

INTERNATIONAL MONETARY FUND

Access to International Capital Markets for First-Time Sovereign Issuers

Prepared by the International Capital Markets Department

In consultation with the Legal and other Departments

Approved by Gerd Häusler

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EXECUTIVE SUMMARY

Drawing on the experience of five first-time sovereign issuers, the paper discusses some considerations that member countries should take into account before issuing bonds in international capital markets for the first time. This paper, which is a first step in establishing a practical guide for countries considering accessing international capital markets, relies on offering memoranda, trade publications, and Fund reports, and has benefited from discussions with market participants, legal advisors, credit rating agencies, and authorities.

The experience of the first-time sovereign issuers showed that, while their objectives for accessing international capital markets differed, they generally issued their debut bonds under favorable domestic and external conditions. These countries had built a record of good economic performance over many years, and their medium-term outlook was positive. In most of these countries, growth was robust, inflation was under control, and the external current account deficit was financed easily. These countries had a prudent fiscal stance, and had a strong record of managing the public debt. First-time sovereign issuers had made progress in establishing transparency in the conduct of monetary policy and in carrying out structural reforms. The political situation in these countries was supportive of the pursuit of appropriate economic policies. Conditions in external markets generally were positive when these countries accessed international capital markets.

The size of the debut bonds varied widely across different issuers. However, other characteristics of the debut bonds tended to be similar. Nearly all of the first-time sovereign issuers placed five-year fixed-coupon, bullet bonds. Most of the bonds placed were in the U.S. dollar market. The initial bond issues generally were underpriced, thereby offering investors attractive initial returns.

The experience of the new sovereign issuers highlights the considerations that countries should take into account before accessing international capital markets. Domestic and external conditions should be favorable for countries to issue a bond successfully for the first time. Investors' lack of familiarity with first-time sovereign issuers needs to be addressed, including through credit ratings. While countries should target their preferred or "natural" investor base with their initial bond issue, they should seek to diversify their investor base with subsequent bond issues to enhance the liquidity of their bonds. Reflecting their preference for liquidity, investors tend to prefer a minimum size of issue. The currency of denomination of the bond should reflect, among others factors, the currency of preference of the investor base. Any currency mismatches associated with a bond issued in international capital markets should be manageable. Even though investors appear to prefer fixed-coupon, bullet bonds, new sovereign issuers could give consideration to the issuance of amortizing bonds to better manage their debt repayment profile. New sovereign issuers should eschew complex structures, including through the use of guarantees. Countries could take some steps to manage the risks associated with bonds issued in international capital markets.

I. INTRODUCTION

1. Many member countries are in the process of accessing international capital markets for the first time or after a prolonged absence. Yet, little attention has been given to assessing the factors determining a country's successful access to international capital markets and the desired characteristics of the debt instruments involved. Building on previous work on the determinants of market access by countries emerging from crisis, this paper attempts to fill this void by examining the experience of emerging market (EM) countries that have issued international bonds for the first time, or after a prolonged absence.¹ Based on the experience of these countries, empirical analysis, and extensive conversations with market practitioners, legal advisors, and credit rating agencies, the paper is a first step in establishing a practical guide for countries accessing international bond markets for the first time. It discusses some considerations that should be taken into account to ensure a successful bond issue in international capital markets.

2. The paper is organized as follows. Section II discusses the findings of the case studies of five first-time sovereign issuers (Bulgaria, the Dominican Republic, Egypt, the Islamic Republic of Iran, and Peru) in 2001–02. These countries were chosen because they attracted significant attention in the capital markets and provided a representative sample of cases across the world. The case studies rely on offering memoranda, trade publications, Fund reports, conversations with market participants, and in the case of Iran, discussions with the authorities. Section III describes the characteristics of the bonds issued by these countries and their investor base. Section IV uses the case studies to highlight a series of considerations that countries should take into account before accessing international capital markets.

II. CHARACTERISTICS OF COUNTRIES THAT HAVE ACCESSED THE MARKET

3. **Countries have various objectives in accessing international capital markets for the first time.** The primary goal is to raise capital to meet financing needs. The desire to diversify financing sources, or replenish international reserves is also important. In addition, countries access capital markets to establish a benchmark for the valuation of sovereign credit risk, which can facilitate future issuance by the sovereign, local governments, public enterprises, and the private sector. In this context, in accessing international capital markets for the first time countries could smooth consumption, take advantage of domestic investment opportunities, and establish a cushion against adverse external events, including a negative terms-of-trade shock. Accessing international capital markets would therefore complement the countries' efforts both to integrate into the global economy and to foster the development of domestic financial markets. However, in accessing these markets countries

¹ The term, "first-time sovereign issuers," also refers to countries that reaccessed international capital markets after a prolonged absence. The term international capital markets is used interchangeably to mean international bond markets.

need to be aware that they take on certain new risks, including foreign exchange and rollover risks, that would have to be carefully managed over time.

4. **Domestic and external conditions generally have to be favorable for countries to issue a bond successfully for the first time.** This is consistent with the experience of countries reaccessing international capital markets after having gone through a crisis,² and the results of an empirical analysis conducted by staff (Box 1). The academic literature on capital inflows to EM is also broadly in line with this observation.³

A. Domestic Conditions

5. **Countries accessing international capital markets for the first time generally had demonstrated a good macroeconomic performance for many years and had a favorable medium-term outlook.** Economic activity was generally robust in the countries included in the case studies, with real GDP growing and employment increasing, and inflation was for the most part well under control. Bulgaria's real GDP is estimated to have grown by about 4 percent in 1998–2000, rising to 4.5 percent in 2001, the year it accessed international capital markets for the first time. During this period, inflation was converging to the inflation rate of its major trading partners. In the Dominican Republic, real GDP, which had grown by an average of 7.7 percent in 1998–2000, grew by 3 percent in 2001, the year the country accessed international capital markets, and inflation was in single digits. Egypt's real GDP growth averaged 5.6 percent in 1998–2000 before it declined to 3.3 percent in 2000. During this period, inflation was falling to the rates of Egypt's main trading partners. Iran's real GDP growth averaged more than 5 percent in 2000–01 (the two years prior to accessing the markets), but inflation, while declining, was high. Favorable domestic economic conditions were important not only for first-time sovereign issuers but also for repeat sovereign issuers (Box 2).

6. **Countries' external current account deficits were comfortably financed at the time of issuance.** Even though the external current account deficit was widening in some countries at the time of issuance, it was largely financed with foreign direct investment (FDI) and official flows. In Bulgaria, the external current account deficit was widening, but it was financed comfortably by FDI, loans from the private sector, and some official financing. Similarly, in the Dominican Republic, the external current account deficit was widening, and it was financed by FDI. In Egypt, the external current account deficit was small when it accessed international capital markets, while in Iran, the external current account recorded

² International Monetary Fund, 2001, "Assessing the Determinants and Prospects for the Pace of Market Access by Countries Emerging from Crises," EBS/01/157, (9/6/01).

³ See Mody, Taylor, and Kim (2001). For the conditions required of companies to make an initial public offering, see Lowry and Schwert (2002); and Pagano, Panetta, and Zingales (1998).

surpluses due to high international oil prices for several years before this country accessed international capital markets.

Box 1. Empirical Estimation of First-Time Emerging Market Sovereign Issuers ^{1/}

An empirical analysis aimed at identifying the determinants of international market access by sovereign issuers produced results broadly in line with the regularities observed in the country cases analyzed in this paper. The dependent variable, the probability of access, is (the logit transformation of) a dummy variable that takes the value of 1 if country i issued a sovereign bond at time t , and 0 otherwise. The explanatory variables include external and domestic factors that are likely to enter the demand and supply for fund equations underlying the reduced regression specification. The sample covers the period 1980–2001 and 38 emerging market economies. The regressions display a good fit: the in-sample prediction produces an average 78 percent probability of the first-time access happening in the year in which the bond issue actually took place. The regressions appear to be robust with respect to: (i) the inclusion of FDI as an alternative channel of financing; (ii) sample truncation, with only post-1985 data used; (iii) the use of a variance-covariance matrix consistent with the high degree of heterogeneity present in the sample; and (iv) the use of alternative proxies for sovereigns' capacity to repay.

Among external variables, higher international interest rates translate into a lower probability of market access, both initially and subsequently. This reflects both the unwillingness of borrowers to pay higher rates, as well as the availability of alternative investment opportunities in developed countries. As expected, U.S. GDP growth, a proxy for availability of liquidity in international markets, is positively correlated with market access. The coefficient on the sovereign's share of world's GDP suggests that smaller countries have a better chance of placing their first international bond than their larger counterparts. This result defies easy explanation. One possible explanation may be that a new bond issue from small countries may benefit from a novelty factor initially, and is likely to add little volatility to emerging market portfolios. However, subsequent issues from these countries may become subject to greater market scrutiny.

Among the variables describing both the need for external financing (from the borrower's point of view) and macroeconomic discipline (from the creditor's point of view), the empirical results vary. While the coefficient on the current account balance indicates that supply-for-funds considerations dominate first-time access (with smaller external deficits implying higher probability of access), the importance of external account discipline fades away for subsequent bond issues. Conversely, the coefficient on the fiscal balance suggests that, irrespective of the sovereign's market experience (i.e., first time or subsequent issuer), the demand for external financing outweighs the fiscal discipline requirement. Finally, GDP growth does not appear to have a net impact on the probability of access, either initially or subsequently.

There appears to be an asymmetry regarding the relevance of foreign assets and liabilities of sovereign borrowers between their first and subsequent issues. While gross foreign reserves (measured in months of imports) seems to be an important factor explaining the first issue, the stock of foreign debt (measured as a ratio to exports) is what markets seem to be paying attention to for subsequent bond issues. This perhaps reflects some asymmetry in debt profiles, with repeat issuers more likely to have a higher debt burden than first time issuers. The coefficient on GDP per capita (a proxy for wealth and capacity to repay) is positive and significant. As expected, high inflation seems to reduce the probability of market access, as this phenomenon is a symptom of fundamental imbalances that call into question the country's medium-term viability.

^{1/} See Grigorian (2003). For an analysis along these lines, see Gelos, Sahay, and Sandleris (2003).

Box 2. Repeat Issuers: The Cases of Croatia, El Salvador, and Tunisia

Croatia, El Salvador, and Tunisia have shown that successful market access depends to a great extent on good economic management.

• **Macroeconomic Stability:** All three countries underwent successful stabilization programs at the beginning of the 1990s, resulting in high real GDP growth and price and exchange rate stability. Croatia has outperformed the Euro area and other European Union accession countries in terms of real GDP growth, achieving an annual growth rate averaging 4.2 percent in 1994–2002. Over this period, inflation (end of period) averaged 3.9 percent. El Salvador's real GDP growth has averaged 3.6 percent annually since 1994, and inflation has averaged 4.6 percent. Over the same period, Tunisia's economy performed strongly with average growth rates of 4.5 percent and inflation of 3.5 percent.

• **Fiscal Discipline:** Croatia, El Salvador, and Tunisia committed themselves to achieving fiscal discipline. In 1994–2002, El Salvador's central government deficit has averaged 2.3 percent while Tunisia's averaged 3.7 percent of GDP. While Croatia's fiscal situation has not been strong, it improved significantly in 2002 and market analysts also consider prospects for EU accession as a disciplining factor looking forward.

• **Good External Debt Management:** Croatia, El Salvador, and Tunisia have shown good external debt management. Since 1994, Croatia's external debt-to-GDP ratio has averaged 40.6 percent of GDP, although it has been increasing in recent years, and debt service has averaged 6.9 percent of GDP. El Salvador's external debt-to-GDP ratio has averaged 24 percent since 1994, and its debt service has accounted for 3.1 percent of GDP. Both Croatia and El Salvador have made efforts to substitute domestic debt with external debt, taking advantage of the lower external interest rates offered to sovereign creditors. Tunisia's external debt, at 60 percent of GDP, has remained broadly stable since 1994.

• **Strong Reserves Accumulation:** Both Croatia and El Salvador have strengthened their international reserve position. Croatia has quadrupled its gross international reserves since 1994, while El Salvador has accumulated nearly 1.5 times the level of its international reserves of that year. However, Tunisia does not have as strong a reserve position.

These countries have accessed international capital markets with ease on many occasions. Croatia has accessed capital markets often since 1997, issuing 14 international bonds in total. The strong performance of these bonds in secondary markets and Croatia's EU accession status have led to a high demand for this country's bonds. Croatia's EMBI Global spreads have remained stable, at around 120 basis points since early May 2002, and their correlation with the broad EM index has been low.

After its debut bond in 1999, El Salvador accessed international markets on seven occasions, including a 30-year issue in April 2002. El Salvador's EMBI index has averaged 370 basis points, while showing a strong positive correlation with the global composite index. El Salvador's success in accessing international markets reflects in part high domestic demand, with secondary markets for this country's bonds being practically inexistent.

Tunisia has accessed international capital markets often since 1994, with a total of 15 bonds. Tunisia tapped the Samurai bond market on several occasions, as well as the U.S. and European markets. Tunisia's spreads have generally had a low correlation with the overall EMBI.

7. **A prudent fiscal stance was the lynchpin of the macroeconomic management in countries accessing international capital markets for the first time.** As an indication of these countries' ability to repay their obligations, a prudent fiscal stance was essential in facilitating the sale of bonds by first-time sovereign issuers. Bulgaria, which experienced a major fiscal adjustment in the mid-1990s, maintained a prudent fiscal stance for many years prior to accessing international capital markets in 2001: the general government registered deficits averaging only about 1 percent of GDP in 1999–2001. Reflecting Bulgaria's strong commitment to fiscal austerity and the anchor resulting from its EU accession status, at the time of issuance the deficit was expected to decline to near balance in 2005. The Dominican Republic maintained a solid fiscal stance for many years before its debut in international capital markets. Iran, which went through a major fiscal adjustment in the mid-1990s, also had a manageable fiscal position for several years before accessing international capital markets in 2002.

8. **The first-time sovereign issuers' ability to service their debt received a positive evaluation by market participants.** While the public debt-to-GDP ratio varied significantly from country to country, first-time sovereign issuers studied had an excellent record in servicing their external debt in the years preceding the issue. The fact that some countries had undergone a debt restructuring earlier (such as a Brady deal), and some had defaulted on their domestic debt, was not a deterrent to international bond issuance. For example, while Bulgaria's public debt-to-GDP ratio was still high for an EM country, it had declined noticeably for several years through 2001. Bulgaria also built an excellent record in servicing its debt after 1994, when it restructured its commercial debt with London Club creditors.

9. **Most countries accessing international capital markets for the first time made progress in establishing transparency in the conduct of monetary policy.** This progress entailed either defining a nominal anchor or publicizing monetary objectives on a regular basis. In this context, the Dominican Republic and Peru were moving toward inflation targeting. Peru also began to publish monthly reports outlining recent monetary developments and announcing monthly monetary targets.

10. **Despite having different exchange rate regimes, the exchange rates were stable at the time of issuance.** The fixed exchange rate regimes, including currency boards (Bulgaria), of first-time sovereign issuers was not a cause of concern among investors, as these regimes worked effectively to help maintain macroeconomic stability. The flexible exchange rates in the other countries (the Dominican Republic and Peru) also worked well, with the exchange rates remaining stable. The foreign exchange markets in the countries included in the case studies were liberalized, or progress had been made in this regard. While the Dominican Republic unified its exchange rate system prior to accessing international capital markets, Iran took steps to liberalize its foreign exchange markets and unified its system in March 2002.

11. **Some countries had undertaken structural reforms over an extended period before issuing bonds in international capital markets.** In particular, some countries made significant efforts to increase the participation of the private sector in the economy. These

efforts included privatization, adoption of realistic and market-based pricing policies for privatized companies, the reduction of legal and administrative requirements to carry out operations, and changes in labor law to introduce more flexibility. This in part helped attract FDI, which, as noted above, preceded the issuance of the bond. Bulgaria and the Dominican Republic made important advances with structural reforms.

12. **The domestic political situation of countries that issued bonds in international capital markets for the first time was stable.** The political cycle also was not seen as adversely affecting policy continuity. Markets appeared to be comfortable with the political situation.

13. **Credit ratings played a key role in countries' access to international capital markets.** All countries in the case studies actively sought to get credit ratings before issuance to increase investors' familiarity with the country's credit profile, and obtained a rating of at least BB-. Credit ratings, in effect, helped first-time issuers overcome the asymmetric information, or lack of familiarity, about their credit.

14. **Fund support for the economic programs of the countries accessing international capital markets for the first time may have been important in some cases.** Fund support for an economic program, akin to credit ratings, may have helped overcome the asymmetry of information or investors' lack of familiarity with countries. For example, Peru had put in place an economic program supported by the Fund just prior to accessing international capital markets, while Bulgaria was in the final stages of negotiations on an economic program to be supported by the Fund.

B. External Conditions

15. **Favorable conditions in international capital markets were generally necessary for a successful bond issue by first-time sovereign issuers.** While such conditions were not relevant in the decision to access international capital markets, in most cases they affected the timing of the access. There appeared to be a "tolerance zone" for external conditions, giving rise to the on-and-off or binary nature of capital markets for EM.⁴ When conditions in international capital markets were favorable, first-time sovereign issuers were typically able to access these markets. Conversely, when conditions were unfavorable, first-time sovereign issuers tended not to issue.

16. **The binary nature of accessing international capital markets by emerging market countries was clearly observable in recent years.** After the surprise cut in U.S. interest rates in January 2001, conditions in global financial markets improved. This allowed emerging market borrowers to come to the market, with Egypt taking advantage of these

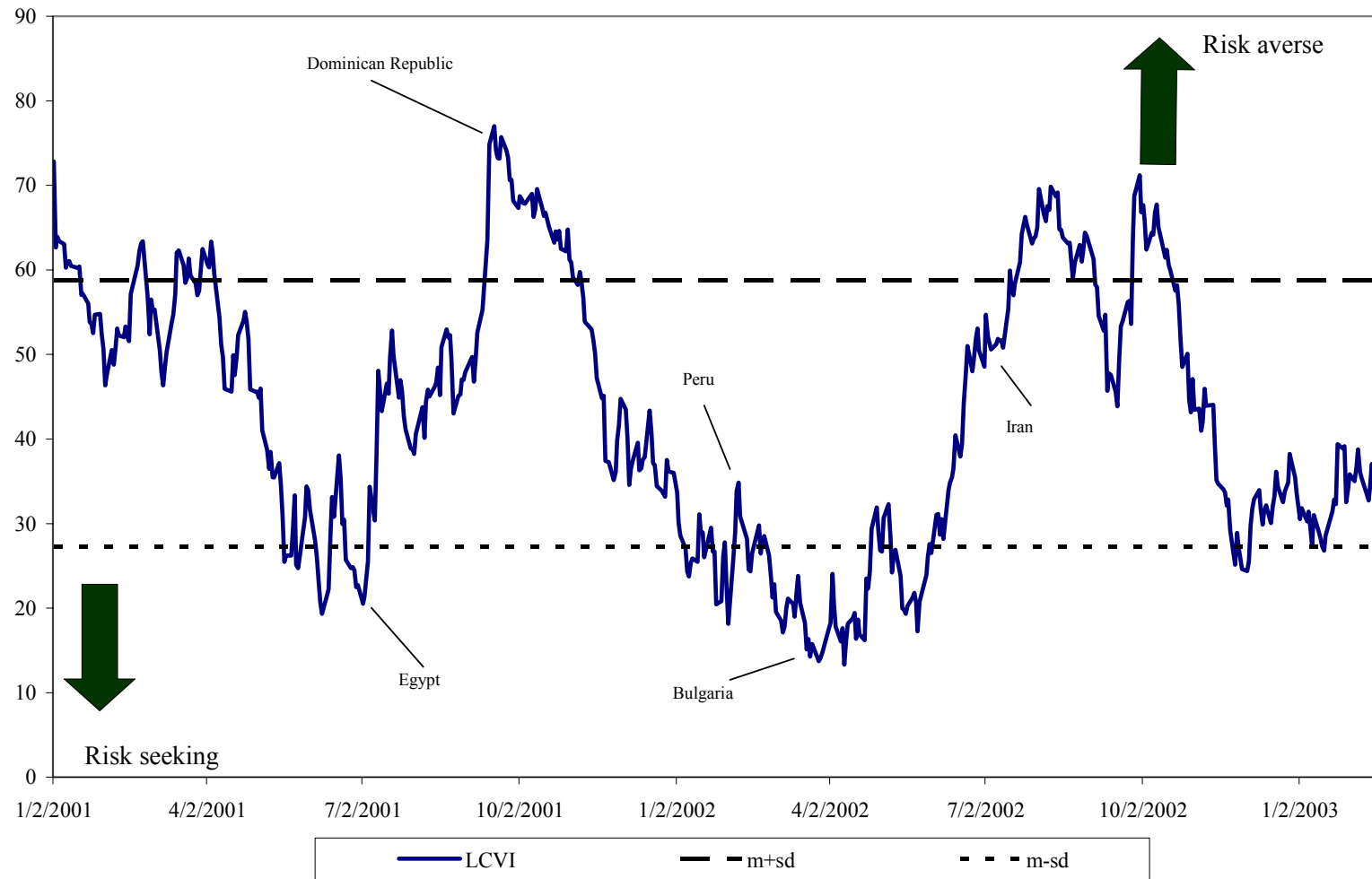
⁴ The binary or so-called "feast or famine" nature of emerging primary markets is analyzed in Annex I of Chapter III of the International Monetary Fund, 2003, *Global Financial Stability Report*, March.

conditions to issue its debut bond in June 2001. However, these conditions virtually disappeared after the events of September 11. Bond issuance in primary markets only recovered in November 2001. In 2002, the poor performance of mature equity markets led to increased interest for emerging market debt securities. Investor demand for new emerging market issues also reflected the higher-than-normal cash holdings of dedicated investors at the beginning of the year and increased allocations by crossover investors in the United States to EM. It is under these circumstances that Peru accessed international capital markets (Figure 1).

17. **External conditions limited, but did not curtail, market access for emerging market countries in some cases.** Despite the unfavorable circumstances in financial markets after September 11, the Dominican Republic showed that emerging market countries with a strong record of economic performance could access international capital markets. The Dominican Republic tested international capital markets by issuing on September 20, 2001, having completed the road show before the September 11 events. Uncertainty in the market reduced somewhat investor interest, and resulted in a higher spread. Nevertheless, despite the option to reduce the total amount to US\$300 million, the authorities ended up placing the targeted US\$500 million.

18. **The diversification needs of international investors were also an important driver for countries accessing international capital markets.** Bulgaria benefited from the opportunities created by these needs by issuing a bond in the context of favorable macroeconomic conditions and its near-investment-grade credit rating. Egypt also took advantage of the needs of international investors to diversify their portfolios at a time when other major emerging market borrowers, particularly Argentina and Turkey, were cut off from international capital markets. The effective marketing campaign used by Egypt to place the bond, and the interest of Egyptian expatriates in the issue, were also helpful in the process. Iran's issue attracted not only many Middle Eastern investors, but also European investors, who valued the diversification provided by a country with a strong commitment to reform and good economic prospects.

**Figure 1: Liquidity, Credit and Volatility Index (LCVI) - Overall Indicator,
January 2001-February 2003**



III. CHARACTERISTICS OF THE BOND ISSUE

A. Amount

19. **Countries accessing international capital markets for the first-time issued bonds ranging from US\$225 million to US\$1.5 billion** (Table 1). The largest issues were the bonds placed by Egypt, and the debt swap combined with a new issue by Peru. The latter country swapped Brady bonds for a new global bond of US\$923 million, and issued a bond of US\$500 million, in an operation designed to increase the country's weight in the JP Morgan EMBI indices. With a view to setting a benchmark issue eligible to be included in these indices, the Dominican Republic issued a bond of US\$500 million.⁵ Establishing this benchmark not only was expected to induce investors to include this bond in their investment portfolio, but also help price other types of investments into the country. The latter was an important reason why Iran accessed international capital markets. Interestingly, the amount of the issues varied greatly across countries when measured by different economic variables. While the Dominican Republic's issue was 2.3 percent of GDP, Iran's issue was 0.6 percent of GDP (Table 2).

Table 1. Characteristics of the Debut Bonds

	Bulgaria	Dominican Republic	Egypt	Iran	Peru	
Announcement Date	11/12/01	9/20/01	6/29/01	7/02	2/06/02	
Amount (million)	€250	\$500	\$500	\$1,000	€625	\$1,423 ^{1/}
Maturity	5.25	5	5	10	5	10
Price	98.86	100	99.63	99.88	99.23	97.73
Coupon (%)	7.25	9.5	7.625	8.75	8.75	9.125
Spread (bps)	376	569	275	335	425	455
Yield (%)	7.51	9.73	7.87	8.96	8.95	9.48
Credit Rating at issuance (S&P)	BB	BB-	BBB-	BBB-	BB-	BB-

Sources: Bloomberg and Bondware.

^{1/} Peru issued a \$500 million Global bond, and completed a \$923 million dollar swap of existing Brady bonds for the new Global bond.

⁵ An issue must be at least US\$500 million to be included in the EMBI indices. Other conditions, such as liquidity in secondary markets, must also be met for inclusion in these indices.

Table 2: Amount of the Issuance

	Total (in million)	As a percentage of GDP	As a percentage of the Stock of Debt 1/	As a percentage of the Stock of Reserves 1/
Bulgaria	€250	1.7	2.1	6.7
Dominican Rep.	\$500	2.3	11.9	45.4
Egypt	\$1,500	1.6	5.7	11.5
Iran	€625	0.6	7.9	8.8
Peru	\$1,423	2.5	5.1	14.8

Source: WEO.

1/ Data at year-end.

20. **Investors' demand was a driving force in determining the amount issued, and in some cases, led to the reopening of the initial issue.** Even though Egypt expected to issue a bond of only US\$300–500 million, it was able to issue a bond that was three times the higher end of the expected range. The strong reception by investors reflected the diversification offered by this bond at a time when some major emerging market borrowers were cut off from international capital markets. This issue was all the more impressive considering that it was entirely new money and not linked to any debt swap. Iran, after tapping €500 million, returned to the market with an offering of €125 million one week later.

B. Maturity

21. **Countries accessing international capital markets for the first time generally placed bonds with a maturity of five years.** This resulted from the issuers' desire to avoid locking in the relatively high interest rates associated with a first-time bond issue. In light of the fact that these were debut issues in international capital markets, countries also sought to accommodate investors, who appeared to prefer bonds with a five-year maturity as a way to manage the market risk associated with these bonds. Bulgaria, the Dominican Republic, Egypt, and Iran initially placed bonds with maturities of five years.

22. **When countries accessed international capital markets, they generally extended the maturity of their bonded debt, and overall debt profile.** The decision to access international bond markets not only represented a major change in the countries' financing policies, but it also led to an extension of the average maturity of the debt profile, particularly through subsequent issues that typically had a longer maturity.⁶ By way of example,

⁶ This process is not that different from what happens in corporate debt markets in mature markets. See Datta, Iskandar-Datta, and Patel (2000).

following its debut issue, Bulgaria issued two bonds with maturities of 11 and 13 years as part of a Brady swap. These operations extended the maturity of Bulgaria's bonded debt from 2.8 years to 10.9 years, in the process creating the longest dated euro benchmark of any EU accession country.

C. Currency

23. **Countries accessing international capital markets for the first time tended to issue U.S. dollar-denominated bonds.** This reflected the depth of the U.S. dollar market, and the benchmarks along the entire yield curve offered in this market. Issuance of bonds denominated in U.S. dollars also resulted from borrowing countries' efforts to target U.S. dollar-based investors, and to take advantage of their commercial ties. The Dominican Republic, Egypt, and Peru accessed international capital markets with U.S. dollar-denominated Eurobonds.

24. **The choices of Bulgaria and Iran for the currency of denomination for their debut bonds reflected strategic considerations concerning the investor base they were targeting.** Bulgaria issued initially in euros, reflecting its desire to appeal to European investors' interest in EU accession countries and to take advantage of its strong trade linkages with Europe. Bulgaria conducted subsequently two exchanges of U.S. dollar-denominated Brady bonds for new bonds denominated in both euros and U.S. dollars. The offer aimed at achieving a high participation rate by satisfying investor preferences toward currency risk. The exchange led to 55 percent of the bonds being issued in U.S. dollars. Iran issued bonds in euros, reflecting its desire to attract European investors.

D. Price and Yield

25. **First-time issuers generally issued fixed-coupon bonds, with yields ranging from 7 percent to 9.7 percent.** This translated into spreads ranging from 80 basis points to 569 basis points. The objective in issuing a bond with a fixed-rate coupon was to simplify the characteristics of the instruments so as to attract a broad range of investors. Most market participants indicated that first-time sovereign issuers typically pay a somewhat higher yield than established issuers with the same credit rating. How much higher the yield is depends on the level of the credit rating and EM spreads at issuance, with some market participants estimating this "premium" at 10–15 basis points for investment grade issuers. The experience of the first-time sovereign issuers did not provide conclusive results in this respect, as comparisons with other issuers were difficult because of different external conditions, geographical considerations, and bond characteristics. The experience of these issuers, however, shows that spreads at launch tend to decline in subsequent issues. The Dominican Republic, which commanded a spread of 569 basis points on its debut issue with a 5-year maturity, paid a spread of 493 basis points on its second issue that had a 10-year maturity. This decline may be partly explained by a favorable change in market circumstances.

26. **While the success of an issue is generally judged by the bond performance over a longer period, first-day returns are likely to have an important effect on market**

psychology. Market participants pointed out that positive returns in the first day (measured by an increase in the price of the bond or a compression of yields) could help shape the perception of investors about both the bond and the sovereign issuer. Investors, who are left with a good impression, are likely to be more willing to purchase the issuer's subsequent bond placements. First-day returns of sovereign issues included in the case studies were positive, except in the case of the Dominican Republic, which issued in a difficult external environment.

E. Enhancements

27. **The international bonds issued by first-time sovereign issuers considered in this paper did not include enhancements.** These bonds were “plain vanilla” bonds; they were general, unsubordinated, and unsecured obligations. As with most bonds issued in international capital markets, these bonds also included two provisions to limit the ability of the sovereign to provide certain type of enhancements in future borrowing: (i) a *pari passu* clause, which requires payment obligations of a bond to have the same priority as the payment obligations on all subsequent indebtedness;⁷ and (ii) a negative pledge clause, which restricts the sovereign's ability to use certain assets to secure future borrowing.

F. Collective Action Clauses

28. **Egypt was the only country to incorporate collective action clauses (CACs) in its debut issuance among the cases studied.** Egypt issued bonds under New York law, which were offered to U.S. institutional investors under Rule 144A of the U.S. Securities Act of 1933 (the “Securities Act”).⁸ These bonds contain a majority restructuring provision, with a voting threshold of 85 percent of outstanding principal, and a very limited form of majority enforcement provision.⁹ However, at the time of issue, the fact that the bonds contained CACs did not attract markets' attention.

⁷ However, the legal effect of this provision in sovereign bonds is unclear.

⁸ While under English law the inclusion of CACs is the norm, under New York law the inclusion of majority restructuring provisions was not common. In 2003, however, some EM issuers, including Brazil, Mexico, South Africa, and the Republic of Korea, issued bonds governed by New York law with CACs. The term CACs refers to clauses that include both majority restructuring and majority enforcement provisions. For a detailed discussion of CACs, see International Monetary Fund, 2002, “The Design of and Effectiveness of Collective Action Clauses,” SM/02/173, (6/7/02); and International Monetary Fund, 2003, “Collective Action Clauses: Recent Developments and Issues,” SM/03/102, (3/25/03).

⁹ Although the majority enforcement provisions in these bonds would require the support of at least 25 percent of outstanding principal to accelerate the entire issue, individual bondholders would still have the right to accelerate their own claims.

G. Investor Base

29. **First-time sovereign issuers placed their initial bond issues in certain markets, often with the intent of attracting a particular investor base.**¹⁰ For example, the Dominican Republic and Peru decided to issue in the United States as a way to tap major institutional investors. These countries succeeded in this strategy, placing more than 70 percent of their bonds with investors based in the United States. Interestingly, sovereign issuers limited the role of local investors at times, with some issuers forbidding them from participating at issuance to broaden their investor base as much as possible. The Dominican Republic did not allow local investors to participate at issuance, but permitted them to trade in the secondary market as a way to support for the bond price. Egypt conditioned the 10-year bond on the absence of local investors in its primary allocation.

30. **The allocation of new sovereign bonds favored institutional investors over retail investors.**¹¹ This reflected the fact that institutional investors were more receptive to new issues and played a key role in providing liquidity for the bond in the secondary market. Among first-time issuers, Egypt allocated the 10-year tranche of its debut issue to institutional investors in Europe and the United States, while distributing the 5-year tranche mostly to retail investors in Europe (mainly Egyptian expatriates). Iran allocated only 10 percent of its debut issue to retail investors. However, knowing who were the final holders of these bonds was complicated by the lack of information about secondary market trades.

IV. CONSIDERATIONS FOR ACCESSING INTERNATIONAL CAPITAL MARKETS

A. Conditions for Countries to Issue a Bond for the First Time

31. **The experience of first-time sovereign issuers highlights the issues that countries should address before accessing international capital markets for the first time.** Countries, in considering to take this step, need not only to understand their financing requirements, but also to have in place a debt management strategy that is sufficiently robust to ensure their ability to meet their debt-service obligations even in the face of major changes in the domestic and international circumstances. The case studies show that first-time sovereign issuers should have a strong record of domestic economic performance, favorable economic prospects, and a stable political situation. The success of a bond placement of countries accessing international capital markets for the first time also hinges on a favorable

¹⁰ The natural investor base is a group of investors who are familiar with the country as a result of economic and cultural links. For example, the natural investor base of both Bulgaria and Croatia consists of European investors because of their EU accession status.

¹¹ The allocation of bonds to institutional investors by new sovereign issuers does not appear to be different from the allocation of initial public offerings to institutional investors in mature markets. See Aggarwal (2000), Aggarwal, Phabhala, and Puri (2002), Ritter and Welch (2002), and Cornelli and Goldreich (2001).

international backdrop. In this connection, volatility and spreads in mature markets should be low, and investors should have low or declining risk aversion. The overall performance of EM should be strong, with declining spreads and rising trading volumes.

B. Characteristics of the Bond Issue

32. **Countries need to consider the characteristics of a bond, including the risks associated with the placement of a bond in international capital markets, and how to overcome investors' possible lack of familiarity with their credit.**¹² In deciding on the characteristics of the debut international bond, countries need to consider the following questions:

- How should countries address the asymmetric information or lack of familiarity associated with their credit?
- Which investors should countries target?
- What should be the amount of the bond issue?
- What should be the maturity of the bond?
- In what currency of denomination should countries issue a bond?
- Should the bond issued have a fixed or flexible coupon?
- Should the bond have bullet or amortizing principal?
- Should the bond include enhancements?
- Where should countries register and list the bond?
- Should the bond include CACs?
- Should countries manage the risks associated with issuing a bond in international capital markets over the life of the bond?

¹² Countries wishing to access international capital markets would need to work closely with financial and legal advisors to define a strategy to issue a bond, including the timing (announcement, subscription period, and closing dates) and the pricing of the bond.

33. **How should countries address the asymmetric information or lack of familiarity associated with their credit?**^{13 14} Countries should address the asymmetric information or lack of familiarity with their credit early on by providing to investors as much information as possible about their economic and political developments and prospects. Subscribing to the Fund's Special Data Dissemination Standard (SDDS) and completing key parts of the Reports on the Observance of Standards and Codes (ROSCs) could be an effective tool in this respect.¹⁵ Lack of familiarity could be overcome by repeat events and reputation building. However, since new sovereign issuers are likely to benefit less from these factors, it could be beneficial for them to secure sovereign credit ratings that, among other things, indicate their capacity to service their debt (Box 3). Issuers would need to undertake effective road shows, while being prepared to stand up to thorough investor scrutiny. Countries should establish investors relations programs to provide data, information on economic policies, and an explanation around data releases, thereby seeking to actively shape investor sentiment (Box 4). In addressing the lack of familiarity with their credit, countries would also benefit from framing their economic policies in a medium- and long-term macroeconomic context that highlights their borrowing needs, ability to service their debt obligations, and the strategy they want to employ in building their presence in international capital markets.

34. **Market participants stressed the need of countries to address the lack of information associated with their credit.** In this context, they underscored the importance of credit ratings. They highlighted that, apart from the provision of information and an assessment of the ability of countries to repay their obligations, credit ratings also allow the issuer to tap a wide investor base as most fund managers are required to invest only in rated securities.

¹³ The finance literature suggests that asymmetric information or lack of familiarity with corporations issuing equity or debt for the first time could have an effect on corporate asset prices. See Akerloff (2002), Covitz and Harrison (1999), Flannery (1986), Ritter and Welch (2002), and Stiglitz (2002).

¹⁴ If the issuer has traded restructured debt and, thus, is familiar to investors, this problem is likely to be less relevant. Among the countries studied, Bulgaria and Peru had Brady bonds.

¹⁵ About 83 percent of major financial institutions are aware of ROSCs, and 58 percent use ROSCs directly in risk assessments. ROSCs may also have an impact on credit ratings. For details, see International Monetary Fund, 2003, "International Standards—Strengthening Surveillance, Domestic Institutions, and International Markets," SM/03/86, (3/6/03).

Box 3: Sovereign Credit Ratings

The Role of credit ratings

Sovereign credit ratings could play a useful role in enabling countries to secure greater access to capital markets:

- Sovereign credit ratings serve as an important mechanism to overcome the asymmetry of information or lack of familiarity with a given country.
- Sovereign credit ratings could serve as a useful indicator of a country's investment climate, creditworthiness, and capacity to service existing debt.
- Sovereign credit ratings could provide an independent mechanism to validate and encourage the pursuit of appropriate macroeconomic policies and the government's commitment to the adoption of market-friendly economic reform. In this connection, rating agencies could serve as a sounding board for various policy initiatives.
- The rating process, as well as the rating itself, could potentially promote good governance and foster transparency in government decision-making and in the collection and dissemination of information.
- By enabling potential investors to differentiate between countries with different credit risk profiles, sovereign credit ratings could promote investments by institutional and retail investors in mature markets.

As a way to allow the African countries to attract a larger share of foreign direct investment and to access international capital markets, the United States and the UNDP are sponsoring programs to subsidize the cost of securing sovereign credit ratings. The programs fund the initial application for credit ratings and the fee for the first year. The program calls for the countries themselves to request the credit ratings.

The credit rating process

1. **Beginning of the process:** At the request of a country seeking to obtain a credit rating, a credit rating agency designates a lead analyst and a back-up analyst. Information useful in assessing the sovereign's ability and willingness to make debt payments is gathered, and a visit to the country is arranged. During the visit, the analyst(s) meets with government officials, business people, consultants, and academics.

2. **Deciding on a credit rating:** The lead analyst prepares a report about the economic and political situation of the country based on the agency's credit ratings framework and the specific circumstances of the country. The report, together with a rating recommendation that considers the ratings of comparable sovereigns, is submitted to the rating committee. After a discussion of the report, this committee, which includes analysts who cover other countries, including in different regions, takes a vote to decide on the rating recommendation.

3. **Publicizing the credit rating:** The rating is then communicated to the sovereign that has the option of either accepting the decision or appealing it. If the sovereign decides to appeal, it could submit additional information that would serve as the basis for the credit rating agency to reevaluate the decision. A new vote would be taken. Once a new decision is made, the sovereign has the option of making public the rating or not publishing it.

4. **Monitoring the credit rating:** After assigning a credit rating, the credit rating agency monitors the credit continuously, and prepares periodic analyses and reports.

Box 4: Investor Relations Programs¹

Investors relations programs (IRPs) could play a useful role in helping countries access international capital markets. In particular, they could:

- Provide economic data and information on economic policies, either directly or through a website.
- Explain the context behind data releases and, therefore, actively shape investor sentiment in line with fundamentals.
- Correct inaccurate information and dispel false rumors.
- Supply information on international and domestic government securities, such as securities outstanding, auction results and future calendars, terms and conditions of securities, historical data on prices and yields, and contact details of primary dealers.
- Provide answers to questions of both retail and institutional investors either directly or through e-mail.
- Serve as a sounding board for sovereign financing operations.
- Help policymakers interpret evolving market techniques, practices, and sentiment.

While there is not any empirical evidence that demonstrates that countries with IRPs have a more favorable access to international capital markets, it is well-known that the lack of information causes increased uncertainty that in turn leads to investors demanding increased risk premia. In this context, an active IRP could be expected to:

- Influence favorably the private sector's decision to maintain exposure to the country, especially when it is addressing emerging pressures in the external accounts.
- Help reduce a sovereign's vulnerability to adverse shifts in market sentiment, whether caused by country-specific concerns or by contagion. In this regard, the IRPs could help to mitigate the volatility of capital inflows.
- Facilitate non-Sovereign entities access to international capital markets.

^{1/} For additional details, see International Monetary Fund, 2001, "Investor Relations Programs—Report of the Capital Markets Consultative Group—Working Group on Creditor-Debtor Relations," SM/01/174, (6/19/01).

35. **Which investors should countries target?** Choosing the target investor base is likely to be a critical step, since it would affect both the overall strategy to access international capital markets and the selection of the bond characteristics, including the jurisdiction under which the bond would be issued. Such a step would be particularly important for countries aiming to establish a permanent presence in international capital markets. In this context, countries should first target their natural investor base, if they have one. A new issuer should also identify so-called "sponsor" or "anchor" investors, that is, investors who know the credit and are willing to absorb a significant share of the issue. Over time, countries would benefit from expanding and diversifying their investor base. In this context, it may be useful to target buy-and-hold institutional investors as a way to cement the

support for the bond, as these investors appear to be less inclined than other institutional investors to sell bonds at the first sign of stress. While retail investors could fulfill a similar role, owing to their buy-and-hold nature, they could limit secondary market trading, which may hamper efforts by countries seeking to establish a benchmark for non-Sovereign issuers. It must be noted that retail investors' appetite for EM has declined markedly as a result of the Argentine default, with the exception of countries with EU accession status.¹⁶

36. **What should be the amount of the bond issue?** The amount of a new bond issue should be consistent with a prudent debt management strategy. In this context, the amount would depend on: (i) the countries' financing requirements; (ii) the size of the domestic financial markets; and (iii) the need to establish a benchmark sovereign bond. Countries need to have a clear understanding of their financing requirements both in the near and medium term. This would be critical not only to determine the amount of the initial bond issue, but also to define a medium-term strategy for accessing international capital markets. A country in need of making a one-time, lump-sum investment may benefit from issuing a single-tranche bond that is sufficiently large to finance the operation. However, a country with financing requirements that extend over the medium term may benefit from issuing a small bond initially, with a view to paving the way for future bond placements. Croatia and El Salvador appear to have benefited greatly from following the latter strategy. The size of domestic capital markets could also have implications for the decision whether to issue a bond domestically or externally. As the case of the Dominican Republic shows, domestic financial markets may be too small to raise significant financing for the sovereign.

37. **The need to establish a benchmark sovereign bond may be an important consideration in determining the size of the bond issue.** The bond issue should be sufficiently large to be liquid. Yuan (2001), using data of six emerging market economies, shows that benchmark sovereign securities serve to: (i) reduce investors' information acquisition costs; (ii) facilitate future bond placement by the sovereign and by non-Sovereign issuers; and (iii) lower the bid-ask spread of corporate bonds. In addition, the liquidity impact on corporate bonds originates from information dissemination, rather than just trading.

38. **Market participants noted that there is a minimum size to attract institutional investors' interest—with a broad consensus at about US\$300 million.** Participants

¹⁶ Some market participants suggested that countries should restrict local investors' participation in the primary allocation, while allowing their participation in the secondary market, as this would ensure good support for the bond in secondary market trading. They noted that local investors have become an important part of the investor base for EM external debt in recent years. Issuers should assess carefully whether to restrict local investors at issuance, while paying attention to the possible costs or higher yield premium that may result from this strategy. It may indeed be the case that local banks could be limited in their ability to buy external debt of the sovereign by prudential regulations. The development of local markets is the subject of ongoing work in the International Capital Markets Department.

indicated that investors generally prefer liquid bonds, while noting that the inclusion of the issue in the main EM indices is less of a concern at least under current circumstances.¹⁷ Some also argued that while a large demand may at times induce countries to issue a large bond relative to, among other things, their international reserves and debt, prudent debt management considerations should prevail. Resisting the temptation to increase the size of the debut deal is likely to pay off by allowing the country to reaccess the market once the debut bond has traded well because of its scarcity value.

39. **What should be the maturity of the bond?** The maturity of a new bond issue should also reflect a prudent debt management strategy. In this regard, the selection of the maturity would depend on an assessment of: (i) the costs associated with different maturities; and (ii) investors' preferences. As the yield on a short-term bond is likely to be lower than the yield on a long-term bond, countries may have an incentive to issue a bond with a short-term maturity. Investors may also prefer to buy a bond with a short-term maturity, which tends to be less susceptible to market risk than medium- and long-term bonds. However, the incentives for countries to issue a short-term bond should be weighed against the need to manage rollover risk by avoiding the creation of large debt-service humps in the near term. In this connection, it may indeed be in the interest of sovereign issuers to place initially a bond with a maturity that is accommodating to investors, while creating the conditions for subsequent issues that could extend maturity and build a yield curve.

40. **Market participants stressed that the decision on the maturity of a bond should take into consideration the needs of investors.** They emphasized that investors are likely to feel more comfortable with the market risk of a bond of short maturity issued by a new sovereign issuer. In this context, they pointed out that new sovereign issuers tended to place bonds with a maturity of 5 years initially, and bonds with longer maturity (10 to 30 years) subsequently. However, they noted that the maturity of the issue also depends on the market targeted, with the United States market being more receptive to a bond with longer maturity than the European market.

41. **In what currency of denomination should countries issue a bond?** The currency of denomination of a new bond issue would depend on many factors, including (i) the use of the proceeds from the bond issue; (ii) the sovereign issuer's ability to generate foreign exchange receipts in the currency of the issue; (iii) the investor base to be targeted; and (iv) the cost. Countries may want to issue a bond in the currency in which they need to boost international reserves, intervene in the foreign exchange markets, or purchase goods and services abroad. However, countries could, if necessary, issue a bond in one currency and convert the resources from the issue to another currency via a foreign exchange swap. Countries may want to issue a bond in the currency of the foreign currency receipts they generate so as to eliminate altogether the foreign exchange risk associated with a new bond

¹⁷ Market participants noted that a few investors prefer a bonds that is not included in the main EM indices, as this may translates in lower volatility of the price of the bond.

issue. For example, oil exporting countries may well want to issue in U.S. dollars. Countries should, in any event, avoid creating unmanageable currency mismatches when issuing a bond in international capital markets.¹⁸ In selecting the currency of denomination of their bond, countries also need to consider the investor base they seek to target. In this context, countries should aim to issue their bond in the currency used by investors that would be most receptive to a new bond issue and have the necessary resources to absorb this bond. In most of the country cases examined in this paper, the decision to issue in U.S. dollars has reflected the desire to tap U.S. dollar-based investors, while the decision to issue in euros reflected the desire to attract euro-based investors.

42. **Market participants confirmed that the investor base targeted is the main factor in the decision about the currency of denomination of a new bond.** They stressed that trade and financial links are also an important element in the decision about the currency of denomination of a new bond as these links could help to reduce the lack of familiarity about the credit of these countries. They noted that if countries do not have a natural investor base or important trade and financial links, countries, in selecting the currency of denomination of the bonds, need to assess the ease in issuing the bond, the size and maturity of the bond, the desired liquidity of the bond, and the likely pricing in alternative currencies. Market participants stressed that yields and volatility in U.S. dollar bonds and euro EM bonds have tended to converge after the Argentine default (yields on U.S. dollar bonds were traditionally higher than yields on Eurobonds before this event), as the importance of European retail investors has declined. In this context, differences in costs across different markets appear to be significantly less now than a few years ago.

43. **Should the bond issued have a fixed or floating coupon?** The decision about whether to issue a bond with a fixed or flexible coupon would depend, among other factors, on: (i) the capacity to meet debt-service obligations; (ii) costs of the different options; and (iii) the preferences of potential investors. Countries need to assess carefully their capacity to service the obligations associated with a new bond. In particular, their projected cash flows should be sufficiently robust to service these bonds over their lifetime, including as a result of a large increase in interest rates. While it may be less expensive to issue a bond with a floating coupon when interest rates are low in mature markets, a sharp rise in interest rates could make such a bond more difficult to service.

44. **Market participants generally expressed a preference for a fixed-coupon bond.** They stressed that a fixed-coupon bond gives investors certainty about the cash-flow stream of a bond, which is critical for some bondholders. They noted that investors' preference for a fixed coupon should be an important element of the sovereign's decision about whether to issue a bond with a fixed or flexible coupon, particularly because the sovereign could, if necessary, enter into a swap operation to obtain exposure to interest rate risk.

¹⁸ For a discussion of currency mismatches, see International Monetary Fund, 2003, "The Balance Sheet Approach and its Application of the Fund," SM/03/227, (7/1/03).

45. **Should the bond have bullet or amortizing principal?** Countries would need to analyze the costs and benefits of issuing a bond with bullet or amortizing principal, while taking into account the preferences of investors. To manage the rollover of refinancing risk, particularly if the size of the bond is large, countries could consider issuing a bond with amortizing principal. Countries could, alternatively, consider creating a sinking fund, whereby periodic, regular allocations would be made toward the amortization of the bond at maturity.¹⁹ Both amortizing and sinking bonds could provide comfort to investors about the country's ability and willingness to service these bonds. However, the costs of such bonds would need to be assessed carefully.

46. **Market participants also expressed a preference for a bullet bond.** The majority of market practitioners contacted expressed this preference clearly, and suggested that debt-service humps could be effectively dealt with through prefunding or debt buyback operations. Some market participants argued that amortizing bonds could help generate a better debt repayment profile, and maintained that efforts to educate markets about these bonds could help to overcome the bias against such bonds.

47. **Should the bond include enhancements?** Enhancements, including guarantees, could serve to lower the costs of new issues. However, enhancements could make bonds of new sovereign issuers more difficult to price. Market participants cautioned against including enhancements in a debut bond, arguing that they limit the investor base, reduce the benchmark function of the bond, and perhaps render future issues more difficult because they could be seen as subordinated to the initial issue. Enhancements could also send a negative signal concerning the country's ability to issue a plain vanilla bond.

48. **Where should countries register and list the bond?** The decision about where to register and list a bond depends on the natural investor base being targeted. In this context, countries could issue a Global bond when they want to place a bond in several markets simultaneously, and reach as wide an investor base as possible. A Global bond could be denominated in different currencies. Alternatively, countries could choose to issue a Eurobond as a way to target investors in Europe initially, or to make a private placement when they want to target a limited number of sophisticated investors. Market participants maintained that new sovereign issuers should seek to issue a bond in a jurisdiction that allows these issuers to reach as wide an investor base as possible. They argued that this was particularly important if issuers want to establish a permanent presence in international capital markets, as a wide distribution of a debut issue would give investors an early opportunity to learn about their credit. In light of the fact that the bond that reaches the widest investor base is issued in the United States (i.e., the Global bond), Box 5 summarizes the disclosure requirements in this country.

¹⁹ Sinking funds differ from amortizing bonds in that the issuer has the option of buying back the bonds below par, while in an amortizing bond, the issuer must repay at par value.

Box 5. Technical Steps for a New Bond Issue in the United States

A prospective issuer invites investment banks to present proposals for a debut issue—this is preferably done after having already obtained a credit rating, although an investment bank may also be helpful in obtaining a desired rating. The issuer then selects an investment bank (often two) to become the lead manager(s) of the transaction. Other banks could be invited as comanagers sometimes, although this is becoming less common as the role of the bank syndicate is diminishing. An engagement letter may be signed between the issuer and the banks, which includes the fee structure. Legal advisors are at times chosen in this early phase (see below).

A prospective issuer needs to choose whether to issue a bond under either a fiscal agency or a trust structure. A fiscal agent is an agent of the borrower that is responsible, among other things, for the mechanics of bond authentication and distribution to end investors. A trustee, on the other hand, represents the bondholders as a group and has fiduciary obligations to them. In addition, the issuer needs to appoint a paying and transfer agent who is responsible for receiving interest and principal payments from the issuer, and distributing these payments to investors.

The role of the lead managers

The lead managers advise the issuer about market timing and the terms of the bond. If a public offering of the securities is contemplated, a registration statement with a preliminary offering circular or prospectus (red herring) is prepared and submitted to the SEC. The preliminary prospectus contains information on the issuer's political and economic situation and prospects, and includes preliminary terms of the bond, its covenants, details about clearance, settlement, underwriting of the bonds, and taxation. The lead managers or book runners begin the preparation of the deal by: i) sounding out prospective buyers of the bond; ii) preparing the documentation in collaboration with the legal advisors; iii) carrying out the due diligence; and iv) organizing the road show. The road show may be of great consequence in forming investors' views, especially on a debut issuer as it will often be the first time that the country authorities have an opportunity to present their credit to a wide range of investors.

Subsequently, the deal is launched with price guidance from the book runners. The public offering of these bonds is not done with a formal auction process; rather the banks involved take orders from their clients and "build the book." The lead investment bank plays an important role in this process. It is possible that during this process, new price guidance is sent to investors and the size of the deal is often increased. Once the book is quite firm, the lead managers underwrite the bonds and the price is finally set. They then allocate the bonds to investors. A final prospectus containing the offering price of the issue is filed with the SEC. The SEC has a registration process under which, after the disclosure in a prospectus has been vetted, gives flexibility to issuers and underwriters to time and price an offering to hit market windows. Settlement follows a few days later with investors receiving book-entry credit for the bonds. A so-called tombstone (which contains the main terms of the bond) is published in a financial paper/magazine.

Registration requirements

At the same time as the prospective borrower engages in discussions with investment bank(s), it may also approach and select legal advisors. It may be preferable to do this early in the process, so that the legal advisors can also advise on the engagement letter with the investment bank(s). The main task of the legal advisors is to prepare the legal documentation necessary to issue the bond. The type of documentation in turn depends on the market(s) that is (are) being tapped. The broader the investor base to which the bond is to be sold, the more demanding the documentation.

Box 5 Contd.//

In the U.S. market, documentation requirements are most stringent when an issuer wants to tap the public at large. In that case, the 1933 Securities Act requires the issuer to provide investors with all the material financial and other information concerning the issuer, the bond, and the offering to enable investors to make an informed evaluation of the merits of the bond offered. This information is made available to the public by filing a registration statement on Schedule B with the SEC. The SEC is not responsible for verifying the truth of the information, but reviews the registration statement for adequacy of the disclosure. The issuer, underwriters of the offering, accountant and other experts that are named with their consent in the registration statement may be subject to civil liability under the Securities Act if the registration statement, once it becomes effective, contains untrue statements of a material fact or omits to state a material fact required to be stated or necessary to make the statements not misleading. These persons (other than the issuer) may, however, avoid liability if they can prove that after reasonable investigation they had reasonable ground to believe and did believe that there was no misstatement or omission in the registration statement. Thus, these non-issuer parties normally undertake an extensive due diligence process to shield themselves from potential liability. The extent of liability under the Securities Act is, in general, the difference between the amount paid for the bond (not exceeding the public offering price) and the market price at the time the lawsuit is brought or the price at which the bond was disposed of before the lawsuit. No registration is needed for the resale of the registered securities.

If the issuer chooses to sell the bond to a select group of U.S. investors in the primary distribution, it may do so through a private placement, relying on one of the exemptions under the Securities Act (i.e., Section 4(2) and Regulation D) and, therefore, need not comply with the registration requirements. The Securities Act and its regulations set forth the conditions for using these exemptions, including the requirements aimed at assuring that investors are sophisticated enough to evaluate the merits and risks of the investment; that no general solicitation of purchases or advertising of the offering is used; and that investors have access to information similar to that provided by a registration statement. These conditions are intended to limit the offerees and purchasers of the privately placed securities to those who do not require the protection of Securities Act registration.

Private placed securities are not freely transferable in the United States. Instead, a person who has purchased the bond from an issuer in a transaction which is exempt from the registration requirements (such as a private placement discussed above) or is an offshore transaction made in accordance with Regulation S, may resell such bond either by registering it with the SEC or relying on Rule 144A under the Securities Act. Rule 144A provides for a safe harbor against the registration requirements for the resale of unregistered securities to “qualified institutional buyers” (QIBs). The QIBs can legally sell the bond only to other QIBs (through a self-policing arrangement) to avoid being subject to the registration requirements. If the issuer and its underwriters plan to sell the bonds also to U.S. retail investors at a later time, the bond could be sold to QIBs under Rule 144A with registration rights. In this case, the issuer is obliged under contractual provisions to register the bond with the SEC within a given time period.

49. **Should the bond include CACs?** On those rare occasions when sovereign debt may need to be restructured, CACs could play a useful role in the orderly resolution of crises and provide a degree of predictability to the restructuring process. While sovereign bonds issued under English law have typically included CACs, those issued under New York law have generally not included majority restructuring provisions. Mexico issued three bonds governed by New York law with CACs between March and April 2003, and Brazil, South Africa, and the Republic of Korea each issued bonds that included CACs in May 2003, without paying a noticeable premium. Market participants stressed that these issues not only

have been a significant step toward including CACs in legal jurisdictions that traditionally have not used these clauses, but also have created a new standard for including CACs in new bond issues by EM. In this context, new sovereign issuers should include CACs in a new bond issue.

50. Should countries manage the risks associated with issuing a bond in international capital markets over the life of the bond? In accessing international capital markets, countries would take on foreign exchange, and refinancing or rollover risks over the life of the bond. The issue of a foreign-currency denominated bond is likely to give rise to a currency mismatch for most new sovereign issuers. The rollover risk would arise if countries could roll over their bonds only at an unusually high cost or, in extreme cases, could not roll over those bonds. Countries could, if they so choose, manage these risks over the life of the bond.²⁰ This may involve costs that need to be assessed carefully. To the extent that the debt-service payments are small and the necessary hedging instruments exist, countries may be able to hedge the foreign exchange risk associated with the debt-service payments of a foreign-currency denominated bond. To ensure that the rollover risk does not lead to debt-servicing difficulties, countries should make a commitment to pursue appropriate macroeconomic policies and a prudent debt management strategy. In this context, countries could also make judicious use of debt buybacks and swaps to manage the rollover risk.

²⁰ New sovereign issuers need to be aware of other risks, including credit, operational, and legal risks. See International Monetary Fund and the World Bank (2001).

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