Market Trends 2018/19: Sovereign Bonds

A Lexis Practice Advisor® Practice Note by
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This article describes current trends and developments during 2018 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.

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 the yield curve for U.S. treasury bonds (U.S. Treasuries) as well as trends in the sovereign's yield curve against U.S. Treasuries or other benchmark securities.

Notable Transactions

Bond yields became volatile at times throughout 2018, with bond yields increasing from previous historical lows as central banks increased interest rates and ended stimulus programs. A sell-off in emerging market debt also held issuances for part of 2018 to their lowest level in years. Late in the year and into the first half of 2019 as expectations for lower growth globally began to materialize, the Federal Reserve expressed a marked shift in its plans to increase interest rates, which similarly also caused the European Central Bank to restart its stimulus program from the financial crisis and for a number of other governments' central banks to lower their own interest rates. This in part lead investors into the bond market and contributed again to lower bond yields. By March 2019, there were reports of global debt yielding less than 0% approaching $10 trillion. Sovereigns have continued to access the markets carefully 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.

A further trend that began with Peru's issuance of $3.08 billion Euroclearable Sol denominated notes in 2017, was an increase in the international issuance of domestic debt in a Euroclearable instrument, typically in a Rule 144A / Regulation S transaction, and with the underlying goal to develop local markets and protect against exchange rate risks. Issues consummated under this trend include Chile's approximately Ps. 104 trillion of bonds issued in July 2018 and Panama's $1 billion issuance of its *Notas del Tesoro* issued in April 2019.

2018 saw a continued interest in green bond and other thematic bond issuances by sovereigns, with notable transactions including Indonesia's issuance in February 2018 of its $1.25 billion green bonds, the first green bond sovereign issue from Asia, and Belgium's $4.5 billion green bond issuance also in February of 2018, the second largest ever sovereign green bond issuance. On October 2018, the Republic of Seychelles issued $15 million of the first ever "blue bonds" meant to finance marine and ocean-based projects by creating a Blue Grants Fund and a Blue Investment Fund focused on supporting sustainable marine and fisheries projects. Although green bond issuances and other thematic bonds 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 under the Paris Accord and to fund marine and ocean-based projects to combat climate change effects.

In addition, certain other sovereigns returned to the markets due to different circumstances. Qatar returned to the market for the first time since 2016 with a $12 billion offering in April 2018, with reported investor interest of $53 billion. Greece also returned to the bond market with a €2.5 billion issuance in January 2019 after having completed its bailout program in August of 2018, with reported demand of over €10 billion.

While sovereigns have less frequently issued floating debt based on London Interbank Offered Rate (LIBOR), with the impending end of LIBOR set to occur by 2021, some sovereigns are likely to include them in their liability management programs in the coming years in order to lessen exposure and unpredictability and also because amendment of bond terms may be hampered by the diffuse nature of ownership of the instruments.

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 multiyear 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 office of the attorney general) 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.

Time Line

Once the sovereign selects financial and legal advisors, the parties will hold the kickoff for the offering. For seasoned repeat issuers with an effective shelf registration statement already on file with the SEC and updated public disclosure, 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 2017/18: Shelf Registrations and Takedowns. For sovereign issuers who access the market more intermittently and whose disclosures may not be updated as frequently, a time line 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 time line. For additional information on road shows, see Preparing for a Road Show and Pre-Road Show 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, 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 a 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 stalemates 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 holdout 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 nonpayment 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 and starting in January 1, 2019, the adoption of provisions addressing the qualified financial contracts rules for U.S. globally systemically important banking organizations, despite not being in effect for sovereign counterparties until January 1, 2020.

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. § 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 2018, there were few new legal or regulatory developments in the United States directly applicable to sovereign bond issuers, although market practice saw continued heightened attention to diligence questions and representations concerning economic sanctions, terrorism financing, and corruption.

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 that 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 alphanumeric 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. While the European Securities and Markets authority had issued temporary measures to ease the transition by allowing trading venues to report their LEI codes instead of the LEI codes of non-EU issuers that did not then have their own LEI code, such temporary measures expired on July 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 2019 has been no exception. While the sovereign bond market continues to see substantial demand in 2019, with the increasing volatility and expected decrease in economic activity, one can anticipate that market participants will study the direction of the market in determining timing of issuances and effects on the overall market. Expectations concerning actions by the Federal Reserve in adjustments to the fed funds rate are also likely to determine the timing and depth of issuances for the remainder of the year.

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Whitney Debevoise's practice involves international financial transactions, public policy, international arbitration, multijurisdictional litigation, banking, and international trade. Mr. Debevoise rejoined the firm in 2010, having served as US Executive Director of the World Bank from 2007.

Mr. Debevoise 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, Mr. Debevoise functions at the forefront of trade liberalization, advising with respect to World Trade Organization (WTO) accession and panel proceedings, and regional trade integration.

Neil Goodman, Partner, Arnold & Porter

Neil Goodman is a partner at Arnold & Porter, 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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