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State of the Market 26: Sovereign bankruptcy, suddenly thinkable

By David A. Smith

Harrisburg, New York State, California, Dubai, and Greece may seem strange bedfellows, but they have in common two things:

- They are all sovereign governments of one sort or another.
- They are all bankrupt.

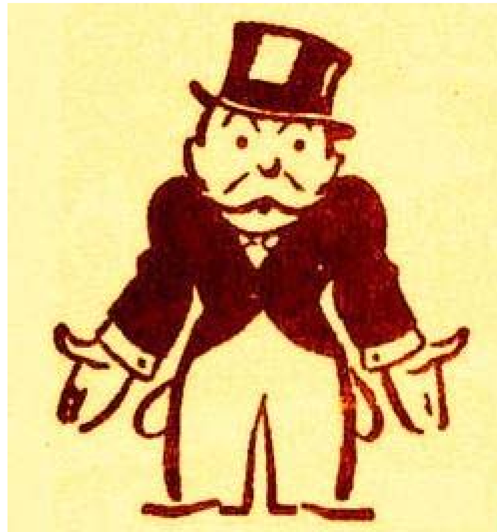
Being governments, none of them will *admit* to bankruptcy, yet they have all met the standard definition used in real estate transactions: "admission in writing of inability to pay their debts when due." I can quote it from memory because definitions matter in real estate transactions, which are governed by written organizational and financing documents … and adjudicated by impartial arms of government.

What happens, though, when the adjudicator of bankruptcy *is* government, and when the entity that cannot pay is the entity whose currency is no more creditworthy than its promise to pay? The answer is of vital interest to everyone in any form of real estate, particularly including housing.

What is sovereign bankruptcy?

Sovereigns go bankrupt the same way properties do – they borrow more than they prove able to repay. But *when* they go bankrupt, what happens is very different than for you, me, and that developer behind that tree.

Governments borrow money. Governments are financial actors, largely as borrowers. Bonds finance highways, roads, schools, dams, water treatment plants. Less sensibly, governments borrow to finance the spread between what they want to pay people today (entitlements) and what they have with which to pay it



Can't I just print some more Monopoly money?

current taxes). Virtually every government in the modern world engages in deficit spending.

The cost of their borrowing depends on the term, the creditworthiness of the unit of government doing the borrowing, and the underlying currency's stability. Solid credits like Germany borrow at low rates; more questionable credits like Greece have to pay more.

Government can't pay all its obligations. Governments are as susceptible to optimism as individuals. Elected officials expand benefits packages, using whatever hopeful assumptions about beneficiary mortality, future tax revenues, or investment returns they need to believe.

Inevitably comes a day when the assumptions are proved false. Recession hits, investment returns plummet, workers retire early and live long, benefit-consuming lives (curse them!). Things get worse and worse, hope is repeatedly exhausted, and sooner or later the sovereign borrower owns up.

38 Chauncy Street, Suite 600 | Boston, MA 02111
T: 617.338.9484 | F: 617.338.9422
E: info@recapadvisors.com | W: recapadvisors.com

These days it happens sooner, when the hedge funds and currency speculators sound the alarm. Then the interest rates to renew expiring debt suddenly spike, as Greece's did versus Germany's only a few weeks ago. That's bad.

So governments, hoping for good luck or to make it a successor government's problem, resort to financial shenanigans to hide borrowing off-balance-sheet. By the time the sovereign's over-spending problem has surfaced, it's much worse than bad.

We've all seen it with real estate properties. By the time the borrower's defaulted on the debt service, the payables have been run up, the maintenance has been deferred, and the resident credit checks have gone all to heck. When the creditors arrive, they have work to do to restore the asset.

Sovereign bankruptcy is unlike private bankruptcy

Private bankruptcy can dissolve the economic entity. When a private entity goes bankrupt, the court treats the debtor as financially dead. Typically, three things happen:

1. The court takes over operations via a court-appointed receiver, as explored in *State of the Market 17: Does your receiver have good hands?*
2. The court and the creditors make a snap decision whether the bankrupt estate is likely to have more value if the business is kept operating as a going concern. If so, the receiver runs the business, charging receivership costs against the estate's value.
3. If not, the estate is gathered, valued, reduced to cash, and liquidated, with the creditors getting the proceeds in their order of priority.

Naturally the last step is complicated, but for our purposes this is enough.

Key is that *the creditors take a haircut, whether they like it or not*, and a court enforces their acceptance of partial-payment settlement, and discharges the debtor.

Bankrupt sovereigns *cannot* dissolve; they must continue to exist. Many of a sovereign's creditors are citizens, or are regulated by the sovereign. Dissolution, available to corporate borrowers under Chapter 7, is impossible for a sovereign state.

A sovereign, itself the court that decides who gets paid and who doesn't, chooses to elevate some classes of payees and lower the priority accorded to others, depending on their political clout. We saw a bare-knuckle version of this in the Administration's handling of the GM not-quite-bankruptcy, where the union pensioners – normally an unsecured creditor group entitled to the lowest priority – were given a proportionately much larger share, and those who had bought GM's secured bonds were squeezed. When they protested, they were jawboned by the President himself.

Such unpredictability comes at a cost: higher bond rates. At the point of crisis, this future cost seems worth paying. Later on, the bargain seems worse and worse.

Why does sovereign insolvency affect housing?

Because rates run up, possibly out of control, and that destroys housing affordability, consumption, and production.

Housing crumples, and with it, the nation's economy.

Housing is the longest-lived financial asset, the underpinning of most people's personal wealth, and the wellspring of their credit. If people cannot borrow long-term, then they cannot buy much housing. If developers cannot borrow long-term, they cannot renovate or build it. If no one can buy, no one can sell. Prices stagnate and fall. National competitiveness grinds to a halt.

Yes. It's that serious.

What happens when a government guarantee proves worthless? Government exists in large part because of the promises of its future integrity. It will establish justice, ensure domestic tranquility, provide for the common defense, and promote the general welfare. It will administer laws without fear or favor. It will turn square corners with its citizens.

It will pay its bills, and it will stand by its guarantees.

But what if it doesn't?

Isn't that impossible? Unthinkable? Lately we've had a lot of foolish press, egged on by foolish politicians, excoriating speculators and hedge funds for driving down bonds, companies, and currencies.

In finance, we call this *shooting the messenger*.

For thirty years or more, the developed world has lived in a benign, bankruptcy-free sovereignty. Sure, benighted developing nations could over-rev their engine and have a Peso crisis or an Asian crisis … but *we* had outgrown such things. *We* knew how to keep our budgets in balance. *They* needed *our* inventions – the International Monetary Fund, the World Bank. *We* would show *them* how to keep a country's economy humming.

Except that it's breaking out all over. Dubai's re-trading its obligations. California's been issuing Monopoly money – IOUs payable 'when we have the money' (that's literally what they say!). New York's failing. Greece's multi-level thrash is fissuring the European Union.

Now it's time for us to confront our own fate. The sooner we uncover the problems, awful though they are, the better.

What does it mean for program participants?

Higher capital costs born of uncertainty.

The risk of the unaccountable counterparty. Every transaction has counterparty risk; markets are used to counterparties that cannot pay. Markets are *not* used to counterparties that can pay, or decline to pay, or offer a pale substitute for payment, and have the ability to compel its acceptance.

Do LIHTC investment capital-charge treatments still make sense? Under our capital and accounting treatments, guaranteed LIHTC is given a much more favorable capital charge than unguaranteed LIHTC – to the point where one extremely large and sophisticated financial institution, that decorum forbids me to name, told me point blank that it would invest solely in guaranteed transactions, not for credit enhancement but rather for the more favorable capital charge.

This is weird, and many years of dealing with weird have taught me, weird does not sustain. Reality will not be fooled, as Richard Feynmann put it. Denial will make it worse.

Sovereign credit guarantees will fall in value. We are used to a world in which financial gravity prevails; larger government entities are stronger credits than smaller ones. That is no longer so; every government counterparty is now suspect.

The last time this happened was the 1970s, when some state HFAs' bond issues – secured by pools of single- and multifamily mortgages – commanded higher credit ratings than their states' general obligation bonds. (Even earlier, John Mitchell, later to be President Nixon's Attorney General, invented the concept of the 'moral obligation' UDC bond – and the markets bought it.)

Corporate credits may become stronger than state ones; municipal credits may become stronger than state. Some municipalities and states may be unable to sell their bonds except at horrendous and politically indefensible discounts.

The yield curve will rise. Aside from the higher inflation risk the further out you go in time, the greater the counterparty risk. Once government bodies show themselves unreliable, that unreliability gets as investors look past future discontinuities like elections. Who can assess political-expropriation risk?

Shorter-term, variable-rate loans proliferate. Upward pressure on the yield curve will make borrowing long and fixed expensive (so do it now!), driving borrowers into a cycle of shorter-term variable-rate bullet loans. Maturities will shrink.

LIHTC prices will remain weak. The LIHTC is a long-term fixed-yield investment with limited practical liquidity. Against a backdrop of a positive and rising yield curve, that's a prescription for exogenous downward pressure on LIHTC prices, further impairing the pipeline's recovery.

The Federal government will be asked to intervene to save a state. It will decline. California's governator has already made mewling noises consistent with wishing-and-hoping for a Federal bailout. Yet the Federal government cannot save one state without placing itself in the position of having to save all – and Washington has spent the last decade and a half aggressively shifting mandates from itself to the states. All that would be undone at a stroke by underwriting (say) California's generous pensions … just as everything Germany has done to build a strong Europe will be undone if the European Union bails out Greece.

What does it mean for investment strategies?

1. Borrowed fixed-rate, for as long as maturity as you can get.
2. Invest long in inflation hedges. Income-producing property is a good one.

How do we get out of this mess?

For a sovereign, the list is short:

- *Major economic recovery*. Call me when it happens, okay?
- *Currency devaluation*. A traditional and popular remedy predicated on having control of one's own central bank. Britain has this option. Individual nations in the mutual economic suicide pact that is the Eurozone do not.
- *Inflation … or hyperinflation*. Zimbabwe's given us the recent case study. Venezuela's hyperinflation is about eighteen months away.

None of these work for the United States, which for half a century has been the world's reserve currency, the bedrock of the global financial system. Which leaves only the extreme solution:

Cut benefits ourselves. This country cannot sustain the promises it has made to a whole generation of beneficiaries – my selfish boomer generation. Either we cut benefits directly … or we inflate our way out of it. Inflation is the young's revenge on the old for their previous overspending.

The sooner we take the medicine – benefit cuts, higher interest rates, you choose – the less risk we take of structural and debilitating inflation.

If you hope I'm exaggerating, ponder this: the capital markets think Warren Buffett is a better credit risk than the United States government.