

A Liability Management Proposal for the Republic of Portugal

1st July 2005

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THIS PRESENTATION FOCUSES ON INTEREST RATE DERIVATIVE AND LIABILITY MANAGEMENT STRATEGIES TO MINIMIZE INTEREST EXPENSE AND DEBT IN THE CURRENT INTEREST RATE ENVIRONMENT

Interest rate derivative products may allow the Republic of Portugal to achieve the following objectives

- Hedge its downside exposure to rising interest rates, minimizing its cost
- Provide a more cost-effective alternative to bond financings in managing duration
- Manage the interest rate budget over the economic cycle
- Smooth refunding of maturing debt over the financial year
- Generate substantial cost benefits versus future cost of funds
- Minimize the impact of large new issuance on market pricing

DERIVATIVE INSTRUMENTS ENABLE DEBT MANAGEMENT AGENCIES TO ACHIEVE A BROAD RANGE OF OBJECTIVES

- Hedge or realize value from interest rate and currency markets
- Manage duration exposure to their 'benchmark' targets
- Enhance the cost benefits on their outstanding portfolio
- Manage repayment profiles, exchange & buy back programs

The greater acceptance of derivatives is based on sovereign clients' awareness that interest rate derivatives can provide

- Attractive economics (e.g. debt service costs reduction)
- Smoothing of outstanding portfolio events
- Efficient budget planning and management of fiscal budgets by the Ministry

Securities Listed on MEDIP/MTS Portugal



OUTSTANDING OT ISSUES

Security	ISIN Code	Type of rate	Status	Outstanding (EUR/m)
OT 5.25% Oct 2005	PTOTEIOE0007	Fixed rate	Benchmark	5,138
OT 9.5% Feb 2006	PTOTEVOE0000	Fixed rate	Regular	831
OT 3% Jul 2006	PTOTEWOE0009	Fixed rate	Benchmark	5,072
OT 6.625% Feb 2007	PTOTEFOE0000	Fixed rate	Regular	2,110
OT 4.875% Aug 2007	PTOTEXOE0016	Fixed rate	Benchmark	5,117
OT 5.375% Jun 2008	PTOTEBOE0012	Fixed rate	Liquid	2,592
OT 3.25% July 2008	PTOTE20E0000	Fixed Rate	Benchmark	6,000
OT 3.95% Jul 2009	PTOTECO0011	Fixed rate	Benchmark	5,000
OT 5.85% May 2010	PTOTEHOE0008	Fixed rate	Benchmark	5,147
OT 5.15% Jun 2011	PTOTEJOE0006	Fixed rate	Benchmark	5,258
OT 5% Jun 2012	PTOTEKOE0003	Fixed rate	Benchmark	5,036
OT 5.45% Sep 2013	PTOTEGOE0009	Fixed rate	Benchmark	5,043
OT 4.375% Jun 2014	PTOTE10E0019	Fixed rate	Benchmark	4,200
OT 3.85% April 2021	PTOTEY0E0007	Fixed Rate	Benchmark	5,077
OTRV Jul 2004	PTOTVE0E0000	Floating rate	Regular	327

Transaction Description

- A derivative-based solution to improve the deficit/GDP ratio by around €370mm in 2005 and €450mm in 2006, while also satisfying other important liability management objectives. Higher savings can be achieved by increasing the size of the transaction.
- It consists in the execution of three 30 year interest rate swaps. The Republic of Portugal would achieve the following objectives:
- Extracting Cost Savings from the shape of the curve: we have estimated positive net interests of around €510mm in February 2006 (€370mm of which to be accounted in 2005).
- Interest Rate Cost Smoothing: by swapping the higher-than-market coupon expenses that the Republic of Portugal faces in February 2005 and 2006 over a longer maturity.
- Locking-in historically low long term interest rate levels. Citigroup believes that current historically low interest rates continue to represent a significant market opportunity for the Republic of Portugal to extend the duration of its debt portfolio, locking-in future fixed funding rates.
- Reducing the cost of extending duration by selling options. The options sold by the Republic of Portugal are covered options: if and when expiring in-the-money, they would cap some of the Republic of Portugal's potential upside rather than generating an outright loss.

Swap 1 - OT 9.5% Feb 2006

Reference OT: OT 9.5% Feb 2006
Notional Amount: 831mm euro (entire issue outstanding)
Swap Start date: 23 February 2005 (Retroactive Start)
Swap Maturity date: 23 February 2036

I) Interest Rate Period from 23 February 2005 to 23 February 2006

Citi pays: 9.5% (annual, ACT/ACT)
Citi receives: 6mo Euribor - 200bps (semi-ann. ACT/360)

II) Interest Rate Period from 23 February 2006 to 23 February 2036

Citi receives: 3.70% (annual, ACT/ACT) every 23 February
Citi pays: 6 month Euribor +0bps (semi-ann. ACT/360) every 23 February/August, subject to a Cap at 3.75%, maturing on 23 February 2011

Option: from 23 February 2011 and every year thereafter Citi has the right to switch the fixed rate into 6m Euribor -100bps

Swap 2

Swap 2- OT 6.625% Feb 2007

Reference OT: OT 6.625% Feb 2007
 Notional Amount: 2,086mm euro (entire issue outstanding)
 Swap Start date: 23 February 2005 (Retroactive Start)
 Swap Maturity date: 23 February 2037

I) Interest Rate Period from 23 February 2005 to 23 February 2007

Citi pays: 6.625% (annual, ACT/ACT)
 Citi receives: 6mo Euribor - 200bps (semi-ann. ACT/360)

II) Interest Rate Period from 23 February 2007 to 23 February 2037

Citi receives: 4.30% (annual, ACT/ACT) every 23 February
 Citi pays: 6 month Euribor +0bps (semi-ann. ACT/360) every 23 February/August, subject to a Cap at 3.75%, maturing on 23 February 2012.

Option: from 23 February 2012 and every year thereafter Citi has the right to switch the fixed rate into 6m Euribor -100bps

Swap 3- OT 5.85% May 2010

Reference OT: OT 5.85% May 2010
 Notional Amount: 5,217mm euro (entire issue outstanding)
 Swap Start date: 20 May 2005 (Retroactive Start)
 Swap Maturity date: 20 May 2037

I) Interest Rate Period from 20 May 2005 to 20 May 2007

Citi pays: 5.85% (annual, ACT/ACT)
 Citi receives: 6mo Euribor - 200bps (semi-ann. ACT/360)

II) Interest Rate Period from 20 May 2007 to 20 May 2037

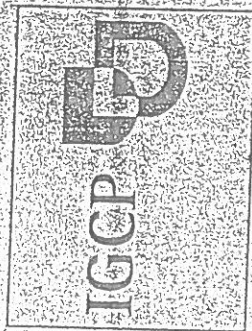
Citi receives: 4.20% (annual, ACT/ACT) every 20 May
 Citi pays: 6 month Euribor +0bps (semi-ann. ACT/360) every 20 May/November, subject to a Cap at 3.75%, maturing on 20 May 2012

Option: from 20 May 2012 and every year thereafter Citi has the right to switch the fixed rate into 6m Euribor -100bps

Swap 1 Overview



From 23 February 2005 to 23 February 2006



9.50% on Feb 06

9.50%

from Feb 05 to Feb 06

Euribor + 200bps

from Feb 05 to Feb 06



From 23 February 2006 to 23 February 2036



6m Euribor + 0bps, capped at 3.75% until February 2010

3.70%



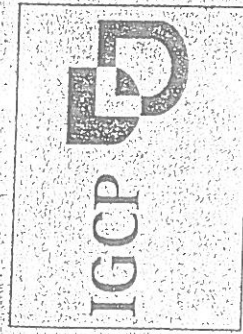
Swap 1 Overview



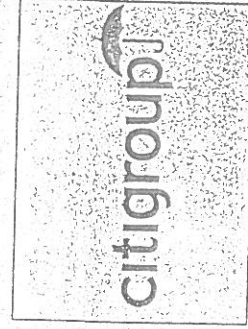
Citigroup Option:

Citigroup has the right to transform Fixed Rate that the IGCP pays into 6m Euribor - 100bps, in February 2011 and every year thereafter

Option Not Exercised



Option Exercised



Swap 2 Overview



From 23 February 2005 to 23 February 2007

6.625%

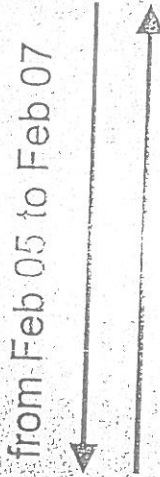
from Feb 05 to Feb 07

Euribor - 200bps

from Feb 05 to Feb 07



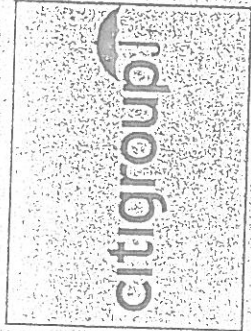
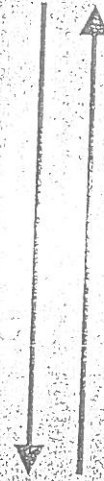
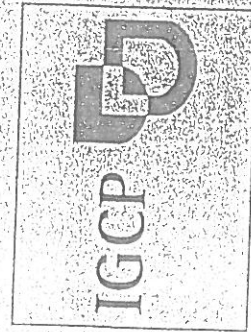
6.625% on Feb 06, 07



From 23 February 2007 to 23 February 2037

6m Euribor +0bps, capped at 3.75% until February 2012

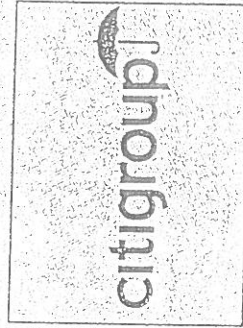
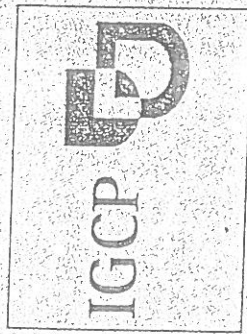
4.30%



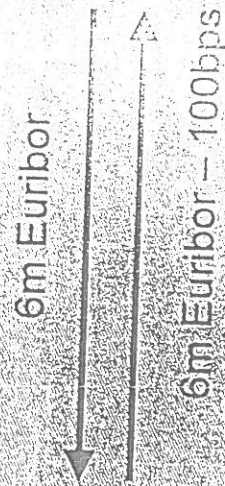
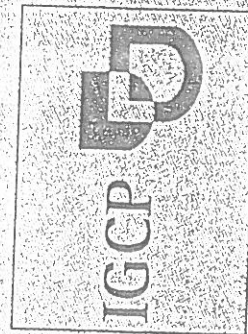
Citigroup Option:

Citigroup has the right to transform Fixed Rate that the IGCP pays into 6m Euribor - 100bps, in February 2012 and every year thereafter

Option Not Exercised



Option Exercised



Swap 3 Overview



From 20 May 2005 to 20 May 2007

5.85%



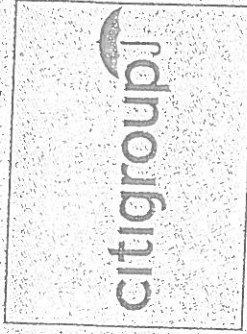
5.85%

from May 05 to May 07



Euribor - 200bps

from May 05 to May 07



From 20 May 2005 to 20 May 2037

6m Euribor + 0bps, capped at 3.75% until May 2012



4.20%



Citigroup Option:

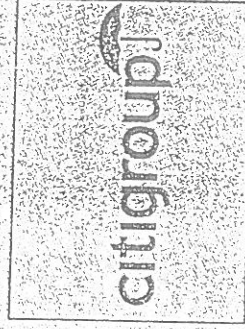
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Option Not Exercised

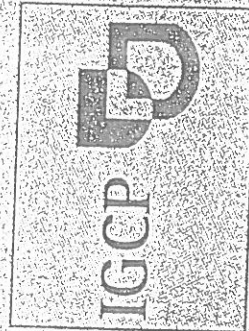


6m Euribor

4.20%

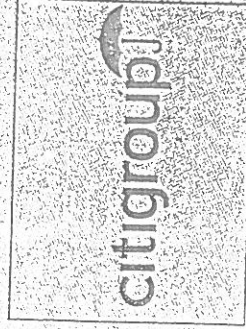


Option Exercised



6m Euribor

6m Euribor - 100bps



The Use of Derivatives by EU Governments

- ➔ Swaps have become a common feature of highly developed debt strategies for EU12 Governments. S&P acknowledge that partly as a result of swaps debt managers have been successful in reducing the average cost of government borrowing and smoothing interest payments and amortization schedules thereby contributing to fiscal improvements
- ➔ S&P summarized the issues involved in a paper dated September 2002, "Accounting for Innovation: Treatment of Off-Balance Sheet Public Sector Financing Operations", in which they acknowledge that "trying to take advantage of the leeway that public accounting rules allow is a legitimate objective." Governments increasingly care about reporting of fiscal performance
- ➔ Following an amendment to European System of Integrated Economic Accounts (ESA) 95 in 2001, streams of interest payments resulting from swap agreements and forward rate agreements count towards deficit calculations but not to net borrowing (debt) calculations
- ➔ EC governments report national accounts to Eurostat which publishes a summary in an annual news release referencing deficits as a % of GDP after derivatives, highlighting the impact of swap transactions. In 2004, Eurostat said the positive impact on the headline deficit number mainly affects Sweden (0.24%), Denmark (0.20%), Finland (0.16%) and Austria (0.15%)
- ➔ S&P say that they will take account of such transactions when analyzing government credit risk and that as of today these transactions have had no material impact. They say that if "innovative" operations were to impact future fiscal flexibility in a more substantial way than in the past, then rating implications are possible. However S&P include Securitization, PFI projects and the use of non-consolidated borrowing institutions as well as swaps in their definition of innovative operations. Fitch and Moody's have said the same



10/6/2003 - 15 September 2003

Second notification of deficit and debt data for 2002
 Euro-zone government deficit at 2.2% of GDP
 and public debt at 69.0% of GDP

Government expenditure and revenue are reported in Eurostat under the ESA95 transmission programme. They are the sum of non-financial transactions of the general government accounts, and include both current and capital transactions. For definitions, see Commission Regulation No. 1505/2000 of 10 July 2000.

It should be noted that, following an amendment in ESA95, the government balance which may be calculated at the deficit procedure (Regulation (EC) No 2559/2001 on the reclassification of settlements under swaps agreements and forward rate agreements) involves the sum of relevant deficits of government debt, surplus and forward rate agreements, and forward rate agreements and forward rate agreements.

For the purpose of the excess-deficit procedure, net lending, net borrowing of general government includes shares of interest payments resulting from swap and forward rate agreements.

The ESA95 definition of net lending and borrowing does not include streams of interest payments resulting from swap agreements and forward rate agreements.

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For most Member States, the difference, if any, between the net balance in euros (less than 0.1% of GDP) except in Sweden (0.2%), Austria (0.2%), and Italy (0.5%).

	1999	2000	2001	2002
Portugal				
GDP in €	170 000	3 073	3 200	3 200
Government deficit / surplus		115 000	123 000	120 000
Government expenditure	2.8	2.8	4.2	2.7
Government revenue	0.3	0.3	0.3	0.3
Government debt	42.4	42.3	42.1	43.3
Primary surplus	40.6	41.0	40.3	39.0
Balance	4.3	4.3	4.3	4.3
Italy				
GDP in €	107 000	1 100 000	1 220 000	1 200 000
Government deficit / surplus		10 100	1 220 000	1 200 000
Government expenditure	1.1	1.1	1.1	1.1
Government revenue	0.0	0.0	0.0	0.0
Government debt	49.1	49.2	49.8	49.2
Primary surplus	123.2	123.2	123.2	123.2
Balance	110.0	110.0	110.0	110.0

The difference between revenue and expenditure may not exactly be equal to the deficit/surplus for the reasons shown in the table below.

For most Member States, the difference, if any, between the net balance in euros (less than 0.1% of GDP) except in Sweden (0.2%), Austria (0.2%), and Italy (0.5%).



11/7/2004 - 23 September 2004

Second notification of deficit and debt data for 2003
 Euro-zone government deficit at 2.7% of GDP
 and public debt at 70.7% of GDP

Government expenditure and revenue are reported in Eurostat under the ESA95 transmission programme. They are the sum of non-financial transactions of the general government accounts, and include both current and capital transactions. For definitions, see Commission Regulation No. 1505/2000 of 10 July 2000.

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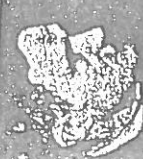
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Financial Times (November 25th 2003) - Reaction to waveling of sanctions on France and Germany

Pact suspension: how they square up



Germany
Hans Eichel, finance minister
Forces the suspension of the pact after refusing to accept Commission recommendations for deeper budget cuts



France
François Mitterrand, finance minister
Like Germany, failed to meet the pact's criteria and ignored demands to reduce its deficit levels

Ireland
Supports the suspension

UK
Backs the German and French stance. Government has said the pact should be interpreted flexibly

Netherlands
Reluctant supporter of the suspension. Agrees the pact should be interpreted flexibly

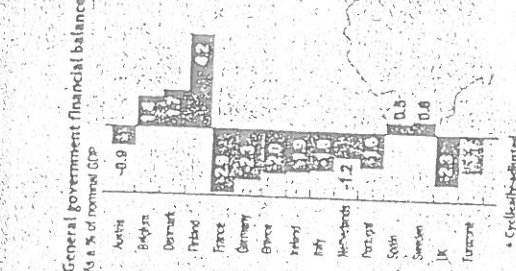
Belgium
Reluctant supporter of the suspension. Agrees the pact should be interpreted flexibly

Luxembourg
Supports the suspension

Greece
debilitant supporter of the suspension. Expected budget deficit this year of below 2 per cent and next year has a target of 1.2 per cent

Sweden
Prime Minister Göran Persson criticised French failure to put finances in order during euro referendum. Country's public finances in surplus*

Denmark
Opposed to suspension. Strong public finances with budget in surplus*



Portugal
Supports the suspension. Earlier broke the pact's 3 per cent limit, but subsequently brought deficits below ceiling


Italy
Proposes the political declaration calling for the suspension. Projects a budget deficit of 2.2 per cent next year and has kept it consistently under 3 per cent by using one-off revenue measures




Austria
One of the fiercest critics of Germany and France for refusing to follow pact rules. Public finances in good order*



Finland
Equally critical of Germany and France. Country's public finances are in surplus



Netherlands
Another fierce critic of both Germany and France particularly as it has taken action to improve public finances



Spain
Surprised many by vigorously defending the pact. Has maintained a balanced budget and been critical of suspension

Outrage as collapse of deficit pact splits EU

Report of system's demise may be exaggerated

Source: OECD. Copyright by the Financial Times

Appendix – Accounting Considerations



Example

Sovereign A issues *debt* to Citigroup under which Sovereign will receive €500mm during year 1 and repay €500mm during year 2 (ignoring the time value of money). The accounting for year 1 would be:

	Cash	Debt	Deficit	Impact on SGP measures
Eurostat (SGP under ESA95)	+500	+500	0	0
Corporate Accounts	+500	+500	0	

Sovereign B enters into a customized funding *swap* (not a standard plain vanilla interest swap) with Citigroup under which Sovereign will receive €500mm during year 1 and repay €500mm during year 2 (ignoring the time value of money). The accounting for year 1 would be:

	Cash	Debt	Deficit	Impact on SGP measures
Eurostat (SGP under ESA95)	+500	0	-500 (reduces deficit)	0
Corporate Accounts	+500	+500	0	

Corporate Accounts are included for comparison to what the accounting treatment would look like for an entity reporting under International Financial Reporting Standards

The accounting above is highly simplified for the purpose of illustration

Appendix – Accounting Considerations

EU Member States (Sovereigns) are required under the “Stability and Growth Pact” (SGP) to:

→ Keep government deficit as a percentage of GDP below 3%; and

→ Keep government debt outstanding as a percentage as GDP below 60%

Deficit and debt calculations are prepared by Eurostat based on the data supplied by Sovereigns from their national accounts. Sovereigns generally do not provide disclosures regarding utilization of derivatives. Eurostat employs basic calculations to roughly estimate such activity.

Eurostat accounts are based on “cash-basis accounting principles” and the concepts of “fair value accounting” and “hedge accounting” are generally not applied.

Differences in the accounting treatment for debt versus funding swaps for the purpose of determining the deficit/GDP ratio may provide incentives for Sovereigns to use such swaps.

In brief, the difference can be highlighted as follows:

→ **Debt.** Funding received through debt issuance will generally be recorded as a liability (no direct impact on deficit calculations). Annual interest payments will impact the current year's deficit.

→ **Funding swap.** Funding received through funding swaps will not be recorded as a liability. Instead the funds received will immediately reduce the current year's deficit. (The swap will effectively be kept “off balance sheet”.)