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Emerging CEMA securitisation

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Despite the significant market volatility that stemmed from the global credit crisis, securitisations remain viable in some sectors and regions. The CEMA region (Central/Eastern Europe, the Middle East and Africa) offers some interesting market opportunities and segments in this respect. This chapter is based on the lessons learned from substantial asset-backed securitisations (ABS) successfully structured and placed in the market during the second half of 2007 and the first few months of 2008.

The CEMA region

CEMA includes a diverse range of countries. There are a number of ways to look at the region – Table 1 summarises the key country groupings from a securitisation perspective

Financing types in the region

Future flow/offshore securitisations

These deals follow a simple approach and are open to organisations that generate substantial offshore cash flows as a natural part of their business. These would include banks that have a large EPOS presence in markets that are heavily visited by tourists, banks that have substantial international payment flows, and can include commodity exporters (oil, gas), airlines (ticket receivables) and telephone companies (roaming charges). As a general principle, trades can be executed only by organisations that are reasonably creditworthy in their own right and are in the top handful of players in their industry segment (the largest banks, the state-run commodity businesses and so on). Historically, these transactions were widely supported by wraps from

Table 1

Region	ABS potential
Emerging Europe Central and Eastern European countries now part of the European Union, such as Poland, the Czech Republic and Hungary; recent joiners to the European Union such as Bulgaria and Romania; plus Croatia, Serbia etc	These are typically limited because most financial institutions are in the hands of foreign banks. A few asset-backed financings have been completed for foreign-owned institutions (typically to manage country risk and capital). Financings have also been completed for independent financial institutions, but these are few and far between.
Commonwealth of Independent States Russia, Ukraine, Kazakhstan and other former members of the Soviet Union not affiliating themselves to the European Union.	These are the most significant securitisation players, since many financial institutions are privately owned and need independent access to finance. These countries also do not have strong savings industries so that any gap between savings and borrowings has to be made up on a cross-border basis.
Countries with strong local markets - **Middle East, South Africa, Israel**	These countries have strong local securitisation markets (or the potential for strong markets) driven by the availability of local liquidity. Transactions are then placed in the domestic markets as cross-border markets cannot compete on price.
Turkey	One of the oldest securitisation markets in the region with high volumes in recent times, but almost exclusively on a future flow/offshore basis. Onshore securitisations are difficult due to the weak sovereign ratings, and offshore deals take advantage of the relative strength of the banking sector.
Others	The rest would include North and Central Africa – from which transactions are now starting to emerge. Many of these countries have nascent consumer finance businesses and banks in independent hands – and these represent some of the most interesting opportunities for the next few years.

monoline insurers, which is no longer likely to be the case (given the cost of the guarantees and the decline in investors' appreciation of the protection offered).

Onshore securitisations

These transactions involve onshore asset classes, such as personal loans, credit cards, residential mortgages and so on. Emerging market securitisations have followed a common model since the first substantial deals involving domestic assets were executed in the early part of this decade in countries such as South Africa, and then on a cross-border basis since 2004/2005. In summary, assets are typically sold to an offshore specially formed company (special purpose vehicle (SPV)), which then issues bonds to investors to fund the purchase. The originator provides a portion of the funds to the SPV on a subordinated basis (maybe 10 per cent to 20 per cent), so that investors in the senior portion are protected against some level of losses. A combination of the subordination, the nature of the asset pool and the structure then allows a rating agency to provide a good credit rating on the senior part of the financing (usually BBB or better). It is often possible to break through the rating that would apply to the relevant sovereign.

Understanding the risk/reward profile

Securitisation investors must understand the risks they are accepting. As a general matter, a securitisation investor is expecting to take simple and pure credit risk on clearly specified assets that form the basis of the transaction. The investment decision is based upon a clear picture of what this credit risk may be. However, there is always more to the story. There are three main areas of concern:

- Do I know what I am financing (eg, invoices, mortgages, securities)?
- Are the assets that I am financing what I think they are (eg, are they properly underwritten with credit checks and processes that ensure that the credit risk is as described)?
- What risks, other than pure credit risks, are being taken (eg, legal and tax risks and risks in terms of the actual market values of collateral assets that are being relied upon)?

Establishing clarity in these respects is one of the most important steps to rebuild market confidence.

Securitisations from the CEMA region, on the face of it, offer a match on all of the above key features:

- Transparent financing – transactions are put together around clearly and simply constructed pools of assets.
- Solid business practices - CEMA financial institutions are generally well run, with proper underwriting and collection processes; they are typically run more rigorously than their western counterparts. Most western financial organisations have systems dating back 20 or more years, and procedures that have not necessarily kept pace with financial innovation. In addition, standards have relaxed in many areas of the credit market as benign environments have encouraged complacency. Most CEMA institutions have been set up in more recent times and most have also sought to locate and implement best practice from first-world organisations. As a result, systems and procedures are usually robust, appropriate and well managed. Furthermore, the lack of developed credit bureau and risk of fraud in many countries mean that the complacency which has arisen in first world markets has not penetrated the developing world.
- Retention of equity risk – securitisations from the CEMA region are used to raise finance and not to sell risk. The originate and distribute model where originators retain no stake in the assets that are being securitised is not a feature of these deals.
- Strong economies – the economic backdrop to the CEMA region is generally strong, with a number of economies strongly supported by commodity, manufacturing and tourism industries.

Consequently, CEMA securitisations compare well with the main culprits of the credit market from the securitisation perspective, principally collateralised debt obligations (CDOs) and sub-prime asset classes originating in economies that are now under stress. For CDOs, the main issue revolves around the black-box nature of some of these structures and the fact that correlation risks were underestimated by rating agencies and the market generally. For sub-prime mortgages, it is reasonably clear that the underlying loans were not sensibly underwritten. In addition to these facts, investors are now concerned with economies potentially moving into recession and adding stress to structures that may not have been constructed with sufficient protections.

The main issue for CEMA securitisations is predominantly around the third concern: what risks other than credit risks are involved in the deal? Here the story gets more complex, reflected in the many pages of 'risk factors' that appear in a typical offering circular. For most transactions, the legal opinions are often much shorter than the qualifications that are applied to them. In addition, there are always considerations surrounding potential political and social volatility, and these can have a significant effect on the performance of a securitisation over time.

Approaching an investment in an emerging-market securitisation therefore involves some different considerations from traditional first-world ABS. There are several factors which should be thought through:

- What is the maturity of the underlying receivables compared to the comfort horizon on the country itself? What extension risks are being run in the financing structure?
- How important is the business sector being supported by the securitisation financing?
- How resilient is the economic environment supporting these receivables in the context of global/western economic performance?

These questions are all very important – in fact, more important generally than the specific risk factors which typically make up the bulk of an emerging market ABS offering circular. By way of example, Russian consumer finance securitisations (on the face of it) would seem to fit well in the above assessment. It is possible to form a view that the Russian economy will be resilient for the next few years, with solid political stability (recent elections now being completed) – and the consumer finance sector is certainly of key strategic importance to the government. The availability of consumer finance is one of the factors supporting the emergence of the new Russian middle class and their lifestyles, in a country that is remarkably underleveraged at the individual level. Russia is also likely to be largely unaffected by recession outside its borders, provided that oil and other commodity prices do not collapse. A similar logic can be applied to the recent securitisations of factored trade receivables.

Another interesting region which should offer some strong opportunities is the Gulf Cooperation Council and other Middle Eastern countries. Again, these are economies (with a couple of exceptions) that are largely immune from credit crunch fears, where asset values (again with a couple of exceptions) are not inflated and there is a reasonable prospect of some political stability.

For emerging-market transactions, the bigger picture is often more important than the minutiae of the legal and tax risks – although these have to be analysed. In the detail, the main areas of general difficulty in structuring an emerging market securitisation usually revolve around some common issues, as articulated in Table 2.

Emerging CEMA ABS investors

Emerging market securitisations have been (and continue even now) to be distributed across four main pools of investor:

- mainstream ABS investors which have obtained (often quite small) capacity for deals from specific countries. These investors have been sidelined for some time, but are gradually returning for the right deals priced correctly;
- multilateral institutions, such as the European Bank for Reconstruction and Development, KfW, EIF, IFC and so on – their capacity and appetite to support transactions which fit within their mandates continues unaffected. At the same time, multilateral finance is rarely of sufficient scale and flexibility to accommodate an entire transaction, so these entities play a supporting role rather than representing a deep and reliable source of funding;
- arranger balance sheets, where mandated banks provide bridging and warehousing facilities to transactions. Most transactions in the second half of 2007 were funded in this way – but there are some limits emerging on the amount of capacity being made available, largely driven by concerns over the potential timing of a market exit (where and when will the refinancing occur?); and
- traditional emerging market investors, including hedge funds and specialist organisations, which have remained very active throughout the periods of market turmoil, picking up selected transactions at the right price which fit with their portfolios. The increase in spreads now being paid has meant that asset-backed transactions now offer attractive value to this community – and, in the first quarter of 2008, this is where most transactions are being placed.

Table 2

Issue	Comment
Enforced use of an offshore SPV	Local jurisdictions often make it impossible to set up a local SPV. This can be due to weak protections for creditors, no enforceability of non-petition language in contract, inability to create subordination and local taxes.
Uncertainty over enforcement of judgments	Typically legal opinions are qualified by a range of concerns, either because the legal system is inherently flexible (eg, *Shari'a* systems tend to provide for a lot of discretion), or are relatively young (eg, in former Soviet bloc countries).
Regulation	Regulatory regimes are often evolving, so there can be a lack of clarity over what activities need to be regulated and by whom.
No concept of 'trust'	Highly developed legal systems usually have the concept that assets can be possessed by one party but remain owned by another (ie, ring-fencing). Many emerging market jurisdictions are yet to implement this concept, which leaves a securitisation open to commingling and cash in transit risks. These can often be greater risks than pure credit risks.
Tax	Tax generally is the main structuring influence, specifically withholding taxes and management of the potential for the SPV to have a local tax footprint (permanent establishment risk). Typically, the securitisation SPV is following a reasonably well-established path in these respects as these issues are often present in many financings.
Currency and interest rates	These can be some of the hardest risks to manage where local market depth is limited to the shorter maturities only, and where there are controls over local and foreign currency movements. As a general principle, local currency assets are better credits than foreign currency assets (as local obligors with foreign currency debts can face greater stress in a time of difficulty because of the foreign exchange risk).
Local currency liquidity	From an arranging bank perspective, reliable access to local currency liquidity is usually one of the key structuring headaches as the arranger typically provides the mechanisms to translate local currency receipts into the SPV into hard currency payments to investors.
History	Often emerging market clients offer a relatively short history, which has also not been stressed through an economic cycle. However, since transactions are usually being arranged to achieve financing rather than risk transfer or capital efficiencies, it is usually possible to negotiate substantial credit enhancement from clients to protect investors against the possible uncertainties that might be present. Experienced arrangers are also usually able to benchmark clients and asset pools based upon information that has been collected over time across the markets generally.

Market outlook

The outlook for 2008 and into 2009 must remain cautious, simply because many sensible opportunities are caught up in the contagion spreading from the troubled sectors of CDO and sub-prime. Emerging market securitisations should offer a relatively safe haven in these troubled times more generally affecting markets around the world. At the same time, these are specialist investment opportunities, and what should be apparent from the above discussion is that a general comfort with the country of the underlying assets is almost more important than the minutiae of the transaction structure itself. Most of the risk discussion revolves around technical uncertainties – which can generally be expected to be resolved satisfactorily in practice if the transactions are properly positioned. A number of investment banks have announced a renewed focus on their emerging markets businesses, and this is no surprise. Securitisation transactions from these regions should offer significant value (once logic returns to the market) – so although we are undoubtedly entering into a quiet period, business should pick up.

This chapter is taken from previously published Deutsche Bank research.