

# Supranationals: A World of Opportunity

Perspectives | December 2022

pfm  asset  
management

Fixed-income investors continue to face challenging market conditions. It remains increasingly difficult to find attractive investment opportunities in bonds issued by U.S. federal agencies and government-sponsored enterprises (GSEs). A key contributing factor is lack of supply of federal agency/GSE debt, which has historically been a mainstay of most conservative portfolios. Investors may want to look beyond traditional U.S. government securities to examine the additional opportunity that supranational bonds (or supranationals) can offer. Investing in supranationals can provide a way to diversify a portfolio, maintain a high degree of liquidity, increase credit quality and modestly enhance portfolio returns. In this edition of PFMAM Perspectives, we will provide an overview of the supranational, sovereign, and non-U.S. federal agency (SSA) markets and focus on the characteristics of supranationals that may make them desirable for inclusion in high-quality fixed-income portfolios.

## An Overview of the SSA Market

The SSA market is made up of:

- ▶ **Supranational bonds**, which are issued by multi-national organizations that transcend national boundaries. Examples include the International Bank for Reconstruction and Development (also known as the World Bank), African Development Bank and Asian Development Bank.
- ▶ **Sovereign bonds**, which are issued by a country's national government. Examples include debt from Canada, the Netherlands and Sweden.
- ▶ **Non-U.S. federal agency bonds**, which are issued by a federal agency of a non-U.S. sovereign government and may be guaranteed by that government. Examples include KfW, the German government-owned development bank and CADES, the French government-owned social security finance federal agency.

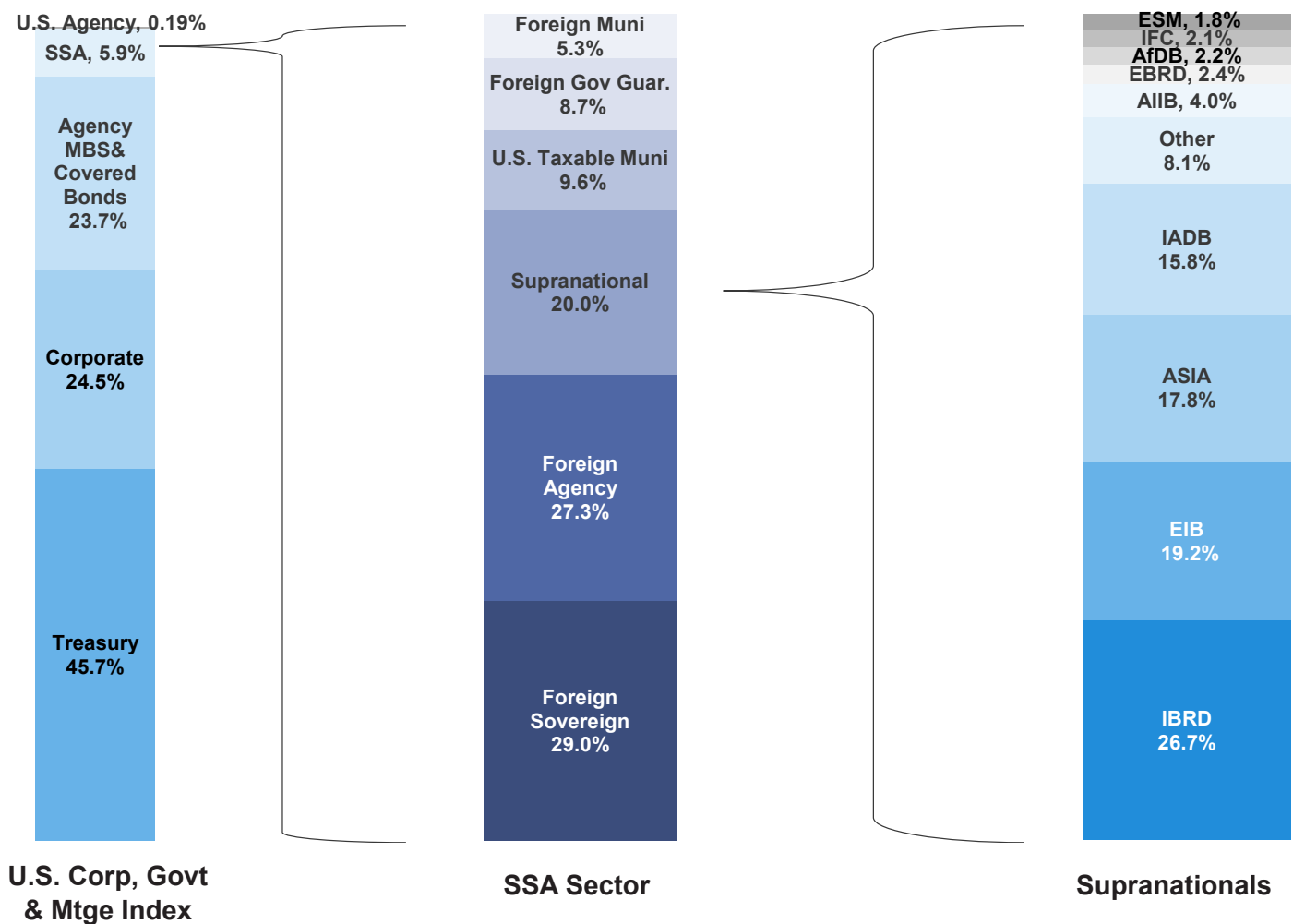
While issuers in the SSA market issue bonds payable in many currencies, we will only discuss investment characteristics and opportunities for debt payable in U.S. dollars.

The SSA market is an important component of the overall U.S. dollar-denominated bond market. Exhibit 1 on the following page shows that securities in the SSA market now represent 5.9% of the broad ICE BofA U.S. Corporate, Government & Mortgage Index, markedly larger than the 0.19% represented by the traditional U.S. federal agency bond market.<sup>1</sup> As shown in the middle bar chart, of that amount, supranational bonds represent approximately 20%. Supranational bonds are further broken down by individual issuer in the rightmost bar. For our purposes, we will focus specifically on supranationals and their role in fixed-income portfolios.



<sup>1</sup> The ICE BofA U.S. Corporate, Government & Mortgage Index includes SSA and federal agency issues with a maturity of one year or longer, a minimum issue size of \$250 million, and an average credit rating of at least Baa3 (as of 9/28/2022).

**Exhibit 1: Composition of the BofA Merrill Lynch U.S. Corporate, Government & Mortgage Index**



Source: Bloomberg; as of 9/28/2022. IBRD: International Bank for Reconstruction and Development; ASIA: Asian Development Bank; IADB: Inter-American Development Bank; AIIB: Asian Infrastructure Investment Bank; EBRD: European Bank for Reconstruction & Development; AfDB: African Development Bank; IFC: International Finance Corporation; ESM: European Stability Mechanism.

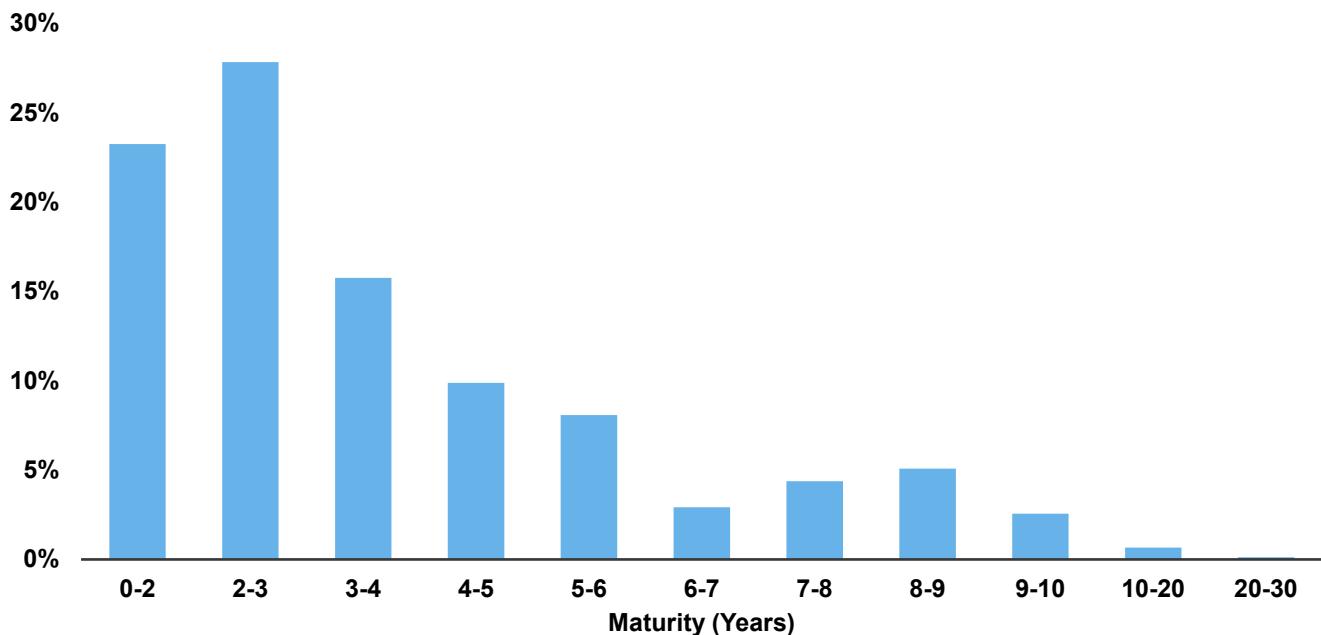
## What are Supranationals?

Supranational organizations are international financial institutions that are generally established by agreements among nations, with member nations contributing capital and participating in management. These agreements provide for limited immunity from the laws of member countries. Bonds issued by these institutions are part of the broader class of SSA sector bonds. Supranational bonds finance economic and infrastructure development and support environmental protection, poverty reduction, and renewable energy around the globe. For example, the World Bank (IBRD), International Finance Corporation (IFC), and African Development Bank (AfDB) have “green bond” programs specifically designed for energy resource conservation and management. Most supranationals have strong operating histories and benefit from their broad, diverse membership.



Since supnationals finance development loans with typical terms of five to 15 years, they tend to issue bonds with intermediate maturities, closely matching the needs of many short- and intermediate-term investors. This is also the maturity range preferred by global central banks and commercial banks which typically hold these issuances on their balance sheets. Exhibit 2 below displays the maturity distribution of outstanding supranational debt; as shown in the chart, roughly 77% of outstanding debt has a maturity of five years or less.

**Exhibit 2: Maturity Distribution of Outstanding Supranational Debt**

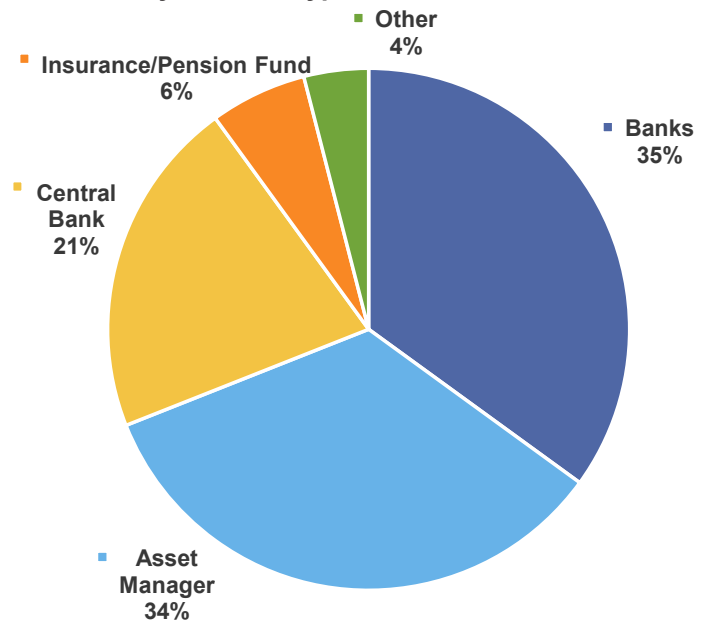


Source: BofA Merrill Lynch Index .

Supranational debt is issued in a variety of currencies, including U.S. dollars and many other key currencies such as euros, British pounds, and Japanese yen. U.S. dollar-denominated securities are traded in U.S. markets by primary dealers and settle through the normal Federal Reserve settlement systems.

Buyers of these securities include non-U.S. institutional investors, commercial banks, foreign central banks, sovereign wealth funds, and large U.S. institutional investors. A more detailed breakdown of buyers by investor type is shown in Exhibit 3.

**Exhibit 3: Supranational Investor Base by Investor Type, 2013 Year to Date**



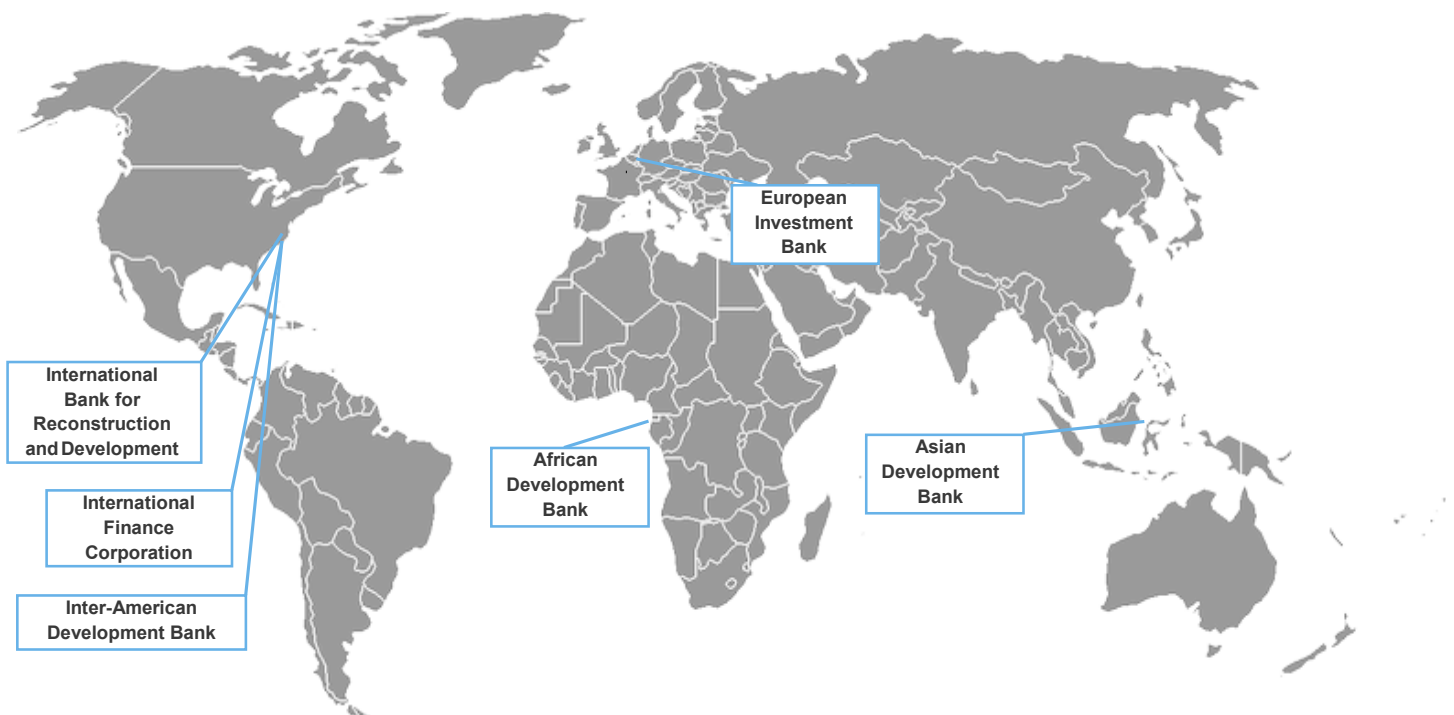
Source: Barclays Research; as of February 2022.



## Involvement of the United States Government in the Supranational Market

Certain supranationals are considered to be “instrumentalities” of the United States, and as such, their securities are exempt from registration under securities laws because U.S. participation is authorized by an Act of Congress and U.S. officials control or participate in managing the organization. For example, the U.S. Secretary of Treasury sits on the Board of Governors at the World Bank and has veto power over each loan considered for approval. Because of the oversight by officials in the U.S. government, the objectives of these organizations are generally aligned with U.S. interests.

**Exhibit 4: Largest AAA-Rated Supranationals**



Three supranationals are based in the U.S. and headquartered in Washington, D.C.:

- ▶ **International Bank for Reconstruction and Development (IBRD or World Bank)**, which helps reduce poverty by promoting sustainable economic development through loans and related assistance for projects and programs in developing member countries;
- ▶ **International Finance Corporation (IFC)**, which provides loans and makes equity investments in private entities in order to support economic growth and development; and
- ▶ **Inter-American Development Bank (IADB)**, which provides long-term financing to governments and other public- sector entities, as well as some private-sector borrowers, in Latin America and the Caribbean.



## Credit Quality of Supranationals

Supranationals typically have excellent credit quality driven by:

- ▶ Multi-national ownership and commitment;
- ▶ A long and successful operating history;
- ▶ Significant capital from a diverse capital base, resulting in strong capital ratios;
- ▶ Conservative lending and risk management practices; and
- ▶ Strong supervision and management representative of multiple sovereign governments.

The majority of the largest supranationals are rated AAA/Aaa by Standard & Poor’s and Moody’s Investors Service, respectively. As shown in Exhibit 5 below, 95% of U.S. dollar-denominated debt in the ICE BofA U.S. Corporate, Government & Mortgage Index carries an average rating of AAA. These supranationals maintained their AAA ratings even after Standard & Poor’s downgraded the U.S. government from AAA to AA+ in 2011.

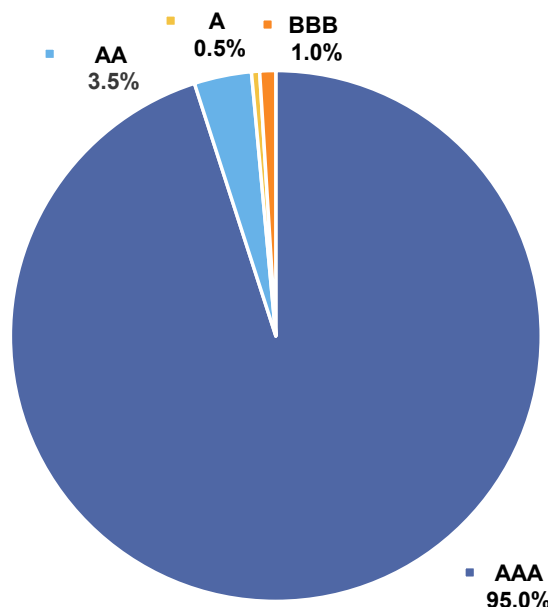
## Using Supranationals in a Portfolio

There are many reasons for investors to consider investments in supranational debt, but one of the biggest reasons is the continued decrease in the supply of federal agency bonds and notes. GSE supply continues to dwindle on account of the market and governance factors related to the conservatorship of the two largest issuers, Fannie Mae and Freddie Mac. Congress has yet to determine a clear path for restructuring the U.S. mortgage finance marketplace, but all signs point to eventually arriving at a much smaller role for Fannie Mae and Freddie Mac. In fact, the Federal Housing Finance Agency (FHFA) — the conservator for the GSEs — has stated that one of its main priorities continues to be the contraction of the GSEs’ balance sheets.

While U.S. federal agency supply is widely expected to remain constrained, the market for supranationals and other SSA debt is forecasted to grow. The ICE BofA U.S. Corporate, Government & Mortgage Index now contains \$383 billion in outstanding U.S. dollar-denominated debt of supranational institutions. Some issuers, like the World Bank, have short-term discount note programs as well.

For investors whose portfolios contain a significant allocation to U.S. agencies or GSEs, adding supranationals could be a way to incorporate a new investment opportunity that offers comparable credit quality and liquidity. Moreover, investing in supranationals have the potential to provide a yield advantage over traditional GSEs, although this is generally modest when investing in the highest-rated issuers. Domestic investors may limit purchases to debt issued in U.S. dollars. For conservative investors, supranational debt offers an expanded opportunity set for stable investments that have weathered multiple economic and political crises.

**Exhibit 5: Credit Quality of U.S. Dollar-Denominated Supranationals in the ICE BofA U.S. Corporate, Government & Mortgage Index**



Source: Barclays Research; as of February 2022.

Investors may also hold supranationals because they can add diversification benefits to a fixed-income portfolio. Unlike U.S. agencies/GSEs, whose lending activity is concentrated within the U.S. housing sector, supranationals provide loans to a diverse group of borrowers and receive capital from a variety of sources across the globe. Likewise, the ownership of these organizations are spread among many different nations, which can provide stability throughout global market cycles. Supranationals achieve funding diversification through a large base of different global investors and through issuance in a variety of global markets. Finally, since most portfolio holdings of U.S. federal agency debt are concentrated in just a few of the largest GSE issuers, further benefits are gained through diversification by issuer.

Furthermore, supranational organizations serve a higher purpose, helping to promote economic development for nations across the globe and supporting environmental protection and renewable energy. As mentioned earlier in the paper, the World Bank, IFC, and AfDB have “green bond” programs focusing on energy resource conservation and management. These objectives are similar to those of public and not-for-profit entities who may consider investing in supranational debt.

## Investment Policy Considerations

Investing in supranationals should start with a review of the investment policy and any governing statutes. Some policies may permit specific supranationals, while others may permit investments in instrumentalities of the United States government. Certain supranationals are characterized as U.S. instrumentalities. Investing in SSAs, including sovereign bonds and non-U.S. agencies, generally requires broader authority such as the authority to invest in obligations of foreign governments and their agencies payable in U.S. dollars.

Thus, in some cases, state statutes may need to be changed in order to permit investing in supranationals or other securities in the SSA sector. The recommended allocation for any specific portfolio would depend on a number of factors, including the portfolio’s investment objectives, risk constraints, range of permitted investments, and return targets.

## Investment Risks

Similar to any investment opportunity, investors should be aware of potential risks associated with supranationals. Although the supply of USD supranationals has remained essentially consistent year over year, the market for these securities is not as large or well-developed as the U.S. Treasury or federal agency market, so liquidity,

### POTENTIAL BENEFITS OF INVESTING IN SUPRANATIONALS

- ▶ Introduces an additional asset class, and thus a broader opportunity set
- ▶ An alternative to the shrinking quantity of U.S. agencies
- ▶ Can enhance portfolio diversification by sector and issuer
- ▶ Adds an element of global exposure, but not currency risk for U.S. dollar-denominated issues
- ▶ Desirable characteristics that may include:
  - High ratings, with many of the largest issuers rated AAA
  - Active secondary markets with generally good liquidity
  - Availability in a wide range of maturities
  - Often a modest yield advantage over traditional U.S. agencies
  - Supporting a higher purpose—providing economic and humanitarian support around the globe
  - Environmentally-oriented “green bond” programs from certain issuers

while strong, is somewhat less than that of Treasuries or agencies. Each organization also has credit risk to its lending counterparties and the projects being funded. However, in most cases, supranationals have the ability to access their member nations for additional capital contributions, which provides a backstop during distressed market environments.

Lastly, like all rated debt securities, supranationals could be downgraded if their underlying finances weaken, or if the credit standing of member countries becomes impaired in some way.

## Key Takeaways

We believe that supranational bonds should be considered for high-quality investment portfolios that have historically relied on a substantial allocation to federal agency debt. Supranationals may play a beneficial role in portfolios by broadening the opportunity set and enhancing diversification by sector and issuer, while maintaining a high degree of liquidity and credit quality.

Investors should carefully review their investment policies for applicability and take the time to understand the potential benefits and risks of investing in supranationals. PFMAM can offer assistance to any institutional investor seeking to expand its investment universe into supranationals—a growing investment sector in a world of shrinking opportunities.

**To learn more or discuss in greater detail,  
please contact your PFMAM representative.**

*PFM Asset Management LLC (“PFMAM”) is an investment adviser registered with the U.S. Securities and Exchange Commission and a subsidiary of U.S. Bancorp Asset Management, Inc. (“USBAM”). USBAM is a subsidiary of U.S. Bank National Association (“U.S. Bank”). U.S. Bank is a separate entity and subsidiary of U.S. Bancorp. U.S. Bank is not responsible for and does not guarantee the products, services or performance of PFMAM.*

**NOT FDIC INSURED : NO BANK GUARANTEE : MAY LOSE VALUE**