SECURITISING PUBLIC SECTOR ASSETS: THE WAY FORWARD IN PUBLIC FUNDING?

Adam Steen, Melbourne Business School, Level2, 380 St Kilda Rd, Melbourne, Victoria 3004 Australia, +613-8696-6768, a.steen@mbs.mteliza.com.au
Keith Turpie, Swinburne University of Technology, PO 218 Hawthorne, Victoria 3122, Australia, +613-9214-4773, k.turpie@swin.edu.au

ABSTRACT

This paper considers the role of securitisation in the financing of government enterprises. We provide a brief history of government involvement in securitisation and consider some recent transactions where new assets and structures were securitised. Whilst the benefits of securitisation have been well documented in industry and academic literature, little attention has been paid to the problems and pitfalls associated with this area of finance. This paper investigates the advantages and disadvantages of securitisation with respect to transactions involving the public sector.

INTRODUCTION

Asset securitisation is a fundraising technique that involves the creation and issue of debt securities whose repayments are funded from the cash flow of one or many underlying assets. These assets are removed from an organisation's balance sheet by sale or assignment to a third party, known as a Special Purpose Vehicle or Entity (SPV/SPE). The ability to raise funds and remove assets from the balance sheet are the principal reasons for the spectacular growth of securitisation in several markets, most notably the US, UK and Australia. The overwhelming majority of assets securitised in these countries are residential mortgages. Securitisation has enabled banks and mortgage originators to raise funds at a lower cost than other funding sources (given credit enhancement), to take mortgage assets off balance sheet and reduce regulatory capital. Whilst these and other benefits of securitisation have been well documented, there has been little mention of any problems or pitfalls associated with this practice, neither has there been any significant discussion of the securitisation of public sector assets. This paper attempts to address these issues.

PUBLIC SECTOR INVOLVEMENT IN THE SECURITISATION MARKET

From its inception, the securitisation market has involved government. Whilst the concept of securitisaion dates back to the late 1930s, the market formally commenced in the US in 1968 and involved financing public housing programs through vehicles such as the Government National Mortgage Association (GNMA, also known as Ginnie Mae), which guaranteed securities issued by public housing programs. Later, the US federal government established Fannie Mae, a private corporation, to create a secondary home mortgage market. Similar developments occurred elsewhere such as in Australia.

The first half of the 1990s saw a dramatic growth in commercial mortgage securitisation. This involved using the cash flows from leasing commercial office blocks to State and Federal Government organizations. These are obvious transactions to securitisers. By taking advantage of the lessee's high quality cash flows, securitisers could command a high credit rating and attract investors. A recent example of securitisation involving commercial property is the police headquarters in Paramatta, New

South Wales, Australia. In addition, Australia's CSIRO has securitised a number of properties which, according to their advisory manager, was "the best part of 1% better than what could have been achieved through a traditional sale and leaseback" (House 2003). In Australia, at least, the spectacular growth in securitization of public sector assets has been facilitated by reduced public sector borrowing requirements, which contracted the supply of quality term debt available for investment.

A recent example of securitization of public sector assets occurred in Hong Kong in 2004 when the Hong Kong government made its first issue of asset backed securities when it packaged the revenue of the government's toll receipts from 5 tunnels and one bridge. While the Government retains ownership of the facilities, the right to annual revenue passes to buyers of the notes for a specified term. The issued notes are listed on the Hong Kong Stock Exchange (HKSE), and a portion of the issue was made available to retail investors to encourage the development of the market. The HK$3.48 billion institutional offering closed after just 2 days, a day earlier than expected, and heavily oversubscribed, indicating the enthusiasm of investors. Further, the HK $2.52 billion retail offering was also heavily oversubscribed. The transaction was driven, in part, by the need of the government to assist in the funding of its significant budget deficit.

CASE FOR AND AGAINST SECURITISING GOVERNMENT ASSETS

The above transactions illustrate the diversity of assets to which securitisation is being applied. In addition to providing an additional source of funding there are other advantages of securitization. Securitisation can be advantageous to both asset owners and investors, as there are inherent benefits to both parties. Asset owners are able to remove assets from their balance sheet and receive immediate consideration, while investors are able to receive a guaranteed return generally from an insured mortgage-backed security. The underlying risk of the asset is transferred away from the owner and investor to the insurer in a private sector securitisation. However, in the case of a securitisation involving public sector assets, the risk inevitably remains with the government, or should we say taxpayer, as any credit enhancement is invariably provided by government guarantee.

According to Cone (2004) public sector assets can be classified as follows:

- Core assets, required to deliver the government's plan
- Strategic assets, needed for the future to deliver the government's plan, and
- Surplus assets, otherwise referred to as lazy assets, which can be disposed of.

Cone (2004) argues it is this third category of assets which would not be kept if governments adopted a "robust corporate asset planning discipline". Cone cites Phillip Fox managing partner Brian Smith as saying securitisation "had been used by President Clinton's administration in the US and had *saved* $56 billion in one year, while in New South Wales more than $300 million was *saved*". There is no detail as to exactly how this money was ***saved***. Presumably, Smith was referring to the proceeds of bond issues backed by public sector assets. These cannot be regarded as savings as interest and principal will have to be paid over several years.

Presumably you need a good use for the funds raised such as repaying debt or funding a major public works program. With many governments such as Australia's running budget surpluses and having radically reduced debt financing over the last 2 decades, the question of public sector asset ownership is not a question of finance but rather a question of philosophy. The prevailing philosophy in government, at least in the US, UK and Australia, is that the public sector should have little investment in real assets. But why shouldn't government own assets such as real estate? If our forbearers had had the attitude of our current political leaders, many of our great national buildings, parks and other public spaces would not exist in public ownership or may not exist at all today. Not everything should be, or needs to be, in private ownership! Cone (2004) argues that there is a need to securitise "lazy assets" If assets are not needed why not sell them? If, on the other hand, assets are needed and are being used, securitisation means that over the longer-term taxpayers continue to pay for these assets which they previously owned.

In New Zealand, Davis (2000) reports several financial institutions have approached the government with proposals to securitise university students' loan portfolios. (Securitising student loan portfolios is commonplace in the US where is it is estimated that there is nearly US$100 billion of securities outstanding backed by such loans[1]). It is anticipated the value of student loans will reach NZ$19 billion by 2024, which is a substantial component of the government's balance sheet (Davis 2000). Most proposals were premised on the basis that such loans perform both commercial and social roles, and that the commercial risks would be better managed in the private sector. This presumption is subjective however, promulgated chiefly by those investment banks that are engaged in such transactions.

Davis argues that the government needs to consider the long-term impact of an interest rate mismatch between borrowing programs and interest rate student lending setting formulas, and how this should be managed. The free cash flow could be used for debt reduction, or increased public expenditure. Furthermore, an added benefit of the securitisation of the student loan portfolio could be an improved credit rating for the government, which may then flow on to companies, given that the government rating represents the ceiling for all New Zealand companies.

A recent case involving the securitisation at a UK University illustrates that securitisation involving public sector assets can be fraught with danger however. In the Keele case the SPV "Owengate Keele plc" was established by the university and issued bonds worth £69.4 million to investors with biennial repayments backed by 30 years of student accommodation rental income. The first 6 year's payments are interest only at a rate of 6.67% amounting to a total interest payment of £51.5 million at 2000 prices (assuming an inflation rate of 2.5%). Insuring the SPV against default provided credit enhancement. The cost of this insurance together with banking, legal and trustee services was £6.1 million of the amount raised, thus increasing the effective rate of interest on the transaction to 7.45% and the effective interest charge over 30 years to £57.4 million at 2000 prices. The SPVs management expenses for the first three years were £102,703 (half year), £103,194 and £132,793 indexed at 2.5%. Adding this to all the other payments increases the effective interest rate to 7.71%. The SPV also had to maintain a liquidity reserve equal to 6 months debt service, further reducing the amount received by the university, and increasing the effective rate to 7.85% and the effective interest charge to £59.5million.

Technically, the university had sold the rents to its student accommodation, however, the university had an agreement with the student union to increase rents over the first few years of the repayments, allowing the initial repayments to the SPV to be lower than interest paid to bondholders. This necessitated the withholding of £5.6 million of bond proceeds together with a debt reserve of £2.3 million "so that the company could survive the period during which income was less than its outgoings" (Armstrong and Fletch, 2004, p.177). Thus the equivalent interest rate increased to 7.94% and the total cost of the transaction increased to £64.1 million at 2000 prices. This was at a time when Keele's total revenue for 2000 was £61 million.

[1] The Bond Market Association, Research Quarterly, February 2004, p.7.

As the authors note the sacrifice of future revenue for immediate capital is a major draw-card for securitisation transactions. But this is premised on the basis that the issuer has good uses for the funds raised. In Keele's case £18.3 million of the amount raised was used to pay down debt. However, the early repayment of the debt incurred early redemption penalties of £3.2 million. Some of the funds raised were used to refurbish the student accommodation, but this would have had to be funded by the university anyway. Around one-third of the money raised was invested in 'dot.com' stocks prior to the 2000 correction in the world's stock markets. The remainder of the funds raised was set aside for investment into "well-worked out business plans demonstrating a return of 8-10% "(Armstrong and Fletch, 2004, p.179). This would have been a very good return if it could have been achieved!

In June 2003 the pro vice chancellor for resources "went briefly off message and on the record with a declaration that the securitisation had made it no longer possible to "support" academic salaries from student rents" (Armstrong and Fletcher 2004 p.180). The result was a loss of 24 academic and 5 support positions from the university's staff. The securitisation enabled the university to circumvent the HEFCE (UK government borrowing limit of long term debt to annual income) on the basis that the transaction was a partial sale and not a loan for financial reporting purposes. Despite the university arguing that this was in fact the case, the university's accounts showed the debt from the bond issue being amortised straight-line over the 30-year life of the contract. However, as Armstrong and Fletcher note, the effective debt does not reduce on a straight-line basis as the effective debt increases during the early years of the contract due to the low early repayments.

CONCLUSION

Securitisation is a tool that can be used to aid the financial risk management strategies of businesses and investors. While the benefits of securitization have been well documented until now there has been little if any discussion of potential problems, in particular those relevant to transactions involving the public sector. Nor has there been much debate about the necessity for such transactions in the first place. In particular, a precondition of any proposed public sector securitisation should be that the returns on its proposed uses of the funds raised should exceed its total cost of capital. As the Keele case demonstrates, the net cost of such transactions may not be obvious at first and a thorough independent evaluation of all costs is essential.

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