Africa’s rising debt

Session 2. Sustainable and transparent lending

#Africasrisingdebt
@ODIdev
Africa's Rising Debt Conference
5 November 2018

Sustainable and Transparent Lending

The case for GDP-Linked Bonds and other State Contingent Debt Instruments

Yannis Manuelides, Allen & Overy LLP
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
Sovereign GDP-linked securities freeze interest expenses relative to GDP

Instrument that aligns debt servicing costs with payment capacity, thus rendering payment default unnecessary
A shift to GDP-linked issuance reduces the tail risk of explosive sovereign debt ratios

Source: Bank of England
Advantages for sovereign issuers

Elevated debt stocks leave little fiscal space to deal with economic and financial stress

- Median
- IMF risk threshold

- Advanced
- Emerging

Debt reversal via inflation is implausible for most sovereign issuers

- Ability to generate substantial inflation
  - Debt denominated in foreign currency
  - Debt denominated in domestic currency

- Inability to generate substantial inflation
  - Emerging Economies with “original sin” (Argentina, Zambia)
  - Emerging Economies with domestic bond market (Brazil, South Africa)
  - Euro area member states (France, Greece)
  - Advanced economies (UK, US, Sweden)

But debt servicing costs are still very low

- Gen. Government interest payments, …
- Advanced economies
- Emerging Markets

Sovereigns can buy insurance against the next downturn by locking in low debt servicing costs relative to GDP

- Switching just a quarter of the outstanding public debt into GDP-linked securities lessens the need for fiscal consolidation by more than 0.1% of GDP for every 1% shock to economic output.
- Even a partial move from fixed rate debt into GDP-linked instruments creates fiscal space for the sovereign and significantly reduces the need for austerity policies in an economic down-turn.
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 (referred to as Sovereign Co-Cos)
References

– IMF’s “State-Contingent Debt Instruments for Sovereigns”
– London Term Sheet and explanatory notes - ICMA’s website
– IMF’s standards for data dissemination
– Sovereign GDP-linked bonds: Rationale and design, an e-book published by CERP
– Many references in all of the above
Thank you! Questions?

These are presentation slides only. The information within these slides does not constitute definitive advice and should not be used as the basis for giving definitive advice without checking the primary sources.

Allen & Overy means Allen & Overy LLP and/or its affiliated undertakings. The term partner is used to refer to a member of Allen & Overy LLP or an employee or consultant with equivalent standing and qualifications or an individual with equivalent status in one of Allen & Overy LLP's affiliated undertakings.
Africa’s rising debt

Session 2. Sustainable and transparent lending

#Africasrisingdebt
@ODIdev
Recent successful innovations for private investment

Based on “Private infrastructure finance in developing countries: five challenges, five solutions”

Judith Tyson

Research Fellow
International Economics and Finance
Reasonable consensus on why private finance is not being mobilised …

- Lack of ‘bankable’ projects
- Political and FX risks
- Product design
“Mega-funds” to syndicate or securitize IFI-originated assets

Success story: The Managed Co-Lending Portfolio Program for Infrastructure (MCPP Infra)

IFC loans
IFC originate and syndicate infrastructure loans to MCPP loan fund

MCPP “mega” fund
Infrastructure debt fund of syndicated assets

IFC “first loss” tranche

$5 billion of institutional investors capital
IFI-seed funded ‘market-makers’ in FX and political risk instruments

- TCX: An example in FX
- Extend approach into new products
  - Political risk
  - Credit derivatives
  - Local currency bonds

Success story: TCX - the currency exchange fund

TCX was seed-funded by 22 IFIs and private investors. It is a vital provider of hedges to investors and has enabled investment into low-income countries and poor households. It has also:

- Become a market-maker in more than 70 emerging-market currencies
- Hedged $4 billion in loans in these currencies
- Built 30% of its portfolio in low-income countries

#Africa'srisingdebt
Reorient IFI mandates towards product origination for private investors

- Continue unique, high-value contributions
  - Project preparation
  - Early stage financing & development
  - Political relationships
- ‘Originate to distribute’:
  - Recycle capital & act as feeders for ‘mega-funds’
  - Product standardization & data
Africa’s rising debt

Session 2. Sustainable and transparent lending

#AfricaSRisingDebt
@ODIdev