Africa’s eurobonds are a blank cheque

Failure to declare the use of proceeds is a threat to debt sustainability

Eurobond financing is booming, even in the least-developed emerging markets. African sovereigns issued $26bn on the market last year alone. You would be hard-pressed, however, to find out how the money was used.

In many eurobond prospectuses, you will find that the “Use of Proceeds” section consists of a mostly blank page containing one short message: “The Republic of . . . will use the net proceeds of the issue for general budgetary purposes.” That blank page is, essentially, a blank cheque.

Despite the risks associated with the potential misallocation of borrowed money and growing debt distress, the quality of public debt management in debtor countries is not reflected in traditional sovereign credit analysis.

In this context, environmental, social and governance (ESG) evaluations could be a game changer. They could focus attention on often overlooked debt management and governance issues, factors that experience has shown to be material to sovereign risk. Scoring those factors would offer investors a more accurate risk profile of sovereign issuers.
As the World Bank and IMF hold their annual meetings in Washington this week, sovereign borrowing without conditionality is certain to be a hot topic. Debt campaigners are clamouring for discipline as the external debt of African countries reaches unsustainable levels. Organisations such as the IMF are being criticised for encouraging reckless borrowing. There are legitimate questions as to how countries can be facing debt distress, given that so many have recently benefited from debt bailouts.

Some of the answers can be found on the blank pages of the eurobond prospectuses.

It seems barely possible today that, despite great pressure for loan transparency from international institutions, G20 governments, rating agencies and official creditors, sovereigns are still able to borrow billions of dollars on the eurobond market with little or no accountability regarding the use of proceeds.

When a private company makes a pitch for new finance, a business and investment plan is essential, including clarity about how the borrowed funds will be invested in future earnings capacity.

In the case of eurobond borrowing, this is notably absent. The general investment themes of bond issuance roadshows notwithstanding, there seems to be a “don’t ask, don’t tell” approach to sovereign bond financing. Issuers shy away from committing to how funds will be spent. Investors don’t ask many questions. Most of the assessment of credit risk is focused on outstanding debt, reserve accumulation, growth forecasts and an overall macroeconomic outlook.

The quid pro quo is that investors get handsome returns in exchange for sovereign finance with few strings attached.

The result is that eurobonds have become an expensive source of discretionary spending. They often plug fiscal deficits and finance short-term political objectives. Longer-term priorities, such as critical infrastructure and economic diversification, fall by the wayside. In consequence, borrowing fails to generate the fiscal revenues needed to cover increased levels of debt service, leading to a vicious cycle of rollover financing.

As a new debt crisis looms on the continent and the ESG performance of African sovereigns remains below target, investors are recognising that more attention should be paid to the uses of eurobond proceeds, to ensure improved performance and better long-term risk profiles for the bonds issued. An opportunity exists to integrate institutional debt management policies and practices, including the use of eurobond proceeds, into ESG evaluations as part of the general governance pillar of ESG analysis.

Higher ratings would be awarded to sovereign debtors that not only disclosed the use of proceeds but also provided periodic feedback through monitoring mechanisms. A methodology could be
developed to measure how effectively sovereign issuers were channelling resources to projects adhering to green and social performance criteria. The scoring system, incorporating several complementary metrics, would be part of a materiality map for sovereign investors and be based on the commonly accepted principle that those countries that perform well on ESG evaluations are less likely to face credit distress or default.

ESG ratings could help to provide transparency in sovereign lending and more accurate credit risk assessments. They could also play a role in making investors active owners of assets and agents of change for better debt management. By engaging directly with issuers, investors can encourage borrowers to pursue long-term investment programmes, reinforce debt strategies and accelerate fiscal consolidation. This would lead to stronger public finances, debt sustainability and an improved risk profile.

*Andrew Roche has more than 20 years of experience in sovereign debt restructuring. He has advised numerous countries on their Paris Club, London Club and commercial debts and has managed World Bank sponsored operations.*

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