Fixed Income Thematic Report:

Are Sovereign Instruments Truly Risk-free?

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Content

Are Sovereign Instruments Truly Risk-Free?

Nature of Risk-Free Instruments

In a strict sense, "risk-free" is a term used to describe safe investments, in which investors can be certain of a future return with zero possibility of loss. All investments carry some degree of risk; however, it is suitable to consider Sovereign instruments as risk-free because the possibility of default is minimal. Therefore, returns on risk-free investments are usually lower relative to other instruments as investors receive less compensation for taking minimal risk.

Sovereign Instruments - What They Really Are?

To finance its growth initiatives, a country can explore several options as means to raise funds. Commonly, increasing direct taxes and issuance of treasury securities are measures explored. In addition, grants, revenue from state-owned enterprises, and public-private partnerships are some of the other financing sources for the Government.

Therefore, Sovereign debt instruments refer to the fixed-income securities issued by a Government to borrow money from the public. It is primarily achieved by selling government securities like treasury notes, bonds, and bills. More importantly, Sovereign instruments are issued in the country's primary currency. For instance, Nigerian Government issues the Federal Government Bond in Naira and promises to repay in Naira. However, they can also issue bonds denominated in foreign currency; these are called Eurobonds and assume higher risks. Hence, Sovereign debt instruments are predominantly considered risk- free because they are backed by the good faith of the country's government and, as such, termed safe. It is also considered that in extreme cases, the Government can print its own currency to repay. They are widely regarded as the yard stick for risk- free investment globally.

We have seen a few defaults in the past

Investment risk can come from different sources, and for an investment in a sovereign instrument, this can include restructuring, haircut, postponement of payment date, and in the extreme, outright default. Some countries have gone through different default circumstance in the past.

Argentina is popularly known as a serial debt defaulter – both on domestic and foreign debts. Specifically, the country has defaulted on its domestic debt over five times since its independence in 1816. In March 2023, the country initiated a swap exchange programme for c. 64% of its domestic debt due to mature in June for new bonds with maturity period of 2024 and 2025. Notably, the swap programme represented its third bond swap since August 2022.

In February 2023, Ghana embarked on a Domestic Debt Exchange Programme (DDEP) with about 85% participation rate. This programme was initiated to exchange of eligible GHS-denominated notes and bonds for new bonds. Specifically, the domestic debtholders exchanged their existing securities for new instruments that offer zero coupon payment in the first year, 5% in the second year, and 10% in the third year. Similarly, the country is expected to approach external creditors in July to reach an agreement for the restructuring of its Eurobonds (projection of a 30% haircut). These arrangements are in alignment with the pre-agreed conditions to secure the USD3bn Extended Credit Facility (ECF) from the International Monetary Fund.

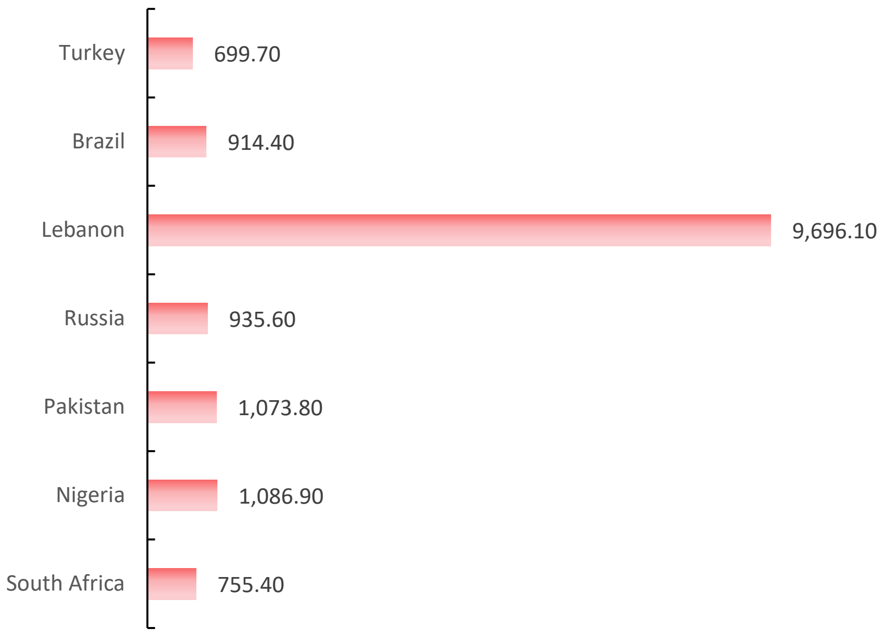
Like the domestic debt default highlighted, there have been notable cases of countries defaulting on their external debt obligations. For instance, during the COVID-19 era, Zambia defaulted on the payment of USD42.50mn interest on one of its Eurobonds. Likewise, in March 2023 – six years after an official default on USD60bn bonds, Venezuela made a tolling announcement that could enable the government and creditors to make restructuring arrangements.

Are there signals of looming default?

Concerns about the debt sustainability of emerging economies, especially Sub-Saharan Africa countries have increased since the outbreak of the COVID-19 pandemic. Particularly, the persistent monetary tightening stance adopted by major central banks have raised discussions about the fiscal sustainability level of countries who have large stock of USD-denominated loans. The significant jump in the debt level of most Sub-Saharan African countries was largely spurred by higher price level, slower growth, and persistent depreciation of their currencies against the USD. Infact, the region's public debt to GDP ratio increased to 56% in 2022, pushing over half of the countries in the region to be at high risk of debt distress.

In identifying countries with high-risk profile, common indications are low government revenue, high debt-service to revenue ratio, dwindling currency value, high basis points (bps) bond spreads and dwindling foreign exchange reserves. In the next few years, some countries in the region (Kenya, Nigeria, South Africa, etc) are expected to make interest and principal payments on outstanding Eurobonds. In 2024 and 2025, an estimated obligations of USD6bn and USD7bn are due from SSA countries cumulatively.

Chart 1: Selected emerging countries with bond spread over 500bps (YtD)



Source: Bloomberg, Meristem Research

Table 1: Debt exposure (%) of selected African countries in 2022

Country	Rating	Public debt/ GDP	Eurobonds/ GDP	Eurobond debt/Total debt	Eurobond maturities (2022-2026) to reserves	Eurobonds/ Reserves	Interest/Revenue
Zambia	Ca	104%	9%	8%	88%	150%	20%
Tunisia	Caa1	86%	7%	9%	46%	48%	12%
Ghana	Caa1	81%	14%	18%	14%	141%	55%
Egypt	B2	94%	9%	10%	37%	124%	47%
Morocco	Ba1	76%	6%	8%	10%	28%	10%
S. Africa	Ba2	76%	5%	7%	13%	50%	18%
Nigeria	B2	32%	3%	10%	4%	37%	29%
Namibia	B1	71%	6%	8%	34%	34%	16%
DR Congo	Caa2	83%	2%	2%	0%	3%	8%
Kenya	B2	71%	6%	8%	22%	78%	29%

Source: Moody's Investors Service, Meristem Research

Fiscal Sustainability: Weak Debt Sustainability and Subsequent Debt Restructuring in Sub-Saharan Africa Questions the Risk-Free Nature of Sovereign Instruments

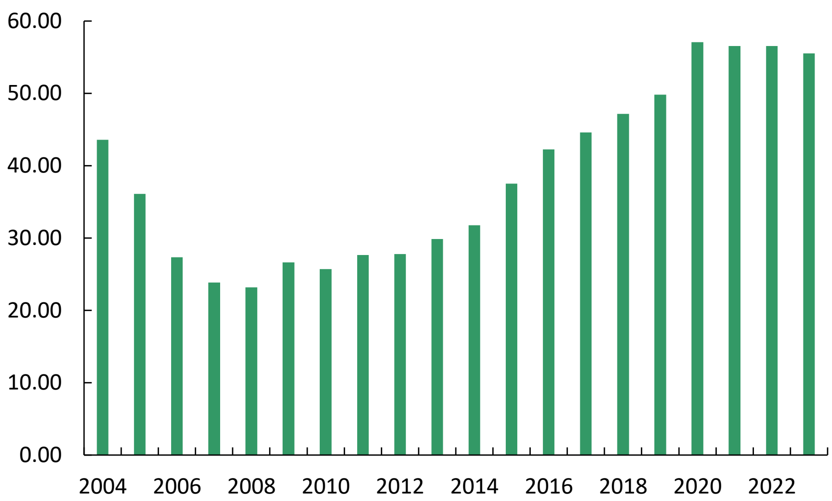
Sub-Saharan Africa (SSA) is at a crossroad as lingering pandemic-induced weakness in fiscal positions, high inflation, and rising rates have left the region grappling with colossal debt burden which have ballooned over the years.

With Sovereign debt surpassing c.60% of GDP in almost half of SSA economies in 2022, debt sustainability deteriorated further in many SSA countries, leading to rising borrowing costs (with heightened risk of default), capital outflows, and credit rating downgrades.

A closer look indicates that there are many countries with increased fiscal risk and on the verge of a default with several existing debt distress cases. According to the Debt Sustainability Analysis (DSA) conducted through the joint World Bank-International Monetary Fund Debt Sustainability Framework, out of 38 Sub-Saharan African Countries eight (8) are already in debt distress, eighteen (18) are at high risk, and thirteen (13) are at moderate risk.

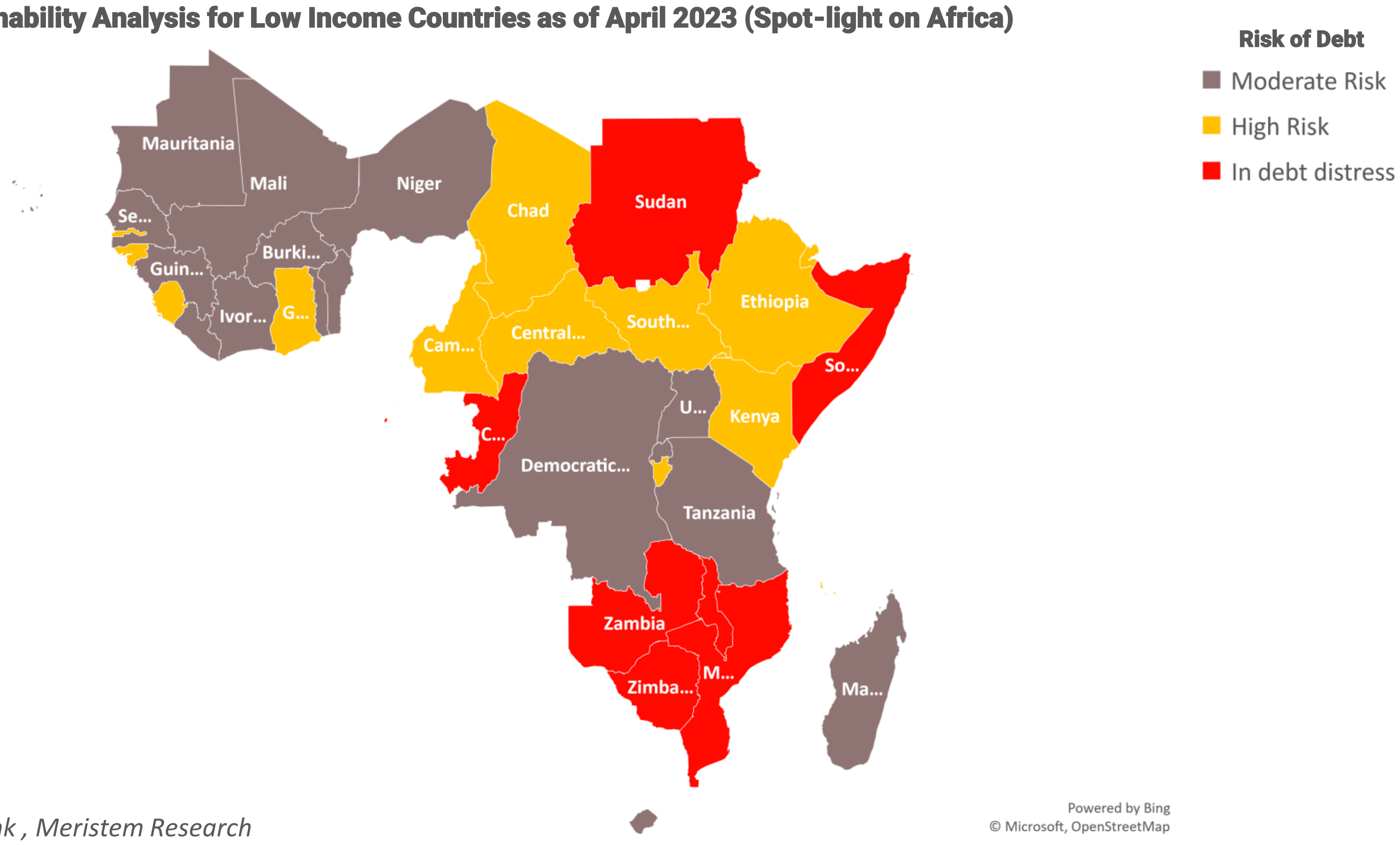
Particularly, the IMF warns that debt levels as a share of GDP in Sub-Saharan Africa have almost doubled in less than a decade, reaching a worrying 55.52% in 2022. The alarming trend of debt-to-GDP ratios surpassing the recommended threshold (50%) persisted since 2019 expounding the greater risk of sovereign debt sustainability.

Chart 2: SSA Debt-to-GDP (%)



Source: IMF, Meristem Research

Chart 3: Debt Sustainability Analysis for Low Income Countries as of April 2023 (Spot-light on Africa)



Source: IMF, World Bank , Meristem Research

Debt sustainability is a country's ability to meet its debt without the need for debt relief and without accumulating delinquency charges. However, according to the IMF, SSA is home to most of Debt Service Suspension Initiative (DSSI) eligible countries. The weakening macroeconomic fundamentals have limited government's ability to support their respective economies. Thus, fiscal deficit of countries in the region widened (contrary to major advanced economies) as borrowings increased and debt level stayed high.

Consequently, the rapid increase in sovereign risk occasioned by the decline in sovereign credit quality have led to credit rating downgrade for most SSA countries.

Unsurprisingly, some countries in SSA have turned to multilateral organizations like the IMF to support their ailing economies and resorted to debt restructuring given the urgent need to reduce fiscal vulnerability in most countries.

Thus, "default in debt obligations" defined by credit-rating agencies as "an episode in which the sovereign makes a restructuring offer at terms that are less favorable than the original debt''; begs the question of whether "are sovereign instruments truly risk free."

Case Studies of Some SSA Countries With Debt Defaults

Zambia

In 2020, Zambia became the first African country to default on its debt obligation. After the Covid-19 shock worsened the already fragile economic conditions, the country announced a suspension of USD120mn in interest payments to its Eurobond holders. Prior to this time, in 2017, the country was categorized by the IMF under its debt sustainability analysis as being at a high risk of debt distress. The Covid-19 pandemic brought more hardship, making the country to grapple with the challenge of low revenue amid needs for funds to combat the pandemic.

According to the IMF, in 2021, the country's overall debt obligation soared to c. 123% of its GDP. This, coupled with its double-digit inflation and dwindling foreign reserve impeded the government's ability to mobilise revenues to pay its debts.

Currently, Zambia is facing a significant debt distress, with a towering debt-to-GDP ratio of 124% and over 30% of government revenue going towards debt servicing. Its existing bonds have been greeted with several losses over the past month with 30% of Zambia's banking sector revenue coming from its government bonds. The decline in bond values is a serious concern for investors and could lead to a financial crisis stemming from heightened risk perception.

Unsurprisingly, Zambia has resorted to restructuring of its debt initiating the process under the G20's Unified Framework for Debt Treatment and ongoing negotiations with creditors. This would enable the country to access a USD1.3bn bailout from the IMF.

Ghana

Ghana suffered from huge fiscal deficits which persisted until 2020, before the impacts of Covid-19 hit the nation's economy. Decline in export earnings and remittance inflows, as well as emergency healthcare spending widened the country's fiscal gap. The situation further deteriorated in February 2022 as the country suffered from spike in food price prompted by the Russia-Ukraine war.

Also, the hike of interest rates by the US Federal reserve in response to the inflation induced by the Eastern Europe crisis strengthened the dollar against the currency of other developing countries.

Thus, Ghana's cedi depreciated, placing it at the bottom of about 148 currencies ranked by Bloomberg currency tracker in 2022, and inflation exceeding 50% as at December 2022.

The rise in dollar value resulted to a more expensive Ghana's US dollar debt (estimated to be over half of the country's total liabilities).

Similarly, its public USD55 billion as at September 2022, 42% of which emanated from its domestic debt market.

In December 2022, Ghana halted payments on its Eurobond, commercial loans and most bilateral lenders essentially defaulting on its debt obligations owing to the economic crisis that bedevilled the country. The country struggled to service its debts leading to downgrades by multiple credit ratings agencies on concerns bothering around debt sustainability.

Expectedly, Ghana resorted to a comprehensive restructuring (through an IMF-backed restructuring plan) of its debts obligations, a condition necessary to receive USD3.00bn from the IMF. In what was called the Domestic Debt Exchange Programme (DDEP), local currency bonds were swapped for new instruments with longer maturities and lower interest rates, coming with severe and harsh conditions for investors.

Chad

Chad was already approaching a tipping point with regards to its public debt burden since 2019 as domestic financing significantly increased to offset for lower-than-expected external budget support. Consequently, the country's risk of debt distress was adjudged high by the IMF. The collapse of oil prices occasioned by the Covid-19 in 2020 pushed the country to a crossroad as its public finances depends largely on oil revenue.

Consequently, the country applied to restructure its debt under the G20's new Common Framework for Debt Treatments.

The country witnessed an improvement in its debt ratios from the last debt sustainability analysis in 2021 due to the increase in oil prices and the debt treatment agreement by commercial and official creditors under the G20 Common Framework. Thus, following the conclusion of this exercise, Chad only moved from being ranked to be in debt distress to being in high risk of external debt distress.

However, the downside risk remains high due to the uncertainties surrounding the volatility of oil prices and possible shortfalls in financing.

Ethiopia

Ethiopia has been at a risk of a high debt distress exacerbated by the economic slow-down caused by the Covid-19 pandemic, political instability, foreign exchange shortages, and spiralling inflation. Thus, the country followed same trend similar with countries under debt distress requesting for a broader debt rework under the G20 Common Framework. The progress was however complicated by a 2-year civil war that broke out in the country placing the country at a high risk of default.

Consequently, Ethiopia's crediting rating was downgraded reflecting the lack of external receipts required to meet significant external financing gaps, as well as the deterioration in the country's external liquidity.

The downgrade in rating also signalled the substantial risk of a default resulting from the government's participation in the G20 Common Framework debt relief initiative.

While the situations vary amongst countries, some SSA countries appear to be more vulnerable to further shocks. A good example is Chad, Ethiopia, Zambia, and Ghana, which have already requested debt treatment under the IMF's Common Framework. Moreover, the deterioration of the debt outlook of the SSA countries poses a serious concern due to the global economic challenges that have lingered throughout 2022 and worsened by the Eastern Europe crisis. Under these circumstances, SSA countries' debt outlook might likely worsen further.

According to Fitch Ratings, the aggregate debt servicing costs due in sub-Saharan Africa over the next two years will be significantly higher than the level seen from 2019 to 2021. Thus, the risk of onerous debt repayment crises across the region is expected to be substantial. This poses serious concerns about the possibility of debt default especially from countries with already weak fundamentals in the region.

The Enigma of Nigeria's Debt Burden

Domestically, there have been increasing concerns about Nigeria's fiscal sustainability. The country's fiscal position has been pressured by a myriad of factors, including imprudent government decisions, weakening revenue generation, economic instability and uncontrollable external shocks. For context, Nigeria's total public debt stock has increased at a Compounded Annual Growth Rate (CAGR) of 19.86% in the last decade. As of December 2022, Nigeria's total public debt stock stood at NGN46.25trn (16.92% higher than it was a year earlier).

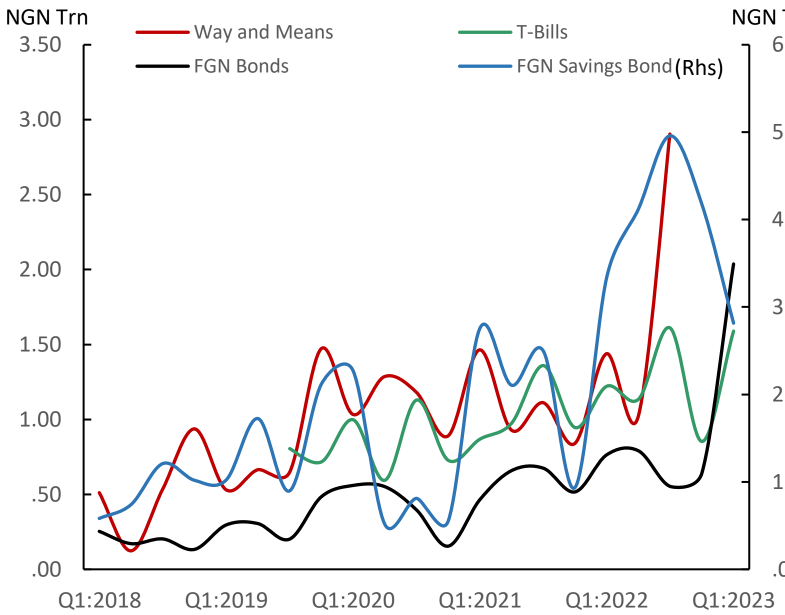
While the government debt level is at its highest on record, some debt metrics (although worsening) remain within set threshold. As of 2022FY, the country had debt to GDP ratio of 22.85% and fiscal balance to GDP ratio of 9.88% (versus a threshold of xx and xx respectively)

The accumulated debt is however pressuring in other debt metrics. Between January and November 2022, debt service gulped c. 81% of FGN's total revenue, which raises sustainability concerns. Furthermore, the government has breached its proposed 70-30 (70% domestic and 30% external) debt funding mix. As of 2022FY, Nigeria's external borrowing (NGN18.70trn) constituted 40.44% of its total public debt (NGN46.25trn). **Considering that the mix was set to manage exposure to foreign exchange risk, the excessive external borrowing constitutes a major risk to sustainability, especially in the face of dwindling foreign exchange earnings and diminishing foreign reserve.**

The Federal Government's major source of debt financing is from the domestic capital and money markets and lately, the FGN's debt funding need has increased drastically. The amount raised through domestic funding sources (FGN bonds, Treasury-bills, FGN savings bonds and CBN ways and means) all increased for the three consecutive years till 2022.

Furthermore, the amount raised through major domestic sources - FGN Bonds (+166.55% YoY) and T-bills (+30.14% YoY) were higher in Q1:2023 than any other similar period in the last five years. Unsurprisingly, the lenders (majorly banks, Pension Fund Administrators, and other institutional investors) have continued to readily provide the Government its required financing, given its assumed "risk-free" nature.

Chart 3: Trend of Major FGN Debt Instruments

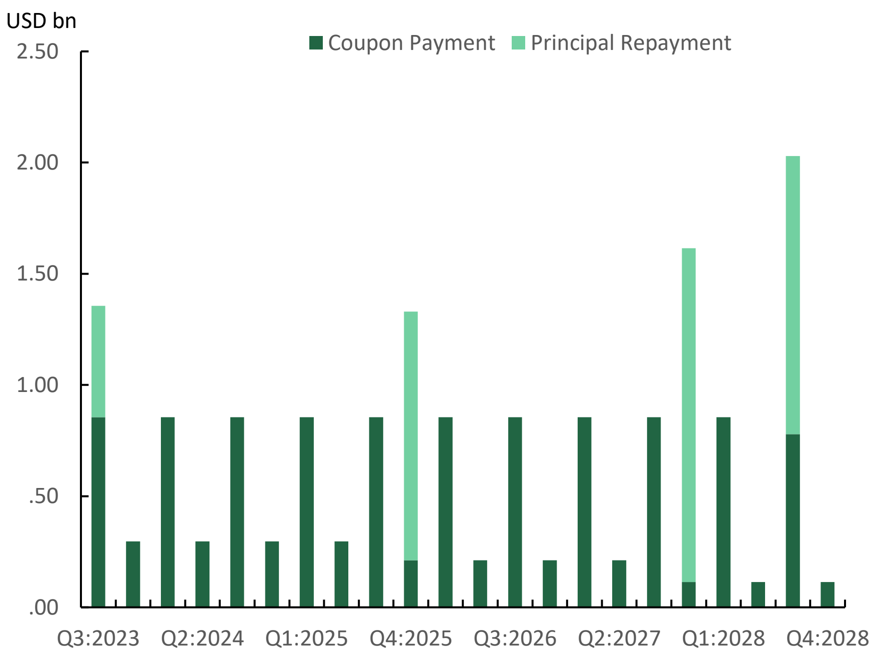


Source: DMO, CBN, Meristem Research

The rapid increase in the FGN's debt stock reflects the ever-widening budget deficit. The country's budget deficit has increased by a CAGR of 29.02% in the last ten years, while budgeted revenue increased by 9.85% during the same period. Also, the government only achieved an average of 61.68% of its target revenue during the period. Thus, actual revenue increased by a CAGR of 5.89% and deficit by 28.37%. Further confirming the dire situation, for the first time, the Government's 2023 budget deficit (NGN11.34trn) exceeds the estimated revenue (NGN10.49trn). Also, the planned deficit is 77.53% higher than the prior year's deficit.

The surge in debt stock has led to fiscal sustainability concerns, as debt service maintain a similar trend in the face of unstable revenue generation. Also, the decline in capital importation and Nigeria's oil production volume, has led to dwindling foreign reserve and a free fall in exchange rate. These thus raise concerns about the country's ability to meet foreign debt obligations. Currently, the country has an external debt stock of USD41.69bn and upcoming foreign debt obligations in the next one year is USD3.96bn (11.25% of external reserve as of Q1:2023).

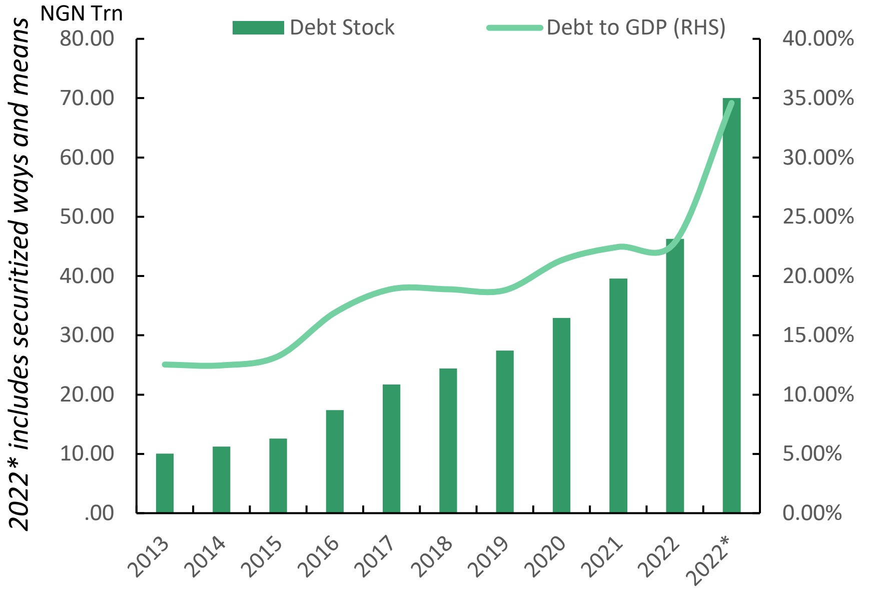
Chart 4: Upcoming Eurobond Repayment Schedule



Source: FMDQ, Meristem Research

The recent securitization of the CBN's ways and means financing creates a clear way of repayment of the loan line. However, the loan which has rapidly increased to NGN23.77trn as of October 2022 further increases the enormous Government (NGN46.25bn). The ways and means loan will cause the Government Debt stock to increase by 51.40% to NGN70.02trn (and debt to GDP to increase to 34.60%). Furthermore, the loan will cost government NGN2.14trn in finance cost annually in the first three years and NGN2.76trn for the next 37 years.

Chart 5: Trend in Debt Stock and Debt to GDP Ratio



Source: DMO, CBN, Meristem Research

The Rough Road Ahead

The current fiscal state of the country raises questions about what is ahead. The major options for the country include deploying fiscal measures to navigate the countries fiscal woes, seeking debt relief or an eventual default. To be able to steer the country from its current fiscal difficulty, the government will have to take a different approach from what has been done in the past.

Avoiding Quantum Insanity

On one hand, policy decisions such as the fuel subsidy removal and the use of Public private Partnerships to provide infrastructure signal easing government expenditure and possible decline debt financing needs. However, other indications such as the recent legislative review of the ways and means threshold to 15% of prior year revenue and the fund demanding initiatives indicate otherwise.

Furthermore, reducing borrowings, is insufficient to achieve the required fiscal headroom. The government will have to channel the savings from subsidy removal into more productive ventures, simultaneously increase revenue generation and cut down on other unproductive outflows such as the spending on Government Owned Enterprises, personnel costs and overheads.

Chart 6: Domestic Debt Composition

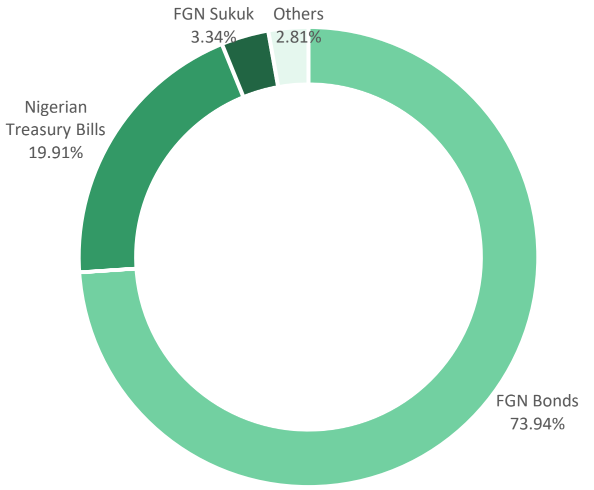
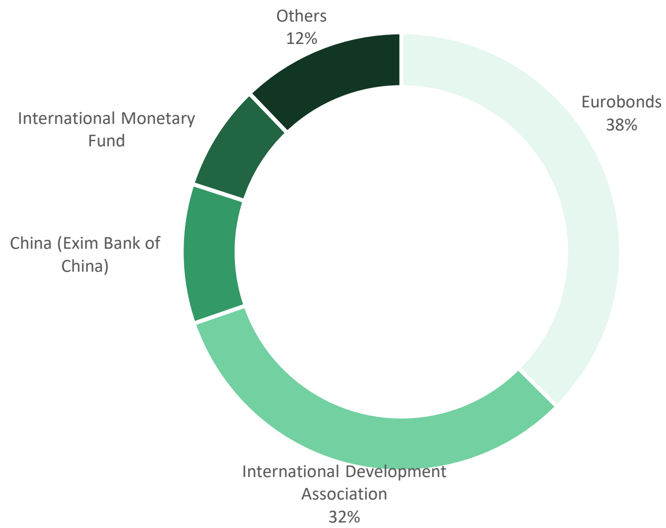


Chart 7: External Debt Composition



Source: DMO, Meristem Research

A less desired respite to the country's debt burden is to seek a debt relief, this involves a partial or total forgiveness of the country's debt or provision of a bail-out by bilateral of multilateral institutions such as the International Monetary Fund (IMF), World Bank and the International Development Association. Debt reliefs are common with countries that have accumulated high debt, especially low-income countries and Nigeria previously explored the option between 2005 and 2006.

The debt relief (with the Paris Club) was worth USD18bn and included a repayment of USD12bn, leading to an overall reduction in debt stock by USD30bn. While utilizing a debt relief will lessen the debt burden on the government, it will require various negotiations with the bilateral lenders. The debt relief agreement will also require implementation of certain economic policies which might differ from the Government's choice. Furthermore, the country's current debt composition makes a debt relief less attractive to the Government. Unlike in 2005 when the bulk of the country's debt was owed to bilateral creditors, the share of bilateral and multilateral creditors debt in Nigeria's present debt composition is 16.19%.

Possibility of a Default

In January 2023, Moody's Investors Service concluded its three months review for downgrade of Nigeria's credit rating. The agency downgraded FGN's long-term foreign currency and local currency issuer rating from B3 to Caa1 and B1 to B2 respectively. The major reason for downgrade of the rating is the expectation that the government's fiscal and debt position will deteriorate even further. With a stable outlook, the rating agency highlights that immediate risk of default is minimal barring any unforeseen shocks. Moody's also noted that while the new administration could introduce policy reforms, implementation will take a while.

In our view, similar to that of the rating agency, the risk of a default is low in the near term. However, near-term policy actions will determine the longer-term default risk. Moreover, the new government's effort to improve fiscal sustainability through measures such as removal of fuel subsidy, are upsides. On the other hand, indications such as the legislation on increasing the ways and means financing point to further debt accumulation.

In all, default risk on Nigeria's sovereign instruments (even in the long term) is remote in our assessment.

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