International Financing Review

Guaranteeing progress

The World Bank's role in local capital market development has been one of its less recognised achievements. Utilising its balance sheet to provide partial credit guarantees and ascribing to market-based principles, the IFC, the private sector arm of the World Bank, has been able to introduce longer tenors and structured products to local investors, improving local investor sophistication and deepening the market. Gabriel DeSanctis reports.

The clear need for the development of local markets emerged from the ashes past crises. Developing countries experienced those crises partly as a result of their general reliance on cross border financing, a source of capital that has historically been short-term, volatile, and foreign currency denominated.

That dependence produced a significant asset and liability mismatch in currency and maturity, a disparity that was exposed when a major crisis erupted. The mismatch and the currency devaluation that often accompanies a crisis frequently devastated the corporate sector, with skyrocketing liabilities and an evaporation of credit, a development that could leave the sector with negative net worth.

The problems with cross border financing and the perceived need for long-term local currency financing in emerging markets led the IFC to focus on the creation of new local currency products for its clients in 2000. Since then, the IFC has executed over 30 deals in multiple markets, fomenting local market sophistication, and introducing longer tenors and structured products to the local investor base. The development has followed the progress of mature markets in the US and Europe.

Over the past seven years, the size of the US bond market doubled from US$11trn to US$22trn, with the portion of the market in structured products increasing from 19% to 31% of that total. In Europe, structured issuance has also risen over the past five years, from US$50bn to US$500bn.

Accelerated growth

Local markets have also experienced extraordinary growth, competing effectively against cross border sources of capital. Analysts believe the amount of local securitisation in Latin American could surpass or equal cross border securitisation for the first time this year. The end result has been felt in international markets, volumes in the bank loan market drying up as a result of increasingly effective local market competition.

But there is still room for improvement. According to officials at the IFC, cross border repayments continue to be a drag on developing economies. In Latin merica, repayments on existing loans have outpaced new loans, with net repayments to foreign banks totalling US$8.7bn last year. Official institutions have also seen a significant trend in repayments, with US$24bn booked last year alone.

In order for the IFC to fulfil its development mandate in local capital markets, the developing country must take initial steps to get the groundwork completed.

Savings and regulation

On the investor side, domestic savings are needed to fund domestic borrowing and a legal and regulatory framework must also be established to facilitate the interest rate environment and the creation of a bond market. Over the past five years everything has been falling into place in both Latin America and Asia, and according to estimates, about US$500bn is held by pension funds, insurers, and banks in each region.

Within a nascent domestic market, the first borrower is usually the sovereign, followed by quasisovereign entities and blue chip corporates. But the process often stalls at this stage and the market begins to stagnate. Investors either lack the credit appetite or, in some cases, are hampered by regulatory requirements that force them to buy high quality local paper.

At this point, the IFC can come in and issue in the local market, introducing another class of high quality assets to local investors and allowing them to become familiar with the name. The multilateral will then get involved from the structured finance perspective, introducing credit enhancements that allow it to create high quality assets that did not exist previously, leveraging its balance sheet and credit quality through its partial guarantee and other products.

The IFC has been successful in its endeavours, breaking new ground for regional multilaterals, some of which have initiated their own partial guarantee programmes. In 2002, the IFC supported the first mortgaged-backed issue by Titularizadora Colombiana, Colombia's first secondary mortgage company. Including mortgages from three different originators, the US$212m inflation-indexed issue incorporated an IFC partial guarantee supporting the Triple A locally rated senior tranche.

The IFC recently broke new ground in Colombia's local market, providing a credit enhancement for Titularizadora Colombiana's first securitisation of non-performing assets, the first in Latin America. Two pools of nonperforming loans backed the US$67m equivalent senior MBS issue from two local banks.

In 2001, the multilateral had enhanced

the first MBS in South Africa. The Rand-denominated issue was broken down into a R1.15bn (US$118m) Triple A locally-rated senior tranche, and small R100m (US$10m) subordinated tranche backed by mortgage loans collateralised by residential properties in South Africa. Since then the market has broadened significantly, no longer requiring the IFC's participation.

Outside the MBS market, the IFC's partial guarantee has allowed some of its clients to extend tenor of their local currency instruments. In 2002, TelecomAsia (TA), the largest private fixed-line telephone operator in Thailand, issued a 18.5bn baht (US$425m) multi-tranche bond issue. Separated into six- and eightyear tranches, the IFC's 3.375bn baht partial guarantee covered nearly half of the longer dated tranche, allowing the local currency earner to access longer-term financing, enhancing the issue's local rating from Triple B to Single A.

In 2003, the IFC provided a riyalde-nominated partial guarantee for a US$15m equivalent bond issue for Saudi Orix Leasing Company, the first corporate bond issue in Saudi Arabia. The company used the proceeds to grow its leasing portfolio, ultimately benefiting local small and mediumsized enterprises in the country. Last year, the IFC participated in the first future flow securitisation in Chile and the first future flow securitisation for a university in Latin America. Diego Portales, a private university, secured a 1m UF (US$23m) inflation-indexed bond with tuition receipts from its law and journalism school with the IFC participating by offering a partial guarantee of 30%, amortising to 25% in equal payments after a four-year grace period.

Enhancing cross border deals

Although it is focused on local capital market development, there are times when the multilateral will enhance cross border transactions. In 2002, the IFC launched its first structured partial credit guarantee for Banco BBA Creditanstalt's US$50m 10-year subordinated bond issue.

Hampered by its small size and lack of deposits, the foreign-owned bank was prevented from selling tier two capital with political risk insurance. With help from an IFC 24-month partial credit guarantee, the deal received a Baa3 rating from Moody's, and priced significantly through the sovereign curve.

Some ratings analysts believe that this relatively new product will increasingly be incorporated into cross border future flow transactions. "There are a lot of good exporters in Mexico and Brazil that can't get to investment grade globally," said Juan De Mollein, director of S&P's Latin America domestic markets team. "The partial guarantee could get them over this hump, providing the benefits of a wrap with partial coverage."

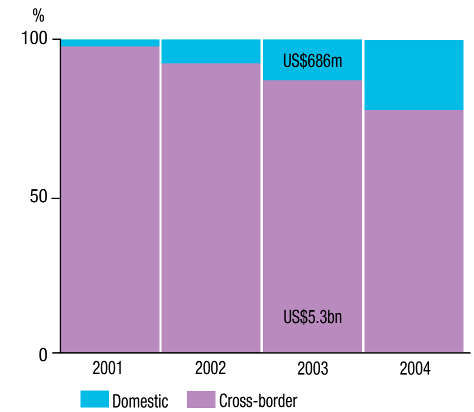
Aside from its malleable partial credit guarantee programme, the IFC has a little trumpeted swaps intermediation business. Essentially, the objective is to bridge the credit gap for clients that may not be able to access global financial markets because of low credit quality or country risk, providing risk management products (forex swaps, interest rate swaps, commodity hedging) at an effective price.

The IFC also provides local currency financing to clients in developing markets by constructing synthetic loans. Both derivatives-based products match local currency revenue streams to obligations, leveraging the multilateral's credit quality and its balance sheet. Over the last four years, the multilateral has been able to help about 60 clients in 30 countries, conducting US$800m–$1bn of business.

"The IFC is being flexible to create financial instruments and utilise market structures that meet client needs; and that also help create sustainable markets for local currency and, where practical, access to international markets," said Nina Shapiro, the IFC's vice-president of finance and treasurer. "Our focus is to use IFC's credit as efficiently as possible to share risk and encourage the market to provide longer term financing with broader access."

Although multilaterals with good credit

Brazil cross-border vs domestic securitisations



Source: S&P

can participate in developing markets in different ways, the IFC believes that its approach has been the most efficient so far, achieving a good balance between the client's risk and the multilateral's superb credit quality, while bringing institutional benefits to local investors and issuers.

"Although not profit-maximising, IFC is a for-profit institution; a primary goal of the organisation is to show that investing in the emerging markets can be done profitably. All our investments have to meet a certain return profile," said Lee Meddin, deputy treasurer and global head of structured finance at the IFC.

"What differentiates us is that we are willing to put in the time and effort to work with local regulators, domestic ratings agencies and investors, getting them comfortable with the credit and the structure for transactions we're involved with. Although time consuming, this is a critical step in the creation of new markets for structured products."

As a development institution, the IFC's ultimate hope is to be "driven out of business", as others in the private sector take up its role once a specific asset class, such as MBS, becomes established. The multilateral can then focus its efforts on creating new asset classes in the country, and introducing the same asset class elsewhere.

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