

How Can Government Foreign Debt Operations Be Made More Transparent?

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BACKGROUND

Emerging market economies are increasingly turning to international capital markets to finance their budget deficits and support their development needs. Unfortunately, in some cases, these arrangements have caused controversies. Allegations of mismanagement of sovereign bonds issued or guaranteed by the governments of Kenya, Mozambique, and Malaysia have received widespread media coverage and highlight important challenges for fiscal transparency and countries' development prospects.

In Kenya the government issued Eurobonds in 2014, raising approximately US\$2.75 billion. The International Budget Partnership's (IBP) [analysis](#) of government budget reports in the country shows that the flow of these revenues has been neither clearly and comprehensively reported on nor reconciled — the numbers disclosed in different budget reports are confusing and seem contradictory.¹

In 2013 in Mozambique a newly formed state company, Mozambican Tuna Co. ("EMATUM"), secured US\$850 million by issuing loan participation notes (i.e., securities that give investors ownership stakes in a bundle of bank loans) that were indirectly guaranteed by the government. The offering circular for the US\$850 million "Tuna Bonds" stated that all of the proceeds were to be used to purchase fishing vessels. However, the money was used to buy naval vessels and other maritime security equipment. The debt was incurred without proper clearances from the Mozambican Parliament, which is legally required to authorize such transactions, bringing the country close to bankruptcy. Subsequently, the government also acknowledged US\$1.4 billion of other undisclosed debt (unrelated to EMATUM) that had been used to fund security and shipping services. An IBP [article](#) describes the problems uncovered in Mozambique, and a recent audit report shows gross mismanagement and points to the likelihood of grand corruption.

In 2016 a U.S. Department of Justice lawsuit alleges the misappropriation of approximately 40 percent of the total US\$6.5 billion raised in three international bonds by 1MDB, a strategic investment development entity wholly

¹ <http://allafrica.com/stories/201511021181.html>

owned by the Malaysian government. These misappropriated funds reportedly were laundered through complex financial transactions and shell companies with bank accounts in a variety of countries. The offering circulars did not disclose that 1MDB would transfer the proceeds of the bonds to a Swiss bank account of an unrelated British Virgin Islands entity. In addition to blatantly violating the “Use of Proceeds” clauses, the circulars in certain instances effectively concealed some underlying investment risks associated with the bonds.

As part of its expanding transparency agenda, IBP looked into government operations in international capital markets in the three countries to assess whether they suffered from a common set of problems. In this report, IBP highlights how limited transparency contributed to the mismanagement of the monies raised by the three governments. IBP also proposes a set of transparency and accountability measures that could potentially mitigate problems in government operations in international capital markets.

LACK OF TRANSPARENCY FOUND THROUGHOUT THE BORROWING PROCESS

The processes adopted in the three countries to manage the issuance of debt in international capital markets illuminate a number of areas where fiscal transparency plays an important role. In each country, to a different degree, a lack of transparency was found at various steps in the debt operations. These steps include the selection of the issuing authority and the loan instrument, the development of a prospectus, management of funds collected offshore, and reporting the funds collected in relevant government financial reports. We describe these issues below and contrast the problems that arose in the three countries.

- Issuer. Borrowings by quasi-sovereign entities can increase the risk of financial irregularities for governments with weak controls over such entities. The blatant theft of public funds in Mozambique and Malaysia was apparently facilitated by the use of quasi-sovereign borrowers whose financial activities faced limited and ineffective scrutiny. While the Kenyan government’s decision to borrow directly certainly did not prevent its own major controversies, there has been no determination of any overt theft of public funds to date. Whether issuing bonds directly or through surrogates, established government investigation channels and a clear official paper trail offer better prospects of extracting an ultimate accounting of the situation.
- Instrument. Debt securities for Mozambique’s Tuna Company (EMATUM) that were derived from bank loans (or loan participation notes as they are termed) provided investors with extremely poor information and due-diligence protections compared to conventional bonds. Of course, as the Kenya and Malaysia 1MDB cases show, the much greater transparency required of conventional bonds can only lessen the risk of malfeasance, not eliminate it.

- Means of issuance. Publicly offered bonds, such as Kenya’s Eurobond, provide all parties with much greater visibility compared to privately placed securities like those in the Mozambique and Malaysia 1MDB cases. Publicly offered sovereign bonds, in principle, should therefore face lower risks of financial irregularities. But, as with the choice of instruments, choosing to issue a sovereign bond in the public markets can at best lower, but not eliminate, the risk of irregularities. In comparison, private placements, including those involving relatively more transparent conventional bonds (e.g., Malaysia’s 1MDB), do not demand the level of information disclosure, regulatory oversight, and credit rating agency reviews of publicly offered securities.
- Prospectus. The crucial prospectus document, which serves as investors’ core source of information on risk, fell considerably short of full disclosure to some degree in the three countries. In particular, the “Use of Proceeds” statement appears to have been grossly misused in at least the Mozambique and Malaysia 1MDB cases; Kenya also is facing a degree of skepticism over whether it used the bond proceeds as it had indicated. The “Risk Factors” section in each case also failed to flag the fiscal transparency problems that these countries ultimately exhibited. Mozambique made blatantly false statements in the EMATUM offering circular, including the government’s attestation of the legality of the sovereign guarantees, despite granting guarantees in excess of the parliament’s approved ceiling.
- Offshore funds management. Neither the prospectus nor other accompanying legal documents that were available to investors in these three cases provided a full and accurate description of how the bond proceeds were to be managed offshore. Such lack of transparency about offshore funds management of sovereign bond proceeds is normal practice. The discrepancy between what actors might have reasonably expected about the offshore management of the bond proceeds and what actually occurred was egregious in the Mozambique and Malaysia 1MDB cases. And, had Kenya’s government been more transparent up front about how it planned to handle the bond proceeds in its foreign bank deposits — including the length of time before repatriating the funds, and its intention to pay external obligations directly from the offshore account — it would have removed a key point of contention that surrounds its bond borrowing.
- Fiscal reporting. Shortcomings in fiscal reporting proved to be key vulnerabilities in all three cases. Kenya’s accounting of the Eurobond proceeds was confusing and has created damaging managerial and reputational problems for the government. Outright fraudulent fiscal reporting occurred in the other two cases. Mozambique failed to disclose enormous sums of external debt to EMATUM’s investors and the International Monetary Fund, while Malaysia’s 1MDB misrepresented certain aspects of its audited financial statements.

- **Budget management.** Inadequacies in cash management and other budgetary practices and controls were also identified in these three cases. Kenya ran into controversies regarding its delay in transferring the bond proceeds that had been repatriated into the Consolidated Fund. Far more serious was Mozambique's failure to adhere to legal restrictions on guarantees and borrowing authorizations and, more generally, to manage the financial activities of its quasi-sovereign borrower. The 1MDB case shows that Malaysia also exerts unsatisfactory control over its state enterprises' financial activities, with potential implications for the sovereign over time.

RECOMMENDATIONS

The broad themes of fiscal transparency that emerge from these three case studies point to some general ways to strengthen fiscal transparency, oversight, and accountability mechanisms of government operations in international capital markets. If implemented, we hope that these measures can reduce the costly risk of actual or perceived funds mismanagement, which would ultimately benefit governments, banks and other intermediaries, and bond investors.

1. **Increase transparency surrounding quasi-sovereigns' borrowing activities.** The relative opacity of the borrowing activities of quasi-sovereign entities creates opportunities for fiscal malfeasance. National legislatures should restrict borrowing by quasi-sovereigns until the public debt management systems meet international good-practice standards. In those cases where quasi-sovereign borrowings are to finance infrastructure projects, the borrower, as well as the lead managers, should be required under the bond agreements to produce and publish widely independent *ex-ante* and *ex-post* studies of the project's financial and operational viability. If issuers choose to redirect funds collected to uses not directly tied to the originally designated project, the parties to the bond exercise and the public should be formally notified.
2. **Strengthen transparency of loan participation notes.** Due diligence and disclosure on loan participation notes are much weaker than on conventional bonds because they are not subject to the regulatory requirements of publicly traded securities. Market regulators should narrow the gap between the standards applied to loan-based securities and those that are applied to publicly offered bonds. Notably, the lead investor arranging loan participation deals should be strictly required to disclose any other financial arrangements that they might have with the underlying borrower so as to avoid any conflicts of interests with their deal's investors.
3. **Improve transparency of privately placed bonds.** Regulators of the country where the bonds are issued should require issuers of private placements to provide investors with the essential

information needed for responsible risk assessments. This would effectively prohibit deals like EMATUM that provided investors with little, or false, information about the borrower and the sovereign. Full, accurate disclosure would strengthen the ability of relevant authorities to resist political pressure to bail out investors who made poor decisions — which, in turn, would powerfully reinforce incentives for responsible risk taking by future investors. Rating agencies should be urged to highlight in their written reports major disclosure gaps, even in such cases where the rating is based not on the issuer but solely on the sovereign guarantee. The lead manager bank should be required to highlight in its disclosures to investors and regulators any key information missing from its privately placed bond prospectus that is normally in the prospectuses of publicly offered bonds.

4. **Enhance disclosure standards in prospectuses.** The key “Use of Proceeds” clause in sovereign bond prospectuses typically provides limited information in boilerplate language that is not legally enforceable. This clause could be strengthened by providing investors the legal right to demand immediate repayment of all amounts owed under the bonds if the terms contained in the Use of Proceeds statement are violated. Further, the prospectus could be strengthened by preventing the issuer and its deal arrangers from claiming excessive limits on their accountability for such responsibilities as the accuracy of information in the prospectus, losses incurred from relying on information in the prospectus, and independently verifying the information in the prospectus.
5. **Require deal managers to certify due-diligence authorizations and policy compliance.** The arrangers of sovereign bond deals should take greater responsibility for certifying key legal authorizations required for external commercial borrowings, as well as actual compliance with the government’s core external debt management policies. Deal managers should be required to directly authenticate that external borrowings meet legal and regulatory controls and that the borrowing agreement is enforceable under the issuing country’s jurisdiction. They should also be strongly encouraged to provide the borrowing government and investors with formal analyses of how the proposed borrowing affects the country’s debt service capacity (including downside scenarios) and how the issuance fits within the borrower’s public debt management goals and strategy.
6. **Clarify and fortify government management and accounting of proceeds from international capital markets.** The proceeds of sovereign and quasi-sovereign bonds are often managed in offshore accounts. Transparency around how this is handled should be strengthened by requiring publicly available bond documents to explicitly detail where the proceeds will be held and permitted to be transferred while offshore. Borrowing governments should be legally mandated to publicly justify any delays in repatriating the bond proceeds, as well as to regularly disclose and formally report offshore balances and explain any withdrawals. To ensure public credibility of public finances, the budget

reporting of sovereign international bond proceeds must also meet high standards that ensure a full, clear, thorough, timely, independently verifiable, and publicly assessable accounting of the transaction. Such reporting should be consistent across the reporting systems and publications of the government, central bank, and other relevant official actors.

7. **Foster international cooperation.** The cross-border nature of sovereign borrowing in global capital markets points to the need to tackle related transparency issues at the international level, as well. Countries should work together to strengthen the domestic and international detection and legal prosecution of government officials and lender banks involved in sovereign borrowing-related acts of corruption, such as the money laundering and unauthorized use of borrowing proceeds apparent in the Mozambique and Malaysia 1MDB cases. Convicted government officials should be dismissed, jailed, fined, and held liable for misappropriated funds.

Bank secrecy laws should be aggressively rolled back to facilitate the discovery of unapproved fund movements, and banks should be held strictly accountable for verifying the source of funds that they are asked to handle. Involved banks should be subject not only to stiff sanctions and fines by regulators but also to third-party liability, if they have not made good-faith efforts to ensure that the funds they helped a sovereign government borrow are used in the public interest.

The international community should develop an effective global framework for identifying and recovering ill-gotten assets across different national jurisdictions. Countries can work — globally and through country legal systems — to advance the recognition of the recovery of stolen assets as a fundamental principle of international public law. Countries can also contribute to supporting international bodies that are dedicated to developing expertise in assisting national enforcement authorities in managing complex international asset-recovery cases.

CONCLUSION

The cases from Kenya, Mozambique, and Malaysia point to flaws in how international capital market operations are managed by governments and international banks. The lack of transparency around such transactions opens the door for conflict of interest and corruption, with considerable negative consequences for investors and countries alike. This report is IBP's first attempt at examining the problems in government operations in international capital markets and how these problems can be mitigated. IBP is keen to obtain feedback from experts on the appropriateness and feasibility of implementing the draft recommendations contained in this report and to identify the appropriate next steps in promoting greater transparency surrounding the management of these operations.