OLIVER WYMAN

Financial Services

NEW PLAYERS IN THE INTERNATIONAL BOND MARKETS

WHAT NEXT TO MANAGE DEBT SUCCESSFULLY?

EXECUTIVE SUMMARY

WE HAVE OBSERVED A NUMBER OF NEW PLAYERS ENTERING THE INTERNATIONAL BOND MARKETS IN RECENT YEARS, LED BY MIDDLE EAST AND AFRICAN (MEA) ECONOMIES THAT HAVE SEEN A PARADIGM SHIFT IN THE HEALTH OF PUBLIC FINANCES.

With the drop in oil and other commodity prices, governments have witnessed subdued economic growth and faced challenges in balancing fiscal budgets. Beyond the introduction of significant tax reforms and selective use of sovereign reserves, governments have had to increase the use of sovereign debt as a financing tool. The escalation in sovereign debt issuance needs to be supported by robust management by governments. This requires strategic discipline and careful management in order to balance the risks that debt financing may bring. Governments must look at the opportunities to develop their local debt market, alongside seeking external investment from issuing in international markets.

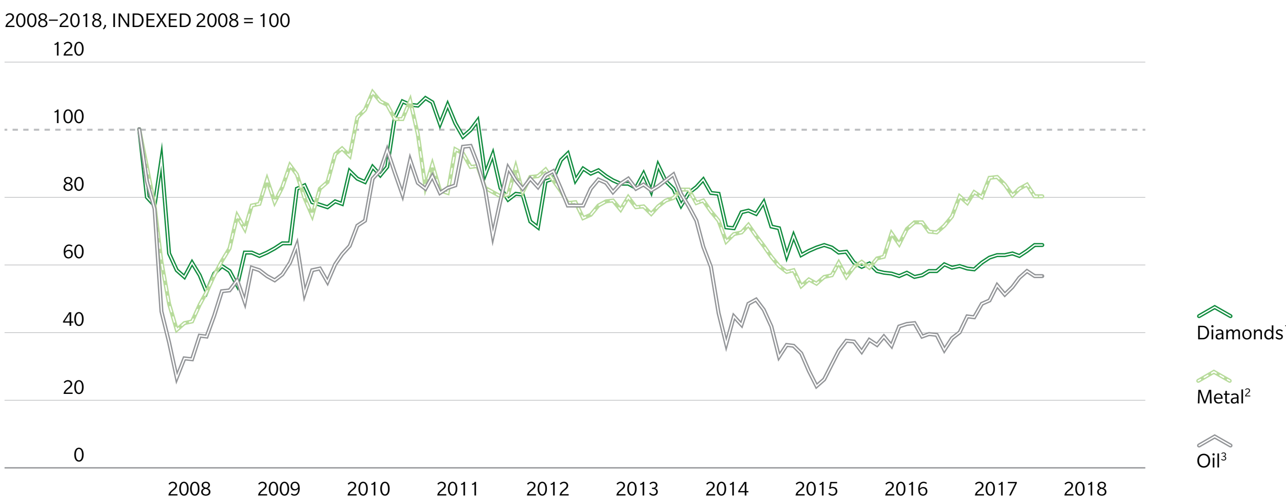
We believe that sovereign debt is here to stay and that debt managers and governments have not taken sufficient action to ensure they are set up to ensure future national financial stability. Whilst this point of view focuses on MEA sovereigns as emerging players in international bond markets, the underlying recommendations and proposed actions are applicable across emerging market countries facing similar challenges.

1. THE RISE IN SOVEREIGN DEBT AND INTRODUCTION OF NEW PLAYERS

Globally, sovereign debt management has become an increasingly important topic for governments. In times of financial crisis and shock, most recently the 2008 global financial crisis and the Eurozone crisis, the need to issue sovereign debt for government funding has risen. As a result, the management and sourcing of sovereign debt has increasingly been at the forefront of the government agenda in developed countries such as the Italy, Spain, and Greece.

For emerging markets, sovereign debt issuance has also been gaining importance. Total issuance volume has grown annually by ~6% since 2012, and in 2017 emerging markets accounted for a third of total international sovereign issuances. This is particularly the case for many MEA countries who have seen significant deterioration of their fiscal positions driven by the impacts of declining commodity prices (Exhibit 1.1).

Exhibit 1.1. Commodity Price Evolution (Select Commodities)



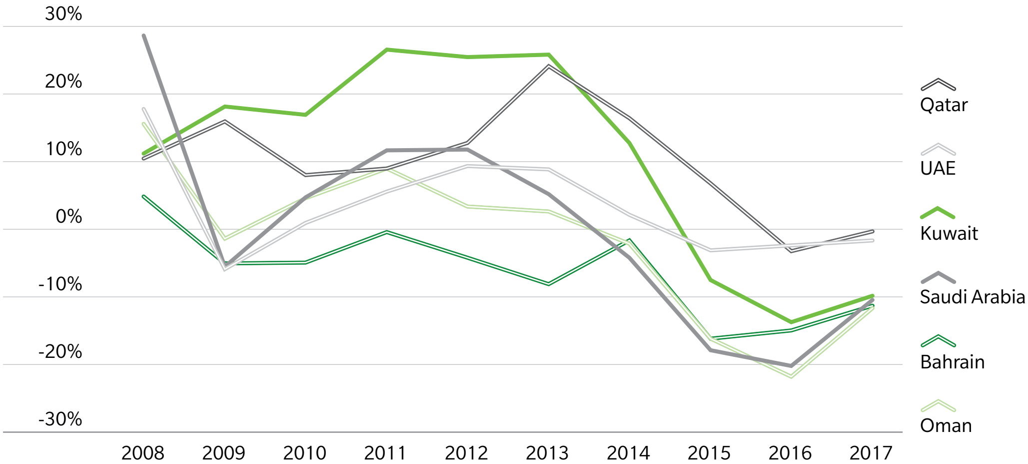
Source: Thomson Reuters Datastream; Oliver Wyman analysis

1. **Diamond** – average price trends across different carat categories
2. **Metal** – includes copper, aluminum, tin, nickel, zinc, lead
3. **Oil** – Brent Crude price/barrel

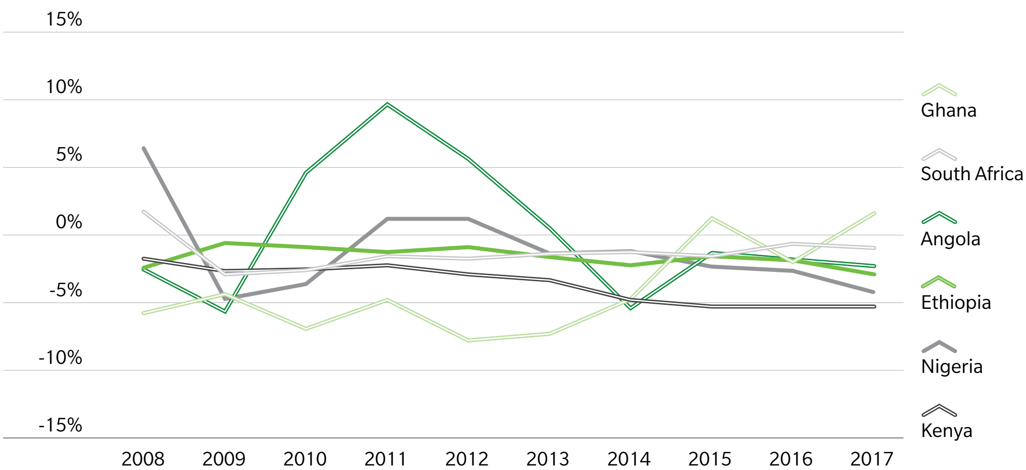
As a result of a high dependency on commodities as a source of government revenue and the deterioration in commodity prices, the fiscal positions of MEA countries have come under pressure (Exhibit 1.2).

Exhibit 1.2. Government Fiscal Balance as a % of GDP[1]

GOVERNMENT FISCAL BALANCE AS A % OF GDP (SELECT MIDDLE EASTERN COUNTRIES)
% OF GDP, 2008-2017



GOVERNMENT FISCAL BALANCE AS A % OF GDP (SELECT AFRICAN COUNTRIES)
% OF GDP, 2008-2017



1. Defined as Government Net Lending and Borrowing (IMF World Economic Outlook)

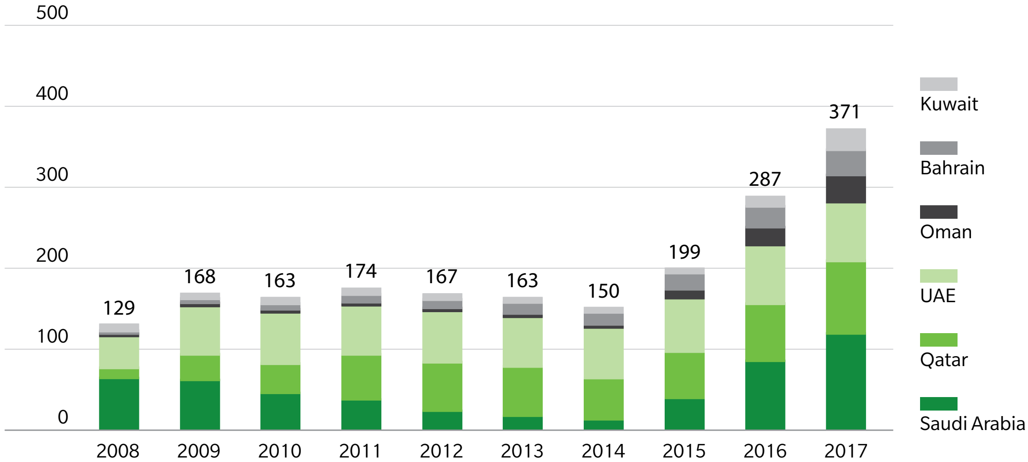
Source: IMF World Economic Outlook Database, April 2018; Oliver Wyman Analysis

Note: Some data points for 2016 and 2017 are estimates (IMF)

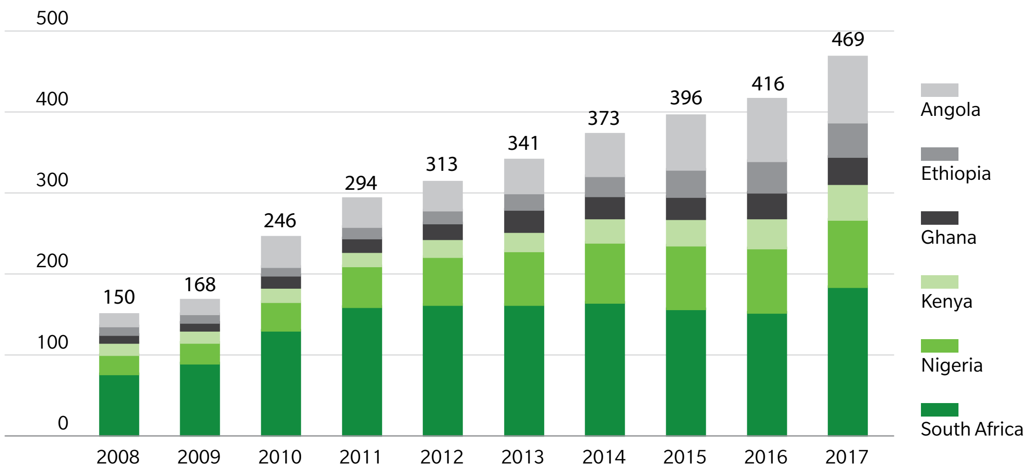
Faced with either deteriorating budget positions, or persistent deficits, a number of MEA governments have increased the volume of sovereign debt issued both on an absolute basis and as a percentage of GDP. In both the Middle East and African economies, absolute levels have grown at over 12% per annum since 2008 (Exhibit 1.3). In some countries such as Bahrain, Qatar, Angola, and Ghana, debt levels have risen to over 50% of GDP (Exhibit 1.4).

Exhibit 1.3. Total Outstanding Government Debt

TOTAL OUTSTANDING GOVERNMENT DEBT (SELECT MIDDLE EASTERN COUNTRIES)
IN US$ BN, 2008–2017



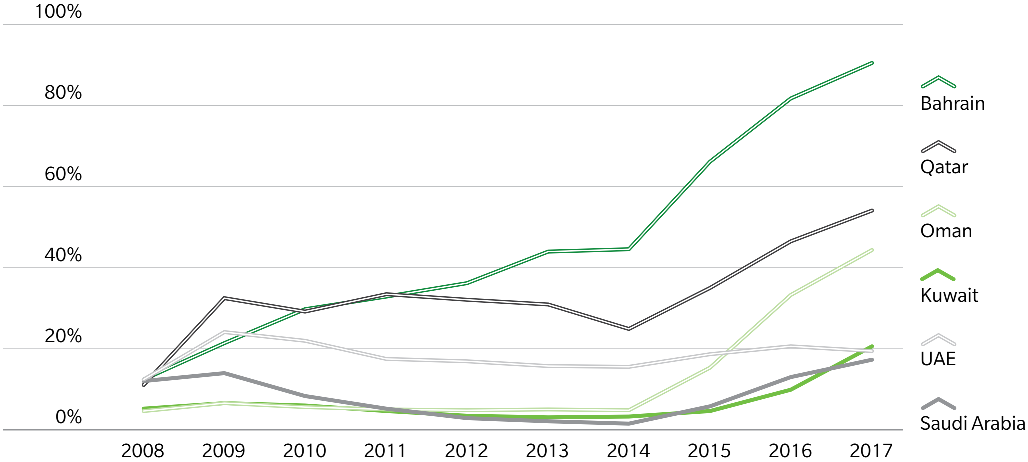
TOTAL OUTSTANDING GOVERNMENT DEBT (SELECT AFRICAN COUNTRIES)
IN US$ BN, 2008–2017



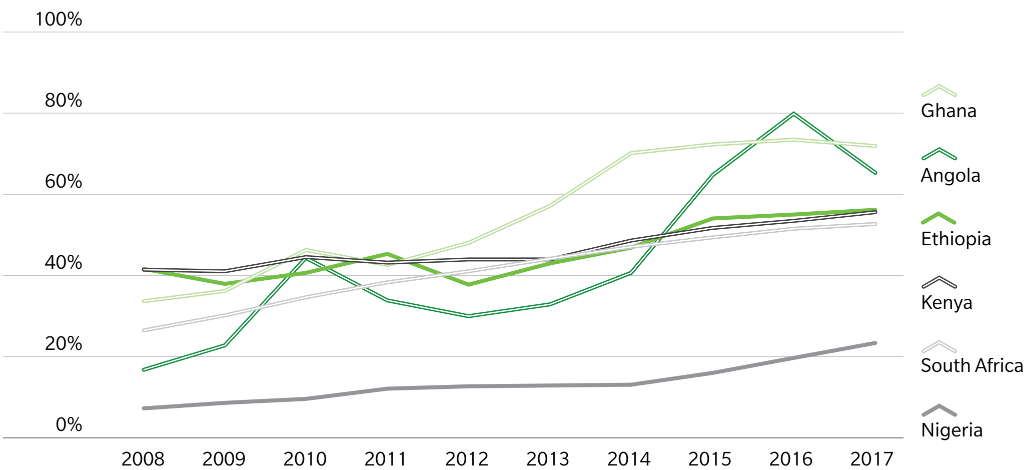
Source: IMF World Economic Outlook Database, April 2018; Oliver Wyman analysis
Note: Based on average exchange rates. Some data points for 2016 and 2017 are estimates (IMF)

Exhibit 1.4. Total Outstanding Government Debt as a % of GDP

TOTAL OUTSTANDING GOVERNMENT DEBT AS A % OF GDP (SELECT MIDDLE EASTERN COUNTRIES)
2008–2017



TOTAL OUTSTANDING GOVERNMENT DEBT AS A % OF GDP (SELECT AFRICAN COUNTRIES)
2008–2017

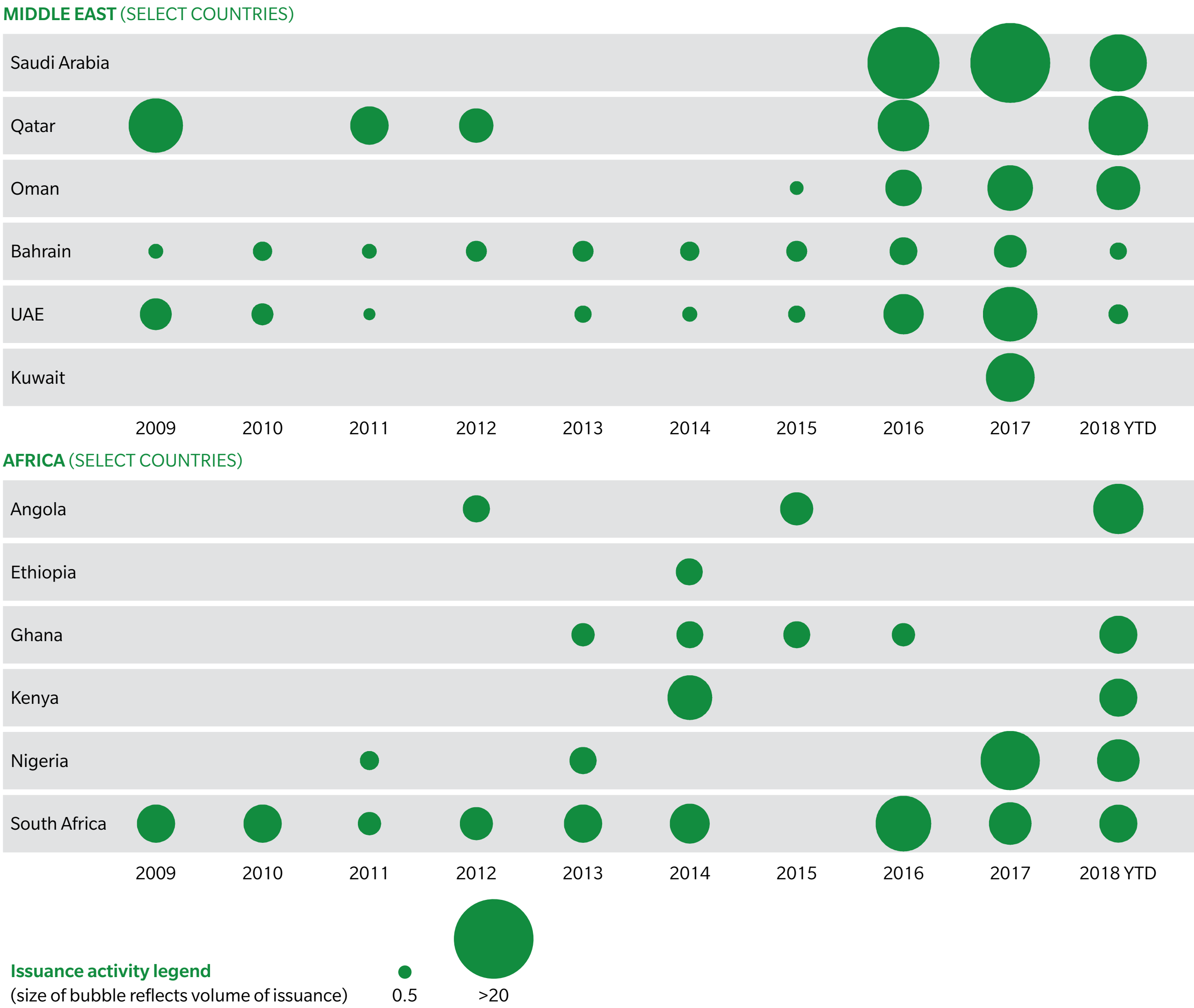


Source: IMF World Economic Outlook Database, April 2018; Oliver Wyman analysis
Note: Some data points for 2016 and 2017 are estimates (IMF)

There has been an increase in international debt issuances in the last five years, particularly by GCC sovereigns since 2016 (Exhibit 5). Saudi Arabia has issued sizeable debt in the last three years, including a US$12.5BN issuance in September 2017 and an US$11BN issuance in April 2018. Kuwait entered the international debt markets in 2017 with a debut $8BN bond, and we have seen Abu Dhabi and Qatar both issuing large bonds in recent years. South Africa sold US$2BN of bonds in May 2018, exemplifying the country's increasing shift to the bond market for funding.

Exhibit 1.5. Timeline of International Sovereign Bond Issuances by MEA Countries (including Sukuk)

2009–2018 YTD, US$ BN



Source: Dealogic, Oliver Wyman analysis

Note: UAE consists of issuances by Abu Dhabi, Dubai, Sharjah, Ras Al Khaimah. 2018YTD as of July 2018

As sovereign debt levels continue to grow, the need for better debt management and the deepening of local debt markets has become more pressing. Most countries in MEA have been relatively late in establishing Debt Management Offices (DMO) and building local debt markets. However, they are now starting to increase efforts to address this. In this point of view, we emphasise the importance for MEA governments to address both of these areas and provide key considerations to accelerate efforts.

2. INCREASING IMPORTANCE OF STRONG DEBT MANAGEMENT

Establishing a strategic Debt Management Office and building out capabilities should be a priority for MEA governments in order to manage the increasing debt exposure. Prudent public debt management practices can help reduce vulnerability to contagion and financial shocks. Governments have a unique opportunity to take advantage of significant advances in debt management practices over the past 20 years. Furthermore, governments who have been proactive in building debt management capabilities have benefited across several dimensions including:

- **Funding diversification.** Broadening financing tools available to the government outside of taxation and utilising government reserves
- **Minimising cost and risk.** Helping the sovereign to borrow at the lowest possible cost given risks
- **Dynamic debt management.** Capacity to manage debt dynamically taking into consideration sustainability and affordability issues
- **Sovereign yield curve.** Building and maintaining a sovereign yield curve that can be used as a benchmark to support the development of a vibrant debt market
- **Coordination.** Market coordination across all parts of government participating in debt markets e.g. State-Owned Enterprises
- **Oversight and reputation.** Ensuring robust controls and procedures related to debt servicing and cash availability
- **Agility.** Ability to react and benefit from market dynamics and risk
- **Resilience.** Enhances ability for countries to be resilient to external market shocks

Governments that do not build out and enhance their debt management capabilities will not only be deprived of these advantages, but may suffer from greater risks. These risks include potentially higher borrowing costs, unsustainable debt levels, operational risks in debt repayments, inability to attract investors, and deteriorating fiscal position.

To further support debt management, governments should also turn their efforts to cultivating a vibrant local debt market as well as utilising international debt markets for financing. A deep and liquid local debt market can deliver additional benefits to the government and wider market:

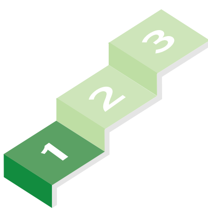
- **Financing options and investor mix.** Increasing financing options for a country across maturities, instruments, and currencies, whilst also opening up a broader set of investors to government debt
- **Market efficiency.** Increase transparency and predictability of local government bond issuance via auction process

- **Local yield curve.** Enable a local yield curve to be established, which can support corporates to issue debt at an efficient price in the market
- **Supporting monetary policy requirements.** Facilitate monetary policy operations via increased liquidity and additional instruments
- **Economic development and private sector participation.** Increase foreign investor participation in the local bond market and provide financing alternatives for large infrastructure projects

3. ESTABLISHING A STATE OF THE ART DEBT MANAGEMENT OFFICE FOR THE SOVEREIGN

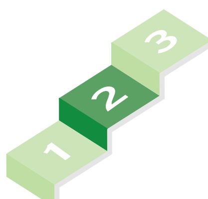
We see an overall evolution in the role and responsibility of Sovereign Debt Management Offices, from acting as an execution office for the Government, all the way through to active debt and liquidity management (Exhibit 3.1). Most Middle Eastern and African countries are in a relatively early stage of development and have yet to progress their infrastructure to fully managing the debt and liquidity of the country.

Exhibit 3.1. Stages of Debt Management Offices



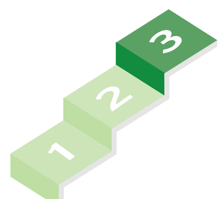
STAGE 1
DEBT EXECUTION

- International/local market debt issuance
- Monitoring and settlement of debt
- Reactive dialogue with investors, rating agencies, etc.
- Initial monitoring of contingent liabilities



+ STAGE 2
ACTIVE DEBT MANAGEMENT

- Development and execution of debt strategy
- Utilise a broader range of debt instruments, maturities
- Development and maintenance of sovereign yield curve
- Proactive management of relationships with investors and other agencies
- Supporting development of secondary market activity
- Extensive management of risks and contingent liabilities



+ STAGE 3
ACTIVE DEBT AND LIQUIDITY MANAGEMENT

- Broader support of government funding requirements
- Shorter term maturity manage-ment, e.g. money markets and cash management of single treasury account
- Centre of excellence for technical markets expertise
- Active hedging of debt portfolios and secondary market activity
- Sophisticated infrastructure to support operations

DEBT MANAGEMENT OFFICE MATURITY SPECTRUM →

The main dimensions that are necessary for a successful Debt Management Office can be described across these three stages of evolution (Exhibit 3.2).

Exhibit 3.2. Stages of Debt Management Office (DMO) Evolution

KEY DIMENSIONS	STAGE 1 **DEBT EXECUTION**	STAGE 2 **ACTIVE DEBT MANAGEMENT**	STAGE 3 **ACTIVE DEBT AND LIQUIDTY MANAGEMENT**
PEOPLE AND ORGANISATION	• Typically, small and lean team with limited distinct skill-sets required • Often consists of government officials supported by advisors with technical expertise	• Larger team and increasing need for specialized skill sets • Attracting and retaining experienced individuals with the right banking, capital markets, debt management and risk management background is critical	• Large team and high degree of specialization by role • Talent pool can include expertise from investment banks, risk specialists, treasuries, technology firms • Requires ability to bring in highly paid experts
INFRASTRUCTURE	• Use of basic standardized tools and applications for debt recording and settlement, predominantly MS Excel based • A number of processes are informal and conducted manually	• Increased sophistication in tool development and automation of end-to-end applications and systems • Formal policies and procedures are in place • Development of key models including debt strategy, risk management and contingent liabilities	• High degree of sophistication with multiple system modules for active debt and liquidity management activities • Integration with markets related systems and risk management
DECISION MAKING AUTONOMY AND AGILITY	• Low level of autonomy with key decisions taken by other Government departments and institutions • DMO executes on decisions given to them (e.g. debt execution) • DMO is a department within the Ministry of Finance or Central Bank	• Increase in autonomy and agility on decision making • Definition of debt financing strategy and risk management thresholds • Autonomy to bring in required talent and expertise • Often increasingly autonomous but remains part of government body	• High degree of autonomy in decision making and agility to act on market opportunities (e.g. debt issuance timing, hedging strategies) • Often has potential to become an independent agency outside of the Ministry of Finance/ Central Bank
STAKEHOLDER COORDINATION	• Limited coordination between internal and external stakeholders • Typically, reactive interaction with key stakeholders such as investors, rating agencies and market participants	• Proactive stakeholder management for key stakeholders (investors, rating agencies, supra national institutions) • Formalization of relationships with cooperation agreements	• High degree of coordination and proactive management of all stakeholders on behalf of the Government • Act as a leading agent in representing the Government on all debt matters

4. DEVELOPING A LOCAL DEBT MARKET: KEY LESSONS

Building a comprehensive local debt market requires governments to ensure that five key underlying foundations are in place (Exhibit 4.1). The specific requirements across each foundation is nuanced by country and is not a one size fits all for Governments.

Exhibit 4.1. Building a Local Debt Market: Key Dimensions

DIMENSIONS	TYPICAL CHALLENGES	REQUIREMENTS	CASE STUDIES	
PRIMARY MARKET DESIGN	• Low volumes • Limited to government or bank issuances	• Continuous and steady supply of new issuances • Efficient approval process to issue • Diverse set of bond types • Government benchmark yield curve for pricing • A tiered issuance process based on the issuer to enable faster issuances	**Singapore** **Thailand**	Developed domestic bond market through annual public borrowing plans Established tiered approval framework for different issuer types to support a more efficient issuance process
SECONDARY MARKET DESIGN	• Limited trading volume • Low liquidity	• Provision for market liquidity • Efficient trading infrastructure including clearing and settlement process • Active repo market • Incentives to drive market making activities	**Indonesia** **South Africa**	Established a private repo market and has a Central Bank repo facility for Government Bonds Recently launched an electronic government bond trading platform
ISSUER BASE	• Highly concentrated in sectors • Barriers to participate	• Sufficiently deep eligible issuer base • Diversity of size and sector coverage • Tiered framework an option to support access for different entities	**USA** **Malaysia**	Made the market accessible to mid-sized enterprises and larger corporations Provided access to international players to build a diverse issuer base
INVESTOR BASE	• Undiversified with few international investors • Low retail participation	• Broad set of investors actively participating in the market • Foreign investor ease of access • Diversity of investor groups covering retail and institutional sectors	**Dubai** **Chile**	Implemented legal incentives to attract foreign investors Amended regulation to support broader access
LEGAL AND REGULATORY STRUCTURE	• Disconnected and complex • Lack of protection for investors	• Transparent and efficient structures • Effective rating systems • Market surveillance for trading and operations • Attractive tax systems and incentives • Bankruptcy and consumer protection	**India** **Dubai**	Hosts six local rating agencies which help ensure that all types of investors have reliable investment information Created a new legal and regulatory structure that promotes fairness, transparency, and investor protection

5. CONCLUSIONS: KEY ACTIONS FOR GOVERNMENTS

Managing sovereign debt is increasingly important for governments across MEA. Governments must realize this, and take necessary actions to both enhance their capabilities along the maturity spectrum and to build their local debt markets as a source of funding. To date, governments have been reactive and face significant risks if debt management is not considered as a priority.

Taking meaningful action can contribute to building and preserving the reputation of governments as credible and reliable borrowers. Whilst individual countries face nuances in legal and institutional systems we observe some key emerging trends in countries that are making progress:

1. **Buy-in from top-level government.** Recognition and support from top level government ministers and stakeholders e.g. Ministers of Finance, Central Bank Governors, Fiscal Policy makers, Sovereign Wealth Fund managers; and involvement of stakeholders in key decisions related to sovereign debt management
2. **Coordination across key governmental institutions.** Integration of debt management into broader fiscal policy formulation, and approaches to manage reserves and sovereign assets
3. **Elevation of Debt Management Offices.** Involvement of the DMO in key debt management related forums e.g. debt management committees; and as a mechanism to drive debt management standards across government related entities
4. **Increased autonomy for Debt Management Offices.** Greater flexibility to take necessary decisions e.g. tactical issuance or buy-backs and to obtain and develop necessary capabilities e.g. skills and talent, tools and infrastructure
5. **Proactive communication with external stakeholders.** Proactive dialogue with key external stakeholders including rating agencies, existing and potential investors, lead arrangers and other market participants

The recent resurgence in commodities prices, particularly crude oil, is expected to contribute to a potential rebound in the fiscal position of MEA economies. As a result, governments may begin to deprioritize sovereign debt as a means of funding, and thus the capabilities to source and manage debt. It is critical that governments do not lose focus. They must continue to build on achievements to date to ensure they have a diverse set of financing options available in times of need, and the infrastructure in place to actively manage this.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

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