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Enhancing Latin America's debt markets

The growth of institutional capital in Latin America is not enough on its own to give the region flourishing domestic bond markets. Local investors are often not ready to take on all the risks involved in buying corporate bonds or securitisations. As **Caren Chesler** reports, the IFC and other multilateral public bodies have played a vital catalytic role by absorbing some of the risks and transferring best practice from one country to another.

THEY SAY YOU ALWAYS hurt the ones you love. Latin American issuers could have made that complaint until recently, since US and European investors were willing to buy their bonds, while investors in their home markets spurned them.

But that is not the case any more. Last year, for the first time, domestic bond issuance outweighed cross-border transactions in Latin America, and this year, the trend has continued. Borrowers have done more structured finance deals this year in their domestic markets than they did offshore.

The result is that lending institutions in the region have more cash to give out. That means microfinance institutions can make more loans to small businesses, mortgage banks can support growth in the housing market, and large manufacturing and construction companies can get financing in their home currencies, avoiding exchange rate risk.

The International Finance Corp, the private sector arm of the World Bank, closed 20 structured finance deals globally in the fiscal year ending June 30, totalling $1.6bn. Of these 11, worth $622m, were in Latin America, all in domestic markets.

Five deals were in Mexico, three in Colombia, and one each in Brazil, Guatemala and Peru.

Many involved the IFC credit-enhancing a bond deal for a lower rated company, a necessary evil because many of the institutional investors are pension funds that can only invest in top-notch credits.

In Mexico, for instance, only 5% of a pension fund's assets may be allocated to single-A credits. The rest of their portfolio is for securities rated double-A or higher, making it difficult for a single-A issuer to access the market.

It is partly because of restrictions like that on the capital markets' development that there is still plenty of bread-and-butter lending to do in the region for agencies like the IFC and the Inter-American Development Bank.

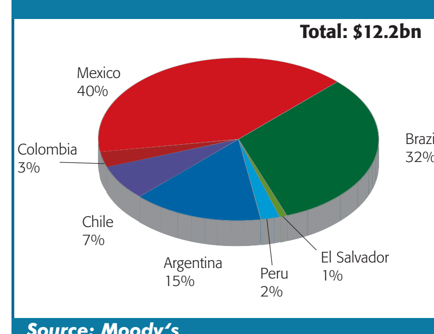
Last month, for instance, the IFC approved a $15m loan to Sociedad Agrícola Drokasa, or Agrokasa, the leading producer and exporter of fresh asparagus and table grapes in Peru. IFC's financing will help the company expand its operations.

In June, the agency signed an agreement to provide $5m of loans to Financiera Nicaragüense de Desarrollo, one of central America's leading regulated microfinance institutions. The money will help the institution extend more loans and transform itself into a commercial bank.

Supporting mortgage markets

But as well as lending, the multilateral agencies have ambitions to help establish new financial techniques in the region that will eventually be able to flourish without their support.

Latin American domestic securitisation in 2005



Source: Moody's

The field that has received perhaps the most concerted support in recent years is the effort to develop mortgage backed securities. Introducing securitisations of residential or commercial mortgages can not only help to develop a country's capital markets and provide much-needed assets for local investors to buy, but acts as a new channel to bring investment into housing, also a crucial need in Latin American countries.

Mexico's MBS market took off in 2003 to help mortgage providers, the Sofoles, to fund the provision of housing loans for low and middle income families.

More than $1.6bn of MBS have been issued in Mexico since 2003, many of them helped by partial guarantees from the IADB and the IFC. The IFC has been particularly active in guaranteeing the mezzanine tranches of MBS deals.

In June 2005 the IFC established a guarantee facility for GMAC Financiera, which aggregates mortgage portfolios from Sofoles and securitises them, along with its own loans.

The facility covered up to $500m of MBS. Deals were issued at first in UDI, Mexico's inflation-linked currency, and later in pesos.

In each deal, GMAC takes the first exposure to losses, up to about 2% of the mortgage portfolio, and the IFC's guarantee absorbs losses after that, for about the next 10% of the mortgage portfolio. Any losses after that would pass to the MBS investors.

The IFC's guarantee increases to a maximum of 10.6% of the outstanding principal as the notes amortise.

The escalating guarantee structure allowed the size of the guarantee to keep matching the credit rating requirement of the notes, and so gave GMAC a cost saving relative to other forms of subordination, like issuing a mezzanine tranche.

However, the market has now developed in Mexico to the point where Credit Suisse, the leading underwriter, no longer needs multilateral institutions to guarantee the mezzanine portion because investors can be found to buy it unguaranteed.

"The IFC focuses on taking that mezzanine risk until the market is more comfortable doing that on their own," says Lee Meddin, deputy treasurer and global head of structured finance at the IFC in Washington.

The IFC also helped securitisation company Titularizadora Colombiana open the Colombian MBS market, which has grown to a point where the IFC barely needs to provide much more than the second loss tranche — the second most subordinated piece of the deal.

TC aggregates mortgage portfolios from banks and other lenders, which keep the first loss risk on the mortgages, up to about 2% of the portfolio. The next layer, a mezzanine tranche of about 1% of the portfolio, would be guaranteed by the IFC. That bond would suffer a principal shortfall — absorbed by the IFC — if losses on the mortgages were to exceed 2% of the total portfolio. The remaining 97% of the portfolio is rated AAA by Duff and Phelps de Colombia.

After seeing how lucrative the mezzanine piece could be, TC started keeping half of that, with the IFC guaranteeing the other half.

"There is still a lot of work to be done in the region with MBS," says Meddin. "Right now we are working on the first MBS deal in Peru. It involves setting up the equivalent of the Titularizadora Colombiana structure."

Brazil is a challenge when it comes to MBS. "In Brazil, historical information needed to analyse asset pools in detail is still very often lacking," said S&P in a recent report on mortgage securitisation in the country. "Critical information such as delinquencies, defaults, foreclosures and prepayments is sometimes difficult if not impossible to get."

It is also difficult to find big enough portfolios of loans with adequate terms for an economically viable securitisation.

Brazil has the CRI, a specific vehicle for real estate receivables, but only a tiny amount of CRI MBS deals have emerged: R$779.4m ($363m) in 2005 and only R$146.3m so far this year.

Brazilian joint venture

The IFC has taken a different tack in Brazil than in other countries, and established a joint venture with Rio Bravo Securitizadora (RBSec), one of the largest of a small group of property securitisation companies in the country.

The IFC and GMAC's Residential Funding Corp put equity of their own into RBSec and now own 40% of the company.

The IFC structured its first local currency 'credit-linked' or 'sovereign-linked' guarantee for the bank funding for an RBSec financing of the construction of 2,500 houses. This guarantee is equivalent to a guarantee by the Brazilian sovereign, because the IFC is obliged to pay in all circumstances except if the Brazilian government defaults on its debt. This makes the guarantee cheaper for the customer.

The guarantee covered up to R$50m ($23m) of debt extended by Banco ABN Amro, covering 100% of any losses on warehouse finance it extended to RBSec so it could acquire mortgages originated by housing developers.

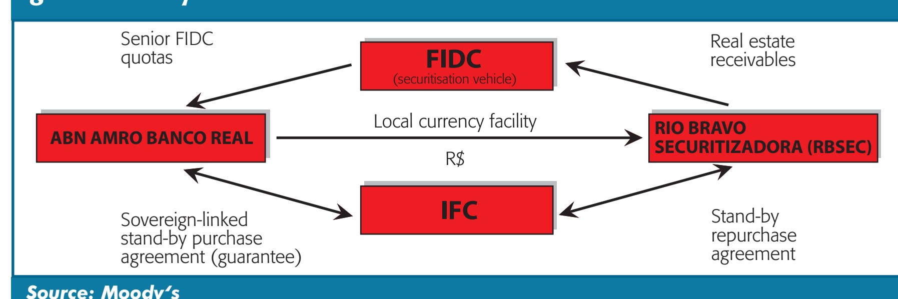
ABN became involved because it has better access to liquidity in reais than the IFC. "We are not in a position where we can give full guarantees on real-denominated facilities so we offered ABN a credit-linked guarantee if they provided the reais to RBSec," says Meddin.

The IFC is also helping to restructure the MBS market in Chile. The market dried up about a year ago when the Chilean MBS structures crumbled under a wave of prepayments by homeowners when Chilean interest rates fell.

Looking for new ideas

Beyond mortgages, the international agencies are on the lookout for other ways to apply their structured finance expertise.

Rio Bravo's warehouse facility, with a sovereign-linked guarantee by IFC



Source: Moody's

"We need to be creative," says Meddin. "We have had tremendous growth in the last two years — 300% growth — either by developing new securitisation markets or new asset classes in these markets."

Securitising new asset classes is becoming easier as governments in Latin America improve regulations to allow for a wider variety of structured deals. It does not matter so much whether the assets perform well or poorly, so long as the performance is predictable, says Meddin.

In its 2005-6 fiscal year, the IFC guaranteed its second bond deal for a Latin American university, backed by future tuition payments from students.

The issuer, Universidad de San Martín de Porres in Peru, sold a $15m tranche from a $30m seven year bond programme. The bond is secured by future tuition receipts from six university faculties and backed by a 30% partial guarantee from IFC.

The IFC's first deal, for Universidad Diego Portales in Chile, had been done in 2003.

A wealth of opportunities

"If you're creative, you can securitise anything that is predictable," Meddin says.

Last year the IFC backed a $17m five year Mexican peso straight bond issue for Financiera Compartamos, its first ever deal for a microfinance institution in Mexico. The company followed that deal with a second issue of $25m.

Both deals were partially guaranteed by IFC for 34% of the outstanding principal amount. The IFC guarantees 100% of debt service payments, up to a maximum of 34% of the principal.

"We do that when we're trying to increase the rating to give companies access to markets they wouldn't otherwise have access to," Meddin says.

Without such credit enhancement, neither the universities nor Financiera Compartamos could have borrowed in their home markets and currencies.

Compartamos had issued a bond before, but it was a private placement. The IFC is trying to get these institutions to the point where they can sell securities to local institutional investors, like pension funds.

"When you sell to [wealthy] individuals, you're not really opening all the doors you want," says Meddin. "At the end of the day, it's the institutional investors, like pension funds, you want to go after because they have the deepest pockets in the region."

External credit enhancement from agencies like the IFC has been the key to opening many new markets in the region, and many of the deepest pockets. ○