Revealed:
Goldman Sachs' mega-deal for Greece
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With the help of Goldman Sachs, Greece has been using giant swaps deals to ensure its national debt ratios meet EU targets. But these deals are likely to prove controversial. By Nicholas Dunbar
Ever since the deficit and debt rules for eurozone member states were drawn up in the early 1990s, there have been persistent rumours and allegations that governments have used derivatives to get around them. For some time, economists have argued that the combination of strict external targets with considerable local autonomy in sovereign debt management almost inevitably leads high-deficit countries towards derivatives.

It is now widely known that since 1996, Italy's Treasury has regularly used swaps transactions to optically reduce its publicly reported debt and deficit ratios. Such trades remain controversial, and were the subject of fierce debate in late 2001, when Italian academic Gustavo Piga published a paper accusing eurozone countries of 'window dressing' their public accounts using derivatives (Risk January 2002, page 17).
Now, Italy has been joined by the Hellenic Republic of Greece, as evidence emerges of a remarkable deal between the public debt division of Greece's finance ministry and the investment bank Goldman Sachs. The deal is not only likely to reopen an old debate on public accounting for derivatives, but also sheds light on the way banks charge clients for taking credit and market risk exposure.
Intended to rein in fiscal profligacy among aspiring eurozone entrants, the Stability and Growth Pact (SGP) – established in 1996 – sets two important targets for member states: a debt/GDP ratio of less than 60% and a deficit/GDP ratio of less than 3%. Of the two, the second is considered more important. Countries that show persistent breaches of the 3% target are liable to pay heavy fines to Brussels of up to 0.5% of GDP under the so-called Excessive Deficit Programme (EDP). Performing the key regulatory role of determining whether the targets have been met is the European Statistical Office (Eurostat).
Greece, which joined the single currency in early 2001, resembles mid-1990s Italy in certain respects. Until recently it was a country of high deficits and high inflation, and for this reason did not bother joining the first wave of eurozone countries in 1998. In the run-up to joining the eurozone, Greek inflation and budget deficits fell sharply, and GDP grew as the incumbent socialist government pursued a policy of UK-style public-sector reform. However, like Italy, Greece's debt/GDP ratio has remained high, at over 100%, and as a result its interest costs are the highest in the eurozone.
Public statement
In November 2001, the Greek finance ministry's public debt division made a public statement about its debt management strategy. It acknowledged that its debt was a 'critical macroeconomic parameter', and pledged to reduce debt servicing costs by means that included 'the extensive use of derivatives'.
Apparently, this was not enough for Brussels. In February 2002, the European Commission pointed out future deficit forecasts by Greece relied 'primarily' on achieving reductions in interest costs. It called for Greece to reduce its 'very high' debt ratio, and to provide 'more detailed information on financial operations'.

Although Greece's public debt division points out that it uses 18 derivatives counterparties, there is no doubt that the division, which is headed by Christopher Sardelis, has a particularly close relationship with Goldman Sachs. Indeed, the account has been handled personally at Goldman Sachs by Antigone Loudiadis, the London-based European head of sales for the firm's fixed-income, currencies and commodities unit. Highly respected by other dealers, Loudiadis has enjoyed a successful career at Goldman, joining the firm's partnership committee and attaining her present position in 2000. According to sources, **in 2001*** Loudiadis and her team put together a deal aimed at alleviating Greece's problem of debt ratios and high interest costs.

The transactions agreed between the Greek public debt division and Goldman Sachs involved cross-currency swaps linked to Greece's outstanding yen and dollar debt. Cross-currency swaps were among the earliest over-the-counter derivatives contracts to be traded, and have a perfectly routine purpose in debt management, namely to transform the currency of an obligation.

For example, an issuer with foreign fixed-rate debt might choose to lock in a favourable exchange rate move. To do this, it could swap a stream of fixed domestic currency payments for a stream of foreign currency ones, referenced to the notional of the debt using the prevailing spot foreign exchange rate, with an exchange of the two notionals at maturity. Because they are transacted at spot exchange rates, cross-currency swaps of this type have zero present value at inception, although the net value (and credit exposure of either counterparty) may subsequently fluctuate.

However, according to sources, the cross-currency swaps transacted by Goldman for Greece's public debt division were 'off-market' – the spot exchange rate was not used for re-denominating the notional of the foreign currency debt. Instead, a weaker level of euro versus dollar or yen was used in the contracts, resulting in a mismatch between the domestic and foreign currency swap notionals. The effect of this was to create an upfront payment by Goldman to Greece at inception, and an increased stream of interest payments to Greece during the lifetime of the swap. Goldman would recoup these non-standard cashflows at maturity, receiving a large 'balloon' cash payment from Greece.

Since neither Goldman nor Greece will comment on the deal, much of the details remain vague. It is not clear which exchange rates were used in the actual contracts. Under the terms of a similar 'off-market' deal transacted by Italy in 1997, the exchange rates prevailing at the time of the underlying bond issue were used, which would have made sense in the case of Greece since the deal happened after a period of euro strengthening against the yen and dollar.

Although the overall deal is believed to have consisted of three or four individual transactions or tranches, according to sources, the total cross-currency swap notional was approximately $10 billion, with tenors ranging from 15 to 20 years. While the size of upfront payment to Greece's public debt division is not clear, it seems the total credit risk incurred by Goldman Sachs was roughly $1 billion. Effectively, Goldman Sachs was extending a long-dated illiquid loan to its client.

Goldman Sachs is known for its conservative approach to credit risk, and chose to hedge its exposure to Greece by immediately placing the risk with a well-known investor in sovereign credit: Frankfurt-based Deutsche Pfandbriefe Bank (Depfa). According to sources, Depfa entered into a credit default swap with Goldman Sachs, selling $1 billion of protection on Greece for up to 20 years. Depfa declined to comment.

Total charge

Details have also emerged of the way Greece's public debt division was charged for the transaction. According to market sources, the total charge was approximately $200 million. This charge can be broken down into several components. First, Greece was charged for the credit risk in the transaction. Long-dated Greek government bonds were trading at a spread of 30 basis points in 2002. A billion-dollar investment in such bonds, purchased in asset swap form and held for 20 years, would yield about $60 million. According to Risk's sources, Depfa demanded a substantial premium for taking on what was in effect an illiquid, privately placed loan.

Second, Greece paid a principal risk charge to Goldman Sachs for its market risk exposure. Although standard euro/dollar and euro/yen cross-currency swaps are highly liquid instruments that trade at tight bid-offer spreads in the interbank market, such large, off-market transactions cannot be hedged in this market without significantly moving the price against the dealer. Goldman Sachs may have hedged some of the risk using futures, forwards and interest rate swaps, while retaining substantial cross-currency and interest rate basis risks in its portfolio. Of course, the ultimate profit and loss experienced by Goldman Sachs on the transactions remains unknown.

Equally murky is the exact effect of Goldman Sachs' transactions on Greece's publicly reported national accounts. Since the deficit was a comfortable 1.2% of GDP in 2002, it is more likely that the cashflows were either used to help lower the debt/GDP ratio from 107% in 2001, to 104.9% in 2002 (by funding

buybacks) or to lower interest payments from 7.4% in 2001 to 6.4% in 2002. But why did the large negative market value of the swaps not appear on the liability side of Greece's balance sheet?
The answer can be found in ESA95, a 243-page manual on government deficit and debt accounting, published by the European Commission and Eurostat in 2002. As revealed by Piga, the drafting of ESA95's section on derivatives was the subject of fierce arguments between the government statisticians and debt managers of certain eurozone countries.
The statisticians wanted derivatives-related cashflows to be treated as financial transactions, with no effect on deficit or interest costs, and with the derivatives' current market value stated as an asset or liability. The debt managers opposed this, insisting on having the freedom to use derivatives to adjust deficit ratios. The published version of ESA95 reflects the victory of the debt managers in this argument with a series of last-minute amendments.
In particular, ESA95 states in a page-long 'clarification' that 'streams of interest payments under swaps agreements will continue... having an impact on general government net borrowing/net lending'. In other words, upfront swap payments – which Eurostat classifies as interest – can reduce debt, without the corresponding negative market value of the swap increasing it. According to ESA95, the clarification only covers 'currency swaps based on existing liabilities'.

Legitimate transaction

There is no doubt that Goldman Sachs' deal with Greece was a completely legitimate transaction under Eurostat rules. Moreover, both Goldman Sachs and Greece's public debt division are following a path well trodden by other European sovereigns and derivatives dealers. However, like many accounting-driven derivatives transactions, such deals are bound to create discomfort among those who like accounts to reflect economic reality. For example, the Greece-Goldman deal may be of interest to credit rating agency Standard & Poor's, which upgraded Greece's long-term debt from A to A+ in June 2003. Among other derivatives dealers, the deal is bound to create envy at Goldman Sachs' skill in solving the risk management needs of such an important client. As long as the current Eurostat rules do not change, the use of derivatives in deficit and debt management by eurozone sovereigns is likely to flourish. The planned expansion of the eurozone to include 15 east European countries may lead to especially rich pickings for dealers able to seize such opportunities.

***An earlier version of this story said erroneously that the deal closed in 2002, not 2001.**