



ARGENTINE GOVERNMENT BONDS MAY BE BACK IN THE INTERNATIONAL MARKET SHORTLY

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Introduction

Though the Argentine economy is performing beyond expectations the fiscal situation of the Provinces and local governments in Argentina requires access to financing. According to several reliable sources, the Provinces face a total debt of approx. Argentine Pesos 100,000M of which approx. 70% belong to debts with the National Government. Furthermore, a material part of the payments in concept of interests and principal matures during this year. Provincial financing needs jumped to 26 billion pesos (\$6.7 billion) in 2010 from 18.5 billion pesos last year.

Last May 10, 2010, the National Government announced the so called Federal Program for Argentine Provinces for debt payment basically consisting on: (i) the refinancing of 89 percent of the debt currently in place, (ii) a grace period until December 2011, (iii) elimination of inflation adjustments on interest payments and (iv) enlargement of maturity term (year 2030) and reduction of annual interest rates at a fixed 6 percent.

Although this program provides a material solution for provincial debts, provincial financial situation requires additional access to lending: total provincial deficit will swell to 13 billion pesos this year, equal to 0.8 percent of gross domestic product, from 9 billion pesos in 2009.

National Budget Law, recently passed in 2009, that provides for the suspension for a two year period of the cap in the indebtedness capacity of Provincial governments which was tied to their gross domestic product, together with the national restructuring debt swap of \$20 billion in defaulted debt, currently in process, may open the way for the country's 23 provinces to sell bonds in the international and local market to cover rising financing needs. The exchange will enable the national government to tap international debt markets for the first time since 2001, making it easier and cheaper for provinces to issue bonds locally and abroad.

Experience with Provincial Bonds

Capital markets have proved to be a good avenue for lowering the cost of funds and extending debt maturities for Argentine provinces: in the past several years many provinces have accessed the bond market, and less than ten have reached international capital markets. The earliest and most active issuer is the Province of Buenos Aires, which launched its first issue in 1994; it is also the second largest issuer, after the city of Buenos Aires. Because of the size of their fiscal deficits, both jurisdictions cannot

finance them through the banking system. Thus they are regular issuers in the bond market, while other provinces are opportunistic issuers.

Among the provincial bonds, in the past 85 percent were issued with fixed interest rates and the most common currency used was the U.S. dollar. The debt in dollar-denominated bonds increased significantly after the currency devaluation. In addition to bonds in Argentine pesos and U.S. dollars, the Province of Buenos Aires and the city of Buenos Aires issued bonds in deutsche marks, yen, Swiss francs, Italian lire, and euros. Co participation of revenues, hydrocarbon royalties, or both were usually used as collateral.

Every local bond issue used a trust scheme, which has proved to be a safe measure, especially during a financial crisis. While many provinces defaulted on their bonds after the sovereign default, there was no default on bonds with a trust scheme. There has been no common approach to dealing with the defaults. A few provinces have taken actions to reschedule their payments, others have done nothing, and still others have deferred payments.

Collateral for Provincial Borrowing

Two main types of collateral back provincial loans and bonds: co participation revenues and hydrocarbon royalties. Most provincial borrowing is backed by pledged co participation revenues.

Co participation Revenues. There are two basic mechanisms for collateralizing a borrowing with co participation payments. The first, and the more common and safer of the two, is the allocation of payments to the creditors at the source of the disbursements: Banco de la Nación Argentina, the commercial bank of the federal government. The second is such allocation at the provincial bank (or the financial agent of the province) that receives the co participation revenues from Banco de la Nación Argentina.

These mechanisms have been tested as a result of the recent Argentine default, and some interesting differences have appeared. At the first level of allocation every bond with a trustee has been honored. At the second level, however, behavior has differed depending on whether the provincial bank had been privatized, and moral hazard problems have arisen. Privatized provincial banks did not follow provincial instructions to default on bonds for which those banks served as trustee. In contrast, provincial banks that had not been privatized followed provincial instructions to default on bonds for which they were the trustee.

Hydrocarbon Royalties. Four provinces have issued bonds backed by hydrocarbon royalties (oil and gas) as collateral (Mendoza, Neuquén, Salta, and Tierra del Fuego). Although transactions backed by hydrocarbon royalties are much more complicated to structure than those backed by co participation revenues, all the bond issues were successful because investors perceive this type of collateral as the safest. Hydrocarbon royalties back the most successful Argentine provincial bond

issue, the Salta Hydrocarbon Royalty Trust.

One of the main advantages of hydrocarbon royalties is that concessionaires pay the royalties to the provinces through private local banks (including offshore banks), avoiding federal and provincial government interference. During the financial crisis affecting provinces in the second half of 2001 and the first half of 2002, there were no defaults on loans and bonds backed by hydrocarbon royalties.

The use of hydrocarbon royalties as collateral is limited to the 10 provinces that have such natural resources and receive royalties.

Conclusions

Argentina provincial debt may represent a window of opportunity for local and foreign law firms to advise Argentine local Governments at the present time in case the national debt swap program ends successfully.

It is important to bear in mind that the appropriate structure that seasoned law firms could provide might represent the difference between a successful placement or not.