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\(\frac{2}{3}\)\% (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
– Forthcoming E-book
– Many references in all of the above
Thank you! Questions?

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