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Chapter 8

Sovereign Securitisation in Europe

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1. INTRODUCTION

The increased number of sovereign ABS deals, as well as the continuous innovation and diversity in the legal structures used, have confirmed that public sector entities are getting more acquainted with a corporate-like handling of their balance sheets and that securitisation has definitely become a financial tool to which sovereign entities resort to keep within their strict indebtedness limits and budget constraints, while still maintaining the ability to pursue the investments and policies they envisage in many sectors of their activity.

Following the groundbreaking Portuguese delinquent tax receivables deal, and with the need to comply with limitations on public deficits and debt issuance as intense as ever, 2004 and 2005 have seen new and creative transactions sponsored by the national authorities of Germany, Belgium and Italy, as well as a spate of sub-national level deals set up by municipalities and autonomous regions, also pressured by the reduction of flows from the central governments.

As anticipated in the Yearbook 2005, the diversification of securitised asset types, the implementation and success of new and innovative legal structures and the promising results achieved by public sector securitisation show that securitisation

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has become a powerful financial tool for sovereign and quasi-sovereign entities, suitable to attain not only purely budgetary goals, but also to help governments and their regional or local subdivisions implementing overreaching social and economic policies.

Having these developments as background, we aim in the following pages to provide a general (legal) update on the public sector securitisation market in Europe. With this goal in mind, we will both look into the performance of the transactions set up in previous years and see how they have resisted the passage of time, as well as briefly going through the most important structures that have come to light in 2005, originating from multiple different sources and revealing very interesting features for the expansion of the securitisation concept. Also, we attempt to draw an overview of what the future of public securitisation may be and try to identify which new trends in terms of legal structures, asset types and originators may come into play.

2. WHY GO ABS?

With grey clouds over European economies which fail to deliver steady economic growth rates, and with stringent public debt and budget deficit limitations, in spite of the momentary easing of the rules decided during 2005 the incentives are more than ever there for sovereign entities to move towards new financial tools such as asset securitisation and monetization of public assets/credits.

Naturally, the main attractiveness of public sector securitisation lies in the ability to raise funds to face financial and budgetary needs, in a context where the flexibility that has been obtained with the recent amendments to the Maastricht Treaty and the Stability and Growth Pact, aiming at dealing with the difficult economic situation endured by most economies of Europe, did not waive the very tight limitations to which Europe's big and small economies are still subject. Thus there is the need to monetize valuable assets and to seek to market them for the purposes of raising funds through alternative financial means while keeping as narrow as possible the access to traditional means of finance.

However, reality is showing that the benefits of securitisation are not limited to financial and budgetary gains. Indeed, the market pressure which is introduced in the management and servicing of the securitised assets often adds significant value and operates as a crucial efficiency-enhancing tool. The need to ensure steady cash-flows to meet the liabilities to investors leads inevitably to higher, more efficient standards, thus rationalizing and improving revenues.

Moreover, also of significance are the externalities that these deals might trigger in relation to the public administration structure, services and equipments which are in many cases linked to the need to supply the investors, market regulators and specialized press with appropriate disclosure of the performance resulting from the accomplishment of the servicing tasks.

3. BUSY YEARS IN EUROPEAN PUBLIC SECTOR SECURITISATION

3.1. Belgium's Delinquent Tax Receivables Transaction

Driven by the need to meet the budget deficit limitation imposed at the EU level, The Kingdom of Belgium became in 2005 a new member of the sovereign ABS originators club with the setting up of a delinquent income tax receivables deal arranged by JP Morgan. Involving asset types (the transaction includes corporate income tax, personal income tax and tax penalties) and a legal structure close to the Portuguese Explorer deal, the Belgium transaction aims at a triple A rating by contemplating a massive over-collateralisation (with the issuance of EUR500 million in notes for the purchase of a EUR9.488 billion portfolio) and by relying strongly on the suitability and reliability of the servicer's performance of its collection tasks.

These mechanisms, plus liquidity facility lines and the swap arrangements that were also created to the benefit of the issuer and also forming part of the isolated pool of assets corresponding to the transaction, ensured the necessary credit enhancement and liquidity structure required to obtain the envisaged ratings.

One particular risk worth mentioning, which can be said to be somehow typical of these public sector deals (in particular those which involve 'sensitive' assets such as tax credits) is the fact that the servicer – The Kingdom of Belgium acting through the Ministry of Finance – cannot be replaced, even in case of poor performance. This derives naturally from the sovereign nature of the tax collection task, which due to Constitutional concerns, cannot by transferred to private entities.

Proper mitigation of this risk is thus a crucial concern, which was essentially addressed by features such as the interest in the portfolio kept by The Kingdom of Belgium (operating as a strong incentive for collections to be as successful and efficient as possible), as well as the incentive fees that the servicer is entitled to receive (thus allocating the servicing compensation in a manner that incentivizes collections, even in the more stressed assets contained in the portfolio).

Moreover, another of the rating agencies' concerns was to obtain detailed and insightful information regarding the relevant enforcement and collection procedures, so as to assess the probabilities and time frames of the recoveries relating to the assigned tax claims. Once these issues were properly dealt with and evaluated on the basis of extensive legal review and due diligence on the applicable rules in the context of the relevant transaction documents, the rating agencies accepted the servicing structure proposed for this deal as being compatible with maximum rating requirements.

Another interesting feature of this transaction was the circumstance that it relied on an unrated entity – Poste Financiere S.A. – to hold the accounts where collections are paid in, thus raising commingling and bankruptcy concerns. This imposed on the originator the commitment to pay to the issuer of the Notes any amounts not transferred by Poste Financiere S.A. to the transaction, thus reducing the commingling and general bankruptcy risks inherent to the structure and thus contributing decisively to the (legal) reliability thereof.

3.2. German Transactions

A context of postponed economic recovery and of continuous high public deficits (which crossed the three per cent threshold for the third year in a row) has also led German government, not traditionally open to engaging in transactions implying the use of legal concepts that are new to a German law environment, to enthusiastically embrace the use of securitisation technologies. In the last couple of years, the ABS market has seen the German Government securitising Russia's Paris Club Debt, as well as the future pension contributions originating from its post and telecommunications privatized companies.

The first deal saw a Germany based SPV – Aries Vermögensverwaltungs GmbH – issuing over EUR5 billion of fixed- and floating-rate credit-linked notes, linked precisely to the obligations of the Russian Federation that were issued and governed by the so-called 'Paris Club' arrangements, thus sharing with investors and the markets Russia's default risk.

Again, and confirming a typical characteristic in these sovereign structures, this deal was based upon massive over-collateralisation – with the securitised Russian sovereign debt amounting to over EUR14 billion for debt issuance worth EUR5 billion. The complex legal structure which was implemented, however, contemplated further mechanisms to address the risk of default by Russia under its sovereign debt. Moreover, the fact that the notes issued were of a credit linked nature (rather then a straightforward pass-through of the amounts paid by Russia), the structure depended on the capability of KfW to perform its obligations towards the issuer of such notes, as well as on the hedging mechanisms put in place.

As for the pension funds securitisation, it basically consisted on the sale of future cash-flows worth EUR8 billion which the federal post and telecommunications pension fund (named '*Bundes-Pensions-Service für Post und Telekommunikation*', (BPS-PT)) is entitled to receive from the (privatized) successors of Germany's postal and telecommunication companies (Deutsche Telekom, Deutsche Post and Deutsche Postbank).

Probably the most special feature of this transaction is the circumstance that, under German law, the Federal Republic of Germany is under the commitment to keep the solvency and liquidity of the seller, which ultimately results in having the issued notes pertaining to this transaction as being backed by claims that, at the end of the day, are guaranteed by the Federal Republic of Germany. Accordingly, the ratings which the transaction aims at rely essentially on the credit risk of the Federal Republic of Germany itself.

This circumstance was particularly important to overcome the special risk triggered by the fact that the 'debtors' (i.e. Deutsche Telekom (A3), Deutsche Post (A1) and Deutsche Postbank (A1)) were entities with ratings lower than those

awarded to the notes. This means, however, that the rating of the transaction becomes sensitive to the rating of the Federal Republic of Germany.

3.3. Explorer Developments

A final word in this Chapter is needed to mention the recent developments that occurred in respect of the performance of the Explorer transaction, the Portuguese securitisation of tax and social security credits in arrears.

Highlighting the portfolio risks of such transactions, some of the junior tranches of the Explorer were downgrades by Fitch and Moody's in the course of 2005. These agencies downgraded their ratings of the junior tranches after the collection of arrears from February 2004 to August 2005 fell EUR427 million below target, reaching only 56 per cent of the figure initially forecast by Fitch.

However, it is worth mentioning that while certain junior tranches were subject to a downgrade of their ratings awarded by said agencies, the triple A rating of the senior classes was reaffirmed by Moody's and Fitch, thereby confirming in an implicit manner the strength of the legal structure the transaction was constructed under.

Moreover, the available data in respect of the servicing performance shows that, notwithstanding the low collections in the course of last year, the overall level of recoveries by the servicer has actually been steadily improving, and that the special measures that, as part of the transaction structure, have been put in place by the Republic of Portugal in order to enhance the efficiency of the enforcement of the securitised claims, have proved successful.

4. RATING ENHANCING (LEGAL) FEATURES

Looking carefully into the structures implemented in the last couple of years with public originated debts as underlying assets, it is now possible to highlight those that seem to have the critical legal features that allow the smooth setting up of reliable structures for these types of assets, capable of achieving top legal security, as evidenced by the ratings achieved by the transactions conducted so far have.

Naturally, the stability and consistency of ABS structures originated by public sector entities relies on a number of legal features that are also relevant in private sector deals. Over-collateralisation, deferred purchase price/equity pieces mechanisms and high advance rates, coupled with adequate swap and liquidity arrangements to ensure interest payments even in case of momentary shortfalls, are crucial to the structure's stability.

Likewise, attention must be paid to the gathering of good historical data (preferably going back as far as 10 years) and to the quality of the due diligence conducted in respect of the relevant assets, as well as adequate due diligence in respect of the legal framework that applies to such assets (origination, enforcement, servicing, etc.), particularly on stress scenarios. Sticking with the legal issues, having in place adequate indemnities and asset substitution mechanisms, as well as efficient ways to avoid commingling concerns and tools to handle things properly in a bankruptcy context, also concur to the achieving of success in the setting up of the transaction.

On top of the requirements that are already common in private sector securitisations, there are, however, certain particular concerns that are usually triggered by public sector securitisations and which require a careful legal work in order to mitigate and risks to the reliability of the structures. Given the special nature of these deal and following the experience resulting from previous public sector securitisations, the rating methodology must also focus on specific features that are crucial to handle properly the particular risks associated with the assets involved, their peculiar characteristics as claims governed by public laws, as well as the issues associated with the sovereign nature of the entities involved.

First, and unlike what happens in typical private deals, the public interest nature of the servicing roles makes it hard to allow for substitution of the initial servicers. In some transactions, as is the case of the above described Belgium deal and as was also the case of the Portuguese Explorer transaction, the law expressly prohibits the servicer to be replaced, irrespective of the level of performance of the collection tasks. Experience shows that there are however sound ways to address these concerns.

Naturally, the selection of the servicer in the first place plays a fundamental role, as well as the need to establish, since the very beginning, adequate and very clear goals in respect of the performance levels that the structure requires. This means that proper attention should be paid in the preparation of the transaction's collections flows, and to the adherence of the servicer to adequate standards of performance, that ensure compliance with the transaction 'business plan'.

In addition, it should be made clear that any authority entitlements and administrative prerogatives relating to the assets enforcement procedures – and which are particularly important in respect of tax or social security claims – are kept in place during the life of the transaction.

This may not be enough though, and further mechanisms to mitigate the moral hazard risk of the servicer may be needed. Therefore, the concept of incentive fees – which are not that common in private originated deals – may be an efficient tool, gathered naturally with a continuous surveillance of the performance of the transaction until the very end thereof, notably by means of proper and regular servicer/investor reports and regular contacts with the servicer.

Moreover, this concern may be further addressed by having the sovereign entity maintaining an interest in the deal, namely by acquiring subordinated tranches or by providing for deferred components of the price paid for the acquisition of the assets, which allow for the upside of the transaction once all the notes are paid in full.

Finally, also decisive for the success of any transaction will always be an in-depth research and knowledge of the political, economic and social context that surrounds the sovereign originator ready to enter the market. This is surely of fundamental importance in order to assess the political risks that may be associated

with contracting with sovereign entities. One must not forget that these entities will often have the power to change the laws, and thus to change the rules under which the transaction evolves.

5. PUBLIC SECTOR SECURITISATION: GOING FORWARD

Public sector securitisation has definitively established itself as a 'to be considered' financial tool for sovereign entities, witnessing an impressive expansion (of originators), diversification (of asset types) and sophistication (of structures and legal features).

The increasing number of deals set up in the last couple of years, the news of more and more transactions in the pipeline of other sovereign or quasi-sovereign entities, as well as the growing (financial, accounting and legal) debate over public sector securitisation proves that the busy days of this market are not a mere coincidence and that this trend shows no sign of hesitation. On the contrary, and as we hope to have demonstrated in the previous pages, the legal 'technologies' made available to the market allow for the smooth implementation of asset-backed structures originated by public sector entities.

This does not mean, as we also hope is clear from the above discussion, that it is always an easy road to follow. In addition to adequate credit risk assessment, and on top of the common concerns that asset backed transactions for the private sector usually raise, there are specific risks triggered by public sector securitisation that must be tackled so as to ensure the reliability of the structure and, thus, its performance in the financial markets.

The opportunities are certainly there in a wider European context for public securitisation and it is therefore a good challenge for all market players (sovereign entities but also arrangers and investors) to seize them.