Sovereign Debt Management Forum 2014

Summary Note for Breakout Session 6

Market dynamics in international capital markets for sovereign debt

I. Summary of session

Doris A. Herrera-Pol, Director/Global Head of Capital Markets, World Bank Treasury, opened the session with an overview of the current market situation for international bond issuance. On the background of strong global liquidity conditions and low interest rates in advanced economies in recent years, demand for emerging market bonds issued in the international capital markets had been very high, and had attracted new issuers, in some cases countries with very low credit ratings. However, looking forward, the environment looks to be more challenging. Volatility has increased in general, and the expectations for 2015 were summarized as bleak. Specifically, downside risks are dominating, with growth expected to be disappointing and challenges for commodity exporters growing in line with falling prices.

The session demonstrated different approaches to and objectives for external borrowing ranging from a need for foreign currency (Sri Lanka), to provide a reference yield curve for private issuers (Brazil), and raise the profile of the country (Azerbaijan). All presenters highlighted the need for good market communication and for seeing the foreign market borrowing as an integrated element in the overall debt management strategy.

II. Key insights from presentations and discussion

Chandrasiri J.P. Siriwardana, Assistant Governor, Central Bank of Sri Lanka presented the Sri Lanka experience as a small regular issuer in the international capital markets. In his introduction he stressed the importance of not seeing international borrowing in isolation, but as an element in the overall debt management strategy. He highlighted the efforts over the past decade of improving the local secondary market for government securities, where bonds with maturities up to 30 years are now issued, and stressed that external borrowing is a complement to low-risk domestic borrowing. Average time to maturity of the portfolio has increased from 2 years a decade ago to currently close to 6 years. A key to these reforms has been a gradual opening of the domestic market to foreign investors.

Initially, the international bonds had a target size of US$ 500 million and maturities were up to 5 years. Over the years the target size has been increased to US$ 1 billion, and maturities have increased to 10 years. An important element in attracting global investors is the legal documentation. All the international bonds of Sri Lanka are of the Reg. S/144 type. The debt management office, in the Central Bank of Sri Lanka, keeps in close contact with investors through information sharing and regular

roadshows. In addition, having ratings from all three main rating agencies was highlighted as an important factor in continuing access to investors.

Otavio Medeiros, Head of Public Debt Strategic Planning, Ministry of Finance, Brazil presented the case of Brazil, which is a large and regular issuer in the international markets. After debt restructurings, Brazil returned to the international capital markets with a JPY issue in 1995, and has since been a regular issuer. For the overall portfolio composition there is a preference for domestic debt. Cost-risk models were used to identify a preferred split between domestic and external debt of 95/5 (19 percent of the total debt is in domestic currency held by foreign investors). Bi- and Multilateral debt is less than 1 percent of the total debt.

An important reason for issuing internationally in both USD and EUR is to provide a benchmark for local borrowers that want to issue in foreign currencies. While foreign reserves are outweighing the foreign currency debt by 10 times, a regular issuance program from the sovereign is considered essential to facilitate private sector borrowing in foreign currencies. Typically, a sovereign issue is followed by in increased activity in private sector issuance. The strategy followed in external borrowing is similar to what is traditionally seen for domestic borrowing, i.e. issuing benchmark bonds and targeting outstanding amounts of individual maturities (up to US$ 5 billion) through re-openings. In addition, since 2006, the Treasury is active in buying back outstanding bonds that they find mispriced compared to their estimated yield curve.

A league-table of the external dealers is prepared regularly, and the performance of the dealers is assessed on an ongoing basis. Part of what the dealers are expected to deliver is ideas for new transactions. There is regular turnover in the dealers. All planning of new deals is done from the Treasury, and instructions are given to the relevant banks (e.g. go or no-go on the planned day of issuance), i.e. there is not need for physical presence in New York etc. on the day of issues. The team responsible for external borrowing is highly professional, and are paid salaries in line with the market. They are continually watching the markets, partly to ensure that the Treasury is able to evaluate proposals and ideas, and not just accepting what the investment banks put forward.

Azer Mursagulov, Deputy Director of Public Debt Management, Ministry of Finance, Azerbaijan, described the case of the recent issuer, that plans to be issuing on an irregular basis going forward, and are not issuing with the purpose of covering funding needs. When the first bond was issued in 2014 in happened on the background of very high foreign reserves (70% of GDP) and strong macro fundamentals. The first investment grade credit rating was received in 2010, and Azerbaijan has been actively working on gradually improving ratings (currently at the BBB level).

The first plans of tapping international markets were prepared in 2007, and were ready to issue just at the international financial crisis hit. The plan at that time was to issue a 5-year maturity of approximately US$ 500 million. In 2013 it was decided to go forward with a Eurobond. The bond was issued in January 2014. The amount raised was US$ 1.25 billion with 10 years maturity.

A key question for Azerbaijan is why to issue at 5 percent and investing at lower interest rates? The main objective was to establish a benchmark to facilitate private sector issuance (two companies have since issued). Furthermore, the objectives include building relationships with investors, and to create interest in Azerbaijan. Further objectives included, through focus from investors and rating agencies, creating internal discipline in domestic economic policy.

Doris asked the panel to provide thoughts about the issue of cost of carry. **Otavio** responded that since the funding and the spending are never exactly matched, cost of carry is always an issue. In practice, they look ahead on the debt service in a four-year rolling window, and reserve foreign currency from the bond issuances to cover these payments. Cost of carry is seen as the cost of providing a yield curve. **Chandrasiri** explained that the situation in Sri Lanka is different from Brazil and Azerbaijan, since the external borrowing is necessary to cover foreign currency needs. While no specific analysis is made, the benefits of external borrowing are seen to greatly outweigh the cost of carry. Finally, **Azer** provided input on Azerbaijan, where the funds from the external borrowing has been targeted at infrastructure investments. In the planning of the bond issue, they were trying to time the issue to minimize the fixed interest rate paid in the bond to subsequently minimize cost of carry

III. Conclusion and issues for further discussion

Doris summarized the presentations, highlighting the various reasons for issuing in the international capital markets, and emphasized that a key area to consider is why to borrow internationally and to have clear objectives, and stressed that “the best time to borrow is when you don't need the money.”