a $3.08 billion Euroclearable note denominated in its own currency and the government of Belize's restructuring of its $526.6 million Bonds due 2038 by a consent solicitation, which had the support of a bondholder's committee established in accordance with a creditor engagement clause negotiated in its prior 2013 restructuring. Belize's restructuring provided a precedent for the usefulness of such creditor engagement clauses in contributing to a faster restructuring as well as certain innovations for a sovereign restructuring done without the International Monetary Fund. These include commitments with respect to fiscal adjustment reflected in an unwind clause if the National Assembly of Belize does not enact a public sector budget that includes fiscal measures projected to produce a fiscal consolidation for the 2017/2018 fiscal year equal to 3.0% of gross domestic product (GDP) (in comparison with Belize's fiscal year that commenced on April 1, 2016). A second innovation was the inclusion of commitments to seek a fiscal surplus of 2.0% of GDP in the next three fiscal years, with consequences for failure to achieve such a surplus. For further information on debt restructurings, see Debt Securities Restructuring Options.

As part of a trend since 2013, emerging market sovereigns continued the issue of euro denominated debt. A December 2017 World Bank study found a range of motivations behind the trend, each dependent on the sovereign that is issuing the debt. The motivations discussed in the study include, among others: the desire for diversification of the sovereign's investor base; political or economic links of the sovereign with the European Union (EU); a short-term effect of lower coupon rates in the euro denominated market; diversification of foreign exchange exposure based on the correlation of sensitivity of currencies to the main commodities exported by the sovereign; and higher demand from euro investors for a particular sovereign's debt than from the dollar denominated market.

The year 2017 also witnessed an increase in green bond issuances by sovereigns, driven in part by funding needs to meet commitments undertaken as a result of the entry into force of the Paris Agreement on climate change. In January 2017, France issued the largest single green bond placement in history with a €7 billion issuance, the proceeds of which will be used to fund eligible green expenditures. Although green bond issuances currently comprise only a small portion of the market, this trend bears watching as projects funded by these bonds diversify in order to meet commitments to cut emissions targets.

Among the Organization for Economic Co-operation and Development (OECD) countries, Austria issued a €3.5 billion century bond in September 2017, making it the Eurozone's first syndicated century eurobond and largest single issue of a century bond to hit the Euro market to date. The sovereign market in general has seen an increase in longer maturities—Austria itself had in the previous year issued €2 billion of a 70-year bond. This trend toward ultra-long maturities may decline in the future if interest rates continue to rise, as small shifts in interest rates may have a greater effect on bond prices that decrease the attractiveness of such long-dated instruments.

In the sub-Saharan African segment of the market, the Federal Republic of Nigeria completed a debut issuance of $300 million diaspora bonds with a tenor of five years. These bonds were registered with the Securities and Exchange Commission (SEC) and the United Kingdom Listing Authority. The offering was the first time a sovereign has issued a tradeable registered bond that was marketed to retail investors in the United States and the United Kingdom. Nigeria is only the second country in the sub-Saharan African region to register bonds with the SEC.

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 U.K. counsel, depending on whether the bonds are to be issued pursuant to New York law or U.K. law and whether the bonds are registered with the 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, Top 10 Practice Tips: Shelf Registration Statements and Takedowns, and Market Trends 2016/17: 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 and Top 10 Practice Tips: Responding to SEC Comment Letters.

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). Since legal compliance due diligence with respect to sanctions, anti-money laundering, and combating terrorism financing has become more prevalent, a separate diligence call is typically undertaken requiring additional coordination with individuals in the central bank or ministry of finance who deal with compliance in this area on a day-to-day basis. These individuals typically differ from the economic and political governmental officials. For more information, see OFAC Due Diligence in Securities Offerings, Ensuring OFAC Compliance in a Securities Offering Checklist, and Money Laundering Laws Compliance Representation and Warranty.

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 Registered Offerings: Applicable Laws, Rules, and Regulations, 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 Rule 144A / Regulation S Offerings Resource Kit, Rule 144A and Regulation S Requirements, 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 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. CACs 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 of 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 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. Other changes in standard documentation include the January 1, 2016 adoption of provisions addressing the EU bail-in regulation for underwriters subject to EU regulation.

Sovereign bond offerings 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) (15 U.S.C.S. § 77q) of the Securities Act and Rule 10b-5 (17 C.F.R. § 240.10b-5) under the Exchange Act, have the practical effect of standardizing disclosures and inducing sovereigns to include in their disclosure important legal and political developments in their countries along with macroeconomic information concerning their budgets, GDP, balance of payment and foreign trade information, international reserve levels, and outstanding debt. If 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. For further information, see Schedule B Foreign Sovereign Debt Offerings.

LEGAL AND REGULATORY TRENDS

In 2017, there were few new legal or regulatory developments in the United States directly applicable to sovereign bond issuers, although market practice saw heightened attention to diligence questions and representations concerning economic sanctions, terrorism financing, and corruption. The imposition of sanctions by the U.S. Department of the Treasury on the participation of U.S. investors in new debt issuances by the government of Venezuela caused some initial confusion and is likely to make any short-term resolution to the Venezuelan debt situation more complicated.

While not specific to sovereigns, one recent change that may affect sovereign issuers that list their securities on European stock exchanges is a new requirement under the Markets in Financial Instruments Directive (MiFID II) relating to trade reporting requirements which became effective on January 3, 2018. Under the MiFID II, investment firms must report information on trade details, parties, and financial instruments. One such piece of information is the legal entity identifier (LEI). The LEI is a 20-digit alpha numeric code developed by the International Organization for Standardization to allow a unique identification of legal entities. Sovereigns are not exempted from the requirement and must obtain an LEI in order for their securities to continue to be traded in EU markets. On December 20, 2017, the European Securities and Markets Authority (ESMA) issued a statement outlining temporary measures to ease the transition which are in effect for six months. Under the temporary measures, trading venues may report their LEI codes instead of LEI codes of non-EU issuers that do not currently have their own LEI code. The United Kingdom's Financial Conduct Authority (FCA) issued a statement in response that it would respect ESMA's temporary rules, but that it was not able to change its own rules by the January 3, 2018 effectiveness date. The FCA further stated that until its rules could be amended, investment firms should not submit trade reports that do not comply with the MiFID II requirements. However, the FCA announced that ESMA's temporary change regarding LEIs were implemented in the FCA's own system beginning March 12, 2018. 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 2018 has been no exception. While the continuing step increase in the U.S. federal funds rate by the Federal Reserve has not yet had a pronounced effect on the sovereign bond market, one can anticipate that market participants will study the direction of the market in determining timing of issuances and effects on the overall market.

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Whitney Debevoise is a partner at Arnold & Porter Kaye Scholer LLP, based in Washington, DC. His practice involves international financial transactions, public policy, international arbitration, multijurisdictional litigation, banking, and international trade. He has extensive experience in major international financial transactions and the capital markets, including five Brady Plan restructurings and other more recent sovereign restructurings (Belize, Greece, Argentina), numerous major privatizations, Eurobonds, and medium term note programs. He has handled significant International Centre for Settlement of Investment Disputes (ICSID) arbitrations and served as an arbitrator in commercial and investor-state cases. In addition, he functions at the forefront of trade liberalization, advising with respect to World Trade Organization (WTO) accession and panel proceedings, and regional trade integration.

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Neil Goodman is a partner at Arnold & Porter Kaye Scholer LLP, based in Washington, DC. He practices primarily in the areas of corporate, securities, and international financial transactions. His practice includes the representation of foreign, public, and private clients and multinational financial institutions as both borrowers and lenders in connection with US and international debt and equity transactions, including capital markets offerings, and private placements, and syndicated and trade finance lending operations, and project financings, including the representation of the Ministries of Finance of Colombia, Costa Rica and El Salvador. He has been involved in a number of complex out-of-court debt restructurings, including several of the largest sovereign debt restructurings, where he represented the Ministries of Finance and Central Banks of Venezuela, Brazil, and Panama. In addition, he maintains an active domestic and cross-border mergers and acquisitions practice.

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Carlos Pelaez, counsel in Arnold & Porter's Corporate and Finance practice, has experience on capital markets, finance and mergers and acquisitions transactions. He has represented issuers and underwriters in equity and debt transactions for corporate, financial institutions and sovereign clients in SEC registered and unregistered transactions. Prior to joining the firm, he was an associate at another large New York law firm. In 2017, The Legal 500 Latin America recognized Mr. Pelaez as a "Next Generation Lawyer" for Capital Markets.

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