Financing the Spanish public administration in 2013

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Central government financing in 2013 should be as challenging or more so than in 2012. State support will continue to be crucial to meet financing needs of regional and local governments.

The financing of the public administration in 2012 presented a mixed picture. The state managed to successfully meet its funding needs without incurring higher costs than in previous years, partly due to a reduction in the average life of outstanding debt. Regional governments faced significant difficulties, thus forcing the state to set up extraordinary funding mechanisms that will, however, very likely end up becoming permanent for many regions, at least for as long as the present financial situation persists. Local authorities have made a substantial fiscal adjustment effort in 2012, which will allow them greater room for maneuver in funding for 2013. Nevertheless, any return to capital markets seems unlikely under present conditions.

Overview of central government financing in 2012

Since the onset of the financial crisis in 2008, the state's funding strategy has been characterized by continuous increases in public debt issuance. The year 2012 was no exception. During the year, the Spanish Treasury obtained funding of nearly 250 billion euros, some 25 billion euros more than in 2009, which had previously been the year with the largest volume of issues in history. Debt maturities also increased to 153 billion euros in the same period. The stock of debt increased by nearly 97 billion euros, to almost 690 billion euros.

The year 2012 was marked by three clearly distinct phases with regard to state funding (Exhibit 1). In the first, between January and March, the Treasury's financing costs fell substantially –especially short term costs– due to the support provided by the ECB's extraordinary 3-year liquidity injections (LTROs). The second phase, between April and July, saw a sharp increase in the cost of financing in conjunction with a loss of confidence in the Spanish economy. Ten-year debt yields hit their highest

Since the ECB's announcement of its OMT program in August last year, the revival of non-resident investor demand for state debt was the key factor allowing the Treasury to successfully complete its funding program in 2012.

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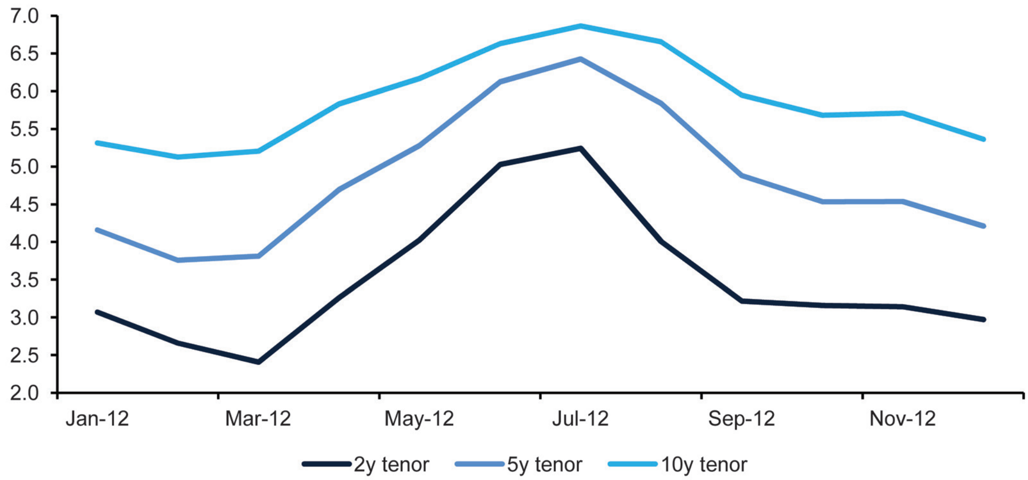
Exhibit 1

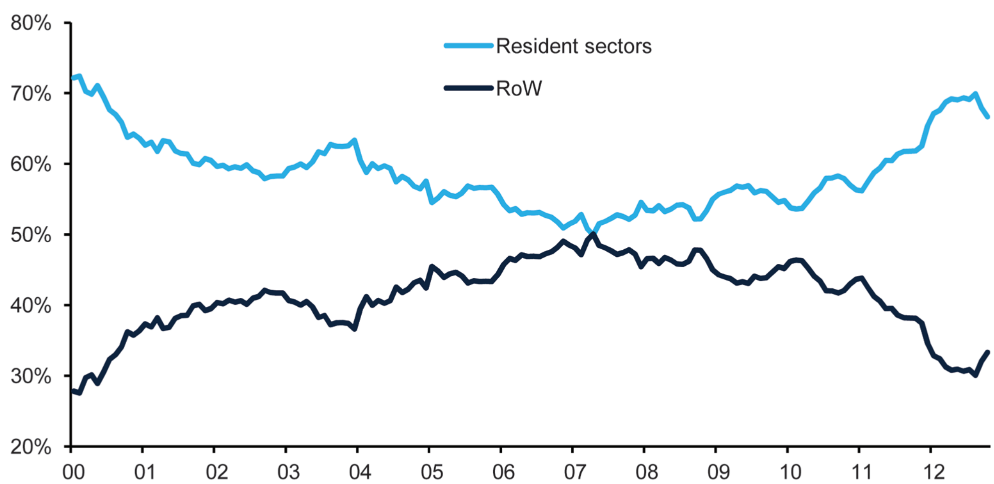
Spanish government debt yields. Monthly average (%)



Sources: Afi from Reuters.

Exhibit 2

Spanish government debt holdings (% of total)



Sources: Afi from Bank of Spain.

levels since the creation of the euro (7.6%) and the pace of debt issuance was adversely affected: net issuance in those months was a negative 14 billion euros. In the third and final phase starting in August, following the ECB's announcement of its Outright Monetary Transactions (OMT) program, the Treasury benefited from a major easing of yields, allowing it to successfully complete its funding program: in the last four months of the year, gross issuance amounted to 83 billion euros.

In this last phase, the revival of non-resident investor demand for state debt was the key factor. Debt holdings by non-residents increased between August and October (the latest available figure) by approximately 25 billion euros, which was greater than the net increase in state debt in the period (16 billion euros). All signs seem to indicate that this trend continued into the closing months of the year, and it would be logical to assume that the debt holdings of non-residents was approximately 34.5% at year-end (see Exhibit 2).

Finally, it should be noted that the elevated volatility in appetite for state debt underlies the performance of a key variable in the strategy for public debt management: the average life of outstanding debt. Indeed, the average life of state debt has gone from 6.5 years in December 2011 to approximately 6.0 by the end of 2012 (Exhibit 3). Although this decline in the average life of debt implies an increase in refinancing risk, this risk is not too high for now (and certainly no higher than in the majority of European countries).

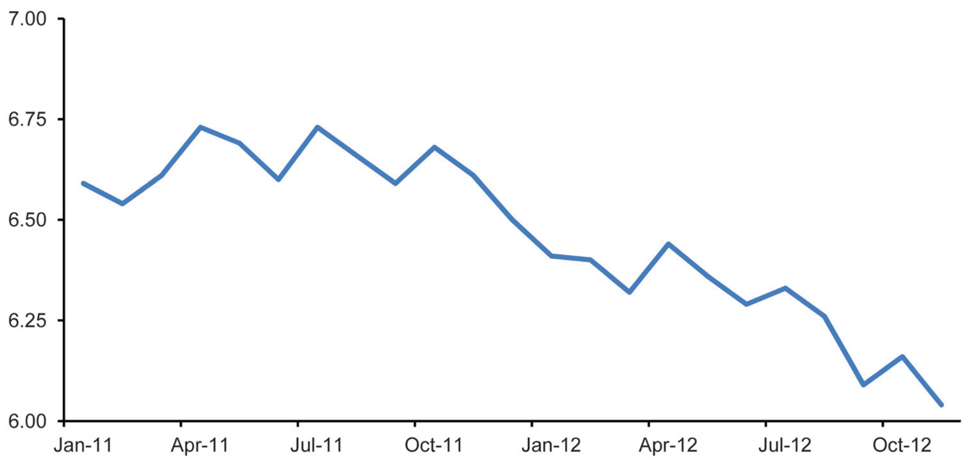
Central government funding in 2013: Just as difficult or even more so than in 2012

The Treasury has published its planned funding strategy for 2013. Gross issuance of state debt will amount to between 215 and 230 billion euros, depending on the use made by autonomous regions of the regional liquidity facility (henceforth the FLA), the mechanism set up by the Treasury to enable regions to meet their debt maturities and fund their deficits. The expected increase in the outstanding state debt in circulation amounts to 71 billion euros, bringing total debt to 761 billion euros by December 2013 (Exhibit 4).

Although early 2013 would appear to be less arduous for state debt financing –due to both the lower total

Exhibit 3

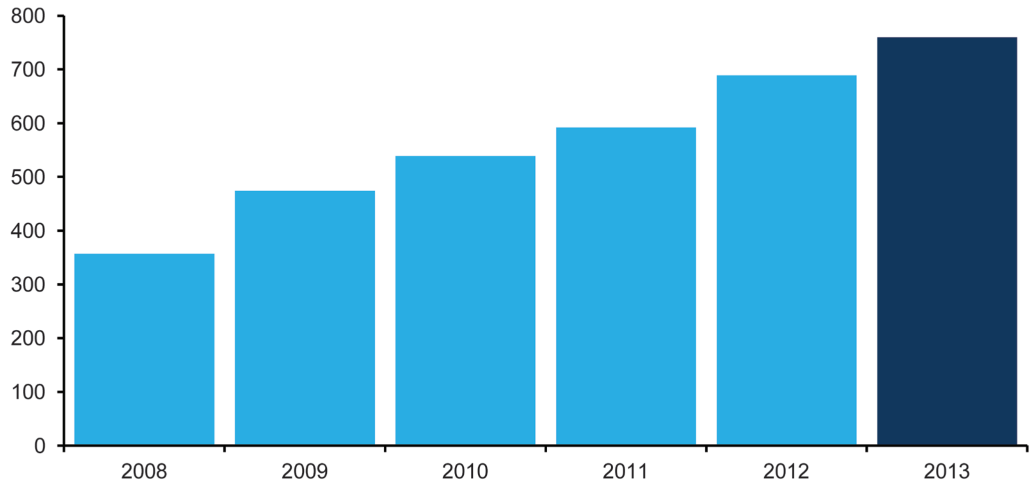
Average lifetime of Spanish government debt (years)



Sources: Afi from Spanish Treasury.

Exhibit 4

Spanish central government outstanding debt (billions of euros)



Sources: Afi, Spanish Treasury.

volume of debt to be placed and the substantial reduction in net issuance– and although the year is beginning with a perception of peripheral risk that is far lower than that of 2012, we must recall that investor confidence is quite volatile, making it advisable to work with the utmost flexibility when implementing an issuance strategy. Accordingly, this is how we interpret the majority of the changes the Treasury has made in its funding strategy for 2013, of which we would highlight the following:

- Incorporation of 2-year bond benchmarks, the ultimate purpose of which may be to offer investors more investment points of reference in the segment of the yield curve that is the focus of present demand for state debt (due to the implicit "protection" that potential implementation of OMTs lends this segment)

- Introduction of special auctions targeted solely at market originators that will not be included in the regular issuance calendar. These auctions will aim to bolster the liquidity of old or off-the-run references, which are occasionally in high demand in the repo market. The Treasury seeks to exploit any improvements in market conditions to finance itself at lower rates.

- The Treasury leaves open the door to issuing debt with a coupon linked to an index, such as the Euribor, with the twofold aim of deferring financial burdens into the future –as against an issue at the same term with a fixed coupon– in view of the present shape of the interest rate curve, and providing an attractive investment instrument for investors with a preference for floating rates.

- Elimination of recourse to new debt through 18-month T-bill issues and creation of T-bills with a residual life of 9 months. Again, the objective is twofold: first, to avoid including collective action clauses in T-bills- see next paragraph and (ii) to foster a concentration of state debt in terms where demand is high, such as in issues with maturities longer than 12 months.

Finally, notable is the fact that, from January 1st, 2013, all new debt series issued by the Treasury at longer than one year must include collective action clauses in their documentation (CACs). This obligation is incumbent on all eurozone governments, who are allowed to issue only a declining proportion (45% in 2013) of gross debt without CACs.

Here, there are a number of aspects we consider to be of importance:

- **Price differentiation.** CACs partly limit moral hazard, as they reduce incentives to not participate in debt restructuring operations; nevertheless, their introduction for sovereign debt will result in higher interest rates compared to "old" bonds that do not include these clauses. This expectation is due to the lesser rights of bondholders that do not accede to such clauses and the fact that they facilitate debt restructuring processes.

- **Formation of majorities.** The quorum needed to activate CACs in euro area countries will be lower than the international standard: 66.6%, as against 75%. This lower percentage even further limits private bondholders' ability to block restructuring (the so-called hold outs).

- **Segmentation of liquidity.** As CAC-free bonds begin to disappear, these instruments' liquidity will diminish. The impact will be clear not only in the spot market, but also in the segregated debt market, given that with the existence of strips of "new" debt with CACs, old, CAC-free debt will not be fungible.

- **Participation of the official sector in restructuring processes.** CACs uphold the seniority of the European Stability Mechanism (ESM) against other bondholders. This element could generate tensions in debt markets, especially in the debt of distressed countries, to the extent that the debt to other bondholders will be subordinated to official creditors. Here, the ECB's role is not clear. Although the ECB has always opposed taking losses on its sovereign debt investments, the new mechanism for purchasing assets in the secondary market (OMT) will not have seniority rights over other bondholders. This could mean that if CACs are invoked in any restructuring process, the ECB would take part in the process on an equal footing with other bondholders, thus generating a potential European-level institutional conflict, as some countries are clearly opposed to this form of public assistance.

- **Retroactive attachment of CACs.** Inclusion of CACs in new debt does not completely eliminate the risk that old debt will be retroactively subject to attachment of CACs, as was the case with Greece. This risk becomes greater as a hypothetical debt restructuring becomes more imminent, as the volume of debt issued with CACs would be too small for any restructuring of that portion of the debt to have significant implications for debt sustainability.

In short, we believe that the introduction of CACs arises from a double segmentation in government debt markets in the eurozone. First, by drawing a red line between countries where such clauses are unlikely to be activated and others in which the market attaches significant probabilities of having to activate them. Moreover, differentiation will be internal, as an issuer will have bonds that are more easily restructured (those with CACs) than others, and this will cause a differentiation in the price among the issuer's bonds, where the price will be higher the more likely the issuer will have to undergo restructuring.

Funding of regional governments: State support will continue to be crucial in 2013

The Spanish debt crisis has had an especially acute effect on the autonomous regions. Although their net debt requirements are far smaller than those of the Treasury, the absence of a liquid secondary market and doubts about compliance with budgetary targets have weakened investor confidence. The complexity of Spain's decentralized state required a strong communication effort. In its absence, international investors chose to reduce their exposure to the country's sub-sovereign risk.

The facts have made clear, however, that the central government is determined to devise mechanisms to back payment commitments undertaken with suppliers and, above all, to ward off any risk of default in servicing the debt.

The success of the supplier payment fund (FFPP), guaranteed by the state, helped to clear away nearly 18 billion euros in outstanding invoices up to year-end 2011 and was undoubtedly a very favorable precedent. But difficulties in accessing the new financing and delays in executing spending cutbacks have again generated a pool of commercial debt that will force the government to take the initiative.

For now, the Ministry of Finance and public authorities have made it a priority for the first quarter of 2013 to set up new financing facilities to enable collections by suppliers.

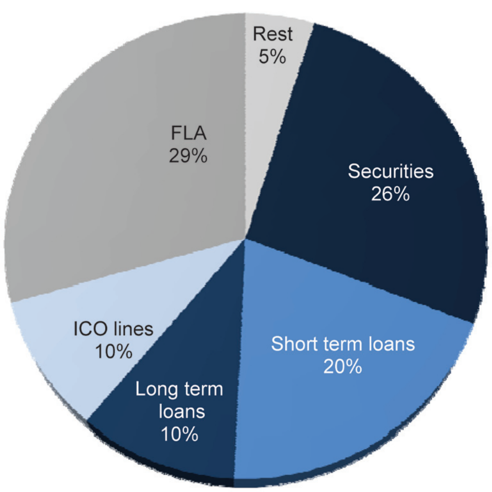
In the meantime, the Treasury has already guaranteed that it will directly finance the regional liquidity fund (FLA) in the order of 23 billion euros, an amount that may be increased if necessary, although at the time this article was written, no information was yet available on either the amounts requested by the regions participating in the mechanism or the amounts to be distributed among the regions.

The funding strategy is known, and it will be simpler than last year's strategy. Although the target pursued last year was to attract outside interest by leveraging the state lottery and betting organization, the operation was ultimately thwarted, and domestic banks had to be used to fund the FLA through syndicated loans and private placements. In 2013, however, the Treasury will directly assume the full volume of its debt issuance policy, thus allowing for broader participation by foreign investors at a time of greater receptivity of non residents in auctions.

The financial terms have yet to be announced, but if they are not too different from the FLA last year,

Exhibit 5

Funding sources for Spanish regions in 2012 (% of total)



Sources: Afi, Regions.

the conditions will be more attractive than any other option without the intermediation of the Treasury. With the current easing of the risk premium, and with the spread on Treasuries remaining at 30-40 bp, regional governments could obtain medium and long-term funding through FLA for less than 5% (in 2012, it was granted at 10 years, with annual repayments and a two-year grace period).

In spite of this, eight regions have started the year with the goal of staying out of the FLA, even if this means bearing higher costs to access markets. These are the same regions that last year managed to meet their needs by exploiting market windows of opportunity in the first quarter and in the final months of the year. The experience of the Madrid region, which issued about 2.4 billion euros in different private issues, left a highly favorable impression after nearly half a year of non-existent demand for paper among foreign investors. But this was not the only case: Galicia, Aragon and Extremadura also managed to complete their debt operations in a market almost completely monopolized by private placement. Although these steps required a significant effort in adjusting financial policy to investor demand, it has allowed these regions to preserve their financial autonomy and helped sustain the pace of issuance in this market.

In short, the technical operation of the FLA must be viewed positively and, although some rating agencies may not have seen it this way, investors and economic actors have improved their perception of the solvency of Spanish public authorities compared to only a few months ago.

Politically, however, the fund was born with the stigma of pejorative connotations with regard to its solvency, a stigma the central government has been unwilling or unable to prevent and which some regional governments have sought to evade. It is clear that some regions had no choice. Meanwhile, others, which chose to call on the support of the FLA, did so to benefit from its better financing conditions, even if their level of financing requirements would have allowed them to consider staying out of the mechanism.

In any case, the primary market for regional debt will be divided into two groups. For the former group, which is the largest, the FLA has budgeted up to 23 billion euros, which should be sufficient to absorb medium and long-term maturities and the 0.7% deficit-to-GDP ratio –approximately 20 billion euros– although a response will be needed for short-term maturities totaling more than 10 billion euros, a part of which could be directly negotiated with financial institutions.

The funding necessities of regions that will seek to autonomously cover the debt in the capital markets are more manageable. They will have to refinance approximately 4.2 billion euros and obtain a further net amount of 3.2 billion euros equivalent to the permitted deficit. The impact of short-term credits on such amounts must be considered, but we believe this should not be an obstacle for these eight authorities.

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Hence, the FLA has a sufficiently representative scope for the total necessities of the sector, which we estimate at approximately 30-32 billion euros, including maturities, yearly deficit and returns to the state from negative settlements of 2008 and 2009 (representing slightly more than 2.1 billion euros). The amount of short-term instruments is somewhat more uncertain. At the end of the third quarter of 2012, they totaled 12 billion euros, but this figure was probably surpassed in December, with total requirements likely approaching 45-46

Table 1
Funding needs for Spanish regions in 2013

All data in € billion	Regions adhered to FLA (1)	Regions not adhered to FLA (2)	(1)+(2)
Short term funding (as of September 2012)	10.657	1.171	11.828
Debt redemptions (medium and long term)	15.086	4.209	19.295
2013 Deficit (equivalent to 0.7% of GDP)	4.339	3.148	7.487
Negative settlements 2008 and 2009	1.407	0.726	2.133
Total funding needs (ex short term funding)	20.833	8.082	28.915

(1) Andalucia, Asturias, Balearic Islands, Canary Islands, Cantabria, Catalonia, Castile-La Mancha, Murcia and Valencia.

(2) Aragon, Castile-Leon, Extremadura, Galicia, La Rioja, Madrid, Navarre and Basque Country.

Sources: Regions' initial budgets and Afi estimates.

billion euros. Although these amounts will have to be curbed in coming years with the consolidation of public accounts, they are high enough to demand planning for the day after the FLA, with the development of a secondary market that will facilitate the liquidity investors demand.

Local authorities' debt: Easing the reins for 2013

The debt levels of local authorities have barely grown in recent years, remaining steady at about 3.5% of GDP since 2009. This discipline, largely due to the tight restrictions imposed by the central government on local authorities for undertaking new debt, even to finance debt maturities, is ultimately more apparent than real. It is true that some city councils have adopted severe spending containment policies more forcefully than other authorities, covering debt maturities with their gross savings. But in response to their inability to take on new debt, these policies also generated a trend among a good number of authorities to use suppliers to finance themselves, thus incurring steep loss carryforwards or accounting anomalies that put off a balancing of their budgets in line with the actual spending obligations they had contracted.

The final outcome of this is known, with the creation of the FFPP. Out of the nearly 27 billion euros channeled by this state-backed mechanism, 8.7 billion euros was earmarked for clearing away the commercial debt of local authorities. Although they represent less than 1% of GDP in volume, it requires increasing outstanding financial debt by 25%, which far surpasses the impact of FFPP in regions in relative terms.

In sum, as against the more than 35 billion euros in debt at the start of last year, the initial figure in 2013 will be 43.44 billion euros. This means that, in aggregate terms, there has been no net increase in debt if we exclude the settlement of commercial debt. Even though the Stability Program allowed local authorities to record a deficit three decimal points above GDP, the Ministry of Finance and public authorities have announced that they may achieve a balanced budget, as will be required of them from this year.

Indeed, the new Organic Law of Budgetary Stability (LOEPSF) introduces certain strict criteria for local authorities, not only prohibiting them from incurring a non-financial deficit –apart from exceptional cases– but they will also have to earmark the surplus for financial debt service.

The Budgetary Law of 2013, however, again introduces greater flexibility by allowing for the use of long-term financial debt by local authorities with net savings whose outstanding capital does not exceed 75% of current assessed income, and it may be increased to 100% with the authorization of the competent body. It also authorizes refinancing of long-term credit operations, eliminating the obligation to unwind positions to cover cash shortfalls and it includes a commitment to again amend article 32 of the LOEPSF to consider proposals that include objectives other than servicing debt with non-financial surpluses.

In short, all of these measures constitute an alteration in the central government's strategy, and they may open the way to a greater willingness to authorize new net debt for authorities in a sounder financial position. Any increase should not be significant, because of the joint zero deficit target and poor financial conditions for new debt issuance, let alone in a market as fragmented and inefficient as that in Spain. We must recall, moreover, that stability regulations call for a debt level of 3% of GDP by 2020, which means reducing its weight to one third.

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Conclusions

The year 2013 presents itself as equally or more difficult for Spanish public authorities with regard to funding. Although gross volumes of debt to be issued –in principle, with greater flexibility in deficit targets awaiting confirmation– will be slightly lower than in 2012, financing conditions remain adverse, in spite of the recent improvement.

The gradual rebalancing of Spain's macro-economic disequilibria and ECB support should help continue to temper the excessive perception of risk associated with Spanish debt, and thus allow for a revival of demand among non-resident investors, who, incidentally, are seeing very low yields on other euro-denominated assets.

The majority of regional governments will have no choice but to stay under the umbrella of the state in order to meet their funding needs. Access to the primary market will have to be different in the future, as the solution presently in place is not optimal and undermines regions' financial autonomy. This will require decisive measures to restore confidence in the country's capacity to stabilize the deficit and, in any event, consideration of other avenues to make their access to the market more efficient.