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## Mozambique should not pay the hidden debt

By Joseph Hanlon

The Mozambican government should not pay \$1157 million in 2013-4 hidden loans to MAM and ProIndicus. In this paper we argue that these loans are to private companies, with no liability to the government. Loan guarantees given by the finance minister violated Mozambican law and the constitution. Under the loan contract, any action relating to failure to repay would be taken in English courts. Mozambique has been advised that English courts would not consider the violation of the Mozambican constitution, but this is not true. A March ruling in the High Court in London said that failure to follow domestic rules by a borrowing state must be considered by an English court. This means that if the lenders brought an action in English courts against the government, the lenders stand a high chance of losing. Therefore they will surely prefer to negotiate a deal with partial repayment, and to try to force the banks which organised the loans, Credit Suisse and VTB, to accept some share of responsibility because their proposals were misleading and inaccurate. Mozambique is already refusing to repay these loans, and it should continue to do so.

The third part of the debt, \$850 million to Ematum, is more complex because the government has accepted responsibility. It nationalised the bonds - converting bonds issued by a private company, Ematum, into bonds issued by the government. Nevertheless, the original Eurobonds also were illegal and were misrepresented by the banks. Mozambique cannot refuse to pay, but the bondholders would agree to reduce the size of the debt.

### The credits

The total credit package is for \$2007 million and is complex. It involves three newly established private Mozambican companies and five credits arranged by two banks, Credit Suisse and the Russian government-owned bank VTB. Three of the credits are in the form of



"syndicated loans", which means that a bank organises a group or "syndicate" of lenders who provide the money; syndicated loans are secret and the borrower makes repayments to the organising bank, without knowing the actual source of the money. Two of the credits were bonds, in the form of Eurobonds, which are public and can be traded on a stock exchange.

Three companies were established and loan packages were agreed in 2013-14. The companies were established as Mozambican private companies owned by the state and controlled by the security services, SISE:

- ProIndicus - first company to be established, January 2013. Owned 76% Monte Binga (Ministry of Defence) and 33% SISE. Syndicated \$622 mn loan - Credit Suisse \$504 mn, VTB \$118 mn. Secret, arranged February and June 2013.
- Ematum (Empresa Moçambicana de Atum) - established August 2013. Owned 1/3 each IGEPE (state holding company), Emopesca (state fishing company) and SISE. Eurobond - total \$850 mn - Credit Suisse \$500 mn, VTB \$350 mn - arranged by these two banks plus BNP Paribas, August 2013. Bonds were sold without parliamentary approval but bond sale was public. President Armando Guebuza, French President François Hollande and shipyard owner Iskandar Safa were present for a 29 September 2013 ceremony at the Cherbourg, Normandy shipyard.
- MAM (Mozambique Asset Management - company name is in English) - established May 2014. Owned 98% SISE, 1% Ematum, 1% ProIndicus. Syndicated loan - VTB \$535 mn. Secret, May 2014.

António Carlos do Rosário, a senior SISE official and the CEO {PCA, Presidente do Conselho de Administração} of the three companies, told a parliamentary commission in 2016 that the contract was given to Constructions Mécaniques de Normandie - Abu Dhabi MAR (CMN/ADM) as a negotiated contract, without a public tender. This company also negotiated the financing. The money went directly to CMM/ADM without passing through the Mozambican treasury; Mozambique receives the equipment and training but not the money.

The Ematum bond issue was controversial and donors began to withhold aid. In November 2013 the IMF and government agreed that \$500 mn of the Ematum bond was for military purchases, not fishing, and the \$500 mn was transferred to the state budget, with \$350 mn remaining with the private company, Ematum. The ProIndicus loan remained secret, and the MAM loan was only organised subsequently.

Elections were on 15 October 2014 and the new government of President Filipe Nyusi took office in January 2015. A standby credit with the IMF was agreed and the first payment was made to Mozambique in December 2015. By late 2015 the government was attempting to renegotiate the Ematum bond issue to pay over a longer period of time. This was finally agreed in March 2016, when the Eurobonds were replaced by a new issue of Mozambique government bonds. Documentation required as part of that bond issue hinted at more debt than had been revealed, and in April 2016 the \$1157 mn in secret MAM and ProIndicus debt was revealed. The IMF cut off the standby credit and donors halted budget support, saying they had been lied to by the government which had failed to include more than \$1 billion in debt guarantees in reports to the IMF and donors. This issue is the core of the legal case, and will be discussed below.



## What is wrong?

There are four factors which make this \$2 bn debt package illegitimate; an illegal guarantee of private credits, exaggerated and dubious statements by the organising banks, failure of lenders and bond buyers to do "due diligence", and likely corruption.

**Government guarantee.** Although all five credits were to private companies, government guarantees were signed by either then Finance Minister Manuel Chang or then National Budget Director (now Vice Minister) Isaltina Lucas, but they had no right to do so. The Parliamentary Commission of Inquiry into the Situation of the Public Debt { Comissão Parlamentar de Inquérito para Averiguar a Situação da Dívida Pública} said in its 30 November 2016 report that "it must be understood that the guarantees issued are void", since the act of issuing the guarantees exceeded the limits set in the 2013 and 2014 budgets and thus "violated" article 179 of the Constitution as well as budget laws. This was confirmed by the Tribunal Administrativo in November 2016.

**Bank prospectuses.** As António Carlos do Rosário made clear to the parliamentary commission, the funding was organised by the contracting company. Documents on the viability of the companies and the loans were prepared by the banks organising the loans, Credit Suisse and VTB. Rosário told the parliamentary commission that the banks agreed to keep secret the military content of the loans, and he stressed that the main purposes of the loans were coastal protection and not fishing. Of the \$850 Ematum bond, only \$91 mn was for fishing boats, he said. The banks provided the feasibility studies, which said that the three companies would be "highly profitable" and able to easily repay the debts, according to the parliamentary commission, which notes that the reality was the opposite and the companies had no possibility to repay the debts. The feasibility studies included entirely unrealistic projections, including that Mozambique could sell tuna for five times the price that Seychelles is paid for identical fish, that boats passing through the Mozambique Channel would pay high tolls to these private companies, and that these companies would gain the contracts for security for the off-share gas projects. Both the creditors and the borrowers could argue that they had been misled.

**Due diligence.** Banks and investment funds are expected to undertake a process known as "due diligence" in which they do an independent investigation of any loan proposal, to ensure that the borrowing party has not lied or grossly exaggerated the prospects of repaying the loan. The banks have a special responsibility to do an due diligence investigation and investment funds buying bonds or taking part in loan syndicates often trust the banks to have carried out the appropriate investigation, although investment funds in the loan syndicates signed agreements saying they had carried out their own due diligence investigations. However, even the most basic due diligence investigation would have shown that the Finance Minister had no right under the constitution to sign the guarantees, that the expected price of tuna was hugely exaggerated, that there were no coastal protection contracts with the gas companies and that they were unlikely, and that the credits were largely for military or security purposes. It should also have been obvious that the entire \$2 bn credit package would increase Mozambique's debt to the level of unsustainability. Thus any due diligence report should have said that there was no chance of the debt being repaid.



**Corruption.** IMF Managing Director Christine Lagarde told the BBC on 18 May 2016 that in keeping loans secret, the Mozambique government is "clearly concealing corruption." The entire structure of the loans - payment abroad, a negotiated contract, lack of accounting, delivering inappropriate ships of little value - seems designed to foster corruption. No one has been identified and charged yet, but a smell of corruption hangs over the whole \$2 bn loan package.

## The debt is illegitimate

Borrowing money has happened for millennia, and it is often good - we borrow money to build our houses and start businesses, and governments, too, borrow money. And there is a contract - the borrower promises to pay, but the bank does not want to waste its money so it checks to see if the borrower is likely to repay. For developing countries and people who are starting new businesses, lenders have a responsibility to see if the use of the money is sensible. This is called a fiduciary duty - an obligation to act in the best interest of another party. Lawyers have a fiduciary duty to their clients and so do banks - people go to banks for financial advice and do not expect to be cheated by the bank.

But in periods when there is surplus global capital, as now, international banks are less careful. With respect to Mozambique's \$2 bn secret loans, the banks did not take the risk themselves, but organised others to lend the money to Mozambique. And they painted a dishonest picture of state guarantees, Mozambique being able to see its fish for five times as much as Seychelles, and guaranteed security contracts. The banks did not do a proper due diligence and thus failed in the fiduciary duty, both to those who lent the money and to Mozambique. This was made worse because the banks kept secret that the loans were for military spending, and was made even worse because the loans facilitate corruption.

A loan is considered "illegitimate" when the bank has not carried out its fiduciary duty, as in this case; the loan becomes the responsibility of the banks and not the borrower. Mozambique has a strong moral case that it should not repay this illegitimate debt. But does it have a legal case?

## Mozambique can refuse to pay

Mozambique at present is simply not repaying any of the secret debt. Could it just refuse to pay? The government has effectively nationalised the Ematum debt by issuing government bonds to replace the ones issued by the private company, making it hard to refuse to pay. We return to this below. But the \$1157 million MAM and ProIndicus loans are different - they are loans to private companies and the government has never accepted liability.

The bond and loan contracts say that any dispute must be resolved in English courts. That means that if they are not being paid, the bondholders and syndicated lenders (who include Mozambican banks) would have to bring a legal action in London - to force payment of the bonds and try to enforce the government guarantees signed by Chang and Lucas on the MAM and ProIndicus loans.

Mozambique's response to any legal action would be that the guarantees violated both the constitution and Mozambican budget laws. Because they were expected to conduct due diligence investigations, both the issuing banks and the lenders should have known that the companies created by the loans were not viable and the guarantees were not legal.



A March ruling in the High Court in London makes it much more likely that Mozambique's defence would succeed, and the court would rule that the guarantee cannot be enforced. We understand that the Mozambique Finance Ministry has been advised that the London court would not take into account the Mozambican constitution and laws. But a ruling in the High Court in London on 29 March by Sir William Blair, brother of former prime minister Tony Blair, said this is not true. He ruled that failure to follow domestic law and the constitution is "relevant" and must be taken into account by an English court.

The case involves Ukraine's refusal to pay a \$3 bn Eurobond organised by the Russian bank VTB, in which Russia bought all the bonds. The bonds, as with Mozambique, are covered by English law. In an identical situation to Mozambique, Ukraine argued that the Finance Minister agreed the loan without it being approved by parliament as required by the constitution. Mr Justice Blair noted that there are no precedents and this seems to be the first case of its kind. It is extremely complex case, in part because it also involves the Russian occupation of Crimea, which is not relevant to Mozambique. The full text of the ruling is on <https://www.judiciary.gov.uk/judgments/law-debenture-v-ukraine/>

Mr Justice Blair ruled against Ukraine, saying that a state has the capacity to borrow, "the Minister of Finance plainly had usual authority to enter into the transaction on behalf of Ukraine", and that the lenders had no reason to suspect that the loan was improper. It is the last point that works in favour Mozambique because the conditions of the Ukraine loan which were opposite to those of Mozambique.

The Ukraine loan was to the government and was approved by the cabinet; there has been many similar loans, the government of Ukraine received the money and it was included in foreign currency accounts of the Treasury as posted on its website; interest payments were made, and it was never stated that the loan was improper.

The loans to Mozambique were exactly opposite this. The loans were to private companies and not the state, were not approved by the Council of Ministers, none of the money entered Mozambique, it was never included in any state accounts, government statements stressed that these are loans to private companies, and all statements by public authorities (parliament, Tribunal Administrativo) said the loan was illegal and unconstitutional. The secrecy of the loan meant that lenders had no public statements to lead them to believe in the legality and should have done their own investigation, which would have shown that the loan was improper. And the contract which the lenders signed said that they had done such an investigation - even if though it appears few actually did so.

Thus, even though Ukraine lost its case, Mozambique could use this case and Mr Justice Blair's statement that failure to follow domestic rules is relevant, to make the case that at least the MAM and ProIndicus syndicated loans are illegitimate and should not be paid.

As with the Ukraine case, it is up to the lenders to bring a legal action in London, and it appears that there is a significant chance that the lenders would lose. This could give a major boost to Mozambique in any renegotiation of the loans.

If Mozambique wins its case, then both the lenders and bondholders could then bring an action against Credit Suisse and VTB, saying that they were misled and that the banks violated their fiduciary duty.



## Renegotiation and reduced payment

We think all parties would prefer that this case not go to court and prefer to instead negotiate a deal with partial repayment, and to try to force the banks to accept some share of responsibility. There are effectively three groups involved, each with its own reasons to not want to go to a London court. The most important reason is that most documents presented in an English court are public, and as none of the parties have clean hands, they would prefer continued secrecy.

- The syndicated loan holders might not win, and would prefer to have some money rather than none. They also would not want to admit in open court that they did not carry out their own due diligence.
- It would be possible that documents would be presented showing corruption or malpractice in Mozambique, which the government would not like to be public.
- The conduct of the banks, Credit Suisse and VTB, has already come in for severe criticism and their own due diligence reports and other documents would be presented in open court.

The Mozambican Finance Ministry, with its consultants, must set a negotiating strategy. It has taken the correct first step by not making any payments on the secret debt. This forces the lenders and bondholders to threaten legal action - and it is interesting that none has done so, suggesting that they do not want to go to a London court. In closed negotiations, Mozambique needs to stress that the debt is illegitimate and it is the responsibility of the private companies, MAM and ProIndicus, and thus that the liability rests with Credit Suisse and VTB which organised the loans and original bonds.

In private, the bondholders do recognise that the original Ematum Eurobonds were illegitimate and that Credit Suisse and VTB acted improperly, but they also argue that the government nationalized the illegitimate Ematum credit and thus took responsibility to repay. In private they also accept that there will be a renegotiation which will reduce the debt that must be repaid.

Lenders and the Mozambican government will want to bring Credit Suisse and VTB into the negotiation, although the banks will resist and it will require threats of legal action. Such a complex multi-sided negotiation could continue for a year or more. The goal would be for syndicated lenders and bondholders to accept a reduction in the value of their credits, for Credit Suisse and VTB to find a way to pay some compensation for their misconduct, and for Mozambique to agree to make some repayments (probably starting only in seven years).

But in any public statement and negotiations Mozambique must make clear that it does not accept any responsibility for the illegal MAM and ProIndicus syndicated loans. Mozambique can and should refuse to pay.

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