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Mozambique's debt crisis: Trawling for answers

Less than two decades after it was granted debt relief, the Government of Mozambique again finds itself unable to honour obligations to international creditors. Pending the publication of an audit of US\$2 billion of borrowing by Mozambican companies afforded questionable sovereign guarantees, Africa Research Institute and *Zitamar News* convened a webinar with four expert panellists: Roberto Tibana, principal consultant at Analitica-RJT; Anne Frühauf, senior vice president with Teneo Intelligence; Tariq Hamoodi, partner at Bybrook Capital; and Dr Joseph Hanlon, visiting senior fellow at the London School of Economics.

This Briefing Note sets out the known details of the controversial loans to Mozambican companies and their ramifications for the government, the banking sector and international financial institutions. It then summarises panellists' perspectives on the debt, and how Mozambique and its creditors might extricate themselves from the crisis.

Fishy business

Between February 2013 and May 2014, three Mozambican companies contracted Middle Eastern shipbuilding group Privinvest and other suppliers to provide a tuna fishing fleet and maritime security. The project eventually involved borrowing US\$2 billion, roughly equivalent to a third of the national budget. This sum exceeded the total amount of external debt raised directly by the government between 2010 and 2012, and breached commitments made to the International Monetary Fund (IMF) in July 2013.¹

At the time, President Armando Guebuza was preparing to depart from office and intent on ensuring that his chosen successor secured a victory for *Frente de Libertação de Moçambique* (Frelimo) in the October 2014 general elections. The Guebuza family is said to have initiated the discussions with Privinvest through connections to the holding company's co-founder and director, Iskandar Safa.² The national security services, *Serviço de Informação e Segurança do Estado* (SISE), which report directly to the president, were tasked with establishing three companies: *Empresa Moçambicana de Atum* (Ematum), ProIndicus and Mozambique Asset Management (MAM). A SISE officer, António Carlos do Rosário, was appointed CEO of all three corporations.³

tonnes per annum.⁶ Fishing boats were not the only item on an undisclosed shopping list; Rosário later admitted that the tuna concept had been a pretext for defence expenditure.⁷

Despite having not built a fishing vessel since the 1980s, Privinvest shipbuilder *Constructions Mécaniques de Normandie* (CMN) was contracted to supply 24 trawlers, in addition to three patrollers and three interceptors (each designed to be armed with a 20mm cannon and 12.7mm machine gun).⁸ The company had unveiled designs for a new 23.5-metre trawler, alongside plans for a new 43-metre trimaran patroller, only six months earlier. Mock-ups of the 32-metre high-speed interceptors were disclosed on the day the deal was announced.⁹ Guebuza and Safa visited the CMN shipyard on 30 September 2013. Within a month, Ematum had transferred US\$836.3 million directly to Abu Dhabi Mar, CMN's holding company, which is part-owned by Privinvest. The balance of the money raised by Credit Suisse and VTB – US\$13.7 million – was spent on banking and transaction fees. Ematum itself was left with no working capital for its operating costs or funds for future debt repayments.¹⁰

Loan sharks

Concurrently, Credit Suisse and VTB Capital arranged further loans totalling US\$1.16 billion for ProIndicus and MAM, apparently disregarding the considerable implications for investors in the Ematum debt. Credit Suisse raised US\$622 million for ProIndicus, a corporation established to provide security for firms involved in offshore gas exploration and shipping in Mozambican waters, despite an absence of demand for these services.¹¹ This followed a feasibility study undertaken by the bank in February 2013, initially assuming a US\$372 million loan.¹² The lending package was signed in June 2013, but not disclosed to investors who purchased the Ematum debt just months later. Credit Suisse reportedly purchased insurance against the risk of Mozambique defaulting at Lloyd's of London.¹³

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During September 2013, the London offices of investment banks Credit Suisse and VTB Capital arranged US\$850 million in “loan participation notes”, akin to an unlisted bond, for Ematum.⁴ According to a three-page prospectus, this was intended to fund a tuna fishing fleet capable of landing 20,000 tonnes of tuna per annum.⁵ Only a year earlier, a South African company, Oceanfresh, had been granted exclusive rights to fish tuna off the Mozambican coast, with a quota of 12,000

Within months of the loans to Ematum and ProIndicus, VTB Capital privately arranged US\$535 million of borrowing for MAM.¹⁴ This entity was hastily incorporated in April 2014, ostensibly to provide services to ProIndicus and others.¹⁵ In May 2014, MAM contracted Privinvest to build two shipyards (in Maputo and Pemba), where it would could construct, under license, Privinvest security vessels. The deal included the provision of spare parts and maintenance for the fleet, and the establishment of a naval training school.¹⁶ VTB Capital charged an up-front arrangement fee of US\$35 million, equivalent to 7% of the amount raised.¹⁷ The co-arranger of the deal was Palomar Capital Advisors, a subsidiary of Privinvest led by Andrew Pearse, who had worked on the fundraising for ProIndicus while at Credit Suisse.¹⁸

In each instance, Manuel Chang, Mozambique's then finance minister, signed paperwork confirming that the government would guarantee the debts. A parliamentary inquiry later found Chang acted in contravention of Article 179 of the Mozambique Constitution, which requires that the legislature be consulted on sovereign guarantees.¹⁹ The sums borrowed also exceeded the limit set by the legislature for that year, thus violating the budget laws.²⁰ A further irregularity was that the contracts exist only in English, while Mozambican law requires such documentation to be translated into Portuguese and authenticated.²¹

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The Office of the Attorney General subsequently characterised the granting of unauthorised sovereign guarantees as a “criminal offence” in the form of “abuse of office”.²² Irregularities surrounding the guarantees may explain why neither the Government of Mozambique, nor the banks arranging the loans, took steps to inform the IMF and World Bank, despite a clause in the loan agreements which stipulated that the guarantor would comply with its obligations to those bodies.²³

President Nyusi, who took office in January 2015, sought to rectify remaining irregularities. The Government of Mozambique formally assumed responsibility for US\$500 million of the US\$850 million Ematum debt, including it in the defence budget for that year, and obtaining retrospective parliamentary endorsement for the borrowing. Mozambique honoured the first scheduled repayment, despite a budget shortfall amid declining commodity prices, substantial currency depreciation and delays to the development of liquid natural gas (LNG) reserves. Officially, at this juncture, Mozambique's external debt stood at some US\$6 billion, exceeding the sum at which the country had been granted debt relief under the Heavily Indebted Poor Countries Programme in 2001.

Mayday! Mayday! Mayday!

In March 2016, struggling to meet its obligations, the government was forced to restructure the balance of the Ematum debt. Mozambique asked international investors to exchange US\$697 million in Ematum notes for new sovereign bonds with a later repayment date.²⁴ To assuage its creditors, the government offered a higher

interest rate and other incentives, thus increasing its total obligation to US\$726.5 million.²⁵ Credit Suisse and VTB Capital arranged the restructuring; however, negotiations with bondholders were rushed. Charles Blitzer, a former IMF assistant director advising investors, asserts that the process failed to comply with recognised principles for fair debt restructuring.²⁶

“ Only after investors had accepted the restructuring terms did details emerge of the US\$622 million loan raised for ProIndicus ”

Only after investors had accepted the restructuring terms did details emerge of the US\$622 million loan raised for ProIndicus.²⁷ The UK Financial Conduct Authority has initiated an inquiry into whether Credit Suisse violated regulations by failing to disclose the existence of the ProIndicus debt to Ematum creditors during the restructuring.²⁸ The bank's hand was forced when, on 15 March 2016, Standard and Poor's downgraded Mozambique's credit rating, which entitled investors in ProIndicus to exercise their right to immediate repayment.²⁹ This situation prompted Credit Suisse to reveal the US\$622 million in additional borrowing.³⁰ The Government of Mozambique then disclosed that a further US\$535 million had been borrowed by MAM.

Alarmed by the fiscal mismanagement and fearing a vast corruption scandal, the IMF halted its programme in Mozambique, including payment of the second instalment of a US\$283 million loan from its Standby Credit Facility.³¹ The World Bank also suspended disbursements, while bilateral donors terminated general budget support. The metical, the national currency, depreciated sharply, losing 40% of its value in two months.³²

Despite the sovereign guarantee, MAM missed its first payment of US\$178 million due on 23 May 2016. In October 2016, the government conceded that it did not have sufficient capital to service any of the three loans, including the restructured Ematum debt. On 18 January 2017, Mozambique missed the first US\$60 million coupon payment on its sovereign bond.³³

Navigating choppy waters

The government and its creditors are at an impasse. Mozambique wishes to restructure the three debts; however, holders of the sovereign bond have refused to negotiate until an independent audit has been completed, and the IMF resumes its programme.³⁴ Webinar panellists acknowledged the challenges faced by Kroll, the firm appointed to audit the accounts of Ematum, ProIndicus and MAM, especially as substantial sums appear to have been transferred directly to Privinvest and associated entities.³⁵ It is unlikely that Mozambicans will ever know precisely how the money borrowed was spent, or what assets remain unaccounted for, given the veil of secrecy surrounding the transactions.

ProIndicus is due to make a capital repayment of US\$119 million on 21 March 2017, but is not expected to pay. As the loan was reportedly syndicated by Credit Suisse to numerous Mozambican banks, the country's financial sector could be severely tested if the

government defaults on its obligations as guarantor.³⁶ Local bondholders include *Millennium BIM* and *Moza Banco* (which is already in administration).³⁷ A related risk is that the capital raised by ProIndicus was used as collateral for commercial loans, or for down-payments on contracts for military equipment, thus increasing the risk of yet more undisclosed debt.³⁸ When addressing a parliamentary inquiry in late 2016, do Rosário spoke of an entire maritime protection system (*Sistema Integrado de Monitoria e de Protecção*) supported by 16 radars, 6 patrol aircraft, drones and satellite imagery.³⁹

Anne Frühauf, senior vice president at Teneo Intelligence, who advises investors in Mozambique, anticipates a “significant restructuring deal” during 2017. She questions how such a negotiation cannot result in a “haircut” for creditors, despite some having already participated in one restructuring. With the government’s repayment capacity practically non-existent, Frühauf anticipates discussion regarding the possibility of postponing debt repayments until the 2020s – the point at which revenue from vast offshore gasfields should become available, assuming final investment decisions on LNG extraction are taken soon. A major challenge is that holders of the original Ematum debt, which has since been repackaged as a sovereign bond, will resent being treated identically to holders of ProIndicus and MAM debt: in 2016, Ematum bondholders agreed to a longer amortisation period in return for a higher coupon rate. Having been restructured into a bullet payment, the annual interest burden related to the sovereign bond is already much lower than the debt-servicing costs associated with ProIndicus and MAM.

Tariq Hamoodi, a partner at Bybrook Capital in London, anticipates Mozambique honouring its obligations – eventually. Panellists noted that the ruling party, Frelimo, is reluctant to acknowledge that the guarantees were issued illegally. The Nyusi government would rather assume the liabilities inherited from the Guebuza administration than risk the political fall-out. Hamoodi points to the recent restructuring of the Ematum bond as having precluded any admission of wrongdoing. He views all three debts as equally binding and regards any calls for differential treatment as unrealistic. Hamoodi anticipates the three being bundled into a single loan, despite sovereign bondholders holding out for a better deal. One way to alleviate the haircut on international investors might involve Mozambique issuing gas warrants, granting creditors a certain share of future revenues from *Empresa Nacional de Hidrocarbonetos* (ENH), the state oil and gas company.

“ Hanlon believes that Credit Suisse and VTB misled investors by claiming that the debts were repayable when this manifestly was not the case ”

Getting off the hook?

Dr Joseph Hanlon, visiting senior fellow at the London School of Economics, pointed out there is an argument against bundling the three loans. ProIndicus and MAM debts were issued by Credit Suisse and VTB Capital as syndicated loans, thus establishing a fiduciary duty on behalf of the banks. By contrast, the Ematum debt is now packaged as a sovereign bond. All three debts were issued in London under contracts governed by English

law. Hanlon believes that a legal process in the UK could prove advantageous for Mozambique. He notes that, historically, governments that default on their debts do better than those which attempt to pay from a position of debt distress.

Hanlon contends that Credit Suisse and VTB face widespread criticism for their failure to either undertake sufficient investigations, or to report their findings to investors. Competent due diligence should have brought to light three facts. First, that in the absence of parliamentary approval, the sovereign guarantees were unconstitutional and illegal. Second, that the Credit Suisse feasibility study was “totally ridiculous”, and founded on assumptions that Mozambique could sell its tuna for three times as much as the Seychelles. Third, that collectively the three loans would make Mozambique’s debt burden unsustainable. Hanlon believes that Credit Suisse and VTB misled investors by claiming that the debts were repayable when this manifestly was not the case.

Hanlon argues that Mozambique should repudiate the “secret” and “illegal” debts issued to ProIndicus and MAM. It would then fall to a bondholder or one of the banks to appeal to the UK courts. The banks might prefer to proceed to arbitration, since the process is private. Hanlon believes that “Credit Suisse do not want to go into open court”, where they would be asked to present due diligence reports. While details of any settlement reached through arbitration would be public, documentation would not need to be disclosed.

As for Ematum, Hanlon concedes that the repackaging of the debt as a sovereign bond complicates further negotiations with creditors. In practice, the government has accepted, however reluctantly, its obligation as a guarantor. That distinction aside, he believes that “the original notes were sold on the same false prospectus”, which – unwittingly or intentionally – misled investors. Even if an agreement cannot be reached immediately with holders of the Ematum bond, renouncing the sovereign guarantee on the ProIndicus and MAM loans would bring Mozambique closer to debt sustainability. Such a scenario could enable the IMF to re-engage with the government, providing it with room for manoeuvre. Although bilateral donors will not want to run the risk of aid money being, in effect, used to service the debt, all parties want Mozambique to return to debt sustainability. Hanlon believes that a government refusal to honour its sovereign guarantees would be accepted, and possibly even welcomed, by the international financial institutions and donors.

Frühauf challenges this scenario on the grounds that the government has displayed no political will to repudiate the debts. Investigations have been limited, and politicians have displayed no sign of wanting to issue a declaration of “odious debt” or “illegitimate debt”, which might provoke further scrutiny. Frühauf argues that Mozambique will remain saddled with a heavy debt burden primarily because of political dynamics within Frelimo. The political cost of implicating allies of former President Guebuza or the security services could divide the party and jeopardise the leadership transition. Nyusi’s recent appointment of a new SISE director could, however, indicate willingness to subject the security services to greater scrutiny.⁴⁰ Frühauf posited that internal opposition to Nyusi and his handling of the debt crisis might grow ahead of the crucial party congress in

September 2017, and pressure to renounce part of the debt could gain traction.

Roberto Tibana, principal consultant at Analitica-RJT, noted that any legal process brought against former finance minister Manuel Chang would inevitably open a can of worms. It remains unclear whether Frelimo elites are ready to “sacrifice” Chang, or indeed to countenance any course of action that might lead to court cases – and revelations. Tibana stressed that government ministers, past and present, would be implicated in any findings. Nyusi was the minister of defence when the debts were issued, making it “difficult to shrug off responsibility”. Tibana believes that all of Mozambique’s creditors will need to take a haircut. He questioned whether Credit Suisse and VTB Capital failed to conduct adequate due diligence or if the loans were issued with their full connivance. Tibana predicted a tricky year ahead for President Nyusi and Frelimo grandees. In September, the party will have to decide whether the incumbent will remain its candidate for the next elections, or if Frelimo needs to replace Nyusi to turn the page on the debt scandal.

“ Tibana predicted a tricky year ahead for the president and his team ”

External actors could yet intervene to Mozambique’s advantage. The US Securities and Exchange Commission (SEC) has requested copies of the documents provided to purchasers of the Ematum bond. Swiss regulators are also known to be taking a keen interest. If further financial transgressions are disclosed, a declaration of “odious debt” or “illegitimate debt” might become more expedient. Not all outsiders sympathise with Mozambique’s plight, however.

The government will struggle to extricate itself from its current predicament without presenting the country, and the region, as a far riskier investment destination than had previously been projected. Trust with the international financial institutions and bilateral donors will also need to be restored if Mozambique is to diversify its sources of concessional borrowing, and this is unlikely to be a smooth process. Perhaps most importantly, as Tibana pointed out, the crisis has come as “a big shock” to hard-pressed Mozambicans, a fact that Frelimo elites have been slow to acknowledge, let alone react to. The party’s 2014 campaign song, *Moçambique confia em Filipe Nyusi*, stressed the trust placed in the presidential aspirant. With Frelimo’s egregious fiscal indiscipline now common knowledge, such confidence will be hard to recover.

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