The Eurozone Debt Crisis: Can Structured Finance Help?

London, 27 September 2011, by Mike Nawas and Amir Khan

We all know that Structured Finance has had its own fall from grace in 2008. But now that debt investors have shifted their concerns mainly to sovereign debt whilst the credit performance of structured finance debt seems to be holding up, there is an opportunity for governments to consider applying structured finance solutions, that offer creative ways of leveraging their assets, in an effort to curb budgetary debt problems paving the way for sustained economic growth. In this article we examine the case for governments in the Eurozone to seek out sound structured finance funding as part of their debt packages.

Introduction

Over the last few months, the Eurozone's sovereign debt problems have entered a new phase with Greece requiring a second bail-out and the possibility coming closer of the debt crisis spreading to Italy and Spain. The European Financial Stability Facility ("EFSF"), created in 2010 as a response to the emerging European sovereign debt crisis, is a €440 billion programme that is chartered to issue bonds or other debt instruments on the market to raise the funds needed to provide loans to the European countries in financial difficulties. These debt instruments will be backed by guarantees given by the Eurozone Member States. The magnitude of the challenge, combined with the ongoing downward trend in sovereign credit ratings, most recently with the further downgrade of Italy, begs the question whether the EFSF, or the indebted sovereigns as the case may be, should rely solely on vanilla sovereign bonds or whether the Eurozone countries should broaden their range of debt instruments to include Structured Finance bonds. In our opinion, the answer should depend on the extent to which such a broadening of the palette of bond issues could contribute to the sustainability of the overall sovereign financing programme and if it will serve the purpose of driving long-term economic growth.

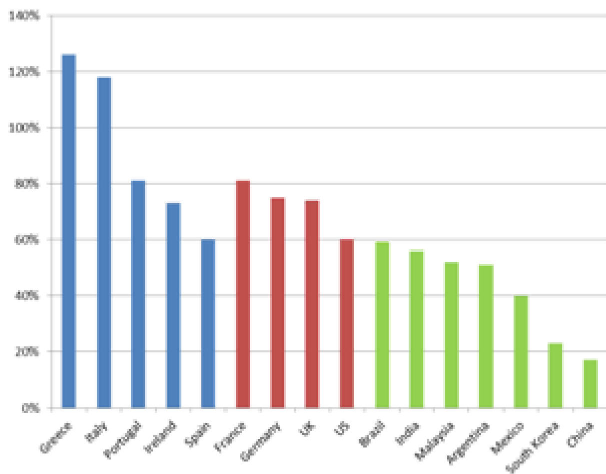
Let's take the obvious example of Greece by way of context. The current bail-out package at €109 billion requires the private bondholders to contribute a target of €37 billion in the form of a rollover or swap of their existing debt for new bonds that mature in 30 years. Furthermore, an additional €12.6 billion is expected to come in commitments from bond owners to sell their holdings at a reduced price as part of a bond buy-back programme.

Scope for Structured Finance

Many of the key macroeconomic indicators for the Eurozone economies are demonstrating trends that traditionally have been associated with emerging markets. For a start, this includes high public debt as percentage of GDP: *Figure 1* reminds us of how true this statement is, with Eurozone countries' debt-to-GDP ratios far exceeding a variety of large emerging market economies.

Other macro-economic challenges typically seen in emerging markets are inflationary pressures, high unemployment, a current account deficit and a large public budgetary deficit. And, as depicted in *Figure 2*, with the exception of the inflationary pressures, most of these indicators are now also appearing in the macro figures of

Figure 1: **Public Debt as % of GDP (2011)**



Source: The Economist

the Eurozone countries. And although inflation may not be prevalent, given the amount of quantitative easing applied in the Eurozone, this may be a feature in the not too distant future.

Sovereign debt crises fuelled by the factors mentioned above used to be confined to emerging markets. Typically, whenever the problems culminated into a sovereign debt crisis, the recipe adopted by the IMF entailed – in return for a restructuring of existing sovereign debt obligations – a devaluation of the country's currency and the implementation of a fiscal rehabilitation plan. For the Eurozone economies, now confronted with a similar challenge, the devaluation instrument is absent as long as the union wishes to avoid any secession of countries out of the Euro, either forced or voluntarily. This leaves the fiscal rehabilitation package as the sole solution to put the sovereign back on a firmer footing.

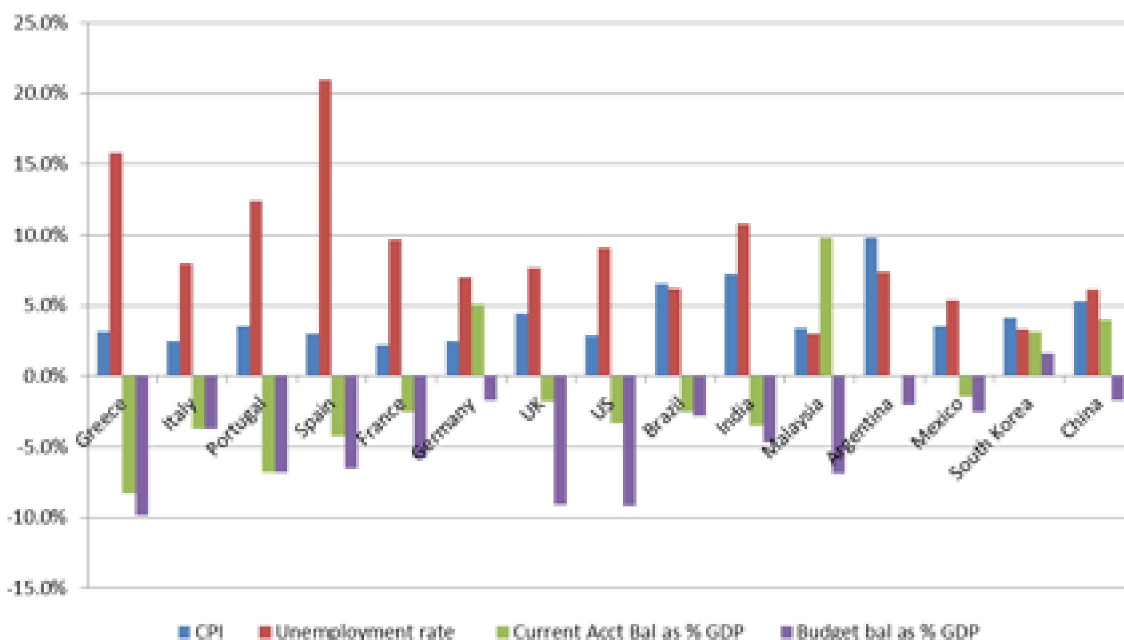
Structured finance solutions in the context of fiscal rehabilitation

Emerging economies have been active participants in the structured finance market and given the economic similarities described above, it is worth considering the utility of structured finance tools for the Eurozone economies. In the remainder of this Market Insight, we consider a number of structured finance solutions, after which we conclude whether they can contribute to what we believe should be three key objectives that any fiscal rehabilitation plan needs to accomplish in order to have a far-reaching impact: deleveraging, enabling future (re)financing on competitive terms and stimulating long-term economic growth.

Monetisation of real estate assets

State owned real estate forms the most obvious asset class which the governments can aim to

Figure 2: **2011 Macroeconomic Indicators (estimated)**



Source: The Economist
(Unemployment figures are actuals obtained over Apr-Jul 2011. India and China are 2010 figures)

leverage. There are three avenues to pursue, as summarised in the table below.

	Sale and leaseback financing	Structured sovereign bonds backed by lease receivables	Structured sovereign bonds backed by rental and disposal flows
Asset pool	Government buildings and properties	Tourist sites allocated for development	Residential and commercial properties
Source of cash flows	Lease payments from the government	Lease payments from a pool of sites managed and developed by property companies/ developers	Rental and disposal proceeds from the tenant pool
Programme roll-out possible in the...	Short-term	Short- to medium-term	Long-term
Key considerations	• Off-balance sheet treatment • Single source of repayment	• Off-balance sheet treatment • Perceived creditworthiness of developers/ lessees • Diversified lessee pool mitigating repayment risk	• Off-balance sheet treatment • Highly granular collateral pool • Potentially evergreen financing avenue

The techniques above can be used as off-balance sheet instruments and therefore contribute to deleveraging. However, it is important to note that the rating agencies and Eurostat are likely to scrutinise these financing structures on the extent to which the risk transfer to private investors has been sufficient to warrant de-consolidation. Their criteria will have to be met. As long as issuers and investors recognise the extent of such risk transfer and this is coupled with an appropriate return on the instruments, the monetisation instruments can be one of the tools available to sovereign debt issuers or the EFSF, as the case may be.

Sale and leaseback financing
An important consideration in this financing approach is the credit quality of the government's rental obligations. Given Greece's current rating, it will be important to build in some credit enhancement to increase marketability to investors and potentially lower the implied interest cost. One such feature can be a guarantee from the EFSF towards the government's rental obligations for the first circa 3 years. This allows the investor to take comfort from a AAA structure for the first years and then reverting to the credit rating of the government. The idea is that the sovereign rating will have improved during that period.

Structured sovereign bonds
backed by lease receivables
A group of international developers and/or property companies can lease the real estate from the government under a long-term contract. Governments can consider committing to a programme of urban, local, regional or industrial renewal to entice the developers to lease the real estate. The cost to the government, which will constitute policies around licenses, infrastructure and exclusivity arrangements, should be tolerable especially in light of the value that will be created for the developer. The government can pool the various lease contracts and sell its rights to lease payments and assign the lease contracts to a SPV. The SPV finances the purchase of these rights through a bond issue. The diversification achieved through a pool of lease contracts should impact credit ratings favourably. This can deliver the intended benefit of monetisation as well as nurture business opportunity driving future economic growth.

Structured sovereign bonds
backed by rental and disposal cash flows
Italy employed this method in the early 2000s under the "SCIP" programme – raising a total of around €9 billion. It involved sale to an SPV of state-owned residential and commercial properties that were occupied by tenants. The SPV issued notes secured by the future rental and disposal proceeds from the tenant pool. An important feature of the programme was that the tenants could acquire the properties at a discount to vacant possession value thereby incentivising purchase and enabling repayment of the notes. It should be noted that the second

issue under the programme was restructured as it met with disposal rates lower than what were envisaged originally. While this form of financing spreads risk over a highly granular pool, the following features make it more of a measure for the longer-term:

- Difficult to convince investors around affordability levels of local tenants in a country such as Greece
- Notwithstanding any over-collateralisation in the structure, housing market needs to stabilise further for investors to take comfort from this principal security

Monetisation of other financial assets

From 1999, the government of Italy undertook a securitisation programme for the credits in arrears of INPS, the Italian social security institution. Issuances occurred over several series raising a total of around €20 billion. These aimed at securitising payments originating from a portfolio of social security contributions in arrears due by companies, self-employed individuals and agricultural sector companies and workers. Italy also employed the same technique on diverse assets such as concessions for a high-speed rail link and lottery revenues. The reactions of rating agencies and Eurostat to these transactions were not always favourable. Some were criticised as one-off measures to address budgetary pressures while others, such as sale of lottery revenues, were treated as government debt by Eurostat as they were not attached to pre-existing assets.

Worker's remittance flows have been a sizeable source of cash for economies where there is a significant emigrant population. Monetisation of workers remittances entails sale by local banks of their rights to receive the remittance flows. Given the volatility in remittance flows, over-collateralisation levels are usually high in such structures (around 7.6x in Banco do Brasil (BdB) US$ 250 million Nikkei Remittance Trust financing, for instance). Furthermore, in case of BdB, Standard & Poor's conducted a survivability assessment of the originating entity prior to rating the transaction higher than the originator's local currency rating. In case of Greece, annual worker's remittance flows have dropped from just above €2 billion in 2008 to around €1.5 billion in 2010. Declining workers remittances in recent years, high over-collateralisations required (in case of Greece, this can potentially be much higher than what was seen on BdB, for instance), and a fragile banking sector (possibly leading to an unfavourable survivability assessment) are likely to prevent raising a meaningful amount.

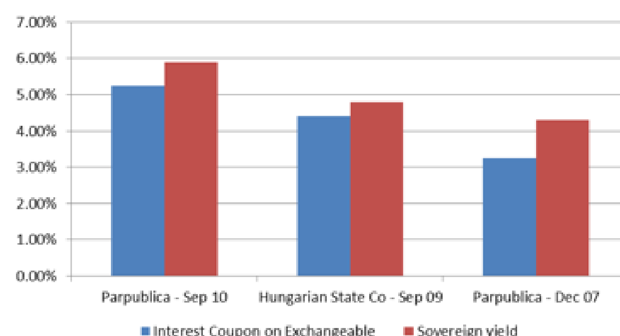
However, use of Diversified Payments Rights (as done in Turkey) can expand the remittance flows to include export earnings, foreign direct investment flows, and foreign currency settlements between domestic institutions. This increases the remittance pot, allows for diversification of remittance sources and can possibly result in a greater amount to be raised. Structuring and subsequent monitoring of such a transaction given the various sources of payment flows is the structured finance challenge that needs to be overcome in each specific case.

Exchangeable debt instruments

As illustrated in the chart below, the government can reduce the interest coupon on its financing by offering the option to debt investors to transfer their holding into share capital of a company. The shares offered in exchange are those already owned by the government. This can be viable for investors on the back of an attractive equity story, for example, if the entity designated under the exchangeable instrument has been identified for a prospective privatisation.

The size of the shareholding to be transferred at exchange is established upfront at issue of the

Figure 3: **Exchangeable pricing and comparable sovereign yields**



Source: Bloomberg

Sovereign yields for Hungary represent the then-prevailing yeild of the 2014 sovereign issue, while those for Portugal are taken off the 7-year Euro yield curve

bond. The share price used to determine the size of equity transferred to the debt investors at exchange is established at a premium to the prevailing share price. Hence, it is common to observe that exchange rights are not available to debt investors during the initial years of the issue thereby allowing share price to develop such that exchange is economically justified. As part of the terms of the offering, issuers often retain the option to redeem the debt through cash prior to exchange.

The exchangeable bond programme can only be implemented if the company has a sufficiently satisfactory trading track record. Moreover, the maximum size of equity designated for exchange will be a function of the amount the government plans to retain as a strategic stake in the entity.

Any exchange can be conceptualised as a form of equity monetisation resulting in immediate reduction in government debt without any actual cash exchange.

Some recent examples of governments using exchangeable debt instruments are listed below:

	September 2010	September 2009	December 2007
Issuer	Parpublica, Portuguese state agency	Hungarian State Holding Company	Parpublica, Portuguese state agency
Issue size	€885.65 million	€833.3 million	€1,015.15 million
Term	7 years	5 years	7 years
Interest coupon	5.25% p.a.	4.40% p.a.	3.25% p.a.
Exchangeable into shares of	Galp Energia, largest oil and gas company in Portugal	Gedeon Richter, one of the largest pharmaceutical companies in Hungary	Energias de Portugal, a major electricity operator in Europe and one of Portugal's largest business groups
Premium over share price	25%	32%	45%

Public Private Partnerships

Projects in physical and social infrastructure will need to be implemented and private sector participation is likely to play a key role in allowing governments to limit direct capital spend. Examples of Public-Private Partnerships ("PPP") can range from simple joint venture agreements and "build and delivery" contracts to the more complicated long-term concessions (where private corporations manage the construction, as well as finance and operate an asset during the entire contract) and modern-day PPP version where a substantial initial capital expenditure is required and the government is the main purchaser of the services through regular payments.

The underlying consideration for governments employing PPP is the project's de-recognition as government asset. The process of de-recognition involves analysis of the transfer of some key risks, which are:

- Construction risk
- Availability risk – during operation of the asset, private partner assumes responsibility of any management inadequacies that result in a volume of services lower than what was contractually agreed
- Demand risk – covers the variability of demand irrespective of the performance of the private partner

In order for de-recognition to be achieved, the private partner must bear the construction risk and either of the availability risk or the demand risk. The achievement of true risk transfer as an economic benefit to the government is also key: it is only fair to ensure that there is real value for the government, at least offsetting the typically higher coupon payments on a PPP compared to regular government borrowing.

Usually, service payments in a PPP are obtained from periodic payments from governments or direct payments by the users of the infrastructure (e.g. tolling).

The first alternative essentially entails a long term payment obligation on the Greek government. Whereas debt is not directly incurred by the government, lenders to the project will include a premium given the credit rating of Greece. The

second alternative does not impose further pressure on the government's payment streams, but the volume risk will lead to substantial margin increases, especially as volume would be directly linked to the uncertain economic development of the country and purchasing power of the users.

One of the benefits of the availability payments variant is that typically, under the project contracts, the government is entitled to up to 75% of future refinancing gains. Given the private partner receives only 25% of the benefit, the quantum of gain needs to be material for their interest to be generated. In the event that the credit risk of Greece reduces, a refinancing scenario could result in lower availability payments to be set that will match the new credit profile and also reduce the future payments burden on the government.

One of the challenges to obtain financing for countries such as Greece will be the ability of commercial banks to participate actively given potential country limits issue that they may face. This issue may be mitigated through an off-shore structure that delinks the cash flows from government credit, however the sectors in which this can be achieved most effectively (such as fossil fuels) may not be relevant in the Greek context. This approach can possibly be tested in the context of airports.

Conclusion

The Eurozone countries affected by the sovereign debt crisis are, on a macro-economic level, showing characteristics similar to those seen in many emerging economies. Whereas in the Eurozone in recent years there has been a move away from deploying structured finance techniques to government debt, emerging markets have continued to deploy these techniques. Given the current macro-economic similarities, we believe that structured finance can once again play a more important role in overcoming the sovereign debt problems in some of the Eurozone countries. The techniques are tried and tested, often aim to enhance credit profile through resilient structures and contribute to three key objectives of fiscal rehabilitation: deleveraging, enabling future (re) financing on competitive terms and stimulating long-term economic growth.

We appreciate that off-balance sheet financing, leading to deleveraging, has received criticism in recent years. But as Eurostat accounting rules have been clarified and as long as the benefits as well as limitations of off-balance sheet financing are understood by both the issuers and investors, it remains a structured finance technique that has its place.

The sovereign debt issues faced by the Eurozone are not only complex but also large in magnitude. Structured finance will not be the one and only solution to these problems, but the techniques presented can contribute in a material way, alongside the traditional recipes of austerity and sovereign debt restructuring. The case for structured finance's role in a fiscal rehabilitation programme becomes even more compelling in light of the Eurozone's deep-routed wish to avoid devaluation, one of the other traditional recipes, which if implemented would entail a painful secession of one or more countries from the single currency. Bishopsfield Capital Partners Ltd. recommends the use of structured finance to not only help governments de-lever in the short to medium term but also deliver long-term economic benefits.

If you agree with our views in this Market Insight, and even if you don't, we would be delighted to hear from you (info@bishopsfieldcapital.com).

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