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State-contingent debt instruments for sovereigns: Can they be made «to work»

by

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GDP-Linked Bonds

The London termsheet: Legal & Commercial considerations

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The genesis of the London Termsheet

- The background: policy debates, economic models but no detail of the design
- The team
- The topic: Contractual design of a GDP-linked bond by reference to an imaginary country, Arcadia
- The proposal
  - Launching a debate - termsheet a “strawman”
  - Make choices so that the debate can be more focussed
  - Part of a process – feedback and iterations
- Today:
  - outline presentation of the design
  - how could this be of help to you

Policy aims

- Increase the fiscal space of sovereign issuers in times of economic downturn and so help
  - avoid costly and disruptive defaults
  - bring a more competitive pricing of fixed rate bonds
- Focus on strength and long-term potential of economy
  - Focus on GDP and growth aligns a sovereign's interest in sound long-term economic policies with that of investors who now seek equity like returns
  - True for both international and domestic investors
- Accuracy and reliability of data
  - issuers and investors want reliability and soundness of data to preserve competitive pricing
  - investors, in addition, seek comparability and consistency of data

Many state contingent debt instruments

- London Termsheet focuses on one SCDI
- Others are possible
- Variables
  - GDP
  - Commodity prices
  - Events
- Pricing and fluctuation
  - Principal and interest
  - Extension of maturities

Nature of GDP linked bond – identity of issuer

- Bond not warrant
  - Warrants: restructuring instruments, highly bespoke
  - Bond: more standardised, issue and redemption price, common mechanics, issued in both normal and extraordinary times
  - Warrants: only upside.
  - Bonds: full risk sharing, symmetrical returns
- Issuer: Arcadia
  - Developing economy - dependence on commodities – potential in manufacturing and services
  - long term economy will grow – but dependence on commodities and forex exposes it to risks

Postulating some parameters – the basic

- Currency: domestic (No consideration of currency unions)
- Investment audience: only wholesale/“sophisticated” investors
- Amount issued: large enough to provide liquidity
- Maturity: 10+ years smoothing of payments /economic cycles
- No call option, i.e, no right of early redemption by the issuer
- No security, “negative pledge” protection
- Listing – Rating
- Trust or fiscal agency structure
- Tax gross-up and other tax protection provisions
- Interest payment frequency and calculation

Postulating some parameters

- Governing law and Jurisdiction: domestic or external (English or New York)
- Pari passu (strict legal) – with what other debt?
- Negative pledge – with what other debt?
- Events of default – cross default with what other debt?
- CACs
  - single limb – only other GDP linked bonds
  - 75.0% ("reserved matters") - 66 2/3% (other matters)
  - Republic and entities controlled disenfranchised
- Aggregation of GDP-linked bonds with fixed rate bonds?

Source of GDP and fall-backs

– Issuer’s statistical agency

– Issuer’s Central Bank.

– If no publication - GDP for the immediately preceding reference period, multiplied by 1.1

  – Disincentive not to publish

  – Remedy period in case of practical inability not to publish

  – Consideration of penal nature of 10% increase at structuring phase

– Investors' requirements with respect to the sources of GDP data and relevant fall-backs for non-publication may vary depending on the particular sovereign

Revisions, calculations & put option for non-availability

- No adjustments if GDP revised after Calculation Date
- All calculations to be done by the Republic
  - Alternatives considered – trustee, independent entity, international organisation
- Early redemption at request of any holder if Put Event occurs:
- (a) Republic and/or its Central Bank do not publish GDP (subject to an agreed grace period);
- (b) *non-publication of an Article IV report for the Republic for two consecutive calendar years*;
- (c) Republic ceases to subscribe to the IMF's Special Data Dissemination Standard applicable to it;

Benefits

- Guiding principle: Payment structure needs to reflect the sovereign's capacity to pay, i.e. it's ability to tax
- Coupon *and* principal are indexed to GDP
  - Indexation is to the *level* of GDP, stabilising both flow *and* stock of debt as a portion of GDP
  - Indexation is to *nominal* GDP
  - Buyer receives inflation protection
- *local currency* bonds - exchange rate protection for issuer
- Long term maturities – certainty of funding
- Fiscal space in time of need
  - insurance against economic downturn & loss of market access
- Better GDP disclosure - Adherence to high standards

Work to be done

- Is the variable GDP or is it something else?
- GDP availability – fall-backs and revisions
- Market practice on disclosure
- Regulatory treatment
- Rating Agencies
- Debt management agencies and investors
- Sharia structures

References

– IMF's "State-Contingent Debt Instruments for Sovereigns"

– London Term Sheet and explanatory notes - ICMA's website

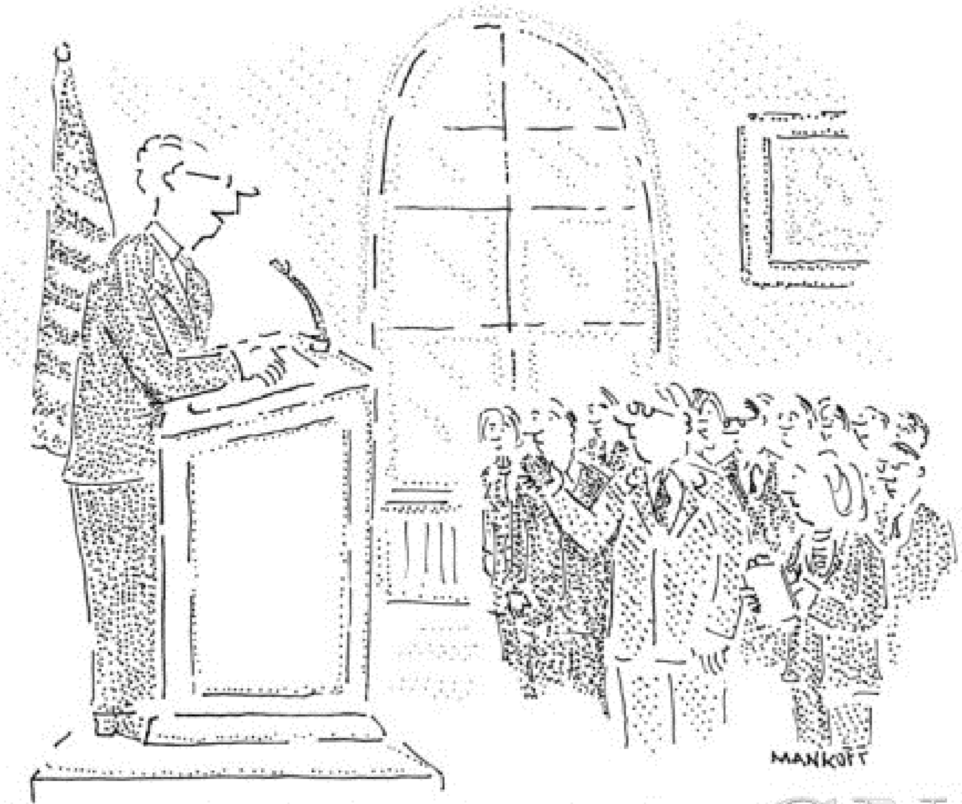
– IMF's standards for data dissemination

– "GDP-linked bonds: a commentary on a termsheet", Capital Markets Law Journal, Volume 12, Issue 2, 1 April 2017

– Forthcoming E-book

– Many references in all of the above

Thank you! Questions?



"That's a very good question, which is why we're going to move on to the next question."

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