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SESSION 1 : ASSURING DURABLE MARKET ACCESS: CHALLENGES FOR NEW AND INFREQUENT ISSUERS

prepared by the IMF

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ASSURING DURABLE MARKET ACCESS: CHALLENGES FOR NEW AND INFREQUENT ISSUERS BACKGROUND DOCUMENT[1]

A. Recent Developments in International Capital Markets

The crisis has had a marked impact on sovereign bond issuance in international capital markets (Figure 1). However, that impact was significantly different across advanced and emerging market economies and low income countries. As government borrowing needs in advanced and emerging market economies surged as a consequence of the crisis (Table 1), debt managers began to expand the scale of activities in international capital markets. That allowed them to marginally reduce the financing burden on domestic debt markets and reflected efforts to achieve greater investor diversification. Issuance by advanced economies in 2009 was over 300 percent larger than the volumes issued in 2007; similarly issuance by emerging market economies broadly doubled in 2009 relative to 2007.

In contrast, just prior to the crisis, low-income countries had just begun to emerge as a new class of issuer. For example, Ghana issued its debut USD bond in September 2007, while Georgia came with its debut in April 2008. That partly reflected global liquidity conditions at the time which prompted an aggressive search for yield. However, as the crisis broke, and investors became more risk averse, planned debuts—including from Kenya and Nigeria—were postponed, reflecting in a sharp drop in volumes in 2009.

The overall situation now appears to be in reverse. Although still slightly elevated, issuance by advanced and emerging market economies appears to be returning to pre-crisis levels, while low-income country issuers are beginning to emerge again. The market for low-income debuts re-opened with Senegal in December 2009 and Nigeria successfully came to market with its postponed debut issue in January 2011, and there is renewed talk of prospective issues from Angola, Ghana, Tanzania, Uganda and Zambia.

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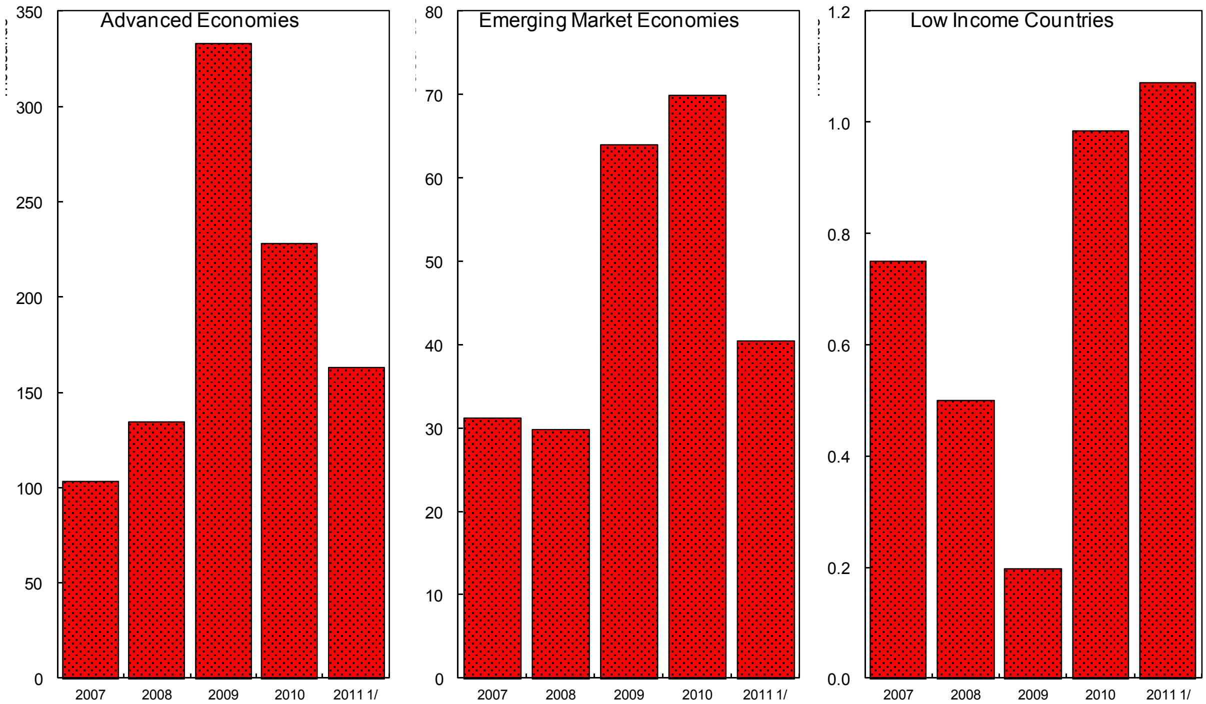
[1] This note has been prepared by Allison Holland of the Sovereign Asset and Liability Management Division, Monetary and Capital Markets Department, IMF. The note is intended for use only at the 12th OECD-WBG-IMF Global Bond Forum. For any citation or other use, please contact Udaibir S. Das (udas@imf.org). This note does not necessarily represent the views of the IMF, its Executive Board, or its Management.

Figure 1. Government Bond Issuance in International Capital Markets

(In billions of U.S. dollars)



Source: Dealogic, IMF staff estimates.

1/ Based on actual issuance in the year to May 13, 2011 annualized.

Table 1. Gross Central Government Financing Need: Selected Countries

	Average 2005-2007 (% of GDP)	Average 2008-2010 (% of GDP)	Ratio		Average 2005-2007 (% of GDP)	Average 2008-2010 (% of GDP)	Ratio
Selected advanced economies				***Selected emerging market economies***			
Australia	0.5	5.4	11.2	Brazil	25.0	16.8	0.7
Belgium	14.8	24.0	1.6	Hungary	21.4	26.0	1.1
Canada	8.9	14.7	1.6	Korea	10.8	10.0	1.0
France	10.6	18.1	1.7	Mexico	7.8	11.5	1.3
Germany	8.8	12.8	1.5	Turkey	3.3	5.7	1.7
Italy	19.2	24.1	1.3				
Japan	50.9	50.6	1.0				
Netherlands	6.3	16.4	2.6				
U.K.	5.7	13.2	2.3				
U.S.	13.4	24.8	1.8				

Sources: WEO; and BIS.

Note: Gross borrowing is calculated as the sum of the overall fiscal balance (based on WEO data) and maturing debt (based on BIS data on short-term debt).

More generally, investor interest in new "frontier" issuers—which go beyond just low-income country issuers[2]—appears to be resurgent. For example, according to trading volumes reported by EMTA[3]—which captures trade volumes reported by more than 50 leading investment and commercial banks, asset management firms and hedge funds active in over 90 emerging market and low-income countries—while overall trading activity in has recovered to pre-crisis levels, due in large part to a sharp resurgence of activity in African and Middle Eastern markets (Figure 2). This could indicate an improvement in the relative risk perception of this asset class, particularly as the perceived credit risk of advanced economies has increased.

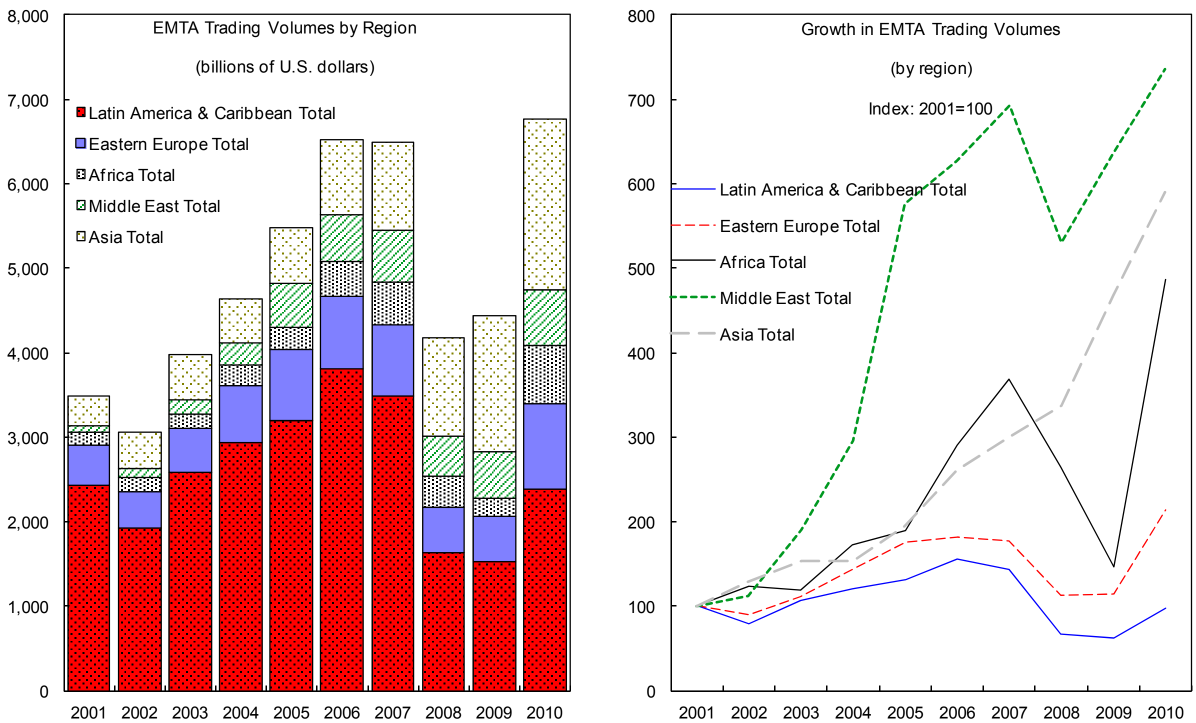
In response to this investor appetite, new issuance activity from "frontier" issuers has increased significantly. In 2010, four new frontier issuers came to market—Albania (October), Belarus (July), Jordan (November) and Montenegro (September)—all in the latter half, followed most recently by Nigeria (January, 2011). These deals have (generally) been well received by the market and heavily oversubscribed (e.g., Montenegro 3 times, Nigeria 2.5 times).

Going forward, it is likely that the trend in supply from these issuers will continue. Countries have large investment gaps to fill, particularly in infrastructure, but local debt markets are still under-developed and official-sector financing is unlikely to be sufficient. Consequently, countries will need to look to the international capital markets to generate resources. Similarly, while issuance volumes from advanced economies looks to be returning to more normal levels, given that overall financing needs will remain elevated over the medium-term and that debt markets remain fragile, it is likely that these issuers will still turn to international markets to supplement their core issuance programs when opportunities arise. This suggests that regular emerging market issuers, who continue to tap the international capital markets in relatively significant size, will face increased and continued competition for those resources.

[2] There is no formal definition of a "frontier market" but these are generally taken to be non-traditional markets, which have underdeveloped local financial markets and often heavy restrictions on foreign portfolio investment. Typically a subset of emerging markets, frontier markets could be considered to fall roughly into three groups: (i) small countries of relatively high development level (such as Estonia) that are too small to be considered emerging markets; (ii) countries with investment restrictions that have begun to loosen as of the mid 2000s (such as the countries of the Gulf Cooperation Council); and (iii) countries at a lower economic development level than the existing "mainstream" emerging markets (such as Kenya or Vietnam).

[3] The Trade Association for the Emerging Markets.

Figure 2. Emerging Market Trading Activity



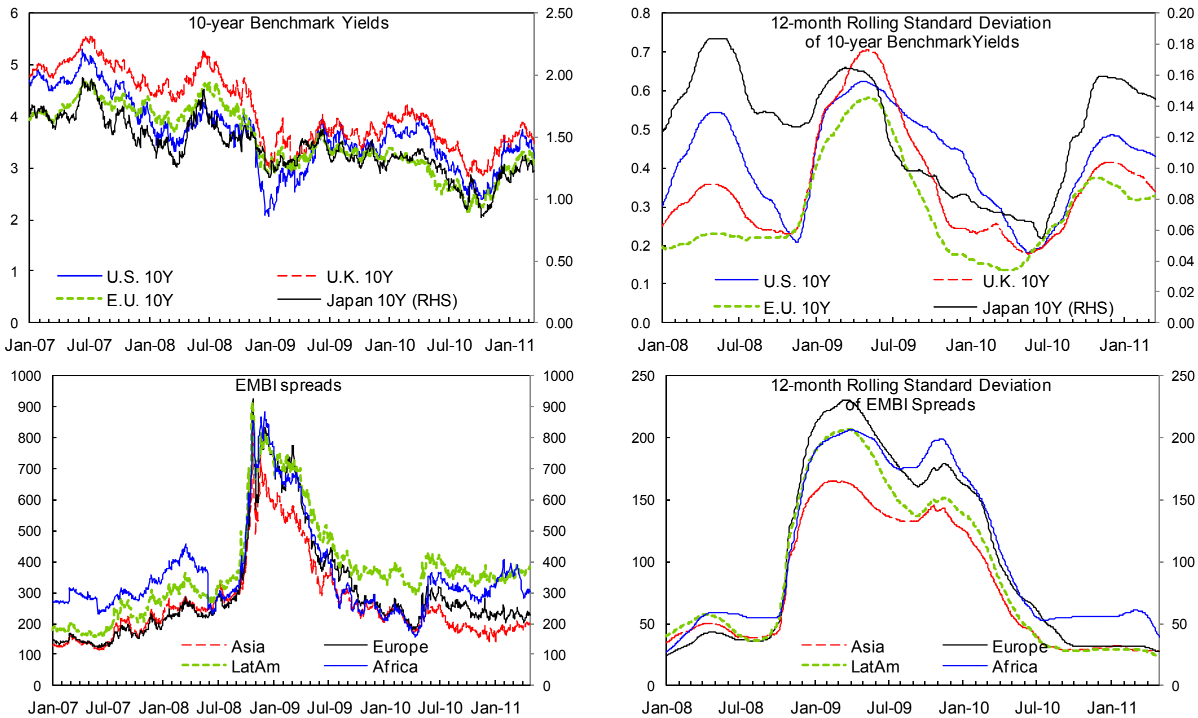
Source: EMTA

B. Challenges Involved in Market Access

Despite the improvement in market conditions, challenges for first time issuers identified in previous work remain (Box 1). Key amongst those are whether issuers have determined the appropriate size and structure of the instrument taking into account the potential use of proceeds and overall debt management strategy. These challenges are also relevant for irregular issuers. As with first-time issuers, there may be a general absence of in-house technical expertise as this is difficult to maintain in the absence of activity. Similarly, in the absence of activity, investment bank research coverage may be very limited (or completely lacking), so they will face some of the same challenges in establishing name recognition with key investors.

The severity of these challenges may also have been aggravated by recent events. The sudden stop in market access observed in international capital markets in the last half of 2008 raise the challenges of managing rollover risk. The assessment of the scale of potential volatility in market prices may also have changed, and indeed, despite improved conditions, particularly in emerging markets, the underlying benchmark markets remain volatile (Figure 3).

Figure 3. Market Pricing Conditions



Source: Bloomberg.

Managing that increased rollover risk suggests it may be useful to revisit the question of design and size of debut issues. Clearly, the market has been biased toward large, bullet instruments. However, once prospective issuers consider the potential costs of insuring against that rollover risk—say by ensuring that liquid assets meet at least 100 percent of debt amortization due over the next 12 months—that may change the cost-benefit of a large, standard bullet relative to , say, a smaller amortizing structure. Given a benchmark size might constitute a very large debt for some frontier issuers—both in terms of the proportion of total debt it represents but also in terms of GDP—the issue of carry cost biases the cost-benefit further toward a smaller issue size.[4] In that context, the recent trend across some European countries to increase the use of Medium-term Note (MTN) Programs—which had been a popular feature of financing plans in the 1990's but which had slightly fallen out of favor—is of interest. Such programs provide significant flexibility to rapidly tap markets but in relatively small size when conditions are particularly favorable; they also provide the flexibility for issuers and offer non-standard designs tailored to individual investor needs—say in response to a direct request from an investor—within the umbrella of the program.

[4] i.e. the cost of carrying the funds until they can be absorbed into the economy, say, through planned investment expenditure.

Box 1. Accessing International Markets by First Time Issuers: Key Considerations[1/]

Accessing international capital markets can bring a number of benefits. It can help (i) diversify financing sources, helping mitigate financing risk; (ii) it can supplement domestic savings, facilitating the execution of the government's desired budget and reducing the risk of crowding out; (iii) it can allow the maturity structure of the debt to be lengthened, particularly where domestic markets are relatively underdeveloped; (iv) closer international market monitoring can enhance the commitment to the macroeconomic reform process; and (v) it can provide a pricing benchmark, facilitating the private sectors' access. However, it also carries some significant risks, in particular, refinancing risk can be significant especially where countries are vulnerable to sharp shifts in terms of trade or exchange rate shocks and /or where the size of the bond is large relative to export revenues.

The successful issuance of an international sovereign bond will depend on a number of key factors, including some preconditions such as having established a track record of good economic performance and where the macroeconomic outlook is relatively stable. The external environment also needs to be supportive, with significant investor interest and risk appetite in evidence. More specifically, when considering the design of a debut issue, careful consideration needs to be given to the following factors. Poor choices in these areas have led to some common mistakes by first time issuers:

- **Use of proceeds** – issuers benefit where there is a clear and explicit plan for the use of proceeds. This could include balance sheet operations, such as repaying or restructuring Paris Club debt or resolving debt in arrears; financing of specific purposes; or general government purposes. While the latter provides the greatest flexibility to the issuer, until the issuer has established a track record with the market, it is likely to prove the most expensive and riskiest in terms of ensuring sufficient revenues will be generated in the future to cover repayment.
- **Context within an overall debt management strategy** – ideally, the issuer would be able to present the issuance of an international bond within the context of an overall debt management strategy, indicating that there has been due account taken of the risk implications. This would generate confidence in the issuer's ability to manage the risks involved.
- **Size of the issue** – This should be clearly linked to the identified use of the proceeds. Countries should seek to minimize any potential cost of carry by only borrowing what they believe can be absorbed within a reasonably short time frame. If issuers have a clear view on how much they will need overall within the next 1-2 years, then some consideration should be given to whether to divide this total into more than one bond issue, say by re-opening the first issue. In making this decision, the key tradeoffs are that larger bond sizes are more liquid, which can be appealing for investors. However, everything else equal, a larger-size issue increases the rollover or refinancing risk. In addition, borrowing more than can be readily absorbed increases the cost of carry. Finally, market perception might be that the size of the initial issue is too large relative to the size of the issuer's economy, raising questions about future debt sustainability; this perceived additional risk could outweigh the liquidity benefits.
- **Structure of the bond** – The maturity and currency structure of the bond should be considered carefully given the overall risk exposure of the total debt portfolio and taking into account the macroeconomic vulnerabilities faced by the country. It may be prudent to consider adopting an amortizing structure if possible to mitigate future refinancing risk, while this may not be the preferred structure from an investor's perspective that is less of a concern if the issuer is likely to be an infrequent issuer going forward.

- **Choice of lead manager** – The country will need to hire a lead manager for the issue. First time issuers might find it advantageous to hire at an earlier stage financial advisors to help develop the issuance strategy, obtain ratings, and select the lead manager. The choice of lead managers should be based on a competitive process, with choice not solely driven by the question of fees but also on the basis of a more qualitative assessment, covering issues such as the lead manager's specific plans to market and distribute the new bonds, including an evaluation of their placement power; the commitment of the lead manager to provide market support after issuance; and whether there are attractive underwriting provisions on offer.
- **Legal issues** - The issuer needs to decide the various legal issues, and non-financial terms which enter into the formal bond documentation, including the choice of underlying law that the bonds will be subject to; whether it will be a global or Eurobond, and what form of collective action clause to include. These decisions should be taken after discussion with legal and financial advisors.
- **Investor relations** – Before going to the market, the issuer needs to have a clear plan with respect to how they are going to generate investor demand and how, going forward, they will keep investors informed. Such a strategy could include plans to undertake non-deal road shows, establishing a website and publishing relevant information on the macroeconomic and financial position of the country, including regularly updated information debt portfolio statistics.

1/ See, Das, Papaioannou, and Polan, 2008, "Strategic Considerations for First-Time Sovereign Bond Issuers", IMF Working Paper No. 08/261 for a fuller discussion.

Similarly, assessing the overall impact within the context of a debt management strategy may also be more complicated. More generally, the dimensions of risk that have been revealed through this crisis suggest there may have been a change in the general cost-risk trade-off facing debt managers. Debt managers should revisit their risk management frameworks to ensure they have adequately assessed the scale and nature of risks they face. That might change some of the trigger points at which accessing international capital markets becomes an appropriate and attractive action.

Finally, in these more volatile markets, establishing an effective dialogue with investors is likely to be even more critical.[5] This will play a key role in minimizing investor uncertainty, containing costs and, also, managing rollover risk more effectively. In that context, positive steps to enhance investor relations programs and improve transparency, including through enhanced data provision, will be critical.[6] Having in place a credible and

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[5] An issue which was discussed at the 11th OECD-WBG-IMF Global Bond Forum and which forms a key pillar of the *Guiding Principles for Managing Sovereign Risk and High Levels of Public Debt* (the "Stockholm Principles") that emerged from the discussions at the 10th Annual IMF consultations on "*Policy and Operational Issues facing Public Debt Management"* co-hosted by the Swedish National Debt Office in Stockholm, June 2010

[6] To support this goal, the Task Force on Finance Statistics has recently finalized the Public Sector Debt Statistics Guide (http://www.tffs.org/PSDStoc.htm) that provides guidance and a template for reporting

(continued)

formal medium-term debt management strategy, supported by a credible and robust economic framework, will provide a key pillar for that dialogue. In addition, prospective issuers should ensure that they have sufficient capacity to produce relevant and accurate data on portfolio developments on a timely basis that is widely accessible.

C. Issues for Discussion

- How do new and irregular emerging and frontier market issuers (e.g., Albania, Jordan, Nigeria, Senegal, etc.) establish durable market access that will be available to help them meet their large infrastructure investment needs?
    - What strategies do they need to employ?
    - How do they provide investors with confidence that credit risk will be contained?
- Are there any implications for instrument design, particularly given trends in advanced economy and regular emerging market issuers?
    - Should new issuers continue to focus on large, standardized benchmarks or should they tailor their instruments to specific target investor groups?
- Do more established issuers need to do anything new to maintain their market access, or is it just business as usual?

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comprehensive debt statistics. The recently established Public Sector Debt Statistics Online Centralized Database of the World Bank-IMF (http://www.worldbank.org/qpsd) also contributes to efforts to enhance transparency.