Regional government debt and the hispabonos debate: Considerations for an improved regional financing model

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Access to finance is become increasingly constrained for the regional governments. In this context it is even more necessary to improve their ability to fund themselves. However, the introduction of any new regional financing mechanism must properly take into consideration market pricing rationale in order to minimize downside risks.

Acute credit restrictions and international investors' growing mistrust of Spanish risk is making it nearly impossible for the regions to meet their financing needs based on traditional fund raising models. In response to these concerns, this article analyses the state of regional debt markets in 2011 and the need for alternative solutions. Consideration is given to a range of options for greater Treasury intervention, including the hispabonos debate, or the creation of a specialized vehicle for regional and local government funding to improve the regions' ability to finance themselves and meet debt service and other budgetary obligations.

The Spanish regions' funding market in the current context

Last year, the regional governments again funded themselves in unprecedented volumes through a wide variety of debt instruments, exploring new ways of accessing the markets. Despite the upheavals of recent years, the regions have until now been able to adapt their borrowing policies to the conditions in the capital markets. However, the acute credit restrictions and international investors' growing mistrust of Spanish risk mean that the existing model can no longer be relied upon to fulfil funding needs, which we estimate at 35 billion euros for this year.

When the regions embarked on their first major transformation twenty years ago, a good part of their debt was subject to a process of disintermediation, led by Andalusia, Catalonia and the Basque Country, through the issue of eurobonds rated by the rating agencies. This freed up the domestic market, saturated in the 1990s crisis by the Spanish public administrations' strong demand for loans from the country's banks.

Two decades later, much of this process has suffered a setback, with international investors losing interest in Spain. Although the ECB's extraordinary liquidity injections created some windows of opportunity in the market for those

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borrowers with stronger solvency ratios, demand for their bonds has been concentrated almost exclusively in the Spanish financial system, with the participation of foreign investors being little more than symbolic.

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In this context, the activity of the rating agencies has been characterized by a procyclical line that has seen Spain's credit rating cut to an average A and some regional governments have even fallen below investment grade.

Exhibit 1

Regional ratings (May 2012)

	Fitch-IBCA		S&P		Moody's	
Spain	A	Negative	BBB+	Negative	A3	Negative
Andalusia	A	Negative	BBB	Negative	A3*-	
Aragon			BBB	Negative		
Asturias	A*-					
Balearic Islands			BBB-	Negative		
Basque Country	AA*-		A	Negative	A2	Negative
Canary Islands	A*-		BBB+	Negative		
Cantabria	A*-				WR	
Castile-La Mancha	BBB+*-				Ba2*-	
Castile-Leon					A3	Negative
Catalonia	BBB+*-		BBB-	Negative	Baa3*-	
Extremadura					A3*-	
Galicia			BBB+	Negative	A3	Negative
Madrid	A	Negative	BBB+	Negative	A3	Negative
Murcia	A*-				Baa2*-	
Navarra			A	Negative		
Valencia			BB	Negative	Ba3*-	

Source: Reuters, Bloomberg and Rating Agencies.

Regardless of the merit of recent rating actions, the fact is that the imbalances generated during this recession have lasted much longer than expected, even in the face of the government's efforts to contain the growth of public spending.

As a result, Spain has experienced a widening of risk premiums toward levels indicative of market failure, but these levels also reflect the absence of investors in the regional debt market. Some regions have already made public their demands for a solution involving the central state, which would provide a mechanism for the funding volumes required this year, bearing in mind that so far barely 8 billion euros have been raised.

This is the context of the debate on the possible development of hispabonos. Although this term is used with different meanings, depending on who is using it, the fact is that regional governments were in need of an alternative mechanism for stable funding. There is no unanimity because some regions are seeking full-scale Treasury involvement, specifically the provision of an explicit guarantee, while other regions are more in favour of limiting the Treasury's contribution to attendance at investor presentations and the coordination of issuance schedules.

This article aims to present the starting point of the regional debt market in 2011 and to analyze the possible alternatives by looking at solutions which have already been explored in other European countries, also with a view to decentralising the provision of services to the population.

Characteristics of the primary market for regional debt in 2011

Last year, the regions raised gross funding of close to 30 billion euros, a spectacular increase bearing in mind that the pre-crisis annual average was 6 billion euros. To achieve this, regional governments have adapted their borrowing policies, adopting strategies to diversify their funding sources and accepting higher costs and shorter maturities. The primary market has been characterised by:

i) **Increased presence in the retail market through public issues:** Issues aimed at retail investors contributed more than 10 billion euros in funding in 2011 at terms of up to 2 years, more than double the amount raised from this source in 2010, when they were first issued.

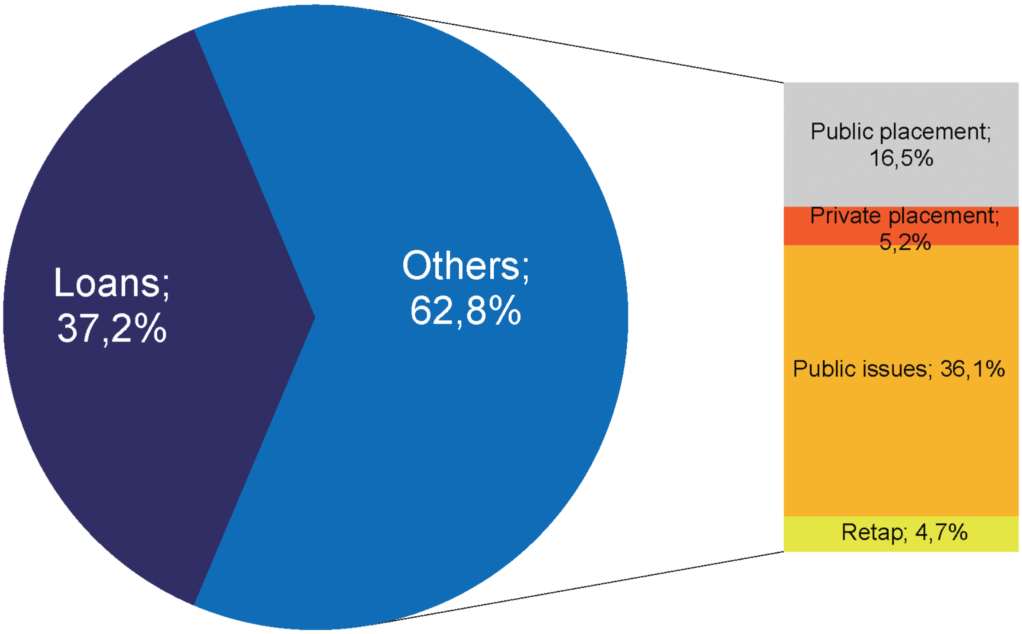
ii) **Fragmentation of borrowing:** Borrowing in 2011 has been centred on the increased use of existing issues (tap issues) and private placements. These instruments have accounted for the largest number of operations. However, with an average issuance amount of 50-75 million euros, if their size does not increase, some regions will find it necessary to renegotiate dozens of operations, as retail issues and public placements are showing signs of exhausting their potential.

iii) **Shorter funding terms:** The average term of new operations in 2011 was less than 4 years, below the average of 7 years of all regional debt at the end of 2010. This shortening of maturities is due mainly to the weight of the retail placements at a maximum term of 2 years, as well as the intensive use of short-term borrowing. Although these instruments, such as credit lines, are designed for cashflow management, some public administrations have been obliged to resort to them as they are unable to raise long-term debt until market conditions improve or they receive the necessary ministerial authorization.

iv) **Greater differentiation in funding costs:** The differentiation of risk premiums between the regions was minimal until a couple of years ago. However, investors are now increasingly discriminating among regions, not only on the basis of credit ratings, but also on the basis of a series of variables

Exhibit 2

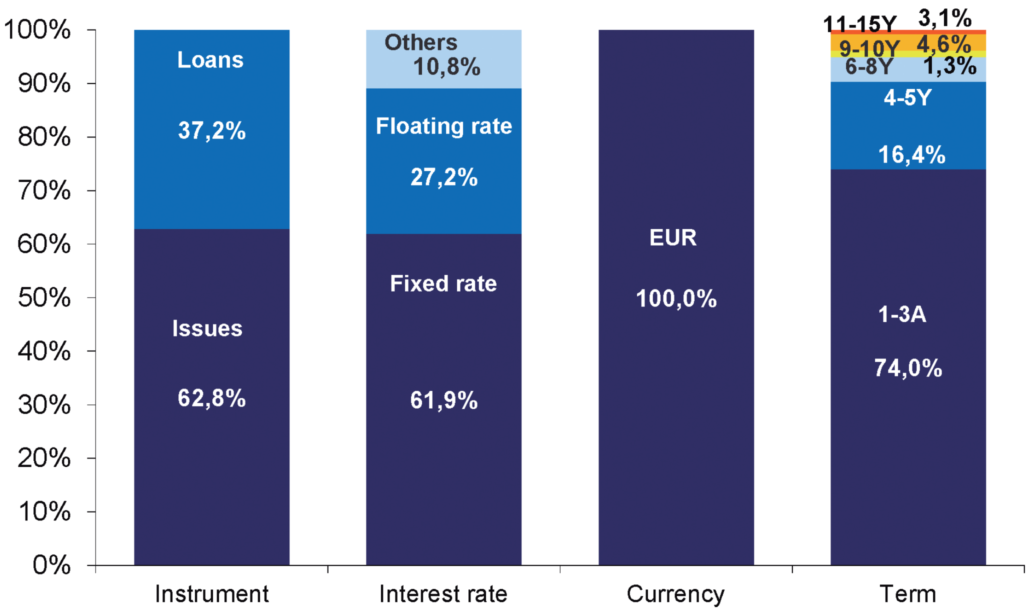
Instruments issued by the regions in 2011



Source: AFI

Exhibit 3

Features of regional borrowing in 2011



Source: AFI

> indicative of the borrower's credit worthiness. Of particular importance are: the degree of commitment and compliance with budget targets, size of the debt, market experience and access, and the liquidity of their issues.
>
> Using the Spanish Treasury yield curve as a basis, investors have been adding a common spread for sub-sovereign risk, which is further increased depending on the specific situation of each region. In 2011, this spread has ranged from 80 bp over the Treasury curve for the best rated regions to more than 300 bp when the market's perception of deterioration was at its height.

Extending this analysis to the first quarter of 2012, we can include additional elements that aggravate the regions' difficulties to access new funding. On the one hand, retail investment is showing signs of exhaustion, with demand limited to rollovers, rather than attracting new savings. On the other hand, the margin of error for increasing the amount of repayments in the coming years is smaller, due to forecasts for further deficits and the financial burden arising from the need to cover each year's gross funding requirements. In short, there are strong arguments in favour of developing support mechanisms and greater collaboration between the central state and regional governments in debt financing.

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International precedents and experiences

At least until now, the present government has agreed that a solution is needed to ease the financing of regional budget deficits and has taken some initiatives on this front. One example of this improved collaboration is the Fund for Financing Payment to Suppliers (FFPP in Spanish). This mechanism provides different public bodies with access to credits guaranteed directly by the Treasury, in the amount of almost 28 billion euros, which will allow a good part of the commercial debt owed to the private sector to be settled. Although this amount is less than the total unfunded deficit from previous periods or than the outstanding commercial debts, it nevertheless provides a strong injection of liquidity for businesses and the self-employed.

Without entering further into the scope and timeliness of this measure, which is undoubtedly very positive for the economy, the Fund represents a first attempt to coordinate efforts to improve the regions' access to the markets, initially through a syndicated loan which from the third year will be refinanced by debt issues. The final borrowers in this transaction are 14 regional governments and close to 5,000 local authorities, to which the market would not have offered the same terms (ten years with a spread of 115 bp over the Treasury rate). Nevertheless, they are the final guarantors, meeting payments with their tax resources, which the state transfers to them periodically via payments on account.

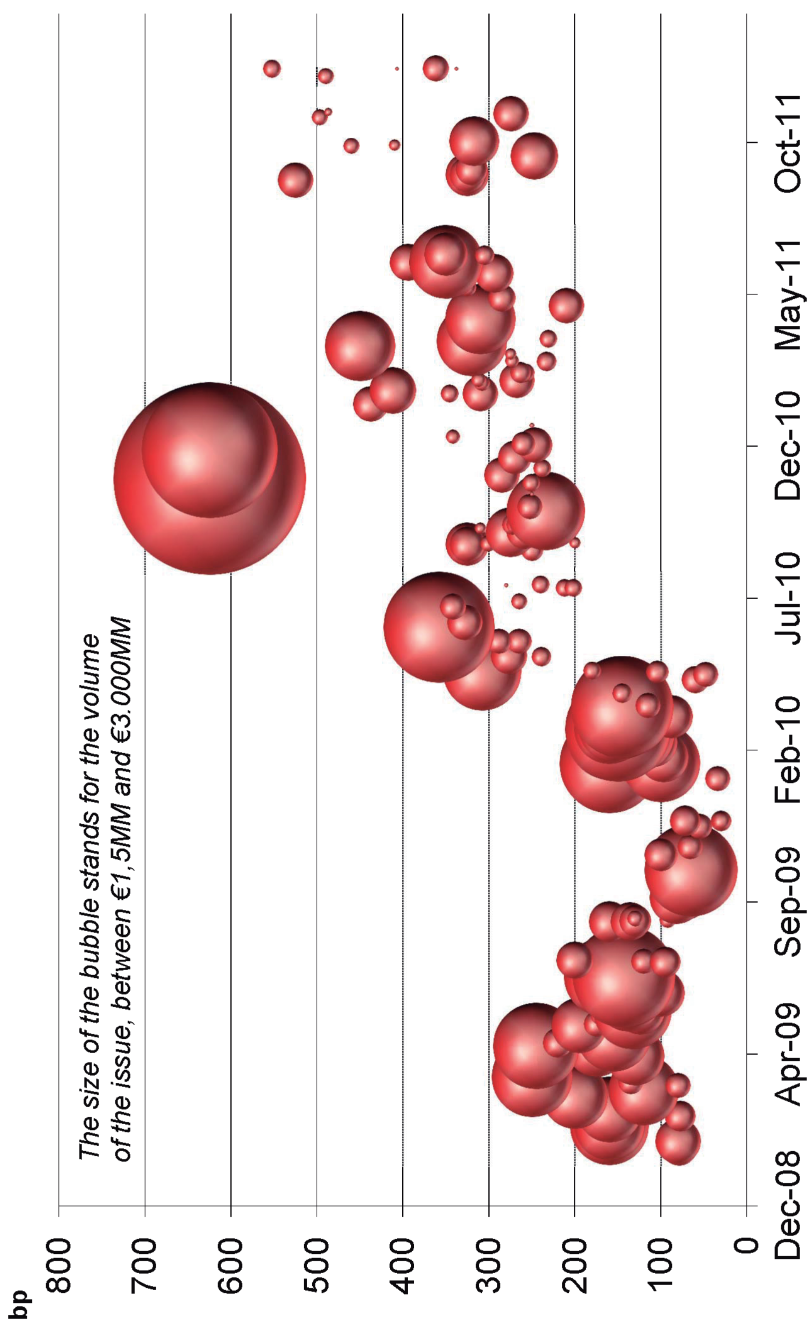
This has obliged the government to reform the Law of Budgetary Stability and Financial Sustainability (LEPSF in Spanish) to give it the legal power to retain the revenues of the regional authorities as a counter-guarantee. Hence, it is a structure involving all the administrations covered by the central government to meet the payment obligations of the regional governments.

Another initiative was undertaken at the beginning of the year when the Official Credit Institute (ICO) designed a short-term funding facility to refinance the debt maturities of regions, seeking to avoid any risk of default on their financial debt during the first half of the year.

Exhibit 4

Financing cost of regional issues in 2011

(bp over IRS to average life)



Source: AFI

Investors are demanding instruments and a market structure which put the Treasury and the regional governments on a more equal footing with regard to debt issuance.

Both of these solutions provide a pragmatic response to the difficult liquidity situation which has been evident in the public sector. However, it is clear that they are provisional measures which do not solve the main underlying problems: investors are demanding instruments and a market structure which put the Treasury and the regional governments on a more equal footing with regard to debt issuance.

Today the funding costs of regional governments show that the markets and the rating agencies clearly distinguish between the Treasury and the regions. If so, a decision which involves, either explicitly or implicitly, the central government's debt growing by 150 billion euros, i.e. 25 %, cannot be harmless.

The possibility of the central government providing an explicit guarantee for regional issues could be an alternative. However, we do not think it is the only one and it also represents an anomaly with regard to both the financial autonomy of the regions and the spirit of the LEPSF. We often hear arguments that minimize the impact of making the state guarantee more explicit. In extreme cases, we believe the government will not allow any public body to default on the service of its debt - as has been demonstrated, for example, with the Valencian Region. Nevertheless, today the funding costs of regional governments show that the markets and the rating agencies clearly distinguish between the Treasury and the regions. If so, a decision which involves, either explicitly or implicitly, the central government's debt growing by 150 billion euros, i.e. 25 %, cannot be harmless. This is even more the case if we consider that the Treasury's annual gross issuance is around 175 billion euros while that of the regions does not reach 35 billion euros.

For a highly decentralised country like Spain, we believe that there is value in the fact that the market recognizes different risks, penalizing or rewarding the credibility and quality of the policies of each administration, central or regional. This does not constitute an obstacle to the implementation of different forms of collaboration but, in this process, taking shortcuts may mean that little differentiation is made between different classes of public and private debt, penalizing central government risk.

Exhibit 5

Debt/GDP of Public Administrations (December 2011)

	Outstanding 2010-2011 (mill.€)				% Debt / Total	Debt/GDP		
	Dec-10	Dec-11	Δ mill €	Δ %	2011	Dec-10	Dec-11	2011-2010
Central Government	488.245	559.459	71.214	14,6%	76,1%	46,4%	52,1%	5,7%
Regions	119.460	140.083	20.622	17,3%	19,1%	11,4%	13,1%	1,7%
Local authorities	35.431	35.420	-11	-0,0%	4,8%	3,4%	3,3%	-0,1%
Total Public sector	**643.136**	**734.961**	**91.825**	**14,3%**	**100,0%**	**61,2%**	**68,5%**	**7,3%**

Source: Bank of Spain

Exhibit 6

Public sector debt of regions (December 2011)

	Outstanding (mill.€)			Debt/GDP	
	2011 (mill.€)	Δ 2010-2011 mill €	%/ Total Regions 2011	%	2011-2010
ANDALUSIA	14.314	2.135	10,2%	9,8%	1,3%
ARAGON	3.403	502	2,4%	10,2%	1,3%
ASTURIAS	2.155	454	1,5%	9,1%	1,7%
BALEARIC ISLANDS	4.432	297	3,2%	16,3%	0,8%
BASQUE COUNTRY	5.536	521	4,0%	8,1%	0,6%
CANARY ISLANDS	3.718	419	2,7%	8,8%	0,8%
CANTABRIA	1.293	301	0,9%	9,3%	2,0%
CASTILE-LA MANCHA	6.587	768	4,7%	18,0%	1,8%
CASTILE-LEON	5.476	1.172	3,9%	9,4%	1,9%
CATALONIA	41.778	7.548	29,8%	20,7%	3,4%
EXTREMADURA	2.021	274	1,4%	10,9%	1,3%
GALICIA	7.009	848	5,0%	12,3%	1,2%
LA RIOJA	900	174	0,6%	11,2%	2,0%
MADRID	15.447	1.956	11,0%	7,9%	0,8%
MURCIA	2.806	699	2,0%	10,1%	2,4%
NAVARRA	2.446	754	1,7%	12,9%	3,8%
VALENCIA	20.762	1.799	14,8%	19,9%	1,3%
TOTAL REGIONS	140.083	20.622	100,0%	11,4%	1,7

Source: Bank of Spain

Bearing this in mind, an alternative that minimizes this risk, in our view, is the establishment of an instrument with a joint and combined guarantee, whose issues would be liquid in the market, creating benchmarks for which the market makers would have an incentive to quote prices in reasonable conditions of supply and demand. Of course, the characteristics of the regional governments as a group mean that the amounts involved are large enough so that, together with the provision of guarantees and the necessary credibility, their issues could become an important asset class for institutional investors.

However, we believe that it is necessary to establish operating principles that do not generate perverse incentives, i.e. the more solvent participants should be assured access to funding on better terms than those regional governments which will benefit most from the existence of this joint mechanism. In any case, our starting point is that all the potential partners in this vehicle have scope to improve on their current situation, at the very least by a reduction in their illiquidity premium, which we estimate at 30-50 basis points. Moreover, consideration should be given to the favourable effect of coordinated communication policies and the economies of scale from any joint vehicle, such as presentations to investors, for example.

These are not outlandish ideas or risky innovations, because joint funding mechanisms have been around in Europe for years, although it must be stressed that they respond to very different needs. For example, in Germany, joint issues have been used mainly in pursuit of increased liquidity, as the regions are guaranteed by the central government. In the French case, joint issues, which do not provide a combined guarantee of all participants, have had the aim of improving the average rating of the participating entities and also of increasing the liquidity of the issues in question. However, in the current funding scenario, the association of issuers in itself, even without sharing additional or combined guarantees, would lead to an improvement in the terms on which the Spanish regions can issue debt.

Another way, perhaps with a more long-term perspective, is the model of the regional funding entities developed in the last twenty years in the Scandinavian countries (Finland, Sweden, Norway and Denmark). Its aim has been to facilitate the funding of a very fragmented public sector of very uneven dimensions, with the aim of solving at source the problems of access to capital markets.

Broadly speaking, these are vehicles, in some cases banks, which are supervised by the

Exhibit 7

Advantages and disadvantages "Specialized vehicle for funding regional and/or local governments"

Vehicle for joint issues by regional governments: Advantages and disadvantages

- **Advantages:**
  - ✓ Reduction in costs compared with separate operations.
  - ✓ Increased participation of investors
  - ✓ Access to investor base in multiple markets and formats. Operability, flexibility and appeal to investors.
  - ✓ Increased liquidity and depth of market with benchmark issues (translating into a more stable investor base).
  - ✓ Possibility of creating a differentiated secondary market.
  - ✓ Economies of scale in admin and management costs.
  - ✓ Cost of constituting the vehicle is affordable and can be recovered through distribution of profits to shareholders (e.g. the regions).

- **Disadvantages:**
  - ✓ Although unlikely, may be more expensive for some regions than issuing alone. Liquidity is very important if ratings are similar.
  - ✓ Risk of debt consolidation? It would be a company that derives its revenue from the market and whose activity is intermediation.
  - ✓ Problems with combined guarantees? Financial efficiency vs. potential political obstacles.
  - ✓ Reduced flexibility. The process of obtaining authorization for debt issues should not be an obstacle to taking advantage of market opportunities.
  - ✓ The institution will need to earn a reputation among investors.

corresponding national authorities and constituted via the contribution of capital by the local and regional governments involved. Their credibility is reinforced by very cautious liquidity management policies (that cover at least a year of maturities), capital ratios in excess of 25% and the direct, joint and combined guarantee of all members (in some cases they also feature the central state's guarantee). Their business model, with hardly any overhead, allows them to be very cost-efficient for the amount of funding they provide. However, although they occupy a dominant position in the domestic market, they are not necessarily trying to cover all the borrowing requirements of their members, in which case local governments have to resort to the other financial institutions operating in the market.

The establishment of this model in Spain could take the form of a bank owned by the regional governments, a body governed by public law, a non-profit agency acting in a manner equivalent to the Treasury, or an open-ended fund without legal personality.

The Central Government has not yet taken a decision about: i) which model will be selected, ii) which type of guarantee scheme will be provided for investors, iii) its role in the model; or, iv) the rate policy to be applied to the regions' funding. At this stage, it has announced that it is in the process of evaluating the distinct options. Nevertheless, the principal actors agree on the need to develop a mechanism that will be operable in the second half of the year, given the urgency to meet the financing needs of regional governments.

Considerations for the future

The Spanish state model places 35% of the burden of public policies on the regional governments, especially those oriented to welfare, such as healthcare, education and social services. There can be no doubt that since these responsibilities were transferred, the improvement in the quality of public services and the provision of infrastructure has been remarkable. However, the budgeting and accounting of these policies has left much to be desired, to the extent that the validity of the model itself has been questioned.

The reforms being implemented in the regulatory framework are intended to convey a message of greater commitment to medium and long-term stability in public sector budgets, and they include mechanisms to promote a rationalization of spending and of the public business sector belonging to the administrations.

However, at the same time, the regions must adopt the procedures and instruments necessary to enable them to refinance debt maturities and cover the gap which arises between income and expenses in exceptional circumstances - and a recession is such a circumstance. Even though Spain is one of the most decentralized countries, it nevertheless also has one of the shortest experiences as such, so it is reasonable to study other experiences, and even more so if systemic dysfunctions, that only lead to financial difficulties, have been detected.

There are already well established regional and local bond markets in Germany, the United States and Italy, to provide a few examples, and more efficient ways of financing of territorial entities, such as that established in some Scandinavian countries.

The possibility of an explicit central government guarantee, though it remains an alternative to consider, conflicts with the principle of responsibility[2] of the various administrations

[2] The principle of responsibility is reflected in article 8 of the preliminary draft of the LEPSF. Its second paragraph notes "the central administration does not assume, and will not be liable for, the commitments of the regions, local corporations and entities related to or dependent on the same, without prejudice to the mutual financial guarantees for the joint implementation of specific projects.
The regions do not assume, and will not be liable for, the commitments of the local corporations nor of entities related to or dependent on the same, without prejudice to the mutual

as upheld in the new LEPSF, and could have undesirable widening effects on the cost of issuance by the Treasury, which is responsible for 80% of the gross debt issued each year by the public sector.

Even without providing guarantees, some of the central government's actions could still provide significant support for regional debt. There can be no doubt that the proactive participation of the Treasury and the Ministries of Economy and Finance in the presentations to investors has been very useful in persuading them of the effectiveness of the government's structural reforms, but we believe a greater coordination and joint action with the regional governments is required. The lack of information and understanding abroad, and even within Spain, about the regional funding model and the distribution of resources among administrations, is an obstacle to accessing the markets on more positives terms, even for the Treasury itself, which is equally susceptible to contagion by the perception of risk emanating from some local and regional governments.

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In summary, other alternatives, that could provide improved functionality and appeal to investors, should be explored, given that in 2012, approximately 35 billion euros need to be raised to finance debt repayments and the forecast budget deficits. In the national context, this is not a huge figure bearing in mind that the Treasury plans to issue up to 190 billion euros of debt, but the effort to do so among 17 regional governments means a dispersion of resources and communication policies which rules out the economies of scale necessary to access international markets when conditions are unfavourable.

Until now, Spain's state model has achieved high standards in the level of public services, even more so if we consider the tax income per inhabitant that Spain is capable of collecting compared with other European countries. However, if Spain wishes to reduce the scope for criticism, whether from the centralist camp or the regional nationalists, the faults detected will have to be corrected. One of the actions required to do so is the promotion of the regions' ability to fund themselves, with a more pragmatic approach than hitherto, to enable them to meet debt amortization and all their other budget obligations.

financial guarantees for the joint implementation of specific projects."