Binge then bust

Politicians have recently expressed alarm at a cross-currency swap conducted between Greece and Goldman Sachs in 2001, which allowed the sovereign to reduce the debt it reported in its public accounts. But other examples now coming to light show the apparent misuse of derivatives by sovereigns and local governments is far from rare. ***Duncan Wood*** *reports*

Latvia's auditor-general, Inguna Sudraba, doesn't mince her words: "This wasn't some advanced financial instrument. It was an attempt to treat everyone else as though they don't understand reality."

Sudraba is talking about a 567 million lati ($1.086 billion) financing arranged for Riga by Deutsche Bank in June 2005, so the city could build the Southern Bridge that today spans the Daugava River. The Latvian government had declined to let Riga borrow that kind of money, but the city refused to see that as the final word – instead, it went looking for a way to pay for the bridge that wouldn't be seen as a loan. Deutsche came to the rescue with a series of contracts, augmented with currency and credit default swaps, which the bank claimed would not count as debt. That proved to be wrong, but – embarrassingly for all concerned – not before Latvia itself had reported the transaction incorrectly in its national accounts for 2005 and 2006.

In 2007, Latvia's national statistical office, the Centrālās Statistikas Pārvaldes (CSP), corrected its debt and deficit figures for the previous two years after consulting the European Commission's (EC) statistics watchdog, Eurostat. As of 2008, the latest year for which national accounts are available, the Riga bridge debt was equivalent to 1% of Latvia's GDP, and Vija Veidemane, head of the government finance section at the CSP, says the figure will be higher when the new accounts are published in April.

One EC civil servant with knowledge of the transaction calls it "a rather shameful" episode. For many Latvians, anger rather than shame is the overriding emotion – they argue the bridge should never have been built. "Riga will be paying for that bridge for 15 years. It means there will be less for schools, for quality streets, for renovation of the city. It's big money," says Sudraba at the Latvijas Republikas Valsts Kontrole (LRVK), the Latvian state auditor. The bridge opened in November 2008.

If this sounds familiar, it should. Greece was castigated in February for effectively using off-market cross-currency swaps to borrow money in 2001, thereby avoiding reporting it as part of the national debt (a transaction first reported by *Risk* in July 2003[1]). The furore has since triggered a closer look at how sovereigns and local governments use derivatives. There is one common thread: when the coffers run dry, politicians love the fact that dealers can find clever ways to put spending money in their hands.

"Which government would not take money upfront for a liability – or a potential liability – in the future? If you give a government that kind of flexibility, it's natural for them to use it," says one dealer.

The problem is that politicians don't acknowledge or don't understand the strings attached. Then, when something draws attention to buried costs, risks or obligations – an unexpected market move or an election campaign, for example – mis-selling accusations follow. Dozens of these disputes have erupted in Europe since the start of the crisis, focusing on complex structured trades in France, bets on interest rate spreads in Germany, zero-coupon swaps in Norway and collars in Italy. It may be the heat generated by the latter that finally puts relationships between banks and local authorities on a different footing: within the next few months, the Italian Treasury is expected to sign off on new rules that would force banks to make radical disclosures at the inception of a trade.

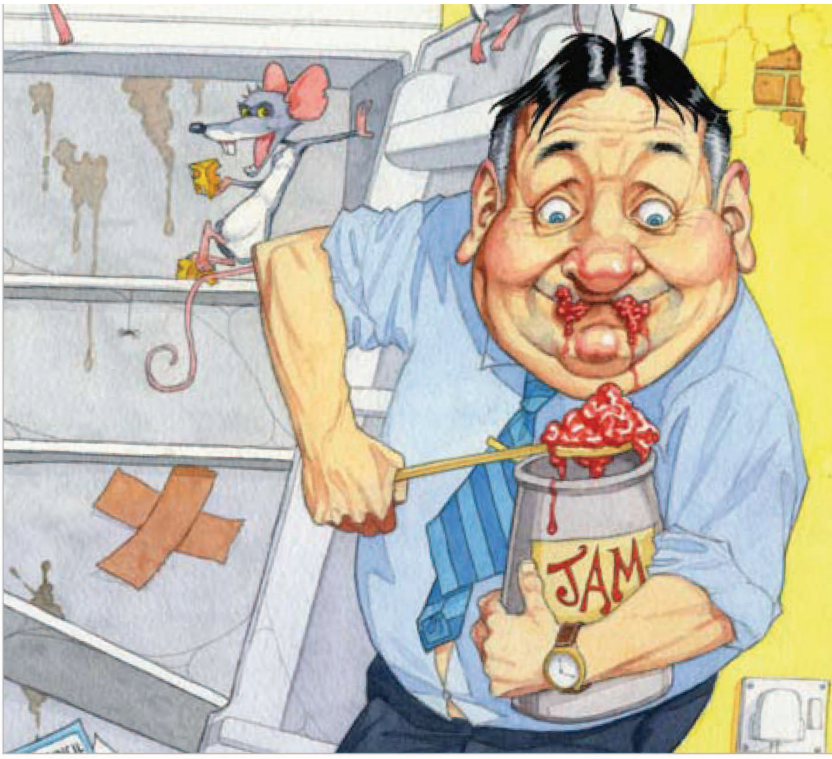
[1] *www.risk.net/risk-magazine/feature/1498135/revealed-goldman-sachs-mega-deal-greece*

Illustration: Stephen Lee, nbillustration

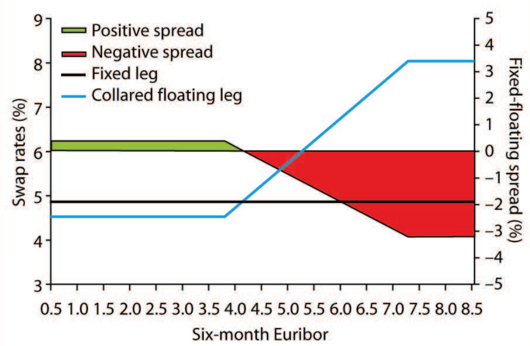
Italy lawsuits

Another European lawyer claims to be preparing to file very similar accusations against Citigroup on behalf of an Italian client. If so, it's tempting to wonder if anyone will notice. According to Fitch Ratings, as many as 500 of the country's local authorities – from small towns to sprawling cities – were using swaps in the mid-2000s, and a sizeable proportion of them are now seeking to close out their trades or are considering seeking redress in court (see page 9).

On the face of it, it's not hard to see why. Marco Ortica, founder of Treviso-based financial consultant, Marco Ortica Investments, says he has worked with around 40 municipalities that wanted to exit derivatives positions – as an example, he points to one client, a town with a population of around 18,000 people in northern Italy. In 2005, the town entered into a 13-year swap in which it received a fixed rate of 4.85% on a notional €26.4 million. In return, it agreed to pay six-month Euribor plus a spread that would fall from 0.9% to 0.3% over the life of the deal. To provide a bit more certainty, this rate was capped at 8% and floored at 4.4% – although the floor stepped up as the additional spread payable by the client wound down.



1 Asymmetry in one Italian swap



Source: Marco Ortica Investments

The end result was a highly asymmetric payout, says Ortica (see figure 1). If rates remained at or below 3.5% in the opening years of the trade, the town would be the net beneficiary, but it could only receive a maximum of €56,972 at each half-yearly exchange of payments because of the narrow spread between the floor and the bank's fixed-rate payments. If rates rose to 4%, the town would become the net payer – and, in contrast, its payments could theoretically go as high as €409,166, he claims.

In this case, there was a happy ending. "The town's treasurer mandated me to analyse the deal and do everything to close it. After the analysis, we wrote a formal notice to the bank and engaged in a negotiation with its managers. Our other option was to run for the court, but it proved not to be necessary – the deal was closed with no net loss for my client," says Ortica.

Stories abound of similarly skewed payouts. Umberto Cherubini, an associate professor at the University of Bologna, says he saw one case in which a municipality agreed to a collared swap where the floor was set at 6%, and this is accompanied by other anecdotes of local treasurers sleepwalking to catastrophe. A finance professor at Bocconi University, who is working with both banks and municipalities, recounts a story he heard from one of his clients: "He's the head of the finance department at one city council. I asked him about how he agreed to the trade and he shrugged and said 'well, I remember going to London, I remember signing some contracts, but I can't speak any English, so I didn't know what I was doing'."