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Global Securitisation Review



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Structured local issuance in emerging markets enter prime-time

by Lee Meddin, International Finance Corporation

Something remarkable happened in 2004 in the world of emerging market structured finance. For the first time, domestic issuance of structured debt in Latin America surpassed that of cross-border issuance. At first glance, this may not appear to be incredibly noteworthy, but it represents a watershed event in how emerging market economies globally are beginning to finance themselves. Rather than relying on cross-border lenders and accepting the volatility and currency mismatch this generally entails, domestic borrowers in the emerging markets are seeing greater and greater access to long-term local currency financing in their own markets. Structured finance has been an important component in allowing this to happen.

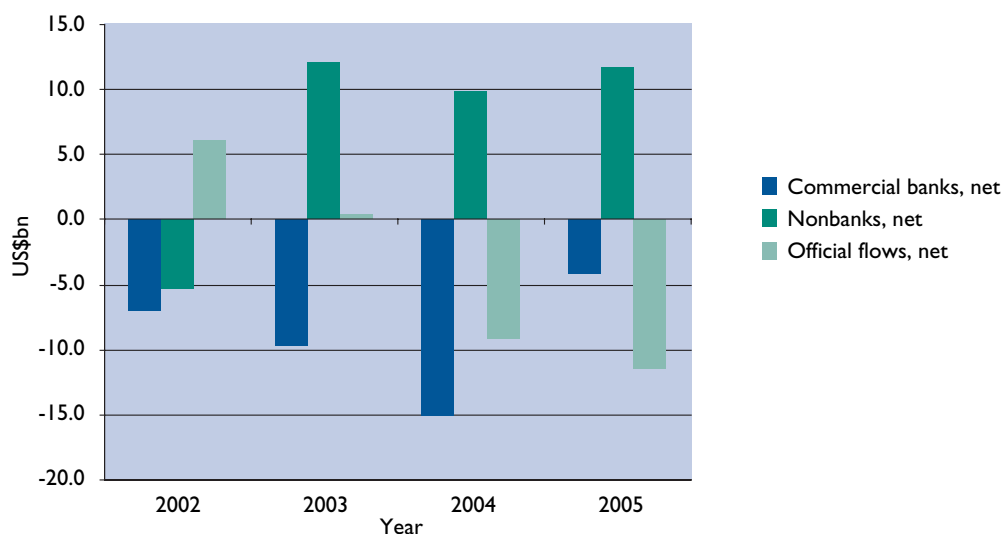
A number of events have occurred simultaneously facilitating the growth in domestic market structured finance in Latin America. On the international front, net external debt financing into Latin America has been on the decline. This has heightened the need for borrowers in this region to diversify their funding sources away from the cross-border market. Over the past three years, cumulative net external financing from private creditors (commercial banks and capital markets investors) and official creditors (international financial institutions and bilateral creditors) has been minus US\$18bn. In 2004 alone, net external debt financing into the region was minus US\$14bn. (See Figure 1).

On the regional front, just as the supply of international financing has been waning, the availability of domestic financing has been growing.

Pension fund assets alone have reached over US\$225bn in Latin America. In Brazil, Colombia, Mexico and Peru, which together represent over US\$150bn in pension fund assets, year-on-year growth averaged over 20% from 2003 to 2004. Factoring in other sources of domestic savings, including mutual funds and banks, the amount of domestic funds available for investment is substantially larger, but it is the pension funds that generally have the ability to create a pool of true long-term local currency financing for domestic borrowers. (See Figure 2).

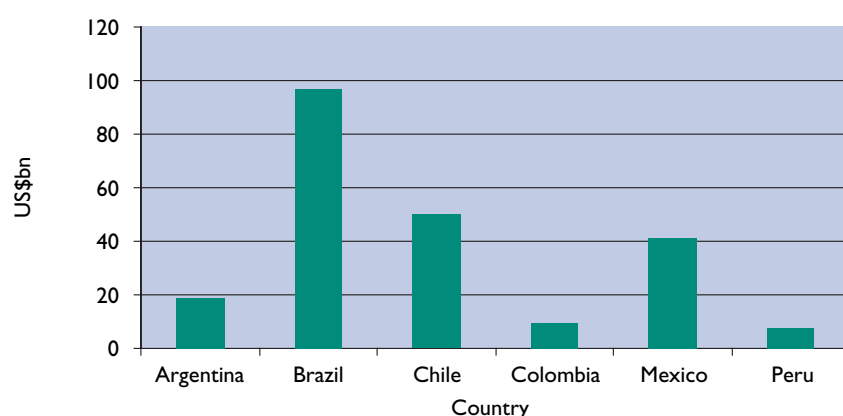
Although the pension funds have this large and growing pool of available cash for investment, it has often proven difficult for them to deploy these funds in anything other than government securities. Pension funds in Colombia, Mexico, and Peru have a

Figure 1: Latin America net external debt financing



Source: Institute of International Finance, (March 31, 2005)

Figure 2: Latin America pension funds 2004 amounts under management



Sources:

FitchRatings, March 2005; Brazilian Association of Private Pension Funds (ABRAPP); Maxima S.A. AFJP; and Business Week, May 2004.

general requirement that all, or virtually all, of their assets have a minimum domestic credit rating of double-A minus. In Brazil, there is a similar requirement, which is that 80% or more of a pension fund's assets be invested in low risk securities. Although sovereign debt meets these criteria, there tend to be relatively few high quality non-sovereign issuers. Thus, there has historically been little else other than government securities for pension funds to buy. However, this is now changing.

There are a number of factors which seem to explain the trend towards growing domestic issuance of structured securities. First, domestic investors are generally required to buy domestic securities to prevent the foreign exchange risk they would otherwise incur if buying offshore assets. Second, growing pension funds, as well as other sources of domestic savings, have resulted in an increased amount of cash to be invested and therefore increased demand for local currency assets. Additionally, domestic investors not only have a growing pool of cash to invest in domestic assets, but are often willing to do so at lower risk premiums than international investors due to a generally reduced perception of sovereign risk, lack of transfer and convertibility risk, and limited investment alternatives.

Domestic demand could not be met if local currency product was not available. Although historically this has been an issue, several events over the last decade have led to a large increase in the number of borrowers seeking local-currency financing. First, crises in many emerging market economies have left many borrowers which funded local currency assets with foreign currency liabilities deeply underwater. Second, there has been a global downtrend in interest rates which has allowed local

currency borrowings to be achieved at attractive rates. Additionally, there have been large improvements in the legal and regulatory environment of many developing countries that have facilitated the growth of domestic bond issuance, including issuance of structured securities. By employing the credit-enhancement techniques of securitisation, high quality assets can be created, providing the pension funds with the investments they require.

Securitisation structures in Latin America

What are the securitisation structures seen in the local markets? As it turns out, the answer is quite country specific. In Argentina, securitisation of consumer loans and credit cards has dominated in recent years. In Brazil, it's been real estate related assets, auto loans, and consumer loans. Colombia has seen an active market develop for residential mortgages, non-performing loans, and bond repackagings. Construction bridge loans, residential mortgages, and tax revenues have been the primary drivers in Mexico, the region's most active market in 2004. Additionally, partial credit guarantees of corporate debt have begun to proliferate in many markets throughout the region.

In an effort to better understand the various structures appearing in the domestic markets, it is worth focusing on a few relevant transactions which have recently been completed. In each of these transactions, the International Finance Corporation (IFC) has played a key role. IFC, the private sector arm of the World Bank Group, has been involved in over US\$3bn of structured debt transactions in the emerging markets over the past few years.

As a development bank with global presence in

emerging markets, IFC is able to act as a conduit, ensuring a knowledge transfer from one market to the next. This is accomplished by acting as a 'structuring investor' in which the organisation not only invests in local currency structured transactions, but also takes an active role in structuring them.

Transactions have been completed for IFC clients in Africa, Latin America, East Asia, South Asia, Eastern Europe, and the Middle East. These transactions have been executed in 14 different currencies and have been for clients in industries as diverse as communication, education, funds management, health, infrastructure, financial services, manufacturing, municipal government and agribusiness.

Here is a sample of recent structured finance transactions in which IFC has participated, in three major categories: mortgage-backed securitisation, asset-backed securitisation and partial credit guarantees.

Mortgage-backed securitisation

Mortgage-backed securities represent the single largest asset class of the single largest market globally. Of the US\$24.1 trillion US bond market, 23% of the assets are mortgage-backed securities. This dwarfs even the 17% component of the market represented by US Treasuries. Hence, it is no surprise that this has often been one of the first asset classes to take off in nascent securitisation markets.

For a bank originating loans secured by residential mortgages, securitisation can often be a godsend. These banks generally earn a healthy income both originating these loans and servicing them on an

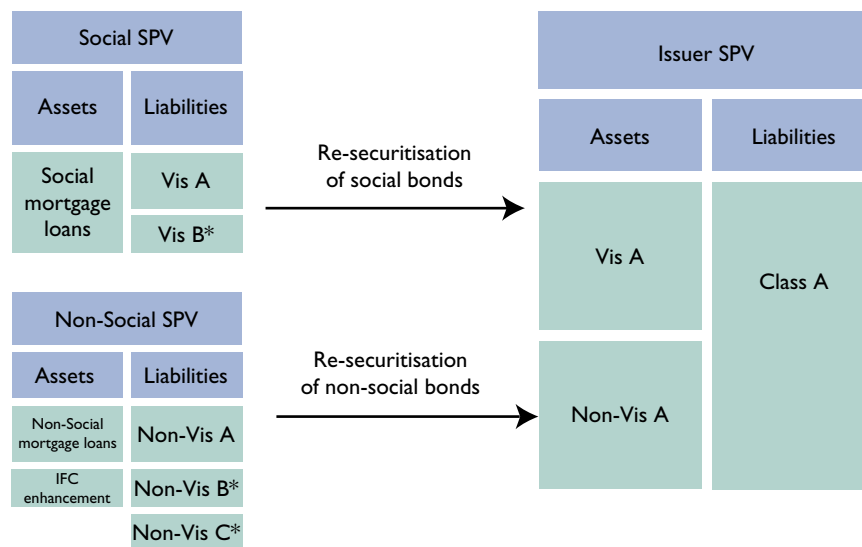
ongoing basis. However, given balance sheet constraints, the banks are often restricted from continuously originating new assets, unless existing portfolios can be sold. Additionally, given the lack of long-term liabilities for most banks, and the lack of long-term swaps in most developing countries, holding a large portfolio of fixed rate mortgages is generally not seen as financially prudent.

Titularizadora Colombiana is Colombia's first secondary mortgage company. The company specialises in supporting the country's residential mortgage market through securitisations and related activities. To accomplish this, Titularizadora Colombiana has established a programme in which it regularly buys portfolios of mortgages from various domestic banks and arranges securitisations backed by these pools. The ability to commingle the individual pools and pursue a programme of regular issuance has allowed the Company to achieve an economy of scale needed to support this business.

Titularizadora's first mortgage backed-securitisation (MBS) involved the securitisation of two distinct collateral pools (social and non-social). The first pool (social) consisted of inflation-indexed loans whose collateral is guaranteed by a governmental agency. This type of loan carried below market rates. The second pool (non-social) was formed by inflation-indexed loans with no governmental guaranty and hence carried market rates.

Overall, the issue amounted to US\$210.5m in mortgage backed securities denominated in inflation-indexed local currency. The issue comprised US\$204m equivalent, or 97%, of AAA-rated senior

Figure 3: Cashflow diagram for Titularizadora Colombiana



*B Bonds sold to Titularizadora Colombiana or into the market

*C Bond retained by originator

bonds in three tranches of varying maturities and US\$6.5m equivalent, or 3%, of A-rated subordinated bonds. The maturities of the senior tranches were five, 10, and 15 years while the subordinated tranche had a 15-year maturity.

IFC provided a local currency credit enhancement facility of up to US\$100m to support the overall programme, of which US\$2.2m was used as a partial credit guarantee of the non-government guaranteed portion of the senior bonds. Titarizadora has successfully completed six transactions in which pools of performing mortgages have been securitised, drawing upon IFC's credit enhancement facility as needed to cover the mezzanine risk in each transaction. (See Figure 3).

Asset-backed securitisation

Although significantly smaller than the portion of the overall market represented by mortgage-backed securities, asset-backed securities nonetheless represent an impressive 7% of the US debt market.

The list of assets which have been, and can be securitised is almost endless. To name but a few, pools of existing assets which are frequently securitised include auto loans, equipment leases, and student loans. Transactions backed by future flows (i.e. cashflows based on obligations which are expected to materialise in the future) include offshore worker remittances, trade receivables, toll roads and student tuition payments.

Another, somewhat specialised asset class for which securitisation has worked well is non-performing loans (NPLs). Securitisation of NPLs allows banks to remove non-performing loans from their balance sheet at a market price, thus providing the banks with liquidity and improving the overall quality of their remaining loan portfolio.

Existing assets: The Argentine banking sector has traditionally funded trade finance activity in the country. However, cutbacks from international and domestic banks due to Argentina's economic crisis in

2001 made it difficult for exporters to obtain pre- and post-shipment trade financing. The Exportadores II programme was designed to help mobilise funding from alternative sources, including domestic institutional investors, in order to provide financing to Argentine exporters.

Exportadores II was sponsored by a consortium of three Argentine banks: HSBC Bank, BBVA Banco Frances, and Banco Rio de la Plata. The sponsors, through the financial trust, securitised US\$20m in pre-shipment export loans to four Argentine exporters: Molinos Rio de la Plata, Pecom Agra, Petroquímica Rio Rercero, and Vitopel. Both the loans and securities had a tenor of 270 days.

There were six components to the structure: 1) the sponsors originate 270-day pre-export loans with the exporters; 2) the Trust purchases the loans from the sponsors; 3) the purchase is made using proceeds from an issuance of securities; 4) the exporters ship the goods to the offshore importers; 5) the importers pay either the Trust or the exporter's off-shore account; and 6) the Trust, after receiving payment from importers, pays investors.

The issue, which included a stand-by purchase commitment from IFC for up to US\$10m, received an A3 rating by the local affiliate of FitchRatings and was placed with domestic institutional investors. The transaction was IFC's first investment in Argentina's domestic financial markets since the onset of the country's economic crisis. (See Figure 4).

Future flows: Universidad Diego Portales (UDP), one of the leading private universities in Chile, was founded in 1982. In order to consolidate market position and improve the overall quality of the service offered, the University embarked on a modernisation and expansion project in 2003 to 2004. This included the construction of new buildings and modernisation of existing facilities to provide the additional space needed to increase student enrollment in the University's new

Figure 4: Cashflow diagram for Exportadores II

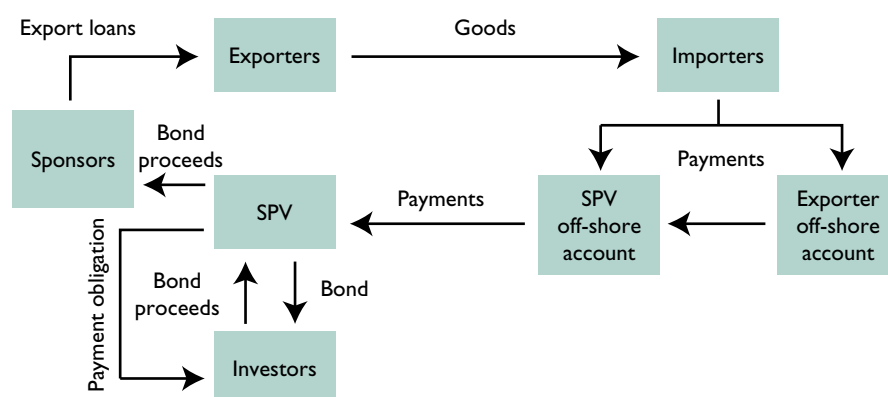
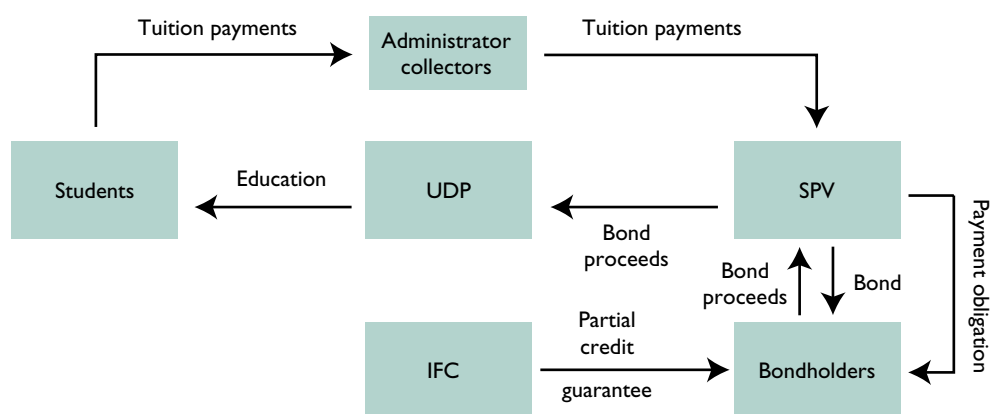


Figure 5: Cashflow diagram for Universidad Diego Portales (UDP)



programmes in medicine, engineering, and humanities. Given the University's business cash flow characteristics, a securitisation of its future tuition flows seemed the ideal way to meet its objectives.

As part of the securitisation transaction, UDP transferred to a Special Purpose Vehicle (SPV) the right to directly receive the future tuition payments of students enrolled in the undergraduate schools of law, design, public relations, and journalism. The SPV in turn funded the purchase of these future tuition receipts by issuing bonds which were secured by these cashflows. In addition to the security provided by the future tuition payments, bondholders also received a guarantee by IFC for up to 30% of the outstanding principal amount of the bonds. The eight year US\$23m equivalent (in UF, inflation-indexed local currency) bonds received a double-A minus rating by the local affiliates of Moody's, Standard & Poor's, and FitchRatings. The transaction marked the first time in which a university was able to secure financing by securitising future tuition receipts, and has since been replicated in other markets. (See Figure 5).

Non-performing loans: As a result of Colombia's financial crisis in 1998, the banking system generally, and the housing finance sector specifically, suffered significant losses. As of December 2003, delinquent mortgage loans accounted for 28% of the entire mortgage sector, with an aggregate balance of non-performing mortgages of US\$796m. In order to create a market for these mortgages, and thus provide additional liquidity for banks, Titularizadora Colombiana launched an initiative to help banks securitise these assets.

Titularizadora's first non-performing MBS involved the securitisation of pools from two originating banks, Conavi and AV Villas amounting to US\$76m and US\$77m equivalent, respectively. The US\$67m (in UVRs, the inflation-indexed local

currency) issue consisted of triple-A rated senior bonds in two tranches of five year and seven year maturities. IFC's credit enhancement in the form of a US\$3.3m partial credit guarantee of the issuing vehicle's obligations, along with additional credit enhancement by the originating banks in the form of cash reserves and over-collateralisation, allowed the senior bonds to achieve a triple-A domestic rating by Duff and Phelps de Colombia and BRC.

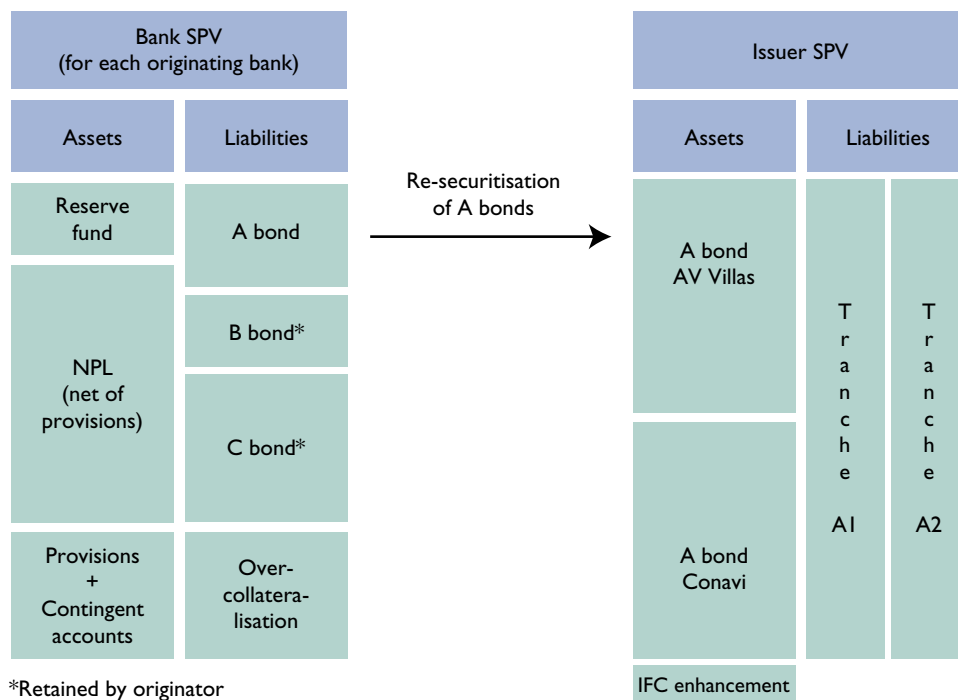
Titularizadora has now completed two securitisations of NPLs, and has plans to continue this business on an ongoing basis. (See Figure 6).

Partial Credit Guarantee

A partial credit guarantee (PCG) is a credit enhancement mechanism for debt instruments (bonds and loans). It is an irrevocable promise to pay principal and/or interest up to a pre-determined amount, irrespective of the cause of the payment default. Typically, IFC's guarantees are structured in such a way as to increase the recovery if a default were to occur, and in certain instances, actually reduce the probability of a default occurring. In terms of increasing recovery given default, IFC's objective is to offer the minimum amount of guarantee necessary in order to facilitate a successful transaction. This generally allows the borrower to achieve the lowest possible funding cost; allows the investors to maximise their return given their risk tolerance; and allows IFC to mobilise the maximum amount of financing for its clients given a level of credit exposure.

Partial guarantee for senior debt: Financiera Compartamos, a Mexican lending institution, provides micro loans with an average size of US\$300 through three products: village banking, solidarity group loans, and individual loans. The company has a growing network of more than 100 branches in 16 regions in Mexico and more than 240,000 borrowers, of which more than 95% are women in rural areas. In providing village banking loans to

Figure 6: Cashflow diagram for Titularizadora Colombiana NPL



groups of 15 to 50 women, Compartamos has become a role model for strong financial performance and established a highly successful lending methodology in microfinance.

As a *Sociedad Financiera de Objeto Limitado* (SOFOL), Compartamos is not allowed to take deposits. Over the past years, the company has funded its growth through local currency revolving credit lines, long-term loans in US dollars, equity and retained earnings. Additionally, the company had issued a domestic bond which was placed with private investors. In an effort to increase the tenor of future bond issuance, diversify its placement to a larger investor base, and reduce borrowing costs, Compartamos established plans for a Ps500m (US\$45m equivalent) bond issuance programme targeted at domestic institutional investors.

As many institutional investors in Mexico have a cut-off of double-A minus for new investments, Compartamos's rating of single-A plus precluded them from accessing this investor base for the size and tenor of the funding they desired. In order to assist Compartamos in overcoming this obstacle, IFC provided the Company with a credit-enhancement facility for the purpose of partially guaranteeing bond issues so that each issue would achieve a rating sufficient to place the paper with institutional investors.

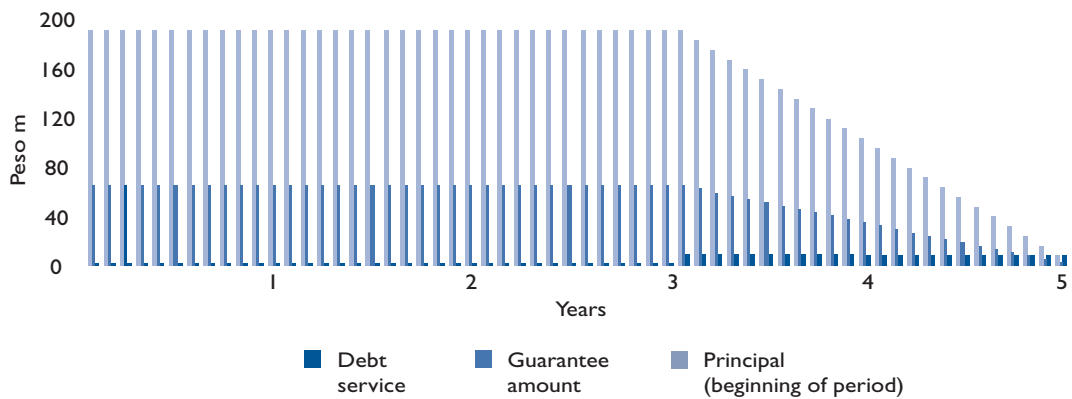
For Compartamos's inaugural issue under the programme, the Company issued a five-year Ps190m (US\$17m equivalent) bond, of which the majority

was sold to institutional investors and mutual funds, with the remainder going to private investors. This was accomplished with the assistance of a partial guarantee by IFC which covered 100% of principal and interest payments, subject to a maximum payout of 34% of outstanding principal. The issue received a domestic rating of double-A by both Standard & Poor's and FitchRatings. (See Figure 7).

Partial guarantee for subordinated debt: Banco Davivienda is Colombia's leading mortgage originator and third largest financial institution. In order to facilitate their expansion and diversification strategy into non-mortgage financing, it became necessary for Davivienda to bolster their capital base. In this endeavor, Davivienda decided to issue a subordinated bond which would qualify as Tier II capital under the new guidelines released by the Banco de la República (the Central Bank of Colombia). As such an issue would be the first of its kind, and as the rating for such an issue would be somewhat below the normal requirements of domestic institutional investors for a bond with the required tenor, IFC assisted Davivienda by offering a partial credit guarantee.

The issue consists of a 10 year, non-call five, UVR1bn (approximately US\$500m) subordinated step-up bond partially guaranteed by IFC for 30% of the face value. The bond carries a coupon of 7.5% over the Colombian inflation rate, and increases to 11.25% over the inflation rate if not called after five and a half years. Interest is payable quarterly and

Figure 7: Cashflow diagram for Compartamos



principal is payable at maturity. As part of the agreement, IFC has an option to purchase up to US\$10m in common equity shares.

The bond achieved a domestic rating of AA+ by the local affiliate of FitchRatings, and was placed among domestic institutional investors within the first day of offering. With this bond, Davivienda was able to tap additional and longer-term funding than it otherwise would have been able to, and to bolster its capital base. Furthermore, this transaction contributed to the development of the Colombian capital market by helping to establish an alternative means for banks to raise capital, and providing an alternative investment opportunity for institutional investors.

Conclusion

Calculating the exact amount of structured finance issuance in any market is never easy, as the definition of what constitutes a structured finance transaction can be opaque, and the way in which various organisations calculate this volume can be quite different. For 2004, FitchRatings reported that there was US\$10bn of structured finance issuance in Latin America, of which 26% was cross-border and 74% was domestic. Moody's reported total issuance of US\$10.9bn, of which 28% was cross-border and 72% was domestic. Although many of the specific

transactions each agency selected in computing these figures differ, there is consensus in terms of overall magnitude. It is this overall magnitude that points to the fact that domestic issuance of structured products has finally entered prime-time in Latin America.

Although Latin America is only one region in the emerging markets, this recent growth of domestic structured finance markets has implications for emerging markets globally. Latin America may be slightly ahead of the general emerging markets curve in terms of domestic capital market development, but often the trends seen in this region begin to percolate elsewhere.

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