Securitization: A Platform for Organic Economic Growth in Emerging Markets

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ABSTRACT

One of the keys to building a solid economy is the existence of a long term debt market. Long term borrowing is crucial for personal home ownership, the creation of critical infrastructure, and the development of major real estate projects.

Most emerging market economies do not have a long term debt market due to numerous factors including political instability, hyper-inflation, and low perceived credit quality. In the light of lending debacles in countries like Argentina and Venezuela, investors tend to punish banks who seek to lend in emerging market economies. For these reasons and more, many lending institutions shy away from lending on a long term basis in these regions. The perceived risk far outweighs the prospect of high returns. The resultant lack of a long term debt market leads to a stagnant or declining economy. Borrowing on a local level too is very difficult as it is cost prohibitive and the prospect of currency risk makes long term lending almost impossible even on a local level.

One of the mechanisms used to “spread the risk” of long term debt is the securitization market. This thesis is structured to look at some of the benefits and externalities of securitization as well as look at how a securitization discipline could fit in an emerging markets quest for growth and stability. Additionally, the thesis will identify several reasons why securitization is not commonplace in most emerging markets and identify potential remedies so that securitization can be managed. Finally, this thesis will suggest ways that multilateral agencies and other would-be lenders can help emerging nations succeed without having the massive overhang of costly debt.

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Introduction

It is commonly accepted that the growth of the securitization market has had a profound impact on the United States economy. Securitization has many immediate effects; it allows creditors to more efficiently utilize its capital (thus making more funds available to lend), gives lenders a lower cost of funding, and also helps take the risk burden off of the primary lender. Of course there are many more benefits of securitization, and those will be discussed in more detail later in the paper. The chief focus however of this document is to outline why securitization is mainly an American and to a lesser extent Western European phenomenon, if emerging market economies could perhaps use the development of a securitization marketplace as a foundation for economic stability and eventual growth, if so, why securitization has not caught on yet, and finally spell out what may help securitization develop in such economies.

Limplly defined, an emerging market economy is an economy that is tattered with very low per capita income among its residents. Emerging market economies have high unemployment, low wages, and may be politically unstable due to transitions from closed market economies (such as communist regimes) to more open market economies (such as socialist or capitalist economies).

Economic reform is omnipresent in emerging market economies. Emerging economies will embark on efforts to become more fiscally transparent and work to stabilize currency via exchange rate calibration in order to give the appearance of economic steadiness and retain
current foreign investment and encourage additional investment. Emerging markets are likely to be receiving financial and technical assistance from major group of ten countries or global organizations like the World Bank or the International Monetary Fund. Much of this aid comes in the form or long term credit, as instabilities in emerging market economies make it difficult for local borrowers to obtain long term credit locally and local creditors find it too risky to extend long term debt to borrowers.

Many academics have pondered why emerging markets fail in obtaining long term debt, paying back debt that has been obtained in the global market, and why internal debt markets fail. While many opinions that exist which explain why emerging markets cannot maintain credible long term debt markets, just as many attempt to offer solutions. One solution suggest that international financial institutions such as the World Bank and IMF develop a "phantom" currency which captures the economic stability of several industrialized nations and use this currency as a lending instrument to emerging nations. Thought being that this blended currency may help mitigate exchange rate mismatches that can trigger lending and collection crises\(^1\). Others have submitted that an international bankruptcy protocol be established to define debt seniority tranching as well as mitigate issues related to weak property rights and collections policies that are in place in emerging market economies\(^2\). The opinion behind such a protocol asserts that established procedures will provide some transparency to lenders and reduce the hesitation to lend to emerging markets. Additionally, it is believed that it may reduce incentive for lenders to originate exceptionally constraining debt structures which in fact may lead to additional debtor crisis (such as large, high rate,
short-term structures). Lastly, established procedures could eliminate moral hazard issues from both the debtor and creditor perspective, as debtors have incentive to borrow well beyond its debt capacity and creditors have pressures to participate in crisis lending, in essence, throwing additional monies into an already sinking pool of funds with the hope that additional cash flow may turn around the crisis. Additionally, debtors have had billions, if not trillions of dollars worth of debt forgiven. With trends as they are, they may not have incentive to create internal mechanisms to ensure that the nation can not only create adequate debt capacity, but also develop a discipline for remuneration. Whatever the thought process, the assertion of this paper is that **direct lending from international financial institutions and other nations is a losing notion and does nothing to help emerging economies grow into stabilized economies**. This pattern of direct lending and subsequent debt forgiveness or restructuring not only creates a moral hazard on the part of the debtor, but also creates mini-crises in the nation that lent the money. The International Monetary Fund admits on its own website admits that to an extent, albeit not as severe as IMF detractors may argue, that its lending programs do encourage some moral hazard on behalf of the debtor nation.\(^3\)

A perfect example of this "moral hazard" issue is the 2001 currency crisis in Argentina that resulted in charges and write downs in the billions of dollars at American lending institutions like Fleet Bank, who lost more than $600 million as a result of the break off of the peg of the Argentinean governments decision to break the peg between the Argentine peso and the United States dollar, due to increasing value of US dollar denominated debt obligations. This change in policy by the Argentine monetary authority made US investments and loans in Argentina worthless. For Fleet, this investment debacle started a "death spiral" which in turn

\(^3\) [www.imf.org: "Common Criticisms of the IMF"]
resulted in stock price dilution, staffing cuts, and is often mentioned as one of the reasons why Fleet became a take over target.

Long term debt markets are essential to the growth of any economy. Foreign investors will look for signs of solid infrastructure such as roads, power, telecommunications and transportation before considering building plants or sales offices. Long term debt is essential to building the necessary infrastructure, as even stabilized economy issue fixed income instruments such as airport bonds to finance development of such major projects. Long term debt is also required to help support the development of organically grown businesses. Businesses need factories and office space, machinery, working capital, and trade credit. Without the proper credit facilities, businesses will not be able to make the capital expenditures required to create sustainable business enterprises. This particular notion is important, as foreign investment is a crucial element in jump starting an economy, however for an economy to ever become self-sufficient, it must have an independent economic foundation.

Additionally, long term debt is essential for building and renovating quality housing. Living conditions may be inadequate due to military actions, lack of previous funds for homes, or existing housing structures may have simply been ignored for too long. In order to attract labor (especially specialized professionals from overseas), a significant amount of investment will need to be made in housing. Long term funds will need to be available to encourage builders to build and the middle and upper classes to buy. Using the United States as a comparison, there is empirical evidence that the vibrant housing market and high rates of
home ownership by United States citizens, nearly 70\%\textsuperscript{4}, leads to a booming and generally health and stable economy.

Emerging markets need to find a way to raise capital in order to finance infrastructure, housing, and commercial development. Unlike countries like the United States or nations in Western Europe, capital is not easy to come by, as sources of capital are very limited. One way to raise this capital is to seek out private capital via direct investment and lending. Although this is one common way that emerging markets attract capital, emerging economies are at the mercy of investing countries economic conditions, organic credit quality, and overall attitude in the global market about direct investment in emerging market economies. As well, emerging economies subject themselves to close investor scrutiny regarding the commercial viability of the country as a whole. Lastly, emerging market economies are subject to particular biases as to what countries are “hot” for investment. The end result of this is volatility in investment and emerging economies potentially having to go without the capital that they need to continue growth.

One logical way to free itself from the stranglehold of foreign direct investment and perhaps gain an edge in the competition for limited funds is to differentiate the investment opportunity from the competing nations. Rather than relying merely on foreign companies, banks, and international lending institutions, emerging markets can vie for a more diverse funding base by offering a wider variety of investment vehicles. This paper asserts that a healthy asset/mortgage backed securities market is just the option that emerging markets need to create in order to differentiate themselves from competing emerging markets as well

\textsuperscript{4} www.mbaa.org
as attract a new class of investor. With a securitization market in place, emerging economies can not only attract the more traditional investors, but they can tap into other investors who wield billions of dollars to invest. These other investors include pension funds, foundations, hedge funds, endowments, insurance companies, and wealthy individuals. Most importantly, by tapping into the global capital markets, emerging markets can efficiently spread and potentially mitigate investment risk.

Although there are many types of asset backed and mortgage backed securities, this paper focuses on those types which are assumed to lead to infrastructure growth, impel the development of industries, and encourages personal wealth. One could argue that all (or most) securitized products lend themselves to economic development, either directly or indirectly, but this paper will focus on three types; future flow securitizations, commercial mortgage backed securities, and residential mortgage backed securities. These three were selected because of their perceived benefit to an unstable economy (which will be discussed in detail further in the paper), but also because these products are some of the most mature among the bevy of securitized product offerings and investors may be more likely to buy more market proven securities, albeit based in different sovereignties.

This paper hopes to advocate that countries should be forced to “make it” on their own, with the support of stable nations and organizations. In essence, this paper asserts that developed nations and international finance organizations should reduce direct lending and start helping countries who help themselves. The old adage “give a man a fish, he eats for a day, teach a man to fish, he eats for life” is apropos if you believe that nations will
develop faster once they are forced to implement policies and procedures that lend itself to both domestic and international credibility. Establishing a securitization regime can help do just this. This paper will identify why securitization has not caught on in developing economies and make suggestions as to how one might be built as well as the impact that it may have on the emerging economy.
What is Securitization?

Securitization is the creation and marketing of bond-like, fixed income securities in which periodic payments of principle and interest are driven from expected cash flows of a pool of assets. Securitized assets are commonly known as asset-backed or mortgage-backed securities. Asset backed securities are securities that are backed by a pool of financial assets with generally predictable cash flows that are originated by banks, other financial institutions, and other credit providers such as trade creditors. These creditors look to recognize cash flows from assets immediately rather than over time. Creditors securitize assets for other reasons as well, including:

- Spread risk among a willing group of investors in exchange for an appropriate interest rate, commensurate with perceived risk
- Eliminate potential interest rate mismatches between short term funding and long term commitments
- Obtain lower cost of funds since securitized assets tend to have higher ratings than the originating creditor
- Reduce capital adequacy requirements set forth by the Bank of International Settlements Basle Accord of 1988
- Moving assets off the balance sheet can improve certain corporate efficiency measures such as return on assets
- Diversify income sources by making fee income rather than spread income
- Create funding liquidity so that creditors can arrange additional credit facilities

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5 Standard & Poor’s Structured Finance – Glossary of Securitization Terms p. 3
• Provide a more diverse source of funding for operations

Consumers also benefit from securitization programs by having more efficient access to long term capital and potentially lower borrowing rates. Because issuers want to produce highly rated pools, securitization encourages strict origination credit standards.

As a whole, economies can benefit from securitization, especially since systematic risk declines as individual risk profiles reduces systematic risk on a macro level.\textsuperscript{6} A securitization market also creates a new fixed product for investors (which often carry higher yields than similarly rated corporate and government bonds). Some schools of thought claim however, that securitization can easily damage an economy if not carefully monitored. Some reasons include:

• Issuer moral hazard (accounting shenanigans, securitizing good loans while holding bad loans, actually reduce credit standards since paper is not on books very long)

• Too much credit may be extended due to the liquidity of the market, especially risky since this allows originators to bypass the economic protections prescribed by the Basle Accord

• Regulators may not be able to control money supply due to the disassociation of credit growth from bank balance sheets\textsuperscript{7}

The securitization industry is relatively young in comparison with the rest of the capital markets. Whereas the equity exchanges that we know now (and often take for granted)

\textsuperscript{6} Cameron L. Cowan: "Hearing on Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit", United States House of Representatives
\textsuperscript{7} Innovation in Financial Services Case Study: Asset-Backed Securitization, p. 15
originated over 400 years ago with the establishment of the Dutch East India Company, the first securitization transaction took place in 1970.

Although mechanisms were in place (both governmental and private sector) to create liquidity in the credit markets, most liquidity driving transactions involved whole loan sales which proved to be difficult and inefficient to transact. By using the capital markets as a platform, a link between issuers and a diverse pool of investor was created, thus allowing issuers to sell off more assets in an easier manner and allowing investors access to additional asset classes which in turn lead to diversification. Additional diversification was available too, as the capital markets allowed investors to seek out assets originated in various regions, thus mitigating an additional risk. Furthermore, an externality effect was created since investors may have felt the need to be “in the market” as they witnessed peers doing so, creating a larger liquid market and eliminating the requirement for a liquidity premium. Because investors are able to diversify and participate in a liquid market, required rates of return fall and thus becomes less expensive for borrowers to access capital.

From virtually nothing prior to 1970, securitization has blossomed into a multi-trillion dollar industry with over $900 billion issued in 2003 alone. Much of this development however is attributable to the United States, as most of the new issuance activity is resident in the United States. Europe is the second largest securitization market and the rest of the world, particularly emerging markets are merely a rounding error when looking at the entire securitization picture. One of the focal points of this paper is to look at emerging economies
and analyze why they have not embraced securitization, or at the least, not been able to originate successful transactions that would gain a global following.
Making Securitization Work

The act of securitization involves many steps and many players, however has turned into a relatively easy process (at least in the mature United States market). The pass through model fashioned by Ginnie Mae has made it so the debtor is essentially unaware that the loan that they took out has been sold or packaged.

The first step in the securitization process is the pooling of assets. In order for the pool to be viable, it must contain a homogeneous product base, meaning that all loans must be similar in traits such as loan type and duration. Pools of assets are more attractive to investors if the product in the pool has been sourced on a geographically diverse basis. Loans in a pool can be captive, meaning that the security issuer was the one that actually originated the loans, or they can be purchased on a whole loan basis on the open market. Loans may be purchased for many reasons, but are often purchased in order to diversify a pool.

Once the pool is constructed, the loans are then sold to a special purpose vehicle. Special purpose vehicles are trusts set in place to act as the cash flow medium between the investors and the underlying loans. Special purpose vehicles exist on paper only, and often have an offshore tax haven as its situs. The special purpose vehicle is extremely important in the securitization process in that it frees the balance sheet of the issuer of the loans and makes the pool of loans remote from any bankruptcy procedures that the issuer may be involved in. This is a critical step in the process in that no party other than the investors should have claim on the cash flows from the assets. For a securitization to work, the issuer must make a "true
sale” of the loans to the special purpose vehicle must be done. True sale is a critical term meaning that the investors in the securities are the only party that has a legal claim on the asset. Most often, a securities lawyer will opine on the sale and issue a true sale opinion, which gives investors comfort in the composition of the special purpose vehicle.

Once the assets are sold to the special purpose vehicle, the pool needs to be analyzed and structured. This process tends to happen simultaneously as investment bankers will look to value and price the issue and the rating agency will review aggregated loan data which gives information on ability to pay, willingness to pay, and overall credit risk, depending on the type of underlying asset which will help them determine what the initial rating structure will be and also advise the investment bankers as to how to tranche the issue. Tranching is the process of assigning ratings levels to specific units of the pool of the underlying assets. Typically, there will be an AAA tranche (or similar, depending on the rating agency), followed by AA, down to BBB, which is the lowest tranche which is considered investment grade. There will be a portion of the issue which will be unrated and is essentially considered equity. The lower rated tranches will absorb any losses or default first, and since the lower rated pieces absorb the most risk, they will command the highest coupon.

How an issue is tranched is extremely important, as the higher rated the overall issue is, the lower required coupon payment. As well, there is a limited set of buyers for lower rated tranches, thus liquidity may become a problem if the tranching is bottom heavy. How a particular issue is rated and subsequently tranched depends on the confidence of the rating agency that the interest and principal payments will be made in a timely fashion. Rating
agencies use sophisticated models that analyze inputs such as loan to value, ageing, and interest rate. After the rating agency analyzes the appropriate data from the pool of underlying loans, they will issue an opinion as to how the pool should be tranched and rated. If the investment banks are not happy with the suggested rating, they may engage in “cherry-picking”, or selectively removing and replacing certain loans in order to improve the rating of the pool.

Simultaneous with the structuring and rating process, the investment banks that are serving as underwriters are surveying their client base and lining up buyers for the issue. The investment banks have incentive to pre-screen the market as well as produce the highest quality security since they most likely have taken some execution risk and thus, are motivated to sell as much of the issue as possible so that their corporate balance sheet is not tied up and the firm risk profile and reputation is not sacrificed.

The final cog in the securitization process is the servicer. The servicer is the agent who acts on behalf of the special purpose vehicle in order to process the cash flows. The servicer often is the bank or financial institution that originated the underlying assets, but not in all cases. The main role of the servicer is to collect principle and interest payments from the debtors and then make scheduled payments to the investors.
Types of Securities

Residential Mortgage Backed Securities

The roots of securitization developed back in the late 1930’s when the United States government first established the Federal National Mortgage Association, commonly referred to as Fannie Mae. In 1968, the Department of Housing and Urban Development created the Government National Mortgage Association, now commonly called Ginnie Mae. In 1970, the Federal Home Loan Mortgage Corporation, also knows as Freddie Mac was founded.

Each of these organizations had the charter to create a liquid secondary market for mortgage loans, the former two focusing on government backed loans, and the latter focusing on non-government back loans. The end goal of these organizations was to reduce the cost of home ownership by creating a forum for investors to diversify their idiosyncratic risk attributable to geography and regionalism, thus reducing the required rate of return for those investors.

Prior to 1970, these loans were traded as packages of whole loans however the market was relatively illiquid due to execution issues (such as pricing and time to complete sale), continued interest rate mismatch, and arduous paperwork requirements. In 1970 Ginnie Mae created the first security, backed by the interest and principal cash flow of government insured residential mortgages, which featured a model that collected mortgage principal and interest and directed it to investors. This model, known as “pass-through” was and still is the backbone of the mortgage backed securities market. This pass through model allowed for the structuring and creation of bond-like instruments which exploit the resources of the

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8 www.fanniemae.com
9 www.ginniemac.org
capital markets, promotes liquidity, mitigates risk, attracts new classes of investors and in the end, reduces the cost of capital for homebuyers.

Several countries such as Hong Kong and Brazil have tried to emulate these quasi-governmental agencies, and have done so with varying success. In addition to the development of other government sponsored agencies such as Fannie Mae, private issuers have created their own market, known as the private label market in order to package and securitize mortgages which do not fit the structural requirements set forth by Fannie Mae, Freddie Mac, and Ginnie Mae. These mortgages, known as non-conforming mortgages, are packaged and sold as bonds on the capital markets as well, but do not traditionally carry the same level of credit worthiness as the conforming mortgage backed securities since the underlying loans are considered riskier.

Asset Backed Securities

The first asset backed security was developed in 1985 when the Sperry Lease Finance Company decided to create a security which was like a mortgage backed security, however backed by cash flows from lease arrangements of Sperry equipment. Nowadays, almost any asset with a predictable set of cash flows can be securitized. It is commonly joked that you can “securitize a ham sandwich”, which may be a little far-reaching however you will commonly see mutual fund fees, credit card receivables, trade receivables, airplane leases, student loans, home equity loans, and dozens of other types of cash producing assets being
securitized. Even recording artists have securitized expected cash flow from royalties. The key factor is like mortgage backed products, the cash flows must be reliable and predictable.

This paper concentrates on one particular variation of asset backed securities. Future-flow securitizations are backed by cash flows that are associated with the ability of an organization to provide a service some time in the future. These types of securitizations are particularly attractive to high performing companies who wish to have access to capital on an international scope, but may be restricted by the low credit rating of its home nation. Companies who like to exploit the future flow markets tend to be in the commodities markets, transportation, utility, or banking industries. Like other asset backed products, the motivation for future flow securitization is mainly access to a cheaper cost of funds, but since many of these issuers reside in unstable or emerging economies, they may be seeking longer duration and cheaper debt products than they can find in their home nation.

The first future flow securitization occurred in 1987 and since then almost $50 billion in transaction volume has occurred\(^{10}\). Future flow transactions are just a mere fraction of the global securitization market, and unlike other asset classes, future flow securitizations have not seen exponential growth as the market has matured. In fact, the frequency of these transactions is highly correlated with economic stresses emerging nations. As emerging economies endure negative economic occurrences, the benefits behind future flow securitizations become greater. Conversely, in more economic times, future flow transactions decrease as better financing options, such as corporate debt issuance or bank debt may be available.

\(^{10}\) Introduction to Emerging Market Future Flow Securitizations, Mark Heberle, Wachovia Securities
Because the primary driver to future flow securitizations is to obtain debt rated higher than the sovereign rating of the company’s home country, those cash flows that are used as collateral must be funneled to an offshore special purpose vehicle. While a traditional asset backed security issuer sells the receivables from current assets to the special purpose vehicle, future flow transactions require the company to sell not only current receivables to the special purpose vehicle but also certain future receivables. Debtors to the issuing companies will then make its usual payments to the special purpose vehicle rather than the company; the special purpose vehicle will in turn make its periodic principle and interest payments to the investors and send any remainders to the issuing company. One of the most important requirements in achieving a higher rating is denominating the issue in a more stable currency than the local currency (usually the US dollar). By separating the transaction from the currency of the issuer’s country, investors are shielded from exchange rate volatility and currency devaluations that are common with emerging market economies.

Since the generation of funds that support the issue is under the direct control of the issuing entity and there is no transparency as to future cash flow, rating agencies look to the guts of the issuer as basis for rating the issue. Rating agencies need to gain confidence that the issuer is healthy enough and has the ability to continue to drive cash flow. Issuers strive to obtain a rating that is higher than their home country’s sovereign rating so that they can obtain cheaper debt financing. Although difficult to obtain, certain rating agencies have a very clear set of requirements in which the issuer (which is often a dominating force in its local industry) must satisfy before being considered for a rating higher than its sovereignty.
Commercial Mortgage Backed Securities

Commercial mortgage backed securities are backed by loans which are secured by multi-family establishments, shopping centers, office buildings, storage malls, and hotels\(^\text{11}\). Although functionally similar to residential mortgage securities in that principal and interest are generally seamlessly passed through from the debtor to buyers of the security, commercial mortgage backed securities have a markedly different risk profile than its residential cousin. First, investors (and rating agencies) will rely on the generation of positive cash flow from the underlying commercial property as an indicator of default risk more so than the credit profile of the debtor. Thus, careful attention is paid to the characteristics of the tenants, duration and expiry of lease agreements, and tenant concentration, as well as typical underwriting statistics such as loan to value and debt service coverage ratio. Second, investors are generally shielded from pre-payment risk as commercial mortgages usually have prepayment lock outs in the first few years of the loan, followed by severe prepayment penalties that are so high that a debtor can usually not extract any value by paying early or refinancing.

As previously mentioned with other asset classes, there was some trading of loans done prior to the development of the commercial mortgage backed securities market, but these transactions occurred in an inefficient market. Most often, these transactions came about as paperwork intense whole loan sales or mortgage participations (similar to syndications). The

\(^\text{11}\) Standard & Poor’s Structured Finance – Glossary of Securitization Terms pp. 7, 19
first commercial mortgage backed security was issued in 1984 by Penn Mutual Life
Insurance. Since then, commercial mortgage backed securitization has grown into a several
hundred billion dollar a year industry. Despite the growth in the market however, the
proportion of commercial mortgages which are securitized is a mere fraction of the
proportion of residential mortgages that are securitized. This could be due to the fact that
three are no governmental agencies that promote liquidity in the asset backed markets.

Commercial mortgage backed securities may take one of several forms. The most common
form is the standard conduit security which maintains a highly diversified pool of loans of
typically 50 or more, and no single loan comprises over 10% of the pool size. Fusion pools
have less than 50 loans; however no loan makes up over one-tenth of the pool value either.
Large Loan pools typically have less than 30 loans in the pool and it is common for more
than one loan to make up over 10% of the total pool. The last major commercial mortgage
backed security is backed by a low leveraged single loan.
Economic Externalities of Securitization

The sale of a bond itself is not going to drive an emerging economy to independence; however some of the externalities that come from creating an additional and efficient source of funding are the keys to driving economic growth and stability. It has been widely claimed that securitization diversifies the funding pool geographically and in turn drives down the cost of borrowing. But credit has to be given for more than just an accounting adjustment when considering the effect of a healthy securitization regime in emerging markets, securitization can also drive commerce.

Take future flow securities for example. By issuing future flow bonds, governments and private companies raise the capital that they need to grow their business and infrastructure. For example:

Toll Roads – toll roads can be built that will be used for basic transportation needs and to connect major cities and potential business centers. The development of a road system involves the purchase of land from private land owners, the employment of a local construction labor force, development of local businesses that will both supply the road system with raw materials but also contribute to local employment, and naturally, additional revenues for which the controlling localities can use to invest in services that assist the residents of the communities.
Ports - ports can be established that can serve as a distribution point for the local countries goods as well as an acceptance point for important products from other countries. It is logical to think that even emerging nations have products that could be sold on the international marketplace. Even if the country does not have any particular product or raw material that the global marketplace lends value to, many emerging markets like to assert a value oriented labor force (compared to developed economies). In order to best market that value proposition, the country will require a modern port system that would allow other countries to ship in raw materials (if they are not locally present) but also have an efficient means for shipping finished products or components to the host country. As well, a good port system will allow for the importation of essential products as well as the heavy machinery required for factory and construction work.

Airports - airports serve a similar purpose for the transport of goods as well as the expedient movement of people between key cities. The swift movement of people is essential for any economy. The lack of efficient modes of travel has a negative effect on the ability for an economy to attract investment or market their own products, resources, and technology to the rest of the world. In the same light, the ability to drive revenues from hospitality based businesses like hotels and restaurants is stifled since these businesses require turnover in order to survive.

Utilities – despite all of the technological developments of the last 30 to 40 years, basic and reliable utilities are the essential backbone to an economy. Many emerging economies have the basic electric, gas, and telecommunication lines, however it stands to question if the
utilities present in these economies can provide the service that is required for the operation of factories or office building. Additionally, with the common use of fax, email and conferencing, telecommunication resources would be taxed beyond repair if businesses were to operate within the current telecom infrastructure. The speed of modern business requires modern day utilities in order to power commerce, and the sale of future flow receivables is a logical way to finance it.

In the case where an entity does not enjoy the “blue-chip” status that is typically required for future flow securitizations, project finance can be sought as initial capitalization, and when the entity establishes a performance track record, look to future flow as a way to refinance the debt burden.

In the same way that future flow securitizations generate commerce and productivity, so does the development of commercial real estate. In order to attract foreign corporations to consider doing business and invest, the proper commercial properties must be in place. Thus, factories must be built in order to support the offering of cheap labor, storage facilities must be constructed to house imports and exports as well as raw materials and finished goods, and office buildings must be built in order to house regional headquarters and sales offices as well as provide work facilities for those companies that are spawned from local economic activities. As well, in order to provide services and conveniences that expatriate workers may be accustom to back in their home countries, shopping, dining, and entertainment facilities will need to be constructed. In order to provide the liquidity required to supply the
capital for these types of projects, an active pass through and risk sharing system for commercial mortgages must be in place.

With more of the emerging markets citizens working and earning more than a living wage because of the increase in commercial activity, the opportunity for citizens to own their own homes becomes much more of a reality. More than anything else, home ownership can serve as a method for families to efficiently save and transfer wealth. With growth in the economy, it is quite possible for home values to rise as well and the increase in value may drive additional spending to preserve and improve their home, to find new opportunities for discretionary spending, and decrease reliance on the government for social fixes such as welfare or retirement.

The onset of residential and development in emerging markets will serve as the genesis for industries that will support development. Commercial, residential, and industrial development will serve as a catalyst for the growth of important industries such as hospitality and entertainment, home improvement and lumber, consumer/retail, education, business services, legal, medical and healthcare, and technology.
Why hasn’t Securitization Caught On?

Although there has been some securitization activity in emerging markets, as a whole, it is a very small percentage of the securitization universe. Some countries in Latin America and Eastern Europe have made several structural changes in order to support the growth of a securitization market (see “Case Study” section). If certain countries have shown some early successes with securitization transactions, then it leads to the question as to why there has not been a flood of securitization activity among other emerging markets. This section highlights several reasons why many emerging markets may not quite be ready to support a securitization system.

Legal

True sale – the gold standard for any securitization transaction is the ability to separate the assets that are being securitized from the books of the originator and place them into a separate legal structure, known as a special purpose vehicle. This step is vital to a securitization transaction, as investors will seek assurance that the originators creditors have zero recourse on those assets in the case of a bankruptcy proceeding or any other legal matter. In order for this to occur, a “true sale” must happen between the originator and a bankruptcy remote entity. In most cases, a legal opinion by local legal counsel must me made as to the validity and legality of the true sale. In many countries however, there are no legal provisions that allow for true sale.
Bankruptcy/foreclosure laws, biases, political issues (U.S. lender v. emerging market homeowner) – very simply put, may countries have biases toward the occupant when it comes to foreclosing on a home. Few judges are likely to put a family out of the street and those who are, it may take as long as two and a half years to complete the bankruptcy proceedings and continue on the auction of the property. In countries where bankruptcy and foreclosure laws are more clear, these laws have largely gone untested, especially in the light of a major economic shock where thousands or even millions may be affected. Particular to securitizations where major investors are from other countries, the question has to be asked if the local legal system will work on behalf of these overseas investors rather than its own citizens. Will a judge put his own constituency out on the street in order to preserve value for an overseas party? In the end, it may boil down to politics, and with politics, outcomes are never certain, which is sure to lead to pause on behalf of investors.

Notification of borrowers, consent to transfer loan – due to secrecy and privacy laws, many countries require consent or at the least, notification of the borrower before any loan can be transferred to another owner. Although eventual consent can be acquired, the process can be very expensive and time consuming as contact would have to be made in many cases to hundreds of borrowers, significant time explaining the transfer process might have to be taken if the borrower is confused, and putting together a suitable pool may end up being difficult if there is widespread refusal to consent.
**Taxes and fees** – In most emerging market economies, there are significant taxes and fees related to registering and transferring loans. These fees make pooling loans very costly and have a negative overall effect on the potential return to investors.

**Domestic pension rules** – many emerging market governments are the major customers of local banks and pension funds. Besides tying up available capital, many governments set rules restricting what funds can invest in. Many funds may not invest in any securities rated below A, and most have certain percentages in which must be invested in each. As well, many governments require investment in government securities.

Facilities

**Lack of centralized credit data/scoring** – unlike the United States, many countries do not have central repositories for consumer credit data. For those who do have some sort of credit database, they do not have the same type of engineered scoring system that allows a creditor to put all consumers on a level playing field. Other credit reporting agencies don’t report negative events or erase negative events after they have been resolved, thus it is very difficult to ascertain any major credit events from the past. This is an inherent risk, as

**Qualified Servicers** – Essential to a successful securitization process is the presence of a quality servicer. Funds need to be efficiently transferred from the debtor, through the SPV, and to the investor. Investors will typically not have patience for delay in payment, so reliability is essential. Just as important is the overall credit quality of the servicer, since they
do have physical possession of the funds prior to disbursement to the investors. In many instances, emerging market banks will service their own portfolio however there are no servicers that can handle servicing pools of loans originated by other lenders. As well, it becomes very muddy as to customs and norms about advancing payment streams to investors in the case of delinquent obligors.

**Dollar denominated v. local currency** – The question in many emerging markets is, denominate in local currency or denominate in a stable currency, like the U.S. dollar. For many borrowers, having a loan denominated in a foreign currency creates a serious mismatch in that their obligation may become unmanageable if the currency in which their cash flow derives from loses value in relation to the currency of their loan. Although many countries that have a strong dollar influence require semi-annual salary adjustments for their employees, it is still hard for debtors to keep up with currency fluctuations. In this case, the risk of default becomes extremely high. In the case where the loans and thus the bonds are denominated in local currencies, the investor will likely face a risk that they will not be willing to take and perhaps too expensive to hedge and thus will simply not be willing to invest in those bonds.

**Limitation of future flow transactions** – unlike most other securitized products, future flow transactions have ongoing credit risk, as the issuer must continue to generate stable cash flows. Additionally, these issuers typically have revenues denominated in local currencies and thus creating the potential for a currency mismatch. For this reason, issuers need to be blue chip organizations in their respective countries and unfortunately, lesser developed
organizations with out blue chip status will have to seek other types of debt financing such as project finance and aspire to refinance with future flow funding.

**Heterogeneous loan products** – In order to produce a pool for securitization, the underlying loans have to be relatively similar in nature, thus items like duration, fixed v. floating rate, currency denomination, and other structural items have to be the same. Without a homogenous pool, rating agencies cannot run accurate default models and the pool becomes very difficult to service. In many emerging market economies, there is little to no standardization of loan products, perhaps due to the fact that each lending situation is truly an individual concern (perhaps related to unstable economies) and requires very specific scrutiny as well as restrictions/covenants in order to solidify the underwriting process. It has been argued that securitization drives standardization, however with all of the different aspects that make emerging market securitizations difficult, this one factor seems to be the easiest one to allay.

**Other**

**Lack of investor sophistication** – investors do not give credit for wraps, which **SHOULD** give AAA ratings to most issues. Investors will often seek a 300-400 basis point premium on comparable rated issues between US and Mexico. Often, blue chip unsecured corporate issues will get dramatically better pricing than wrapped asset backed securities. Educating investors on the merits of securitized products is key for promoting sales of future RMBS/CMBS/ABS issuances in emerging markets.
Catch 22 – emerging markets find themselves in a tough situation in that many are in need of funding and turn to the global capital markets for these funds. Ironically from a due diligence perspective, many investors and would-be investors look to see some positive economic activity before opting to commit funds to these areas. The problem emerging markets now face is how to demonstrate positive economic activity, when they need the funding in order to produce the activity that investors want to see.

Debt markets are out of favor vs. equity – for foreign investors, investments in many emerging markets are opportunistic investments, typically not core investments. When emerging market equity indicators are doing well, thus those who can issue equity do, and investor funds are channeled to equity opportunities. In these times, those who are limited to debt as their sole funding opportunity, suffer as debt investment dries up in favor of equity, which may offer higher returns.

Lack of local capital markets – raising capital is cheaper domestically, but there are little or no local capital markets to connect investors and issuers. One of the major considerations is the rate of savings, as pension funds and other mandatory retirement and savings plans are major providers of capital in domestic markets. When wages are low, statutory savings rates are low, or when these funds have tight restrictions on what they can invest in, access to capital can be restrictive.
Customs/tradition/culture – in most emerging markets, personal credit is a tool for only the very elite and is often not considered a right, as it is in the United States. With the lack of critical mass of consumer credit, and the likely inability of consumers to properly manage many kinds of consumer credit without proper education and counseling (except perhaps home loans) it is doubtful that a pool could be constructed that would satisfy the needs of investors, at least in the short run.

Expensive financing option – securitization can be a very expensive option for financing for some, but could be the best if not the only option when facing the prospect of debt covenants that severely restrict operations or in the alternative, even more costly and short duration bank capital, or worse, no external funding at all.
Attracting Investors / Creating a Saleable ABS

Assuming that the required changes can be made in a particular market so that securitization is possible, it is still necessary to craft a transaction that will gain the attention of potential investors. It is likely that there will be a perception that the transaction will be risky and thus the investor will either require to be compensated for assuming the risk or will require credit enhancement. Credit enhancement are methods used by issuers to make the creditworthiness of the transaction better, and can come from careful pooling and structuring of the transaction, or may come from external sources such as guarantors. As mentioned previously, there are limited capital resources in many emerging economies due to restrictions on risk levels, so in order to capture as much domestic funding as possible, seeking credit enhancement may be the preferred option to compensate investors for risk. Outlined below are several options that are relevant for emerging market transactions:

“Cherry Picking”

Pooling loans in zones which are in high contract enforceability countries/less judicial biases

– Emerging markets are often very political, and questions arise when it comes to the issue of foreclosing on a home and displacing the family that is occupying the dwelling, especially with cross border bondholders. In many emerging markets, culture will bias judges on the side of the debtor. To provide comfort to investors, issuers may consider pooling loans where the associated real property is located in municipalities that have a track record of strictly enforcing loan and mortgage contracts and expeditiously adjudicating legal
procedures without bias. To that end, issuers should formalize their debt collection procedures in order to expedite the foreclosure process. Precise documentation of all communications between the debtor and issuer, including records and notes from all calls and copies of all letters should be kept in a file for review by the courts.

Structuring

High subordination levels – Tranching is probably one of the most important tasks in completing a securitization transaction. The lower tranches (i.e. equity tranche, B rated) serve as protection to the senior tranches since they absorb all losses first, and receive any principal pay down last. To the extent possible, as subordination is limited by the number of willing investors who would purchase these subordinated bonds and the amount of premium that these investors require, issuers can provide cost free credit enhancement to its senior bondholders.

Over-collateralization – Over-collateralization is defined as a capital structure by which pooled assets exceed liabilities\textsuperscript{12}. By offering up more collateral in value on an asset backed issuance than proceeds that the issuer receives, the issuer shifts some of the credit risk back to themselves, as they now have to absorb more off the losses in order to ensure that the bondholders do not. Although this method of credit enhancement requires essentially no upfront cash flow, issuers do have to be mindful of how much of the risk they can reasonable

\textsuperscript{12} Standard & Poor’s Structured Finance – Glossary of Securitization Terms p. 21
subsidize because in the case of an economic shock, the issuer could end up using much of
the cash they raised to adjudicate repossessions and foreclosures.

**Off-shore escrow accounts/cash reserve accounts/excess spread account** – As a simple and
less costly method of credit enhancement, monies can be placed in an interest bearing escrow
account offshore and under the control of the special purpose vehicle. This account can be
used for several purposes including; make cash advances in the case of delinquent payments
from debtors, using excess spread and interest earned on escrow to pay down senior bond
debt, and using excess spread and interest earned on escrow to pay premiums for surety
bonds or other external forms of credit enhancement.

**Denominate for retail buyers who may seek out the equity like characteristics such as high
net worth individuals** – Because institutions like pension funds and insurance companies in
many emerging are restricted as to the type, risk, and quantity of securities that they can hold,
though should be given to the creation of another domestic market. By issuing smaller
denominated securities, issuers can attract a retail customer who may be more risk does not
have the same constrictions that institutions do. Additionally, a higher concentration of local
bondholders may help mitigate political issues when it comes to settling foreclosure
procedures, especially in the wake of macroeconomic shocks.
External Enhancements

**Surety Bonds** – Although a bit costly, surety bonds from a highly rated monoline insurer can greatly increase the ratings and salability of a bond issuance. The role of the insurer is to provide liquidity to a transaction by absorbing losses suffered in a pool of loans. The insurer makes the bondholders whole on any losses that they may have suffered due to circumstances that have been spelled out in the insurance policy. Note: surety bonds will typically only cover specific events related to loan default. Political actions such as currency devaluations or any other political event that drives down asset value is not covered by a surety bond. In those situations, political risk insurance is warranted.

**Partial guarantees and letters of credit** – both global banks and multilateral organizations offer the strength of their balance sheets to ABS/MBS issuers as a form of credit enhancement, in exchange for an annual fee. By tapping into the financial strengths of these external organizations, issuers can achieve a higher credit rating, pay a lower coupon and potential extend durations on issuances.

**Political Risk Insurance** - In the late nineties, political risk insurance was introduced to protect investors who purchased asset backed securities from emerging market nations. This insurance allowed companies to seek alternative debt options and assure investors that regular payments would be made in the case where sovereign risk factors such as political activity would prevent the company from servicing its debt obligations.
Direct debit – Many financial institutions globally offer customers a discount on their interest rate if they agree to have the creditor direct debit their monthly payments directly from their personal bank accounts. This agreement tends to be a winning proposition for both the debtor and the issuer as collection becomes a much more fluid process for the issuer (timely receipt of funds, less manual processing, better float) and the debtor gets a meaningful discount. An additional benefit for the issuer is that with better collection, there may not be the need for as much credit enhancement (external or internal) as thus, makes the over all issue much less extensive.

Targeting only best banking customers – Creditors should be diligent in terms of targeting loan customers. Since many countries have only partial credit reporting at best, banks can focus its development efforts on current clients that they have good financial data on. Information as to income, cash balances, and credit performance. Having this information will greatly improve the underwriting process and potentially lead to a more favorable loan loss ratio and less risk to bondholders (i.e. lower coupon). As well, a solid track record in origination and performance can drive increased interest in future securitized issues and make execution much simpler.

Develop a workout protocol – When considering the time (often over two years) and expense related to foreclosure, especially in geographies where judicial biases favor mortgage holders, having a plan of action for workouts of bad credits can often preserve value for the
bondholders. Many instances when a debtor is not able to meet their obligations are temporary, and thus the obligor can get back on track. The present value of a workout in many times can exceed the value in a recovery.

Investment banks have the incentive to create saleable bonds, as ABS/CMBS/RMBS in developed nations are commoditized – Investment banks have incentive to develop new and innovative products, not only as a service to their institutional investor client base, but also as a way of seeking out new revenue opportunities and position itself as a market leader (especially in new markets). First mover advantage can lead to not only a dominant market share for asset based transactions in emerging markets, but those who work closely with the proper officials in helping build local capital markets will earn a potential greater advantage as far as government issues, as well as corporate issues and other transactions.

Despite numerous obstacles, both real and perceived, securitization can happen and is important, however investors will seek a premium for the risk or credit enhancement will add costs to the transaction. Issuers need to perform careful diligence and decide what they must do to create a saleable bond and then ensure that it is cost effective.
Shift in Multilateral Agency Focus

International financial agencies like the World Bank, International Monetary Fund, and International Development Bank have played a vital role in the development of stabilized economies. Through trillions of dollars or loans, millions of man hours of consultative assistance, and to some extent, providing financial guarantees, these organizations have made a profound impact on the global economy and development of nations. The organizations however can take on a completely different role and still provide valuable financial assistance to needy economies, yet lessen some of the criticisms associated with these organizations, most notably the issue with debtor moral hazard.

One of the easiest things that international financial organizations and larger developed economy creditors can do is expand their practice of providing guarantees on external loans to emerging markets. In this context, rather than guaranteeing unsecured loans, these organizations can offer their solid balance sheets and credit rating to provide financial guarantees to securitizations in emerging markets, particularly with initial transactions in nations who have recently created the legal and practical framework for asset backed issuances. By offering no or low cost guarantees and letters of credit, these would be lenders can still offer valuable financial assistance which will make securitization financing cheaper, while forcing emerging nations to stand on their own merits. Any murmur of the moral hazard problem being shifted to creditors can be extinguished quickly if high standards are set for this financial backing and careful due diligence procedures are followed.
The other major opportunity for these international lending organizations is to become a market maker of asset backed products, particularly mortgage backed securities. These member organizations, who build their balance sheet via collection of dues from its membership, have the financial wherewithal and low cost funding base to purchase mortgage paper from around the world and then resell mortgage backed securities backed a diversified pool of loans to investors on a global basis.

This particular idea would not come simple, but the end result could have a dramatic impact on a global scale. Currently, there is no global secondary market for mortgage loans. Much of this is likely due to the lack of standardization in mortgage products, as well as differences in legal systems, foreclosure, and currency. At first, it may be necessary to purchase only the mortgage receivables (optimally from higher rated banks) and not the underlying loan, but eventually, like the government sponsored entities in the United States have done, these organizations could drive standardization (at least in product type) and will serve as a catalyst for additional private securitizations. By emulating a model of entities like Fannie Mae, organizations like the IMF and World Bank can create a cheaper funding source and provide liquidity for emerging market lenders who provide home ownership options. Ultimately, the global economy can enjoy the positive externalities that come with widespread homeownership, a common barometer for gauging economic health.

In those countries where the concept of securitization has not been embraced, multilateral agencies can serve as educators and lobbyists. Most of these organizations already devote a significant amount of man hours providing consulting and other forms of technical assistance
to developing economies on dozens of topics related to developing physical infrastructure, banking systems, healthcare, trade agreements, and capital markets. Within that framework, multilateral organizations can influence policy makers and encourage the adoption of policies that would open the door for a securitization regime. As organizations with a truly global reach, multilaterals could build a powerful database showing best practices in almost any situation from around the world to use in strengthening its education and argument for building a securitization market.
Case Study – Brazil

Several nations have been proactive in making securitization a viable financing option for its local institutions, particularly in Latin America where Brazil, Columbia, Chile, and Mexico have become leaders in securitization transactions. As well, even smaller countries like Uruguay have slowly gotten into the securitization fray with smaller transactions. In 2003, Latin American countries issued US$8.1 billion in asset and mortgage backed securities, up from $5.6 billion in 2002\textsuperscript{13}. Although $8.1 billion worth of transaction volume is small on a global scale, this is significant for Latin America as volume has exploded over the past two years.

What is even more significant is the ratio of cross-border transactions to domestic transactions. Of the $8.1 billion in Latin American volume in 2003, $5.6 billion (almost 70\%) was issued on a cross border basis\textsuperscript{14}, coming mainly from Brazil in the form of future flow and residential mortgage securitizations. This figure is a prime indicator that there is an investor appetite for emerging market asset backed products, assuming that they are well structured and have the appropriate credit enhancement. Speaking to the evolving strength of Latin American issues, less than 25\% of the cross border transactions came with credit enhancement provided by highly rated financial guarantors. Just last year, approximately 50\% featured this form of enhancement\textsuperscript{15}.

\textsuperscript{13} Moody’s Investor Service. 2003 Review and 2004 Outlook: Latin American Asset-Backed and Mortgage Backed Securities
\textsuperscript{14} Ibid
\textsuperscript{15} Ibid
Of the major Latin American issuers, Brazil by far has the most mature and developed securitization market in the region (although other countries are developing quickly as well). As the 8th largest economy in the world, it seems almost like a given that securitization would be a common option for financing, however many of the mechanisms necessary for a securitization market were not in place until quite recently.

Law 951416

In November 1997, the Brazilian government enacted Law 9514, a measure designed to assist in the development of liquidity in the commercial and residential real estate markets. With the passage of Law 9514, a legal structure for the securitization of mortgages was created. The most significant resource to evolve from Law 9514 is the securitization company. The securitization company has the sole purpose of separating mortgage loans from the legal reach of the originator, thus creating a true sale. Prior to the enactment of Law 9514, true sale was an extremely difficult, if not impossible condition to satisfy and thus, creating a secondary market with out the originator or its creditors having recourse was impossible. The major securitization company in Brazil, CIBRASEC, was established simultaneous with the passage of Law 9514. CIBRASEC’s charter is in many ways similar to the government sponsored entities in the United States in that is main purpose is to administer to a secondary mortgage market. Also like the US government sponsored agencies, CIBRASEC will have the volume and influence standardization amongst mortgage products, underwriting standards, and servicing by setting rules by which they will accept mortgages for purchase.

16 Moody’s Investor Service, Brazil’s New Mortgage Law and the Development of a Mortgage Market
Law 9514 also brought clear definition to a mortgage related security. The law defines a Certificate of Real Estate Receivables or Certificado de Recebíveis Imobiliários (CRI) as a bond issued by a securitization company for the purpose of purchasing mortgages, and those bonds will be backed by the mortgages purchased with the proceeds of the sale of the bonds.

Finally, and just as important to the nativity of the secondary mortgage market in Brazil, Law 9514 makes it easier for a creditor to foreclose and liquidate a property if a borrower defaults. A repossession process that once took years can now be done in months, as the process is primarily conducted outside the auspices of the judiciary and is thus free from onerous proceedings, delays and biases. In the end, this makes securitization much more attractive to investors, as the longer a foreclosure takes, the more it cost in fees and the lower the present value of a recovery will be.

Resolution 2493

Resolution 2493 was passed about six months after Law 9514, in May of 1998. This resolution, although not as robust and as ground breaking as Law 9514, is very important as it takes some of the cumbersome and expensive work out of assembling a pool for securitization. Prior to this resolution, banks had to obtain the permission of the Brazilian Central Bank prior to transferring the loan to another party, due to Brazil’s bank Secrecy Laws. Now, as long as the third party is a special purpose entity (such as a securitization company) whose sole purpose is to purchase and remarket those loans as bonds. It is
important to note however that this rule does not exempt creditor from having to notify each
debtor as the pool is being assembled.

CCV and CCI

Historically in Brazil, developers have served as the primary residential mortgage lender in
that aspiring home owners pay a down payment to a developer and then pay the developer
monthly until the unit is constructed and inhabitable. The developer uses these funds to
finance construction. This financial arrangement between the developer and buyer is called a
CCV (contrato de compromisso de compra e venda) and serves as an official documentation
of a purchase/sale agreement. In general this arrangement has not been securitization-
friendly (except for take-out construction securitizations) because until the final payment is
made and the buyer takes possession of the completed property, the title remains in the hand
of the developer and thus in the case of developer bankruptcy, a claim on the underlying
asset and so true sale is not feasible.

The CCI (Cedula de Credito Imobiliario) is an instrument that allows securitization
companies to essentially buy out the developer and obtain the claim over mortgage
receivables and a financial interest in the underlying mortgaged property. This CCI, which
comes in the form of an electronic registry satisfies the legal requirements in order to create a
true sale, and thus make the mortgage loans securitizable.
The enactment of these laws that make securitization easier is critical to the development of
the Brazilian economy. A liquid market leads to an additional finding source for the
development of essential commercial and residential real estate projects. Additionally,
securitization of these assets allows for critical risk sharing. Most importantly however,
because of the liquidity of funding for housing and the spreading of risk, developers are able
to address the severe housing shortage in Brazil and provide affordable and adequate housing
for more citizens. As well, Brazil can enjoy some of the positive economic externalities that
are associated with community growth, such as increased retail and service business
activities.
**Conclusion**

Emerging nations all share goals of eventually becoming a healthy and stable economy. Leaders of emerging nations long for adequate health care, sufficient housing options for its inhabitants, and the elimination of poverty. As well, emerging nations wish to compete commercially and bring its unique goods to the global marketplace. In order to do this however, emerging economies need to develop a strategy to attract the critical long term capital resources that are required for enterprise development. A securitization regime should be one component of this plan.

Securitization is not the only financing option, but it is an option, and a viable one for countries in need of long term capital, particularly foreign capital. Creditors will naturally prefer to have something to secure their investment and borrowers would likely rather not tie up their assets when borrowing. The concept of borrowing on a secured basis should not be new to borrowers or lenders. On a micro level, borrowers who are not deemed creditworthy are forced to pledge assets as a form of security to lenders, thus on a macro level (ex politics) things should be no different. Emerging economies should be motivated to implement the required framework in order to facilitate securitization, and primary lending sources can insist that these nations do so. As a primary resource for emerging market economies, multilateral agencies wield particular strength in educating these nations on the benefits of securitization and insisting that they be proactive in breaking down barriers to securitization.
Several nations have embraced securitization and although it is still too early to make an accurate call on what affect securitization has had on emerging market economies, but early indications are that investors are interested and additional funding may be available for would-be issuers. Many transactions, especially in Latin America have been over subscribed. Despite all of the excitement however, some risks exist that could potentially stifle momentum. New laws that encourage and support securitization stand largely untested in the face of financial turmoil. As well, there needs to be much more time before anyone can meaningfully analyze and opine on the macroeconomic impact that securitization has had on a country. However, if the United States can be used as a model, these economies will enjoy the fruits of stabilization and perhaps be able to rise to the economic elite on a global scale.


Special Note

In the course of doing my research, many people have offered their own vision as to what emerging economies need to become viable, stable nations. There is no doubt that securitization is not the only piece of the puzzle, but I feel that it is an important piece of the puzzle. Some of those who agreed that securitization is an important component of stabilization suggested that the securitization of consumer credit was just as important or even more important as the securitization of more commercial credits. This is true, after all here in the United States, measures of economic growth and stability include statistics like retail sales, consumer credit growth, housing starts, manufacturing productivity, and durable goods orders.

No one factor will propel an emerging economy into a global economic powerhouse and the suggestions put forth in my thesis were not meant to imply that securitization is the only way to economic strength. The road to stability is political, social, as well as financial. Strong governments must be in place and diplomatic relationships need to be strong. Citizens need to be patient and offer support for governments and businesses during its growth phase, especially in the light of potential “growing pains”. Additionally, residents need to be involved in the economy in order to help spur organic economic growth.

One item that is vital to economic growth and stability that was not focused on in the thesis is the matter of entrepreneurship. The phrase “necessity is the mother of invention” holds especially true in emerging market economies. Who better to recognize the needs of the
economy than the people who live in it? From the basic needs of food, clothing, and shelter for locals to providing goods and services that foreign investors and expatriates require, entrepreneurs play a vital role in the development of the economy. Furthermore, as foreign investment expands the demand for local suppliers and outsource service providers will grow. Capital will be needed to fund these businesses, however entrepreneurs have limited access to capital. Absent of short term and expensive credit facilities from banks (and potential investment by offshore corporations), many businesses may have growth stifled due to the lack of funds. Unlike more developed nations, venture capital and private equity resources are not readily available and without the development of local capital markets, these resources are not likely to emerge due to implied risk and lack of exit strategies. Existence of a more mature securitization regime may allow small businesses to find additional funding through securitization of receivables as well as cheaper rates on equipment leases due to the liquidity and risk abating effects of securitization.

The moral of the story is that all aspects of an economies capital markets have to be developed. There needs to be stronger links between investors and issuers in order to facilitate economic growth. My argument is that securitization is a logical first step in this process.
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Appendix I – Types of Asset Backed and Mortgage Backed Securities

Representative Asset Backed Securities

- Airplane Leases
- Auto Loans
- Consumer Loans
- Credit Cards
- Equipment Leases
- Franchise Loans
- Future Flow
- Manufactured Housing
- Mutual Fund Fees
- Small Business Administration Loans
- Student Loans
- Timber Property
- Tobacco Settlement
- Trade Receivables

Representative Mortgage Related Securitizations

- Commercial Mortgage
- Home Equity Lines of Credit
- Home Equity Loans
- Manufactured Housing
- Residential Mortgage
### Appendix II – Bond Ratings

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</tr>
<tr>
<td>B1</td>
<td>B+</td>
<td>B+</td>
<td>Highly Speculative</td>
</tr>
<tr>
<td>B2</td>
<td>B</td>
<td>B</td>
<td></td>
</tr>
<tr>
<td>B3</td>
<td>B-</td>
<td>B-</td>
<td></td>
</tr>
<tr>
<td>Caa1</td>
<td>CCC+</td>
<td>CCC+</td>
<td>Substantial Risk</td>
</tr>
<tr>
<td>Caa2</td>
<td>CCC</td>
<td></td>
<td>In Poor Standing</td>
</tr>
<tr>
<td>Caa3</td>
<td>CCC-</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ca</td>
<td></td>
<td></td>
<td>Extremely Speculative</td>
</tr>
<tr>
<td>C</td>
<td></td>
<td></td>
<td>May be in Default</td>
</tr>
<tr>
<td></td>
<td>D</td>
<td>D</td>
<td>Default</td>
</tr>
</tbody>
</table>

Source: Bondsonline.com
Appendix III – Tranching

AAA

Senior portion of the tranche. This section has the highest rating as the expectation is that holders of senior debt have the least likelihood of loss and may often receive principle pay down first.

BBB

Subordinated portion of the tranche. Junior to the AAA rated section, but is senior to the non-rated tranche. As such, the required return is between the non-rated and senior levels.

NR

Non-rated or “equity” portion of tranche. Absorbs losses first, but requires higher rates of return to compensate for risk.