Emerging Markets Review xxx (xxxx) xxx–xxx

Contents lists available at ScienceDirect

Emerging Markets Review

journal homepage: www.elsevier.com/locate/emr

Does governing law affect bond spreads?

Dilip Ratha, Supriyo De*, Sergio Kurlat

The World Bank, 1818 H St. NW, Washington DC 20433, United States

ARTICLE INFO

JEL classifications:
F21
F34
G10
G12
G15

Keywords:
Bond spreads
Development finance
Emerging markets
Sovereign ratings
Governing law

ABSTRACT

Controlling for bond and issuer characteristics, bond spreads are expected to be equal across different legal jurisdictions, and differences are expected to disappear through arbitrage. However, an analysis of 490 U.S. dollar–denominated bonds issued by 53 emerging market sovereigns during 1990–2015 reveals that after the financial crisis of 2008, launch spreads of sovereign bonds issued under U.K. law have been higher than those issued under U.S. law, by 130 basis points for BB+ bonds and 175 basis points for B− bonds. This effect was not significant for investment grade bonds. On average, bonds issued under U.K. law had weaker ratings and shorter tenors post-crisis. The post-crisis impact of governing law on sovereign bond spreads is not explained by collective action clauses, or first-time bond issuances. Instead, the difference seems to be related to the perception that U.S. law offers stronger investor protection, and that the investor base for bonds issued under U.S. law is larger than that for bonds issued under U.K. law. The difference in spreads persists in the secondary market even after 180 days, perhaps because of the lack of liquidity, as investors tend to buy and hold these more attractive bonds on a longer-term basis.

1. Introduction

This paper explores whether the governing law has any lasting impact on sovereign bond spreads. Foreign currency sovereign bond issuances comprise a significant and vital part of total emerging market (EM) bond issuance. Sovereign bonds are important not only for government finances, but also for providing a benchmark for sub-sovereign borrowings. The use of governing law of an external jurisdiction other than that of the sovereign issuing debt (very often the U.S. or the U.K.) is a widespread practice especially among emerging market sovereign issuers. This is an attempt to mitigate risks associated with sovereign debt default by negating the possible influence a sovereign may have on its national courts. Yet the role of governing law as a distinguishing feature of a bond has received very little attention in the literature.

The main research questions examined in this paper are:

1. Are there systematic differences between the spreads of dollar-denominated emerging market sovereign bonds issued under U.K. and U.S. law, after controlling for bond and issuer characteristics?
2. What factors could explain such differences, if any?

Conventionally, controlling for bond and issuer characteristics, spreads are expected to be equal across different legal jurisdictions. Differences in spreads, if any, are expected to disappear over time through arbitrage. An analysis of 490 sovereign U.S. dollar bonds issued by 53 emerging market sovereigns during 1990–2015 reveals that since the global financial crisis in 2008, the governing law seems to affect bond spreads for sub-investment grade bonds. During 2008–2015, the launch spread of sovereign bonds issued

* Corresponding author.
E-mail address: sde@worldbank.org (S. De).

https://doi.org/10.1016/j.ememar.2018.04.005
Received 2 February 2017; Received in revised form 18 January 2018; Accepted 5 April 2018
1566-0141/ © 2018 Published by Elsevier B.V.

ARTICLE IN PRESS

under U.K. law has been higher than those issued under U.S. law. While the difference in spreads was not significant for investment grade bonds, it ranged from 130 basis points for BB+ bonds to 175 basis points for B− bonds. After controlling for bond characteristics such as ratings, tenor, issue size and country growth, plausible explanations such as presence of CACs and first-time issuances do not adequately explain this difference. However, bonds with U.S. SEC registration attract lower spreads. Further, the difference in spreads arises due to lower spreads of U.S. law bonds in the post-crisis period. This may indicate that the increase in risk aversion following the crisis, the greater investor protection brought in by legislations, and consequent flight to the safety of SEC registered bonds increased the value of U.S. law bonds in the perception of investors.

These issues are linked to the literature on law and finance (following Porta et al. (1997, 1998) often referred to as LLSV) which deals with the relationship between legal rules, their origins, enforcement and impact on financial flows. This literature posits that differences in legal protections offered to investors impact the structure, pricing and volume of financial flows. The paper advances and addresses gaps in this literature by:

1. Focusing on the importance of governing law of the jurisdiction under which the bond is issued, rather than the laws of the issuing sovereign.
2. Highlighting differences between the two largest governing law jurisdictions for sovereign bonds, namely, the U.S. and the U.K.
3. Examining the role of SEC registration, first time issuances and investment grade ratings in driving spreads as opposed to the CAC provisions that hitherto attracted more attention.

Much of the current literature explores how a country's legal origins and rules impact financing including bank and syndicated loans (Qian and Strahan, 2007; Godlewski and Weill, 2008). However, these studies focus on laws of the country issuing debt or equity not those of other jurisdictions that may govern such transactions. This is a gap that this paper seeks to address. The observed difference in spreads based on governing law may be related to the perception that U.S. law offers stronger investor protection and greater regulatory enforcement. For instance, Jackson (2007) states: "Compared to at least the United Kingdom and Germany, the intensity of securities enforcement actions in the United States appears to be strikingly higher. Not only are there more financial regulators in the United States, but they also carry bigger sticks than their foreign counterparts. While the laws on the books may be converging, the level of enforcement efforts seems to vary widely across national boundaries and even within regions such as Europe."

There has also been a change in the investor base for emerging market bonds. Post-crisis, the volume of assets managed by mutual funds has increased while hedge fund investment in emerging markets has stagnated (International Monetary Fund, 2014). This may imply a greater move towards safer assets. Also, the U.S. investor base is much larger. For instance, the volume of international portfolio investment originating from the United States is about 2.5 times that from the U.K. (International Monetary Fund, 2015).

There has also been a segregation in terms of bond characteristics between U.S. and U.K. law issues. Besides the noticeable difference in spreads, U.S.-law, dollar-denominated sovereign bond issues tend to have higher ratings and longer tenors indicating that the issuers were more creditworthy and long term oriented. However, these characteristics do not wholly account for the observed spread difference in empirical estimates.

Another strand in the literature has examined issues related to the economics and law of sovereign debt and default (see Panizza et al. (2009) for a survey of this literature). These include studies examining legal decisions or contractual clauses related to orderly resolution in cases of default (for example Eichengreen and Mody, 2004). Collective action clauses (CACs) that reduce the possibility of minority investors holding out on a debt settlement with a borrower, which were featured originally in the U.K. law but not in the U.S. law, are a possible source of differences in bond spreads. But empirical evidence from the literature is inconclusive on this point. Furthermore, CACs are now common in bonds issued under both U.K. and U.S. governing law. Consequently, this paper examines other possible sources of spread differences such as first-time bond issuance by a new borrower, impact of investment grade ratings and SEC registration.

The paper is structured as follows. In the following section, we describe the stylized facts, legal background and relevant literature motivating this study. We document historical trends, focusing on the changes that occurred in this particular market after the crisis.[1] Section 3 describes the data, presents our estimation methodology, benchmark results and its extension to the secondary market. In Section 4 we explore plausible causes of the spread difference, and offer possible explanations to the puzzle. We conclude in Section 5 with policy recommendations and future research directions.

2. Stylized facts, legal aspects, and the literature

Emerging market bond issuances during 1990–2015 totaled $16.8 trillion (Fig. 1). Of these, public sector issuances accounted for 72% ($11.9 trillion), and central government debt, about one-third ($5.5 trillion). Out of a total of $1300 billion foreign currency sovereign bonds, US$-denominated sovereign bonds issued under U.K. or U.S. law amounted to just under $700 billion. The average deal size of the latter was larger, $844 million, compared to $395 million for public issuances generally, and $116 million for private bonds. Dollar-denominated bonds comprise a large chunk of sovereign bond issuances (65% of sovereign foreign currency bond proceeds and 49% of sovereign foreign currency bond issues). Issuers targeting clients are known to issue currency specific bonds adhering to specific governing laws (such as Samurai bonds). But dollar-denominated bonds appeal to a large share of international

[1] The more general trends occurring in sovereign bond markets have already been studied. For example, Claessens et al. (2003) already documented the increased participation of developing countries in international markets, and identified the macroeconomic and institutional determinants of sovereign bond currency composition, as well as the policy motivations for issuing abroad.

Download English Version:

https://daneshyari.com/en/article/8942332

Download Persian Version:

https://daneshyari.com/article/8942332

Daneshyari.com