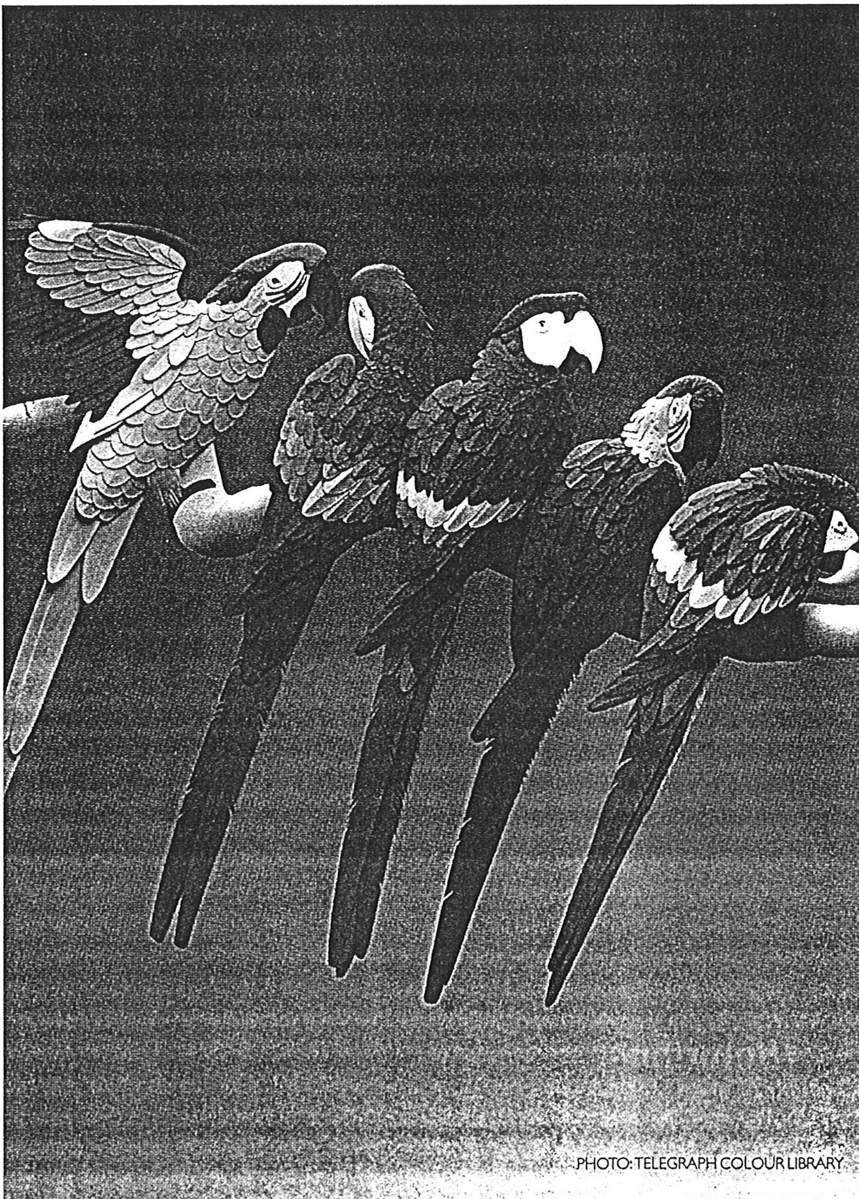
With several European countries planning an economic and monetary union before the turn of the century, will everyone involved measure up to the universal standards required for membership? Joseph M Pimbley explores the use of securitisation as a means for governments to balance out required ratios of debt to GDP. (developed from an idea by Ettore Thermes)

Birds of a feather – coming together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The greatest political event of the past 50 years has been the West's Cold War victory over the Soviet bloc in the 1980s. The Berlin Wall fell; East and West Germany reunited; and a huge military burden fell off the shoulders of both sides. Political freedom is the new invader of all corners of the world and will likely soon overrun the old entrenched states of North Korea and Cuba.

The end of the Cold War was just as much economic as historic and political. World prosperity has grown since the means of production were freed up to create true value, and as economic freedom has risen with its political counterpart.

Many European countries are contriving another historic event with great economic consequences: the formation of a 'monetary union'. Eleven countries will begin living with a common currency and central bank in early 1999 within the framework of this European Economic and Monetary Union (EMU).

It is a large-scale economic and political experiment in which proponents claim that a subrogation of economic autonomy for the sake of uniformity will promote prosperity.

As one central bank will set policies with interest-rate levels of only one currency, the inflation environments in member countries should be similar. As a result, the 'entry criteria' for member nations require sufficiently low levels of total debt and annual budget deficits to gross domestic product.

Several countries are struggling to reach these debt and deficit monetary union targets. A country's standard options for reducing debt are cutting expenses, expanding the economy, and raising taxes to the extent that tax revenues increase as a result.

The financial markets have yet another option that the prospective EMU members might consider. The 'securitisation' of assets is a procedure by which a government may sell an asset associated with a particular programme to private investors while preserving the existence of the project. It is then possible to reduce government debt without eliminating the associated government activity.

Securitisation has primarily been the domain of financial institutions and corporations. It began almost 20 years ago with home mortgages in the US and has expanded to include credit card receivables, automobile loans, home equity loans, bonds, bank loans, manufactured housing loans, trade receivables and more. With the exception of government-sponsored enterprises in the US, governments have not been significant participants.

The twin observations that European governments have a strong interest in debt reduction and that securitisation is a vehicle that achieves that goal leads us to consider securitisation as a financial tool to promote monetary union in Europe. Ettore Thermes of Prebon Yamane argues that there is a long list of assets (home mortgages, receivables, toll-roads and bridges, for instance) that a government may securitise in order to reduce its debt level.

This article will give more detail on monetary union and securitisation and will then discuss a small number of debt-reducing securitisations that have already taken place. Questions are raised about whether the European Commission will 'accept' securitisation and whether there should be concern about the proper disposition of the 'equity tranche' in such transactions.

The article lists the general steps and decisions through which a sovereign entity must proceed to launch a securitisation and then concludes with a summary.

EU detail

Stage III of monetary union under the Treaty of Maastricht will begin on January 1 1999. In this stage the countries that have elected to join and have received approval to join will begin merging currencies into the euro. Eleven countries are now at this stage. They are Germany, France, Italy, Spain, Portugal, Belgium, Luxembourg, the Netherlands, Ireland, Finland and Austria.

One common explanation for the wisdom of such a union is the success of the US. European politicians and planners see the US as a large 'common market' with a single currency and central bank. Europe seeks to emulate the success of the US by matching its market size.

As separate countries, the level of interest rates and the value of one currency against another are different and variable. To merge all currencies into one and to have all countries live with just one interest rate (loosely speaking) requires a set of common goals towards which each country must strive in managing its economy.

The Treaty of Maastricht lists 'The Procedure for Starting Stage Three of EMU' as Article 109j. The procedure asks that each country "stabilise prices"; manage its currency so that it remains within "normal fluctuation margins"; hold its annual budget deficit to 3% or less of its gross domestic product; and bring down its national debt to 60% or less of GDP.

These last two points, that there are targets for a nation's budget deficit and its total debt, contribute to the focus of this article. Even accepted member states must continue to reduce their debt levels to meet the targets as their admission was contingent on further improvement.

Securitisation details

All securitisations have three common themes: pooling of assets; the establishment of a bankruptcy-remote trust that purchases the assets and issues the liabilities; and the division of liabilities into various classes, or tranches, to provide investors with the choice of different risk levels and/or different maturities.

Securitisation is essentially a transfer of the pool of assets from the original owner to investors. The transfer takes place through a trust, or special purpose vehicle, which is legally separate and distinct from the original asset owner.

The 'entry criteria' for EMU member nations require sufficiently low levels of total debt and annual budget deficits to gross domestic product

The owner sells the assets to the trust. If this owner later defaults on its liabilities, a bankruptcy court does not have claim to the assets that previous trusts have purchased, even though this owner may service the assets for the trust and effectively control its day-to-day operation.

The trust borrows funds from investors to purchase assets by issuing 'trust certificates' that entitle investors to proportionate shares of the performance of pool assets.

The third element of securitisation is the division of these trust certificates into different classes with different risks. A primary risk in all securitisations is default of the assets within the

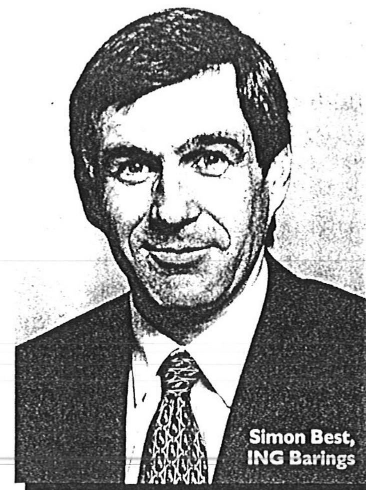
pool. An 'equity' or 'subordinate' tranche, which may comprise between 5% and 40% of the total value of all trust liabilities, bears the first default losses.

Equity investors generally receive a high yield due to the magnified, leveraged risk they take. As the size of the equity tranche is invariably greater than the expected default losses of the pool, this equity tranche, no matter how small, tends to have the default risk of the entire pool.

Clearly, the issuer will sell assets to a trust to effect the securitisation only if such a transaction is profitable in some sense for the issuer. There are several potential motives for the issuer. The first is simply the desire to obtain more capital for the particular business activity.

A second is that it takes debt off the issuer's balance sheet. Banks securitise to reduce their 'risk assets' in order to meet the Bank for International Settlement capital rules.

Finally, securitisation can be a viable business strategy to enable the issuer to leverage its risk position (a good example being the high-yield bond fund manager that issues a collateralised bond obligation and retains the equity tranche).


Simon Best, ING Barings

Actual deals

If securitisation is, indeed, a viable means of debt reduction for European governments that seek to join EMU, then theory is still ahead of practice. "There have only been isolated cases of securitisation for sovereign debt reduction," said Simon Best of ING Barings. One such case is the sequence of Fennica transactions that ING Barings has led for the Finnish government.

The Housing Fund of Finland (ARA) – a government entity – lends to property companies, housing companies, municipalities, and others for the purpose of constructing social housing. To fund the loans the government must increase its own debt burden.

The ARA embraced securitisation in two transactions: Fennica No 1 plc and Fennica No 2 plc. The former provided US$364m in US dollar-denominated securities while the latter gave investors FM1.5bn in Finnish markka investments.

Duff & Phelps and Standard & Poor's rated the senior tranche Triple A in both trades and a mezzanine tranche Single A. Subordinated loans from the ARA to the trusts added credit support for the mezzanine and senior tranches.

Paul Taylor of Duff & Phelps confirmed that the subordination of the loan and mezzanine tranche provided the Triple A rating to the senior tranche. In the US dollar trade of Fennica No 1, this rating exceeds the Double A credit standing of the Finnish sovereign.

Financial Security Assurance, a UK guarantor, insured the trust's performance on a US$/FM currency swap to permit the Triple A rating of the senior tranche. (The swap converted cashflows from the Finnish markka assets to those of the US dollar liabilities.)

Teuvo Ijäs, director general of the ARA, cited three benefits of securitisation: the government avoids increasing state debt; the government continues to guarantee funding for social housing; and, even in recession, the government can improve employment by maintaining the construction programme.

The first two of these benefits provide the ideal situation for government planners. The government creates a programme (such as social housing) and then funds it in the private sector. The third benefit echoes the advantage to the government of being freed of the requirement to fund the programme.

The ARA also considers the funding level of the senior tranche to be quite attractive relative to the state's unsecured debt. A Fennica No 3 deal will follow. It is also likely that similar transactions will take place in Finland and Sweden, according to Ijäs. The subordinated loans, which are the equity tranches of these deals, "have no risk for the government since the loans perform very well".

But the subordinated loans do stick out as an issue for consideration. The benefits of securitisation that the director general cites come down to one interesting point: a government can create and direct its projects with private financing. Truly 'free' programs do not exist, of course. Somebody somewhere must bear the cost.

In this case the citizens of Finland bear the risk of social housing loan defaults in the form of the ARA's subordinated loans and, thus, pay the costs of the social housing programme. Had a private lender made these loans, then the Finnish government would be taking a risk-free and cost-less position (assuming the housing loan proceeds were nominally sufficient to meet all debt service obligations).

Luke Mellor of ABN AMRO observed that the UK government has launched several securitisations (eg, Annington Homes and Angel Train Contract). These transactions "have the effect of reducing debt, but that's not the most important aspect", according to Mellor.

In Annington Homes (see ISR No 28, March 1998), the Ministry of Defence sold houses to the bankruptcy-remote trust and leased them

back with guaranteed minimum payments. Investors that purchased the Triple A and Single A liabilities of the trust funded the government's military housing programme.

It appears in this transaction that the issuer (Ministry of Defence) did not retain the equity. In this way, it shed all the real estate risk but also paid a premium for the funding. That is, the average yield investors receive (well over sterling Libor) is far greater than the level of UK government direct debt that would support the housing as government assets.

The UK government is pursuing its private finance initiative (PFI) with such trades. The PFI "is phenomenally active" in the words of David Wallis of MBIA-Ambac, a guarantor that insures many of the structured transactions. "While meeting EMU criteria is not an explicit incentive, the government does seek to minimise its direct debt. It provides a more efficient form of financing."

As noted above, it does not appear that the financing is 'efficient' in terms of providing a smaller funding cost than direct debt. But these PFI structures do seem to remove risk from the UK government to the extent that the government does not retain an equity position. It therefore seems reasonable to pay a higher funding cost to eliminate risk.

Wallis' view is that this claim of higher ultimate interest cost and reduced risk for the government misses a key advantage of the PFI: the privatisation aspect imposes a market discipline and "keeps costs lower through the competitive process"

SBC Warburg led the Optimum Finance securitisation. The Italian Export Credit Agency (SACE) sold the right to receive Paris club debt proceeds to an SPV. The debt represents restructured emerging market receivables payable (originally) to Italian exporters. (See ISR, March 1998.)

Securitisation certainly does remove debt, so it is not at all unreasonable to report a lower debt level as a result

The export agency receives US$650m from the SPV in the latter's sale of Triple A, Double A and Single A tranches to private investors. This funding reduces the Italian government's debt. The total value of the SPV's assets (ie, Paris club debt), however, is US$805m. The extra US$155m is equity overcollateralisation. It appears that SACE retained the equity tranche.

There has not been a rush of deals yet to reduce debt to meet EMU criteria. ING Barings' Best does not foresee a future rush, either. "The EMU countries don't really meet the debt and deficit targets, anyway," he observed.

(The EC judged that Greece alone of the 15 EU nations did not meet EMU entry criteria. Greece's rate of inflation, budget deficit, and total debt are excessive. But Italy and Belgium 'passed' the screen despite a clear failure to meet the 60% numerical guideline for debt as a fraction of GDP. Their debts are double this benchmark. Furthermore, although generally not missing by a wide margin, Denmark, Germany, Spain, Ireland, the Netherlands, Austria, Portugal, and Sweden failed to hit the 60% mark as well.)

The point is that there will be less debt reduction of any kind if the will and discipline are lacking.

Paul Taylor, Duff & Phelps

Maarten Stegwee of Banque Paribas offers an opposing view. "Government securitisation is an extraordinarily important area for our business," he said. Stegwee sees most of the activity in Italy, France, Spain and the UK in which, with the exception of the UK, the countries prize the concomitant debt reduction that improves the likelihood of meeting EMU debt/deficit criteria.

"We've only scratched the surface" In terms of EMU-motivated government securitisation programmes, "we've only scratched the surface", according to Stegwee. "The German government wants to sell real estate in privatisations. Italy will see many more trades like Optimum Finance. Spain is liberalising its legal and regulatory framework for asset-backed securities."

Apparently lax entry standards for EMU also worry Stegwee. "There is danger of a weak euro due to unemployment in Spain and France and debt in Belgium and Italy." Finding opportunity in distress, he added: "Eleven countries now have incentive to reduce continuously their debt burdens."

Acceptable to EC?

Does the European Commission 'approve' of this form of debt reduction for entry into the monetary union? Robert Palache of Clifford Chance said: "It's hard to say. Each government reports its own financials with 'generally accepted' accounting principles. There's no audit from Brussels."

A few other market participants echoed that view. There appear to be two views of the situation. Securitisation certainly does remove debt, so it is not at all unreasonable to report a lower debt level as a result. Even with a change in the debt level, however, one may wonder if the underlying economics have changed at all.

Let us imagine that a country borrows funds to build a toll-road. The government now has debt and an asset (the road with an accompanying revenue stream). It can choose to keep both the debt and the asset and permit the toll revenues to service the debt. Or it can sell the asset (in a securitisation) and retire the debt with the proceeds of the asset sale.

The country's debt level falls in this latter option, but have the economics of the country changed at all? The debt is gone, but so is the asset that would have serviced the debt. A key issue would seem to be the risk. The risk in any business and country is that the assets will underperform, fall in value, and leave the owner with debts that are more difficult to honour.

To the extent that securitisation leaves the government better able to meet its other debt obligations without recourse to inflationary practices, the debt reduction should certainly 'count' in the European Commission's review of a country's finances.

Maarten Stegwee, Banque Paribas

Concern over equity tranche

Consider the high-yield bond fund manager that issues a CBO. This manager's true goal is to borrow other people's money to finance his/her purchase of risky bonds. The senior tranche often bears a Double A or Triple A credit rating which means that, barring an absolute catastrophe, the trust will be able to pay interest and principal to all senior investors.

In other words, the senior tranche risk is much less than that of the total asset pool of non-investment grade bonds. The equity tranche removes almost all of the risk from the senior securities by serving as 'first-loss protection'.

The flip side is that this equity tranche bears much more risk relative to its size than does the entire, non-investment grade asset pool. The assertion that the equity investor bears the risk of the entire asset pool is approximately correct as, relatively speaking, the senior investor has essentially no risk.

The strategy of the high-yield manager, then, is to retain the equity tranche and sell the senior tranche. This manager deliberately holds the risk for the upside gain potential that will accrue if he/she manages the portfolio well.

Banks pursue the same strategy when they retain the equity in CLOs. Issuers that hold the equity maintain upside potential but continue to bear the downside risk as well. That is, the securitisation has done nothing to reduce the issuer's risk position.

This observation is particularly relevant for debt-laden countries (or companies) that reduce their debt loads by securitisation. Retention of the equity does not reduce this entity's risk.

Yet, it is this 'debt risk' that provides the motive to reduce debt. Reduction of debt without reduction of risk does not serve what should be the true purpose of debt and deficit-reduction for entry into EMU.

The equity tranches of the two Fennica transactions are the subordinated loans from ARA. SACE, the issuer of the Optimum Finance structure, retained the equity interest in the form of the overcollateralisation of the rated SPV liabilities. Issuer retention of the equity, and thus virtually all of the risk, does appear to be the norm in European sovereign securitisations.

To be fair, it is often difficult to sell equity in asset-backed deals. The most likely buyer is the investor that best understands the trust assets and this investor is generally the issuer (that sold the assets to the trust).

Sovereign securitisation recipe

For a sovereign entity that wishes to reduce its direct debt burden by securitisation, let us list the steps to follow to bring the transaction to market. First and foremost is the decision to securitise. Although there are clear benefits, securitisation does introduce more complexity to a state's funding programme.

The government incurs expenses in the form of underwriting fees and the time and energy of employees to build and tell the 'story' of the underlying assets to investors, rating agencies, and other external parties. The government entity will likely disclose much more to the public about its programmes than it would otherwise.

After deciding to securitise, the issuer must consider whether to hold or sell the equity. Holding the equity keeps the visible costs low as the trust need only pay interest to highly rated senior tranches. In this case, however, the issuer retains essentially all the risk of the assets and has, therefore, gained little in terms of true economic benefit.

(After all, it is likely the government entity could have issued direct debt in place of selling senior tranches at interest levels more favourable than these asset-backed securities. All the issuer gains is the appearance of less debt.) Selling the

equity, on the other hand, removes the issuer's risk and is thus highly defensible as 'true debt reduction'. But it is more expensive. The trust must pay a high return to equity investors.

Furthermore, the issuer that sells the equity tranche loses much control over the programme. Consider Fennica. The issuer (Finland's ARA) holds the equity in the form of subordinated loans.

If borrowers of the social housing loans default, the ARA as the subordinated lender takes the losses and can forgive the defaulted debt or restructure it if it feels such steps conform to the political and social purpose of the programmes. If a private entity had made these loans, the government would have no such control.

Next comes the decision of which assets to securitise. All governments have a variety of programmes that offer various options. Ideally, the performance of the assets should be understandable and predictable. The actual risk of the assets is less important than these two characteristics.

It is often difficult to sell equity in asset-backed deals. The most likely buyer is the investor that best understands the trust assets and this investor is generally the issuer

For example, the Optimum Finance securitisation for SACE is quite sensible in that the investor community understands emerging market debt. It is risky, but the investor may calibrate the risk to known securities in the market.

(We should note that a complication in this transaction was that the issuer did not tell investors precisely which individual sovereign risks the trust held. Undoubtedly, this made the sale to investors more difficult and pushed the yield higher.)

The issuer must then hire an underwriter that understands the asset class and how to appeal in an optimal manner to the target investors. Because the asset class will be difficult to understand, in general, the bulk of the investment for sale must have a high credit rating.

That is, the underwriter must work with one or several prominent rating agencies and must determine how best to produce a high rating for most of the investments it sells to the public.

The senior tranches will earn high ratings by pure structuring (ie, the existence of significant equity or subordinated debt) or by purchasing a financial guarantee from firms such as MBIA-Ambac or FGIC (the Financial Guaranty Insurance Co).

The last steps of choosing the best structure for the target market and executing the offering hinge on the expertise of the underwriter. The most important steps, however, are the first two over which the sovereign has direct control: the decision to securitise and the choice of assets.

Securitisation is resoundingly positive for the sake of political and economic democracy in that it encourages the government to scrutinise the benefits and costs of its programmes and to present such programmes to the public.

Summary

Monetary union is coming to most of Europe. Despite the certainty of many, it is a large-scale and interesting experiment in political economics. Entry criteria, which are daunting to some prospective member states, are forcing participants to find creative solutions to persistent debt and deficit problems.

Securitisation has provided a debt-reduction solution to financial institutions and private corporations for more than a decade and boasts other benefits as well. This article discussed the application of securitisation to governments reducing debt burdens in their applications to join EMU and a small number of trades that have taken place.

Although not completely clear, it appears the European Commission would accept such steps. There are questions, however, regarding the extent of true risk-reduction accompanying debt reduction in some implementations. The steps a government must follow to bring a securitisation to fruition have been listed. The most important of these is the initial securitisation decision itself.

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