# The risky interconnectedness between investment funds and developing country debt

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**The investment industry has been integrating government and corporate bonds from high income and middle to low income developing countries in investment funds at an increasing pace. While it has satisfied investors' demand for high profits, it has increased the debt burden of the countries involved. This paper intends to raise awareness how the dynamics of the investment fund industry contribute to more volatile financial markets and irresponsible lending, which in turn affects the debt repayment risks for developing countries.**

**The first part of this briefing exposes the risky interaction between the investment fund industry and the debt issuing carried out by developing countries. The second part gives the example of a government bond issued by Ghana and its integration into investment funds. It discloses how ownership of the bonds is being scattered around the world while profits are being made throughout the investment industry without responsibility for its impacts.**

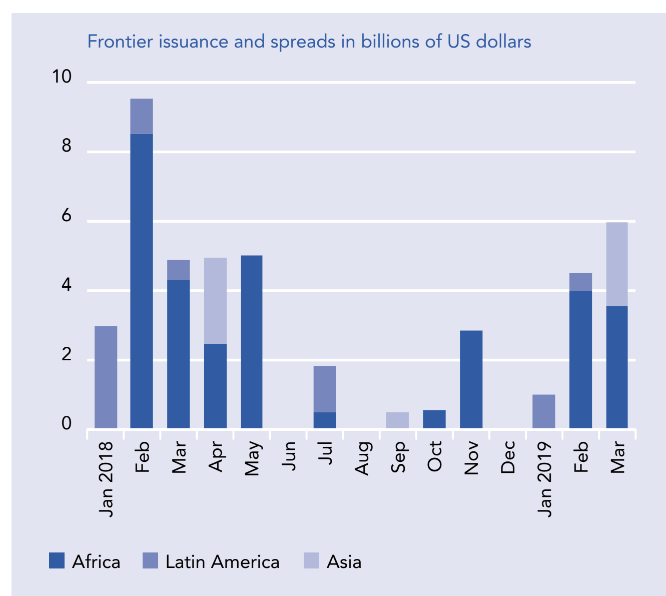
## Part 1

## Investment funds have become volatile players in developing country bond markets

Financial markets, in which institutional investors and investment banks constantly move capital in search of the highest profit around the globe, showed periods of rather high volatility in 2018 and 2019.[1] Between April and August 2018, currencies and equities from emerging market and developing countries have been devaluating as a result of capital outflows. Global investors saw opportunities for less risky and better profit making in dollars elsewhere in reaction to changes in US monetary policies and higher interest rates. The bond and equity markets from what investors call emerging market (EM) countries were again under pressure, to a lesser extent, in the last quarter of 2018. Global investors viewed that a few EM countries showed economic weaknesses and faced financial or debt repayment problems due to foreign investors' reaction to monetary and political changes in developed countries, especially the US.[2]

In 2019, when global investors considered investment profitability prospects in the developed countries to be weakening due to decreasing interest rates, slim economic growth and their fear of the negative impacts of the US-China trade war, they were again buying bonds from emerging markets and developing countries. The governments from some middle income, low income or small developing countries (referred to as 'frontier markets' by investors, and including some African countries[3]) as well as EM countries, took up the opportunity of the investor's new interest in higher returns from risky investments, and started to issue bonds again (see Figure 1). Many EM and developing countries saw that the demand for their bonds was manifold higher than the amount their bond issuance was offering. That was for instance the case for Ghana in March 2019, as explained in Part 2 of this briefing. Also the heavily indebted government of South Africa[4] was able to increase its planned bond issuance from US$ 4bn to an actual issuance of a record US$ 5 bn[5] after investors manifested very high interest in buying the bonds in September 2019.

**Figure 1** Volatility in 'frontier' developing countries' issuance of bonds due to shifting interest by investors




*Source: IMF, Financial Stability Board, April 2019, p. 30,.*

## The attraction of EM and developing country bonds

The appeal of EM country bonds for investors is part of a longer trend. Since the financial crisis in 2008, the period of low economic growth and loose monetary policies in Western countries increased the volume of money in banks and financial markets. Within a global regime of free movement of capital, it emboldened global private investors to increase their holdings of EM country government bonds up to US$ 1.5 trillion over the last decade.[6]

The interest rates from bonds ('debt securities' or 'debt') issued by developing country governments or companies were much higher compared to the low, and recently negative, interest rates in developed countries.

In the investment world, higher interest rates compensate investors for the higher risk that EM and developing countries will not be able to repay their debt. The higher risk is indicated by the low ratings provided by credit rating agencies assessing those bonds. When developing countries or corporations issue bonds denominated in foreign currencies, foreign debt can become difficult to service and repay if the local currency is devaluated. Since developing countries cannot 'print' hard currencies, currencies are susceptible to devaluations due to pressures from capital outflows from foreign (portfolio) investors, currency speculation and lack of foreign exchange income from exports, amongst others. In contrast, when investors' demand was high for bonds from EM and developing countries and corporations, their interest rates were reduced in relative terms and more bond issuance was possible. Such bond issuance has increased the debt burden for these countries while debt being held by foreign investors can increase the problems of debt servicing.

## EM country bonds integration in investment funds

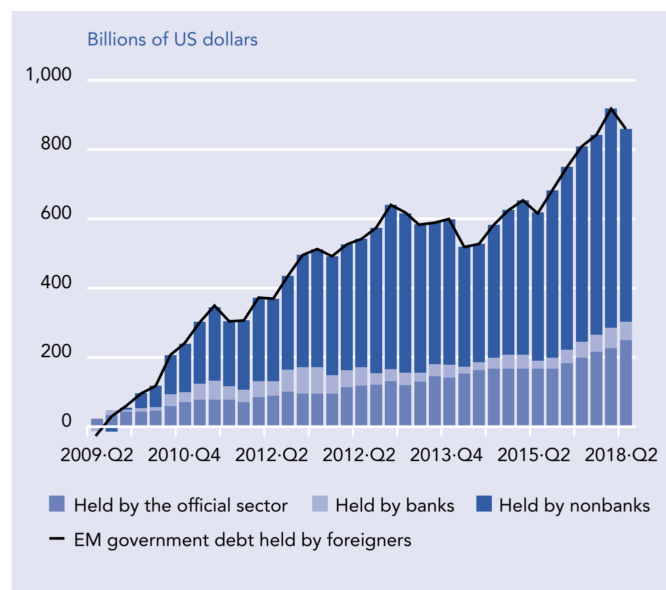
EM and developing country bonds were bought not only by institutional investors such as insurance companies, pension funds and hedge funds, but also increasingly by asset managers of investment funds. These investment fund managers have created investment funds for professional and individual investors, in the form of mutual funds and exchange traded funds (ETFs, whose shares are sold on the stock market). ETFs have become an increasingly popular investment product because they are easy to buy and sell ('high liquidity'), and have lower risks and lower costs than buying single shares or bonds. ETFs with bonds ('fixed income' ETFs) have grown the last year and are expected to grow.[7] Investment funds with EM and developing country government and corporate bonds are spreading the risks of non-payments of the bonds by including hundreds of different bonds from many different developing countries in one investment fund (see also Part 2).

Specific indexes or benchmarks are used to facilitate the selection of the bonds in the investment fund. Each index or benchmark integrates a pre-determined percentage of government and/or corporate bonds in local or foreign currencies from different EM and developing countries, which have to fulfil particular criteria to be included.

It can include bonds with different issuance dates and different interest rates from the same country. The managers of the EM bond investment funds buy the bonds according to the

index configuration and/or buy assets to achieve the same or better returns: the index is used to benchmark the financial returns of the fund or compare with the returns of a similar index. Investors' money that is benchmarked according to the most popular EM bond indices has quadrupled since the 2008 financial crisis, up to US$ 800 billion in 2018.[8]

**Figure 2** Cumulative increase of foreign investors in EM government bond markets




*Source: IMF, Financial Stability Board, April 2019, Online Annex I, p. 22.*

The allocation of a certain bond in an index can influence the bond's attractiveness. For instance, if an investment fund with an EM bond index is popular, i.e. investors pour more money in the fund, the investment fund manager buys more bonds according to their percentage in the index, especially when the fund is a passively managed index tracking ETF ('tracker'). The opposite happens when investors withdraw from the fund. Investment funds that are actively managed can in principle deviate from the index substantially when buying and selling bonds or other fund assets in order to get better returns. However, the IMF indicates that EM bond investment funds are increasingly acting as passive funds, with accordingly reactive buying and selling of the related bonds. It is estimated that 70% percent of the choices to include a country in an investment fund are influenced by indices.[9] This also means that bond buying becomes less influenced by the economic and financial situation of a country.

## Investors' interest in 'frontier' countries

More and more countries are being included in the EM bond indices. Some countries even adapt their bond issuance according to the inclusion criteria of index providers.
A popular index, the J.P. Morgan Emerging Market Bond Index (see also Part 2), has included 70 countries, double the amount when it started in 2007.[10] New non-EM developing countries that have been included in popular EM bond index funds are the so-called 'frontier' countries, constituting between 13% and 23% of the bonds eligible in those funds.[11]

As a result, these newly included countries have been increasingly successful in issuing new government bonds. For instance, more than 20 frontier countries have been able to issue foreign currency bonds for the first time. However, these countries might face even more difficulties to repay their debts than EM country governments, due to the weaknesses in their economies or poorer management of foreign exchange and indebtedness.

## Risky dynamics

Professional investors in the EM bond index funds are aware that they might miss financial returns from the fund due to some bond issuers' defaults, interest payment difficulties, or economic difficulties. They have shown to be eager to swiftly withdraw their money from what they know is a risky fund. Even if only a few EM or developing countries are in trouble, investors have been withdrawing money, and they can do so massively ('fire sales'). This might be reinforced when a country's (bond) credit rating is lowered to 'no-investment' rating ('junk') and other institutional investors are compelled by their rules to sell the bond, lowering the value of the bond in the financial markets.[12]
Massive withdrawals also occur when investors see better profitability in other investment products or in other countries, or react to other financial market events.
The growing investors in EM bond funds have been reacting to such external factors more than for other investment funds and can have a larger impact then a few years ago.[13]
Given that (passive) EM bond index funds follow particular percentages ('weights') of bonds, in case of fund withdrawals the fund manager is selling bonds not only from the countries in payment difficulties but all countries ('mechanical rebalancing of the index weights'[14]).
In circumstances of sell-off, bonds might not be attractive to be bought by other investors in the financial markets ('lack of liquidity'). This affects the attractiveness and pricing of the bonds of all the countries in the investment fund, unrelated to country circumstances.

When an index or investment fund changes the composition of countries whose bonds are included in the fund, all country bonds might be affected as the risks and credit rating of the whole fund might be assessed differently, e.g. when more countries exposed to oil prices or with lower investment ratings are included.[15]

**Box 1** **The pros and the cons of EM and developing country debt in EM index funds**

**Positive aspects**

- Investors are more willing to finance governments and companies of EM and developing countries, by indirectly investing in their bonds even though they are risky and have a low credit rating.
- Because the bonds are integrated in mutual funds or ETFs that each have hundreds of bonds in their portfolio, the risk of negative financial returns of one bond or country is being spread and might not directly affect the country in trouble.

**Negative aspects**

- The growing capital inflows into EM and developing countries are increasingly influenced by the purchase of bonds by EM index or benchmarked funds, which are in turn highly influenced by the moods and volatility of global financial markets. As a result, the outflows in response to an external negative factor are much greater than a few years ago.[21] When there is a positive mood among global investors, the buying of EM and developing country or company bonds has increased the debt burden and risks of debt services problems.
- Because investors tend to treat emerging markets as a group without assessing country-specific developments, they invest or disinvest from EM bond index funds according to events affecting EM in general or some countries in particular. This affects all the bonds in the EM bond index funds.
- Excessive inflows or outflows of index funds can have a financial instability effect on the countries included in the index, especially when the index includes bonds in local currencies.
- Even though the holdings of EM bond index funds are still not very large relative to the whole of the benchmarked investment fund industry, they intensify the already high interconnectedness among the investors and financial markets ('great correlation between the securities investors hold', 'herd behaviour').

Large financial inflows and outflows of ETFs are possible because regulations allow investors to buy and sell ETF shares at any time (except in cases of extreme outflows) and for a short time. Also, many EM and developing countries have no or relaxed capital controls, while not having sufficient means to manage excessive capital inflows and outflows. The level of 'open capital accounts' is even one of the criteria to be included in some EM bond indices.[16] Countries where investors are based also allow huge capital outflows and inflows because of their commitment to free movement of capital, as fixed in trade and investment agreements amongst others.

In conclusion, the growing billions invested in EM and developing country governments and corporations bonds through investment funds in EM bond indices easily flow in and out of the funds because of their perceived general riskiness or investor reaction to unrelated financial or profitability prospects. This contributes to the increasing volatility in the global financial markets– which in turn influences the debt servicing capacity of related to EM and developing countries and the risk of excessive indebtedness and financial instability or crises. The interconnectedness of these financial markets is being explained in more detail in part 2.

# Part 2

## The case of Ghanaian bonds in EM index fund

One of the countries that took advantage of the willingness of global investors to buy risky bonds, was Ghana.

On 26 March 2019[17], the Ministry of Finance of Ghana issued US$ 3 billion in bonds. This issuance was divided in three kind of bonds[18]:

1. One bond issuance amounting to US$ 750 million at an interest rate of 7.875%, ending on 26 March 2027 (ISIN[19]: XS1968714110).
2. One bond issuance of US$ 1.25 billion (bn) at an interest rate of 8.125%, ending on 26 March 2032 (ISIN: XS1968714540).
3. One bond issuance of US$ 1 bn at an interest rate of 8.95%, ending on 26 March 2051 and referred to as the '31-year bond' (ISIN: XS1968714623).

The purpose of the bonds ending in 2027 and 2032 was to finance the fiscal deficit and financing needs of Ghana's government. The remaining US$ 1bn of the 31-year bond was intended to pay for outstanding Ghanaian debt, including re-purchasing an issued bond of US$ 283.3 million due by 2023 which had higher interest rates.[20]

The bond issuance in March 2019 was preceded by budget approvals from the government's cabinet and the Parliament in 2018, in order to be able to quickly act on favourable market conditions in 2019.[22] It came at a time that Ghana was ending its IMF financial assistance programme that started in 2015 when total external public debt and debt servicing was US$ 19.8 bn[23] and the currency had devalued so that borrowing from financial markets had become hindered by too high interest rates. The IMF programme included debt reduction although debt continued to grow, including through bonds.[24] The IMF continued to give advice on further issuance of bonds.[25]

In order to promote the issuance of the debt, the Minister and Deputy Minister of Finance as well as the Governor and Deputy Governor of the central bank and Deputy Minister for Energy went to the US and London to meet 120 investors face-to-face and via conference calls. This three-day trip was dubbed the 'Ghana on the Rise' roadshow.[26]

Orders to buy the bonds at issuance were made seven times the amount issued, valued at more than US$21 billion.[27] The issuance of the 31-year long term bond of US$ 1 billion had the longest duration ever issued by an African government. Given that long term bonds are assessed to be riskier than short term bonds, the interest rate of the 31-year bond was the highest of the three bond issuances in March 2019, namely 8.95%. The Finance Minister still called this high interest rate 'competitively priced'.[28] The credit rating of Ghana's longest term bond in March 2019 was an average rating 'B'[29], which is a low investment rating. The enormous interest from investors to buy the risky bonds, was 'a sign about the appetite for risky assets is still going strong' according the Finance Minister.[30] Ghana's bond issuance reflected the experience of many emerging market and developing country borrowers as explained in Part 1, except that African countries had to pay on average a higher interest rate. The Finance Minister was considering issuing thereafter an even longer-term bond, 50 years or more, if investors and market circumstances would allow.[31]

However, there were also speculative elements. Investors were betting that the income of the bonds would 'boost central bank reserves and help it protect the Ghanaian currency, which had weakened 9.6 percent' by 19 March in 2019. After the bonds were issued, the currency (the Cedi) gained 4.2 % against the dollar.[32] The Finance Minister called this 'really a speculative bubble'.[33]

## How the Ghanaian 31-year bond ends up in investment funds

This briefing investigates how the 31-year bond issuance by the Ghanaian government has been incorporated into investment funds.

The US$ 1 bn of the Ghanaian government's 31-year bond will have to be fully repaid, or refinanced, by the Ghanaian public budget by 26 March 2051. The semi-annual interest payments ('coupons') totalling 8.95% per year, means a debt service of US$ 89.5 million per year and a total of US$ 2.77 bn in 31 years, for the benefit of the bond holders.[34] Such high debt servicing can endanger financing of the many economic, social and environmental needs.

The Finance Ministry of Ghana had selected international and local investment banks and advisors to manage and underwrite the issuance and to distribute the three bonds on 26 March 2019. The issuance of the risky 31-year bond was supported by a syndicate of international banks, namely J.P. Morgan Securities plc, Merrill Lynch International, Morgan Stanley & Co. International plc, The Standard Bank of South Africa Limited, and Standard Chartered Bank. The five co-managers were Ghanaian investment banks and advisors, namely Databank Brokerage LTD[35], Fidelity Bank Ghana Limited, IC Securities (Ghana) LTD, GCB Bank LTD, and Strategic African Securities LTD.

The 31-year bond was admitted for trading on the London Stock exchange for an estimate fee of £ 3,650.[36] Like most (risky) bonds, the bond was mostly traded non-publicly through brokers and on non-public trading platforms accessible to professional investors, such as organised trading facilities (OTFs) (See Table A). In order to be traded, the bond had to be registered and processed ('cleared') by the clearing houses Clearstream and Euroclear.[37]

**Table A** Overview of public and closed trading platforms where the 31-year Ghana bonds can be traded

| Venue name/market identifier code | Operating venue country |
|---|---|
| BGC Brokers Lp - OTF (BGCO) | UK |
| Bloomberg Trading Facility Limited (BMTF) | UK |
| Boerse Stuttgart - Freiverkehr (STUB) | Germany |
| Deutsche Boerse Ag (XFRA) | Germany |
| GFI Securities LTD - OTF (GFSO) | UK |
| ICAP Securities OTF - Corporate Bonds and Securitised Debt (IOFI) | UK |
| London Stock Exchange (XLON) | UK |
| MarketAxess NL B.V. (MANL) | US/NL[37] |
| Tradeweb Europe Limited (TREU) | UK |
| Tullett Prebon Securities - OTF - Corporate Bonds and Securitised Debt (TSFI) | UK |

*Source: Thomson Reuters Eikon, database, viewed 6 august 2019.*

Only the investment managers who bought risky long term 31-year Ghanaian bonds on which we focus in this briefing, could be traced through the database of Thomson Reuters Eikon.[39] Fifty-six (56) investment fund managers and asset managers had bought 31-year Ghanaian bonds. Most were

subsidiaries of well-known and very large global players such as BlackRock (the largest global investment manager company with US$ 6.8 trillion assets under management[40]), Pimco (specialised in bond investment management with US$ 1.8 trillion under management[41]), Vanguard (one of the largest global investment fund managers with $5.2 trillion assets under management)[42] and Amundi (a top European asset manager with € 1.48 trillion assets under management)[43]. Also the globally largest too-big-to-fail[44] investment banks or banks' asset management divisions, which create investment funds, bought 31-year Ghanaian bonds, such as JP Morgan, Morgan Stanley, HSBC and BNP Paribas, to name just a few. The data base Thomson Reuters Eikon indicated on 6 August 2019 that these investment fund managers and asset managers held in total US$ 150,496,000 (US$ 150.5 million) worth of the total of US$ 1 billion Ghanaian bond issuance.[45]

**Table B** JP Morgan subsidiaries and investment funds holding the Ghana 31-year bond

| JPMorgan Asset Management U.K. Limited – United Kingdom | | | |
|---|---|---|---|
| | | in thousand US$ | in thousand US$ |
| | | 1,682 | -5,743 |
| **Fund name** | **Reporting date** | **Face value of 31-year Ghana bond** | **Change of 1-year Ghana bond ownership** |
| JPMF Emerging Markets Local Currency Debt | 30-Apr-19 | 1,480 | 0 |
| JPMorgan Emerging Markets Strategic Bond | 30-Apr-19 | 200 | -2,050 |
| JPMorgan Multi-Asset Trust plc | 31-May-19 | 2 | -3 |
| JPMorgan Global Bond Opportunities | 30-Apr-19 | 0 | -2,640 |
| JPM Income Fund A Acc USD | 30-Apr-19 | 0 | -660 |
| JPM Global Strategic Bond Fund | 30-Apr-19 | 0 | -390 |

| JPMorgan Asset Management – United States | | | |
|---|---|---|---|
| | | in thousand US$ | in thousand US$ |
| | | 15 | -1,950 |
| **Fund name** | **Reporting date** | **Face value of 31-year Ghana bond** | **Change of 1-year Ghana bond ownership** |
| JPM Global Multi Strategy Income A Div EUR | 30-Apr-19 | 15 | -60 |
| JPM Emerging Markets Aggregate Bond Fund | 30-Apr-19 | 0 | -1,890 |

*Source: Thomson Reuters Eikon, database, 6 August 2019.*

The fifty-six investment fund managers who bought Ghanaian bonds included parts of their purchase in 109 different investment funds or portfolios they had created each on average between one and four funds. [46] Fidelity Worldwide Investment (UK) Ltd, a global investment fund manager, divided US$ 1.6 million worth of Ghanaian bonds in eight different investment funds as of 31 March and 31 May 2019.[47]

Some global fund managers had different subsidiaries that bought 31-year Ghanaian bonds. For instance (see Table B), JPMorgan Asset Management U.K. managed US$ 1.68 million worth of the Ghanaian 31-year bond in three funds on 30 June 2019, while JP Morgan Asset Management (U.S.) owned US$ 15 thousand worth of the bond in one fund on 30 April 2019.[48] The managers of the investment funds that the JP Morgan subsidiaries had created, bought and sold bonds as part of the investment funds' assets. After the issuance date of 26 March 2019, they already removed some of the 31-year Ghanaian bonds out of investment funds they were issuing: JPMorgan Asset Management U.K. had already moved out US$ 5.74 million out of five funds; JP Morgan Asset Management (U.S.) had removed US$ 1.95 million out of two funds. Also many of the other fifty-six investment fund managers and asset managers had moved the Ghanaian 31-year bonds out or into their funds' assets.

## How a BlackRock investment fund absorbs a Ghanaian bond

As an example of how the long-term Ghanaian 31-year bonds are included in one of the 109 investment funds, this briefing looks at the investment fund managed by BlackRock Asset Management Ireland Limited, which was holding most of the Ghanaian 31-year bond according to the Thomson Reuters Eikon data available on 6 August 2019. BlackRock Advisors (UK) LTD, a subsidiary of the BlackRock group, was holding in the 'iShares J.P. Morgan $ EM Bond UCITS ETF' investment fund US$ 19.2 million worth of Ghanaian 31-year bonds on 30 June 2019. The iShares J.P. Morgan $ EM Bond UCITS ETF fund held in total assets worth US$ 10.3 billion in August 2019.[49]

The investors who were buying the shares of the iShares J.P. Morgan $ EM Bond UCITS ETF fund were amongst others other funds. Data registered on 30 September 2019 show that 273 funds managed by 132 asset managers integrated small amounts – between 3.6% and less than 0.01% – of the iShare shares in their funds or managed assets.[50] These funds were selling participation in their funds to professional and individual end investors. In other words, the packaging of the Ghanaian 31-year bonds in the iShares J.P. Morgan $ EM Bond UCITS ETF, and its repacking in other funds, resulted in the end investors of the bonds being widely distributed around the world.

### **Box 2** The term of the 'iShares J.P. Morgan $ EM Bond UCITS ETF' investment fund explained

The name of the fund 'iShares J.P. Morgan $ EM Bond UCITS ETF' explains much about the legal form and the content of the fund. 'iShares' is the name of a series of the investment funds issued and managed by BlackRock. This iShares fund was following, but not replicating, the J.P. Morgan EM bond index, a list of different government and a few corporate bonds from up to 70[51] emerging market (EM) countries, holding around 469 bonds in August 2019.[52] Apart from the Ghanaian 31-year bonds, this investment fund held Ghanaian bonds of different duration and different issuance dates. Although the fund's name pretends to follow bonds from emerging market countries or companies, Ghana is an example how a 'frontier' country (see part 1) was included in emerging market investment fund. The Ghanaian 31-year bond constituted 0.20% of the fund on 31 July 2019.[53]

The name of the fund also referred to the fact that it was respecting the EU law rules regarding, amongst other, its composition, i.e. the Undertakings for the Collective Investment in Transferable Securities law (UCITS, Directive 2009/65/EC[54], e.g. chapter VIII). The Term ETF referred to the fact that the fund was an exchange traded fund (ETF), i.e., it issued shares to be bought on exchanges by end investors.

## The financial industry profits from the Ghanaian bond issuance

The way the investment fund industry integrated the long term Ghanaian 31-year bonds provides an insight into how the financial industry is making profits out of the bond issuance, processing and packaging, and further sales across the investment value chain.

First, in order to determine the interest rate for the issuance of the 31-year bond, to (guarantee and) operate the issuance, and to raise the interest among professional investors to buy the bond, the five co-lead managers and the five co-managers (see above) were paid by the Ghanaian Finance Ministry, presumably a high fee.[55] The fact that five international and five national managers were involved in the bond issuance, meant that the risks would be spread among the (lead) managers in case the issuance would be a disaster. Fees had to be paid for clearing and trading the bonds.

The high interest of 8.95% per year to be paid from Ghana's public budget to investors and investment funds who bought the bond, was one of the highest of emerging markets and developing country sovereign bonds that were included in the aforementioned investment fund iShares J.P. Morgan $ EM Bond UCITS ETF.[56] The bi-annual interest rate payments involves a large volume of transactions to be paid for throughout the investment industry value chain.

Each of the investment fund managing firms that were buying long term Ghanaian 31-year bonds had to pay the costs for creating, issuing, marketing and distributing a legally accepted investment fund that is attractive to investors. The management fee to be paid by those buying shares in the iShares J.P. Morgan $ EM Bond UCITS ETF USD was 0.45%, which includes the costs for[57]:

- The asset management of the fund, by BlackRock Asset Management Ireland Limited: to buy and sell particular bonds of countries and companies included in the fund, according to the index, the number of shareholders in the fund and the bonds' value.[58] This includes transaction costs.
- The administrator, State Street Fund Services (Ireland) Ltd: to provide administrative services such as accounting, preparing the prospectus and the (semi-) annual reports to shareholders.
- The custodian, State Street Custodial Services (Ireland) Limited: to fulfil legal requirements to deposit the fund's bonds at a certified securities' repository firm.
- The index provider, J.P. Morgan EMBI Global Core Index[59]: payment of the intellectual property rights for the use of the index.

The bonds that are the assets of the iShares J.P. Morgan $ EM Bond UCITS ETF fund are being lent out short term to investors who speculate they can make profits by borrowing for a fee some of the bonds held by the fund. The borrowers have to provide collateral to the fund, which is public on the website's fund[60]: mainly governmental bonds and a few company shares from the Western countries. BlackRock explains that 'securities lending is a core investment management function' for its funds and is supported by BlackRock research services to help to reduce the costs of managing the fund: the fund retains 62.5% of the income from lending while BlackRock receives 37.5% and covers the costs.[61] On average, 14.7% of the assets have been lent during the 12 months until 30 June 2019,

resulting in return valued at 0.03% of the assets of the whole fund[62], i.e. around US$ 3 million.

Another way the fund manager tries to optimise the income from the iShares J.P. Morgan $ EM Bond UCITS ETF fund and achieve a similar or better return than the index it uses, is to not only buy the bonds that make up the index – which constitute the majority of the funds' assets – but also financial derivative instruments (which guarantee, or bet on the prices of the referenced assets).[63] A way to protect against non-payment of the bonds' interest or repayment, is by buying credit default swaps (CDS) that pay out if the bond issuer defaults. In general, BlackRock managers do use CDOs but it is not clear whether they used them for managing the assets of the described iShares fund.[64] Fees have to be paid for the creation, management and trading of these derivatives.

Professional and individual investors can buy for a fee shares of the iShares J.P. Morgan $ EM Bond UCITS ETF fund. Non-professional investors who want to buy shares from the fund have to pay a broker to do so. The fund and its sub-funds in different currencies can be bought on different (specialised) commercial exchanges, namely on the Deutsche Boerse Xetra (Germany), the SIX Swiss Exchange, the Borsa Italiana, the London Stock Exchange and the Bolsa Mexica De Valores.[65] The sub-funds in the Euro, the British pound and the Swiss Franc had a higher management fee of 0.50%. Some of these sub-funds had hedging derivatives to shelter against losses from negative currency changes against the US dollar,[66] which involves trading fees.

Given that the shares of the iShares J.P. Morgan $ EM Bond UCITS ETF fund were traded on exchanges, speculators could buy derivatives ('options') to bet about the future value of the fund's shares.[67] This speculative trading involves fees and income for the investment industry (investment banks, hedge funds, etc.).

## Concluding remarks

Part 2 of this briefing exposes how part of the ownership of the 31-year bond issued by the Ghanaian government at a time of high investors' interest was ultimately scattered around the world. This allowed for profit making throughout the investment fund industry while not taking responsibility for its impact on indebtedness and sustainable development of the country. The described investment fund that is holding the Ghanaian 31-year bond, iShares J.P. Morgan $ EM Bond UCITS ETF, also relates to financial speculation and shadow banking by lending its assets against collateral, using derivatives and betting on the future value of its shares This illustrates the global interconnectedness of the financial sector, which is very profitable in good times but is transferring risks and volatility or even crisis throughout global financial markets when investors decide to swiftly move assets, which ultimately rebounds on Ghana's currency, debt burden and bond issuance prospects, as explained in part 1.

## Recommendations

Given that investment funds with bonds from EM and developing countries are increasing the interconnectedness in the financial system and indebtedness of developing countries, while vast flows in and out of these funds are allowed and contribute to financial market volatility, much more tools need to prevent and respond to negative impacts. 'Fixed income' ETFs are growing in popularity, but the investment fund industry (often referred to as the 'non-bank financial sector' or 'shadow banking') is much less regulated than banks. Supervisors have fewer tools to prevent the problems and lax monetary and interest rate policies are increasing the problems. New policies, instruments and regulation should be urgently introduced, amongst others:

**By legislators, regulators and supervisors of (EM index) investment funds:**

- Imposing stricter stress testing obligations on investment funds managers should improve risk management based on volatility and indebtedness scenarios.
- Improved legally binding due diligence regulations should impose responsibility on the fund managers and index providers to avoid reckless investing in highly indebted countries whose bonds are in the index/benchmark and/or funds, even if the demand for emerging market investment funds is high and the countries are willing to issue more bonds.
- The EM bond indexed/benchmarked funds should be limited in the total size of the assets they can hold. They should be obliged to hold more capital buffers and have better restrictions on massive and sudden investors' withdrawal from the funds since investors consider them risky. This should avoid panic throughout the financial markets at moments of non-payment by bond issuers or EM investment funds, which can easily lead to higher indebtedness.
- The lending of (EM indexed) investment fund assets by fund managers and the speculative derivatives on the share prices of the ETFs by investors have to be assessed with a view of regulating their phasing out and their prohibition. This would reduce the interconnectedness and socially useless financial activities by the (EM) investment fund industry.

- Regulations should ensure that more data is regularly made public, including who all the bond holders are, which bonds are being included in which indexes/benchmarks and related funds, and how many credit default swaps are being issued and held per bond by which financial corporation. This could lead to a kind of regularly updated public register.

**By EM index/benchmarked investment fund managers:**

- Improved risk management and stress testing using volatility and indebtedness scenarios should result in holding higher capital buffers and restrictions on sell-offs in times of massive outflows, even beyond regulatory requirements.
- When undertaking an environmental, social and governance (ESG) assessment of the investment funds, for instance when applying the EU Directive on sustainability disclosure (DSR, 2019), fund managers should take into account and be transparent about whether EM and developing country spending of the bonds' income is earmarked for fulfilling human rights obligations, achieving the UN Sustainable Development Goals (SDGs) and/or a transition towards the Paris climate goals.
- When implementing their due diligence, fund managers need to avoid buying bonds that increase excessive levels of indebtedness by the country concerned. They should apply the UNCTAD Principles on Promoting Responsible Sovereign Lending and Borrowing[68] or the G20 Operational Guidelines for Sustainable Financing.[69] In addition, they should introduce and ensure that bond contracts have balanced standardised clauses[70] for a fair distribution of risks of non-payment and debt restructuring in case countries cannot service their debt.
- In case bond issuing countries cannot service their bond interest rate or (re-)payment, fund managers should assume the losses of their high risk taking. At the very least, they should constructively participate in debt restructuring (based on balanced contract clauses). They should publically commit not to sell the distressed bonds to investors who are known to obstruct debt restricting (so-called 'vulture funds'). They should also carefully change the weight of particular country bonds in the fund to avoid particular EM and developing countries being unduly affected regardless of their economic situation.

**By providers of benchmarks/indices that include EM and developing country bonds:**

- The details of the composition of the benchmarks and changes thereof, and the eligibility criteria for index inclusion, as well as the ESG impact assessments, should be made more publicly available.[71]
- Bonds from countries with high (risk of) indebtedness and interest payment problems, the so-called frontier countries, should be responsibly excluded from indices and benchmarks.

**For professional and individual investors in emerging market investment funds:**

- End investors should improve their due diligence and responsible investment practices by searching and assessing information about the riskiness not only for the value of their investment, but also for the social, environmental and governance sustainability of the countries whose debt is included in the indexed investment funds and ETFs. They should ensure that investment funds have policies of responsible debt lending and restructuring (as described above), and not engaging in securities lending.
- Professional investors should have policies in place to avoid investing in, or swiftly disinvesting from, funds with bonds from highly indebted countries.

**By EM and developing countries whose bonds are included in indexed/benchmarked investment funds:**

- By improving their information about which indices and related funds include their country bonds, EM and developing countries should prevent excessive indebtedness in the short and the long term, including by not giving in to the favourable investors mood for buying new bonds.
- Bonds should be issued with contracts that include balanced debt work out clauses and ensure reckless investors cannot be bailed out.
- More information is to be made publicly available about all the costs of issuing and servicing the bonds, the full contents of the bonds' contract, and details of the spending the bonds' proceeds.
- EM and developing country central banks should have enough intervention instruments and policy flexibility to prevent, and to act in the case of, excessive financial inflows and outflows. This would include smartly managing capital controls and safeguard their use from prohibitions by eligibility criteria of benchmark indices, trade and investment agreement rules[72], adherence to the OECD Code of Liberalisation of Capital Movements and the IMF's institutional view on capital controls.
- In case of excessive debt, debt restructuring has to start in time to avoid that debt service undermines spending to full human rights', SDGs' and climate related commitments.

**By international financial institutions such as IMF, Financial Stability Board (FSB), the Bank of International Settlements (BIS), International Organization of Securities Commissions (IOSCO) and the Organisation for Economic Co-operation and Development (OECD):**

- Central bankers and supervisors, when meeting at the IM, FSB, the BIS, the G20 and IOSO, should raise discussions regarding how smart capital controls should be used more to prevent unduly speculative and excessively risky investors from creating financial and debt bubbles. This should include measures by developed countries with hard currencies to prevent speculative capital flows or so-called 'negative spill-overs' resulting from lax monetary policy and changing exchange rates.[73]
- The international community should urgently negotiate in the UN sustainable debt work-out mechanisms for bonds held by private investors.
- IOSCO should review its Principles for Financial Benchmarks[74] to include more considerations regarding the social and environmental sustainability impact of the bond issuing countries.
- The OECD should not ask and help more countries to adhere to the reviewed OECD code of Liberalisation of Capital Movements[75] since full and swift flexibility to apply capital controls might be needed to avoid negative impacts of speculative financial markets.

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