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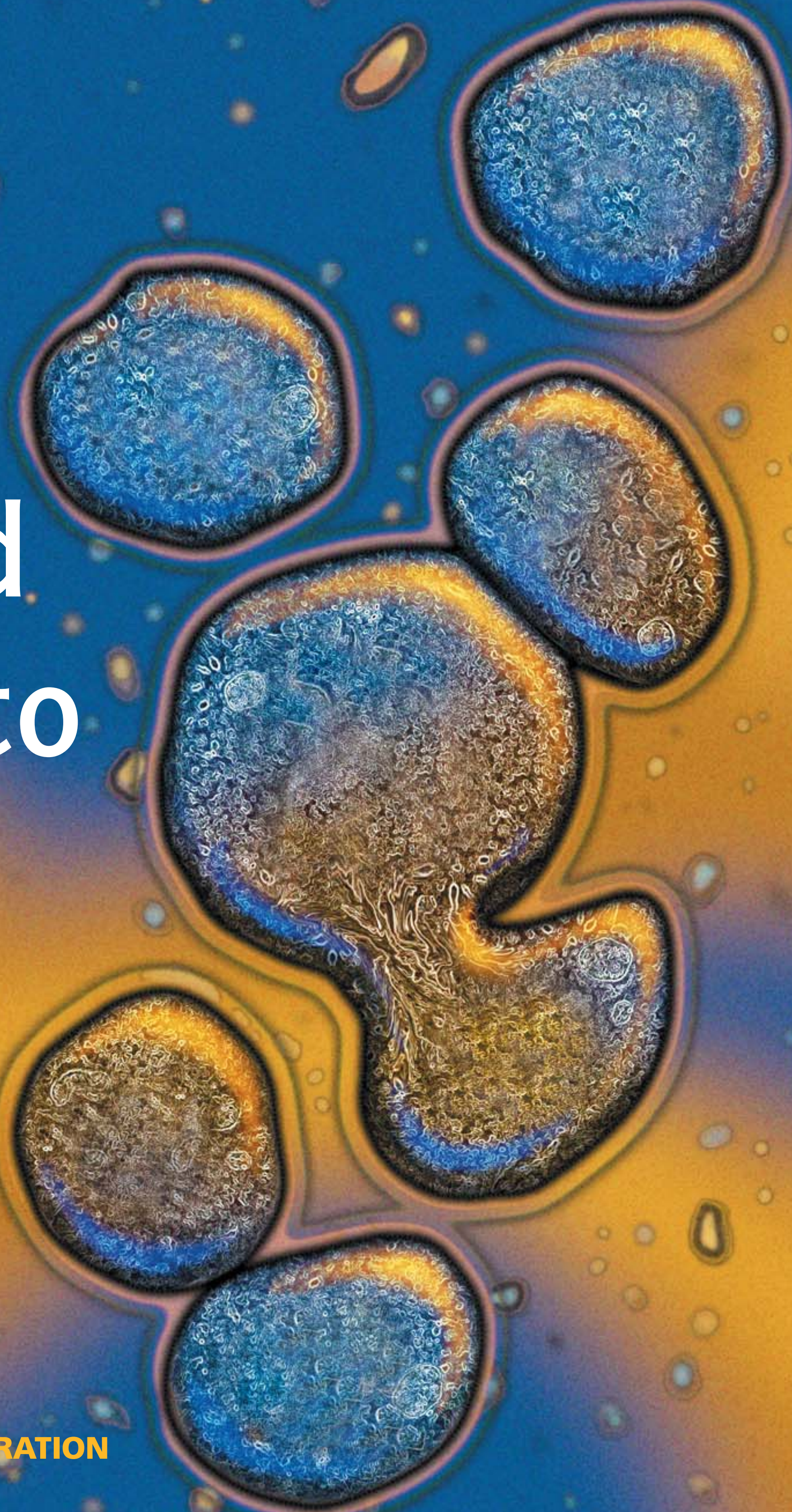
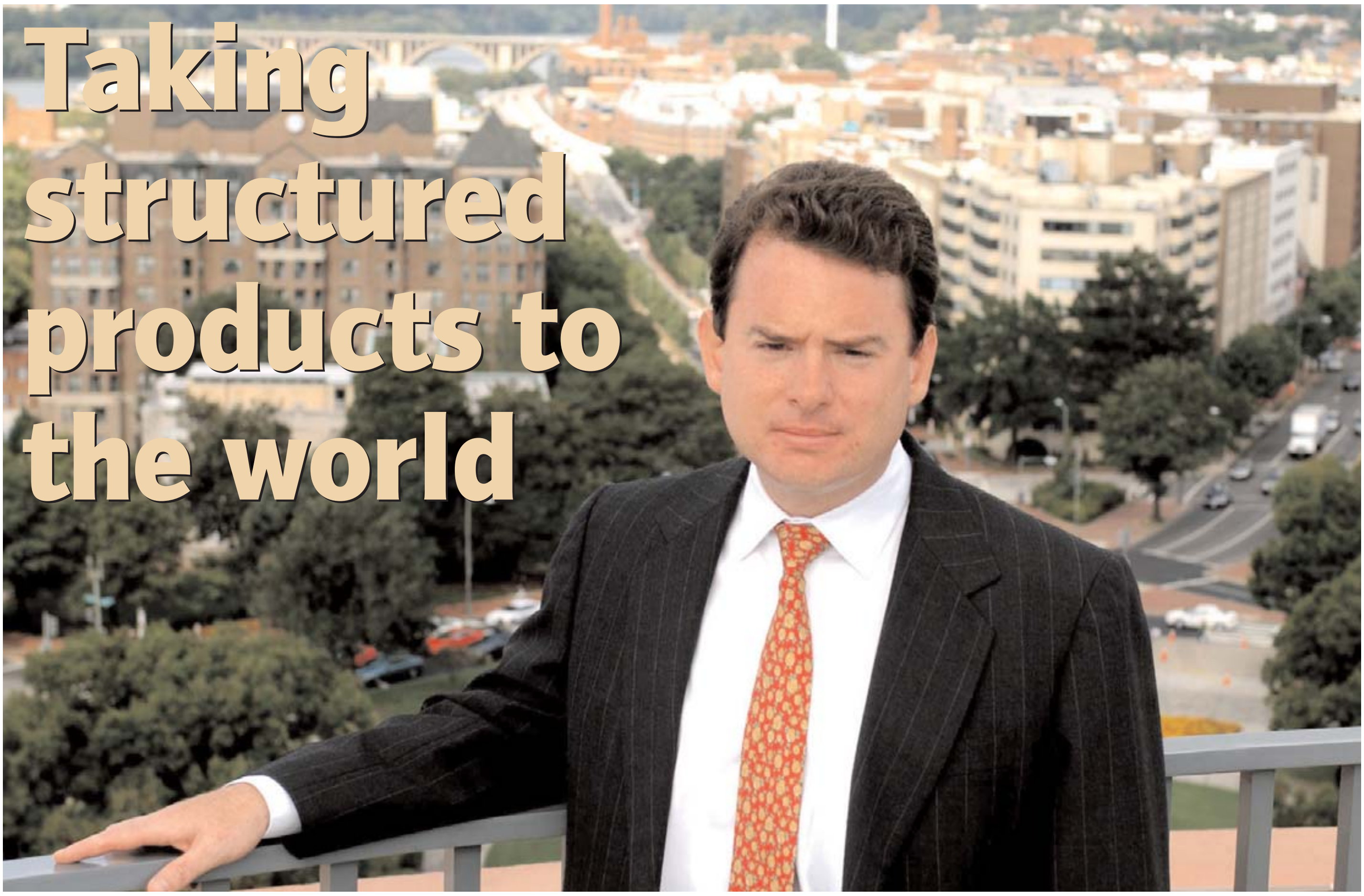


INTERNATIONAL FINANCE CORPORATION
WORLD BANK GROUP



Taking structured products to the world

Latin American domestic structured issuance has caught up with the more established cross-border market, thanks in large part to the work of the International Finance Corporation and structured products expert Lee Meddin. But this is just the start of Meddin's plans for the emerging markets, with Latin America likely to take a pioneering role again. ● ***Felix Salmon*** *reports*

EUROMONEY'S FINANCE MINISTER of the year award usually goes to an emerging-market official, and for good reason. Finance ministers outside the OECD might not be smarter or more sophisticated than their G7 counterparts (although many are) but they certainly have a much harder job to do when it comes to managing their countries' debt.

The problem is known as "original sin" – the fact that countries and companies in emerging markets, when they can borrow, can usually only raise money in foreign currency, or at short tenors, or both.

Emerging-market borrowers, then, inevitably have levels of currency, interest-rate and rollover risk that their developed-market counterparts would never dream of having to deal with.

The problem is well known, and the solution has long been known in theory: emerging-market economies have to develop liquid domestic capital markets, with well-defined yield curves and the ability to fund a wide range of credits.

That's easier said than done, though, so the International Finance Corporation has decided to step in and help out, with the aid of a few hundred million dollars in World Bank capital.

The man at the IFC in charge of making this happen is Lee Meddin, a former structured-products expert at ABN Amro in Singapore, who was tapped to set up a new structured products group in Washington at the end of 2000. Since then, his group has helped to mobilize more than $2.5 billion, while putting up only $500 million of its own money. Moreover, Meddin assures *Euromoney*, that $500 million generated very impressive returns for the Bank.

Meddin has set himself a highly ambitious goal: to create whole new asset classes in emerging-market economies around the world. If he is successful, these asset classes will require zero involvement from the IFC once the first few deals have been done.

The initial conditions are certainly in place. Structured products in general – asset-backed and mortgage-backed securities – are now a $7 trillion market in the US, accounting for 31% of the total size of the bond market. Treasury bonds, by contrast, are just 24%.

Europe, too, has posted impressive growth in structured products: the market there grew tenfold, from $50 billion to $500 billion, in the five years between 1998 and 2003.

An ideal market

The success of structured products in Europe and the US should be repeated in good measure in emerging markets. For one thing, emerging-market economies are far more crisis-prone than those in developing nations, and structured products usually have much lower ratings volatility than similarly rated plain-vanilla corporate issues.

Emerging-market pension and mutual funds with long time horizons, then, should love to invest in these deals. Even in cases of multi-billion-dollar fraud, such as with Parmalat in Brazil, many structures have held up perfectly, with no loss to investors.

Emerging-market institutional investors certainly have cash – Meddin estimates that both Latin America and emerging Asia have about $500 billion in domestic savings looking to be put to work – not including the money that residents of those countries have held offshore and that might be repatriated if local investments started looking attractive enough.

The problem is that there are severe constraints on permissible investments for most of the funds, especially in Latin America. A lot of Latin countries have only a very small number of big blue-chip companies with the sort of credit ratings that the government regulators require – and those companies can usually get cheaper funding from local banks than they can from the domestic capital markets.

With securitization and partial guarantees, however, any issuer can get the kind of credit rating that will allow it to market securities to domestic institutional investors. Now that most emerging-market economies have low nominal interest rates, along with a relatively solid legal and regulatory framework for such issuance, there's really nothing preventing structured issuance from constituting the lion's share of the domestic non-sovereign capital markets in some countries.

Meddin's goal isn't simply to increase the quantity of structured-product transactions in the emerging markets, however: he wants the issuers that he is sponsoring to return at some later date with plain-vanilla issues as well.

"With a partial guarantee, you're having the investors do due diligence on the underlying credit," he says. "So the borrowing paves the way for them to borrow in their own name without further enhancement."

Those credits do not need to be classical issuers, either. In August, the IFC provided a 34% partial credit guarantee to a bond deal from Financiera Compartamos, a microfinance institution in Mexico. Compartamos is based on the hugely successful Bangladeshi model: 94% of its customers are women, the average loan is $300, and most of the loans go to small groups of between 15 and 50 women, making repayment in full extremely likely.

Once the IFC got involved, the deal, for just Ps190 million ($16.5 million), received an investment-grade double-A local-scale credit rating from both Standard & Poor's and Fitch. The lead manager, Citigroup/Banamex, then distributed the bonds to more than 13 institutional investors. "Just as many as any deal of any size," says Meddin.

"We need good distribution," says Meddin. "We follow the bookbuilding process very closely," making sure that as many real-money investors as possible are introduced to the credit and to the asset class.

With an AA rating, that's possible. Mexican pension funds are only allowed to invest 5% of their assets in single-A rated assets, which is what Compartamos is, and they generally save that allocation for fallen angels – AA-rated corporations which, for whatever reason, have been downgraded. Now they are comfortable with the credit, however, they will probably happily take up the rest of Compartamos's Ps500 million borrowing programme, and maybe even find entities that could be willing to lend to it directly.

Occasionally, a few hedge funds will even be allowed into the deal, in countries where domestic hedge funds are active, such as Brazil and India. "Sometimes a small allocation to a hedge-fund investor base is helpful because it provides liquidity in the secondary market," Meddin says.

One, investor, however, will always be a part of any deal that Meddin is involved in: the IFC itself. When he first started his group, Meddin got involved only as an adviser in some deals. Those days are over. Meddin's keen to put his money where his mouth is, usually taking the riskiest tranche of any deal. That helps to reassure investors, as well as giving him a good return on his investment of time and expertise.

In hiring mode

The IFC has now done 30 deals as what it calls "a structuring investor", mostly in Latin America, and it hopes eventually to do that many each year. Meddin is in hiring mode: with six professionals at the moment, he hopes to have two more by the end of the year, and another couple in the months following.

The IFC-sponsored deals have taken place around the world, in many shapes and forms. Meddin doesn't really draw a distinction between the securitizations and the partial credit guarantees. In both instances the IFC puts up capital, takes risk, and tries to bring new borrowers to the markets.

Because the IFC's books are dollar-denominated, it can't lend directly in local currency without hedging its foreign-exchange risk with a swap; those can be expensive in emerging markets, especially at longer tenors. Often, then, a partial credit guarantee makes more sense from the IFC's point of view. Since it is just a guarantee, no money needs to be disbursed, and no swap needs to be entered into. The IFC can provision the guarantee at its dollar value when the bond is issued, and charge for it accordingly.

To be sure, there is always the risk that the currency will appreciate, and the dollar value of the IFC's guarantee will go up. But, notes Meddin: "There's a correlation between corporate defaults and macroeconomic crises. If things improve, one might expect the currency to increase in value but the economy as a whole will improve too" – meaning that default, and an IFC payout, will be that much less likely. "We can pick the better credits in a market," Meddin says. He's confident that he is not going to invest in companies that will default despite an improving economy. So far his results bear him out: he has never suffered a loss on any of his deals.

Groundbreaking deals

And it's not as if Meddin is picking the easy deals. His first was a partial credit guarantee for Indian paper manufacturer Ballarpur Industries in February 2001, when no issuer without a triple-A local credit rating had ever done a five-year deal. Ballarpur, in contrast, came with a 10-year bond on an issue rated AA+ by Standard & Poor's.

Then, in June, Meddin helped to create the very first mortgage-backed security in Korea. Issued by KoMoCo, a borrower that had been set up with the IFC's assistance, the bond had a senior tranche of W228 billion ($174.4 million) and a subordinated tranche of W9.7 billion. The IFC bought W54 billion in all, hedged with dollar-won swaps.

The deal was a huge success. "Today, there's no role for the IFC in that market, which is a very established market," Meddin says proudly. In Korea, just as in South Africa, where the IFC did a similar deal – the first MBS in Africa – for South African Home Loans in December 2001, the MBS market is now mature, and needs no outside help.

Since the end of 2001, Meddin has been active all over the world – especially in Latin America, but also in Russia and Asia. Eastern Europe is a tougher nut to crack, he says, "because the best corporates were bought by western companies". In any case, now that much of eastern Europe is in the EU, those countries are "not a target market for us," says Meddin.

But Russia has seen a lot of IFC deals, especially with Russky Standart Bank. "When the longest issues in the market were three months, we helped do a six-month bond," says Meddin. "Then the market was doing six months, so we helped them do a one-year deal." The lead manager on the issues was Troika Dialog, in line with the IFC's commitment to fostering domestic capital markets through the use of domestic players.

In Thailand, the IFC provided a partial guarantee in October 2002 on what was the largest domestic corporate bond ever issued in the country – a two-tranche, Bt18.45 billion ($425 million) deal for Telecom Asia. The six-year tranche had no IFC guarantee at all; the eight-year tranche had a partial guarantee of just under 50%.

In Argentina, the IFC got involved in the domestic peso market post default, with a securitization of pre-shipment export loans by three Argentine banks in August 2003.

In Mexico and South Africa, the IFC provided the first-ever partial credit guarantees for municipalities: Tlanepantla in Mexico in February 2003, and Johannesburg in South Africa in June 2004.

> Meddin usually takes the riskiest tranche of any deal for the IFC. That helps reassure other investors and gives a good return

And in Saudi Arabia, the IFC was involved in the first ever corporate bond issue in the country, for Saudi Oryx Leasing Company in March 2003.

All of these deals, however, essentially took ideas that had been tried and tested elsewhere, and simply applied them to emerging markets. In Chile, Meddin went a step further, in an attempt to find financing for the Universidad Diego Portales, a university with an ambitious expansion plan and no obvious funding source.

Student loan securitizations are nothing new, of course, but UDP wasn't lending its students money, so it wasn't collecting their loan repayments. Instead, it decided to securitize its student's tuition payments, with a UF1 million ($23 million) bond denominated in Chile's inflation-indexed currency unit. The IFC's 30% guarantee got the deal a AA– rating from all three ratings agencies, and the eight-year bond came 240 basis points over the sovereign.

More innovation is forthcoming from Meddin's team. Eventually, Meddin hopes to help out not only the big companies and projects that he has been funding so far, but also the small and medium-size enterprises that account for more than 60% of global GDP.

Meddin doesn't foresee SMEs individually tapping domestic capital markets, of course. But, he notes: "Banks can't keep funding SMEs. They're good at originating and servicing loans, but they're bad at warehousing them." That's where the IFC can come in. By helping move SME loans off banks' balance sheets and into the portfolios of institutional investors, Meddin can help free up more lending capacity across the emerging markets.

Helping banks lend longer

"Banks haven't been lending long term," Meddin notes, "and you need long-term lending to a larger group of SMEs." If banks can start securitizing their loan portfolios, then they will have less of a duration mismatch if they start lending at longer tenors. So the IFC has already taken on mezzanine risk at certain banks – Meddin won't say which – in order to build a track record that it can eventually show to the market.

Further out in the future are even bigger possible deals – maybe a securitization of non-performing loans in China, or even, eventually, a securitization of the entire IFC portfolio of structured bond issues.

But even after just four years in the job, Meddin has already seen domestic structured issuance in Latin America catch up with the much more established cross-border market. If things go according to Meddin's plan, that could be just the beginning.

The first hint of what such deals might look like came in June, when the IFC provided a partial guarantee on Latin America's first ever securitization of non-performing loans.

The deal was in Colombia, where Titularizadora Colombiana, Colombia's secondary mortgage market company, issued the equivalent $67 million in bonds backed by non-performing mortgages at two Colombian banks. The IFC's guarantee helped the senior tranches, at five and seven years' duration, get a triple-A local-currency rating, creating a real market for non-performing loans in Colombia.