global securitisation review

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Foreword – Establishing new markets for securitisation: The value-added of the credit-enhancer

by Lee Meddin, International Finance Corporation (IFC), World Bank Group

There are a variety of forms of credit enhancement available to help create highly rated senior tranches of securitisation transactions. These include reserve accounts (placing money aside at the inception of the transaction to cover potential payment shortfalls), excess spread (capturing the difference between the income generated on the asset pool and the expense required to service the liabilities of the issuing trust), over-collateralisation (having the assets in the trust initially outweigh the liabilities), and the issuance of subordinated tranches of securities (see Figure 1). In addition to these forms of credit enhancement, there is also the possibility of having a highly rated third-party guarantee a portion of the issuing vehicle's liabilities (see Figure 1). When introducing securitisation to a new market, or simply introducing a new asset class to an existing market, there are a number of advantages in including such third-party credit enhancement in addition to any other forms of credit enhancement which may be embedded into the structure.

As a leading provider of credit enhancement in new markets and for new asset classes, IFC has experience credit enhancing structured transactions in over 20 emerging markets.

IFC's exact role as a credit-enhancer is that of a "structuring investor". As the name implies, IFC not only takes risk in the deals in which it participates, but takes an active role in structuring this risk by becoming involved in transactions at their inception. Although this somewhat unique experience gained as a structuring investor and member of the World Bank Group serves as the basis for this article, the benefits of including a credit-enhancer when introducing securitisation to new markets are numerous, and there are numerous providers of such enhancement.

Role of the credit-enhancer

Lead investor

In the emerging markets, a hypothetical structure for a partially guaranteed mortgage-backed securitisation (MBS) may have a first-loss of 3% retained by the originator in the form of equity, a mezzanine tranche of risk of 10% guaranteed by the credit-enhancer, with the remaining risk being sold to senior investors (see Figure 1). In such a structure, although the mezzanine risk may notionally represent only 10% of the total liabilities, this tranche absorbs a disproportionately large portion of the overall risk, often as high as 45% of the total risk in the transaction, sometimes even higher (see Figure 1). Hence, the credit-enhancer not only takes the junior most risk in the transaction beyond that retained by the originator, but generally absorbs a significant portion of the overall risk of the deal. This places the credit-enhancer in the *de facto* role of lead investor, thus aligning the interests of this party with those of the senior investors.

Having such a lead investor involved at the inception of the transaction often adds a great deal of benefit when the time comes to market the deal to senior investors and convince them to invest in a new asset class. Much of this benefit comes from the fact that given the way in which the cashflow waterfall works, senior investors will generally not experience their first dollar of loss until the credit-enhancer has lost its entire notional amount. As the credit-enhancer typically plays an active role in structuring the deal in order to minimise its own probability of loss, having such a lead investor often acts as a catalyst for bringing in senior investors.

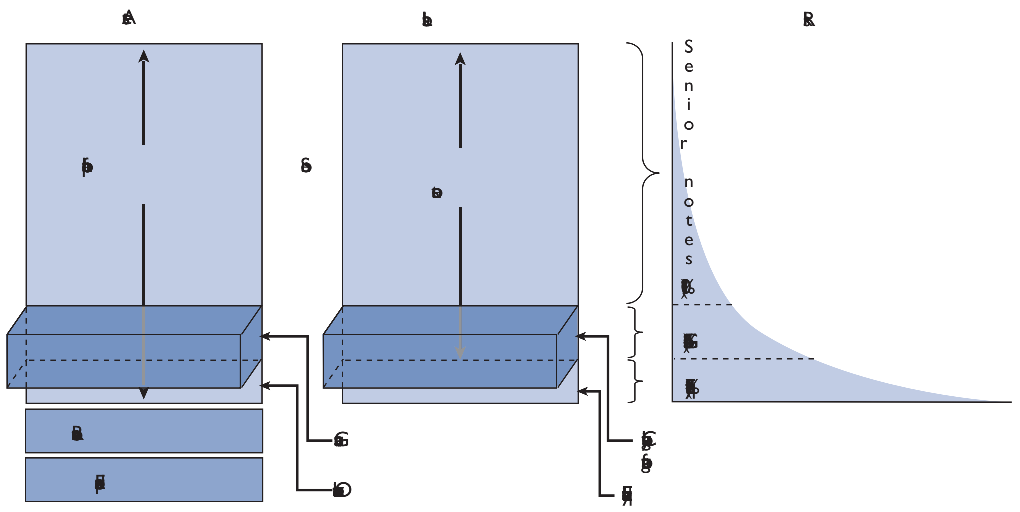
Legal expertise

Although hiring local counsel and international counsel to draft documents is always an option, it is often an expensive and time consuming proposition. As a shortcut, working with a credit-enhancer who has sample document templates which have worked in numerous other new markets can decrease both execution time and legal costs.

Due diligence and supervision

Senior investors in securitisations often base much of their decision as to whether or not to participate in a transaction on the information which is contained in the prospectus. Credit-enhancers on the other hand generally conduct a thorough due-diligence on both the originator and the asset pool. Then, on an ongoing basis, there may be an additional role for the credit-enhancer in monitoring

Figure 1: Anatomy of a credit enhanced securitisation



the transaction. Thus, having a credit-enhancer who has a vested interest in ensuring losses on the portfolio remain at a minimum, can be an important risk mitigant in securitisation transactions.

Compliment the arranger

Even though the arranger (usually an investment bank) has a very important role to play in establishing securitisation in new markets, and new asset classes in existing markets, the agreement to take on such deals may sometimes be viewed as a loss-leader given the time and effort required for such deals. Hence, having a third-party credit-enhancer that can assist with much of the traditional work of the arranger, such as structuring and negotiating with rating agencies, often improves the overall economics of the deal. Additionally, the global experience of a third-party credit-enhancer in introducing securitisation structures in new markets often compliments the deep capital markets knowledge which the arranger has of its domestic market.

Ratings

The expertise gained by a credit-enhancer operating internationally through participation in the credit ratings process for numerous deals in numerous countries can add substantial value in the ratings process. Much of this value is derived by having a party to the deal that understands and has first-hand experience with the ratings criteria that have been implemented by the international rating agencies (Fitch, Moody's, and Standard & Poor's) for similar transactions in other countries, as well as the relevant criteria that have been implemented by various domestic rating agencies throughout the world. This aids the originator in ensuring that its transaction meets international standards, even if the transaction is rated by a local rating agency, and gives great confidence to senior investors that their tranche has been properly structured and that the rating on this tranche accurately reflects the inherent risk.

Coordinate with regulators

Often there are legal and/or regulatory hurdles that need to be overcome in order to introduce securitisation to a new market. A credit-enhancer with global experience in opening new markets, and a reputation as an honest broker in working with market counterparts, including regulators, may facilitate clearing the last hurdles required for securitisation to become a reality in a new market.

Best practices of a credit-enhancer

Get involved early

Given the multitude of ways in which securitisations can be structured, it is important that the credit-enhancer be brought into transactions at a very early stage. The downside of not doing so is that the deal is structured in a manner which does not meet the credit-enhancer's specific requirements, whereas a slightly different structure may have given the credit-enhancer the comfort required to invest in and support the transaction.

Maintain high standards, but remain flexible in approach

One of the wonderful things about structured finance is the numerous alternatives available to mitigate specific risks. As a credit-enhancer taking subordinated risks, it is important to ensure that certain risks in the transaction are safe-guarded against, and that those that are not are properly understood and priced. However, to be most effective, it is important to stay away from a "one size fits all" approach. Rather, it is important that each transaction be tailored in a way that works for all parties involved, yet presents the credit-enhancer with an acceptable risk and reward.

Focus first on internal credit enhancement and structure, and then on guarantee amount

All too often credit-enhancers are asked to guarantee a specific amount early in the structuring process, sometimes even before the ratings process is initiated. In most cases, this is simply based on someone's desire to see a minimum amount of credit enhancement in a deal, rather than specific quantitative factors. However, as third-party credit enhancement comes at a price, it is generally in everyone's best interest to ensure that the minimum amount of enhancement is offered in order to achieve a successful deal. As this minimum amount is generally not known until the final stages of the structuring process, it pays to remain flexible and seek ways to minimise the amount of third-party credit enhancement required.

Ensure investors understand the value-added in both the credit enhancement and the credit-enhancer

There is much more that a credit-enhancer brings to a transaction than simply a willingness to take on risk for a given price. Foremost is the ability to help close a successful deal in as short a time period as possible. To accomplish this, the credit-enhancer needs the ability to i) draft documents quickly and have a quick turn-around when reviewing documents, ii) conduct a timely and thorough due-diligence and receive its internal credit approvals in a timely manner, and iii) understand and model the structures being proposed and be value-added in finding ways to arrive at an optimum structure. Additionally, the credit-enhancer should have a successful track-record structuring and investing in similar assets. This instills confidence in senior investors, as these investors will only experience a loss on their investment if the credit-enhancer has experienced a significantly larger relative loss. Hence, the ability to have a credit-enhancer with a proven track-record gives additional confidence to senior investors that their investment is sound.

Build relationships and approach the structuring process as a dialogue amongst interested parties, not adversaries

In an already complex transaction involving an originator, arranger, rating agencies, regulators, investors, trustee, and lawyers, often the last thing one wants when structuring a securitisation is another party to the deal. Hence, the credit-enhancer needs to ensure its presence is perceived as value-added by each of these parties. This is definitely achievable, but only with a great deal of care.

For investments in securitisations, offer guarantees rather than an agreement to purchase mezzanine securities

For local currency transactions, a primary reason for guaranteeing securities, rather than purchasing securities, is the inability to properly hedge the currency risk. Even for currencies in which a cross-currency swap is available, there is unlikely to be a cancellable swap which is required to hedge the prepayment risk typically associated with securitisation. By guaranteeing risk, rather than purchasing local currency mezzanine securities, the credit-enhancer is able to defer any payments of local currency, and therefore mitigate currency risk, until such time as the guarantee is called upon, if ever.

Another important reason for this is the confidence that a guarantee gives to investors that the credit-enhancer has a long term perspective. Unlike a mezzanine security which can be sold at any time, providing a guarantee locks the credit-enhancer into the transaction for the entire duration. Additionally, as a guarantor, the credit-enhancer is able to be a formal party to the transaction and contribute to the structuring, documentation, and rating processes. This is not a right that purchasers of mezzanine securities necessarily have. Hence, being a formal party to the transaction allows the credit-enhancer to maximise its contribution.

Focus on mezzanine risk, not first loss

The originator typically plays a very large role in securitisations, beyond that of simply selling a portfolio to the issuing vehicle at the inception of the transaction. In most securitisations, the originator has an ongoing role as servicer of the asset portfolio. Additionally, in transactions with a dynamic asset pool and those with a ramp-up period, the originator is tasked with later adding assets to the vehicle based upon pre-established underwriting criteria. Although it is expected that the originator will act professionally in these capacities, a moral hazard does exist which is best mitigated by having the originator retain a first-loss in the transaction. This creates a natural role for the credit-enhancer in the mezzanine tranche of risk.

Take less than 50% of the risk to avoid consolidation

Given recent changes in international accounting principles, it is important for the credit-enhancer to ensure that the transaction is structured in such a way that no one party takes more than 50% of the risk in the transaction. Even though a credit-enhancer may have a mezzanine position which is only 15% of the entire deal, it is quite possible that such a relatively small investment may absorb more than 50% of the expected loss, thus requiring the credit-enhancer to consolidate the entire transaction on its balance sheet. This is easily avoided by doing the proper risk calculations during the structuring process, to ensure that the credit-enhancer retains a minority of the overall risk in the deal.

Finding a credit-enhancer that follows all of these best practices will help to facilitate clean execution, optimal structuring, and successful placement of transactions. Finally, as a way for a credit-enhancer to optimise its role in a transaction, it should treat transactions as an opportunity to positively impact sustainable domestic capital market development, the development of new asset classes, and the ability of the originator to eventually access funds without the need for third-party credit enhancement.

Innovation

In order to maximise the value-added that a credit-enhancer can bring to a deal, it is very important to remain focused on innovation. Rather than assuming what has worked in the past is what is needed in the future, a pragmatic approach of introducing new credit enhancement products and fine-tuning existing ones is paramount. To better illustrate this, a few products recently introduced by IFC are described below:

Dynamic mezzanine enhancement

For a securitisation of assets such as mortgages, the peak credit exposure is expected to be sometime after the issuance date, but quite a bit before the maturity date. The reason for this is that on the issuance date the overall credit quality of the portfolio is known. But, from that day forward, the portfolio credit quality has the ability to vary, and thus this potential variance results in risk. However, over time, the assets themselves pay down, thereby reducing the notional at risk, and additionally, reducing the loan-to-value of the asset pool. Together, these events reduce the risk inherent in the transaction.

Taking all of this into account, it can be seen that for certain transactions, an ideal credit enhancement would be one that grows over time as the risk increases, and then reduces in later years as the risk reduces. With the issuance of mezzanine securities this is difficult to accomplish since there is no guarantee that further mezzanine securities can be issued in the future, and thus there is a requirement that the full amount of subordination be established at the inception of the deal. However, for credit enhancement by a third-party, there is the possibility to structure a guarantee that grows over time and then reduces. As a guarantee fee is only charged on actual value-at-risk of the guarantor, such a structure presents the originator with a potential cost savings over other forms of credit enhancement such as the issuance of mezzanine securities or inclusion of static guarantees.

Credit-linked guarantees

The concept of receiving a triple-A international guarantee sounds wonderful, but at times causes "sticker-shock" when the recipients themselves are in countries where their own sovereign has a non-investment grade international credit rating. The reason for this is that domestic investors are often satisfied with a credit that simply meets the criteria for a domestic triple-A rating, and generally place little additional value on credits that exceed this. Hence, investors are generally reluctant to accept a lower yield than that which a domestic triple-A offers, even if the credit quality of an alternative investment is higher using an international benchmark. Given that an international triple-A guarantee often costs more than a guarantee which simply meets the criteria for triple-A on a national scale, but is not necessarily valued any more by domestic investors, this poses an issue for guarantors which are themselves rated triple-A internationally.

To address this conundrum, IFC has introduced credit-linked guarantees into its product line. For such guarantees, the claim on the guarantee is conditional on a reference credit in the issuer's domestic market not defaulting. Hence, the guarantee is of no higher value than the reference credit itself, and to the degree that the default risk of the reference credit and the entity being guaranteed are positively correlated, the risk to the credit-enhancer is reduced, and therefore the price charged for the guarantee may be less than that for a traditional guarantee.

Guaranteed Offshore Liquidity Facility (GOLF)

For cross-border securitisations of domestic assets originated in the emerging markets, there is generally the need to provide risk cover for currency transferability and convertibility (T&C) risk in order for the senior securities to receive an investment grade credit rating. This has traditionally been accomplished by having the issuing trust purchase a policy for political risk insurance (PRI). To avoid the need to seek an independent PRI provider, and thus add yet another party to an already complex transaction, IFC introduced the Guaranteed Offshore Liquidity Facility (GOLF). This product, which is designed to integrate easily into a securitisation structure, allows the originator to cover T&C risk, with the benefit of having an offshore triple-A rated liquidity facility as a backstop. The liquidity facility simply ensures that the needed funds will always be available to the issuing trust as long as the disbursement criteria has been met. Since the burden to cover any shortfall as a result of a T&C event ultimately lies with the originator, the GOLF product is priced like a true liquidity facility, which can be substantially cheaper than traditional PRI, and thus provide the originator with a substantial cost savings.

Conclusion

Over the past few years, IFC has been involved in over US$5bn equivalent of emerging market structured finance transactions as a structuring investor, primarily as a credit-enhancer providing guarantees. With a cumulative on-balance sheet credit exposure in these transactions of over US$1bn, this has facilitated more than 60 transactions in 22 countries. In each of these transactions, IFC has played an important role in introducing securitisation (or other structured finance product) to a new market, or introducing a new asset class to an existing market.

As asset classes become established, the need for third-party credit enhancement diminishes. For example, after having initially helped develop the markets for MBS in South Korea and South Africa, there became little need for IFC to be involved in future deals in these markets. IFC then focused on providing credit enhancement to help develop the markets for MBS in Colombia and Latvia, and now as those markets have begun to mature, the focus more recently has been on developing markets for MBS in Mexico, Russia, and Saudi Arabia. As for establishing new asset classes in existing markets, IFC's credit enhancement has recently helped to mobilise financing for municipals in Mexico, South Africa, Guatemala, and Russia; for microfinance institutions in the Balkans, Mexico, and Morocco; for schools and students in Ghana, Chile, and Peru; and for environmental lending in China and Hungary.

With all the value that a credit-enhancer can provide in the process of establishing new markets, this role is not meant to be a permanent one. Rather, the role of the credit-enhancer is to act as a bridge until such time as a new asset class becomes established and institutional investors become comfortable taking on the subordinated risk. At this point, if the mandate of the credit-enhancer is developmental in nature, as it is for IFC, it becomes time to move on and focus on new asset classes and new markets. If the role of the credit-enhancer is purely commercial, then it becomes time to compete with other institutional investors for the mezzanine risk, which in turn leads to an efficient market for this newly established asset class.

Author:
Lee Meddin,
Deputy Treasurer and Global Head of Structured Finance
International Finance Corporation (IFC),
World Bank Group
2121 Pennyslvania Ave NW
Washington DC, 20433
USA
Tel: +1 202 473 4300
Fax: +1 202 614 1204
Email: lmeddin@ifc.org
Website: www.ifc.org/structuredfinance