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USING COMMODITIZED REVENUE FLOWS TO LEVERAGE ACCESS TO INTERNATIONAL FINANCE; WITH A SPECIAL FOCUS ON MIGRANT REMITTANCES AND PAYMENT FLOWS

Study prepared by the UNCTAD secretariat

Executive summary

The field of finance for developing countries has changed in a revolutionary manner since the international debt crisis of the 1980s. The losses that international banks incurred discouraged them from continuing to lend on an unsecured basis to developing countries governments and private entities. But as demand for credit remained strong and profit margins were high, some of them rapidly developed new techniques for dealing with the risks.

Many of these risk mitigation techniques relate to the field of structured finance – discussed extensively in earlier UNCTAD papers. One particular form of structured finance is future flow finance, in which the financier takes some form of control over the future export earnings of the borrower (thus, the financier no longer relies on the borrower's willingness to reimburse, but rather, on its continuation in business). Most of the future flow finance for developing countries has been for commodity exports: the resulting products are easy to sell, minimum export flows are easily predictable, buyers are often large western companies and export prices are quite transparent.

As this remains a rather specialized area in the banking industry (and those involved understandably first go for the easiest transactions), it is perhaps not surprising that many opportunities remain open. This paper focuses on the most recent forms of future flow finance, which are structured on the back of two commoditized revenue streams that have only been identified over the past ten years as providing the potential for underpinning hard currency credits: migrant remittances and trade payment flows. Deals structured around these flows have only been struck in a handful of countries, even though in principle, possibilities exist in most developing countries. It is hoped that this brief paper will help draw the attention of decision makers in governments and the financial sector to the opportunities that exist in this area, and that it provides a good insight in how to structure the related transactions.

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INTRODUCTION

After the debt crisis of the mid-1980s, banks had a negative perception of lending to developing countries. Nevertheless, credit demand from these countries was still strong and potential margins were high. Imaginative bankers soon found that despite the difficulties in which they found themselves, all of these countries still managed to export their key commodities.

Even the countries that were in principle the most risky for international financiers, e.g. poor, commodity dependent countries that relied on just one or two agricultural commodities for most of their foreign exchange earnings, safety could be found in the fact that these countries' incentive to export was high. Once goods were successfully exported, it was often possible to look to an entity resident in Organization of Economic Co-operation and Development (OECD) country for payment.

This realization formed the basis of classical structured finance that began to be used to support much of developing country trade. Under these structures, international banks provided financing in such a way that they assumed the risk of developing country exporters and transferred payment risk to an entity in an OECD country.

As far as they went, these structures were only able to support short-term finance flows but did not provide any solution to the fundamental need of many developing country economies to access medium-term financing necessary to ensure future growth of the economy and maintenance of export growth.

The funding arising from these structures were characterized by:

- short tenors, not exceeding 360 days;
- a focus on exports with little or no support for investment financing;
- import financing was virtually excluded except if cash-collateralized or backed by export receivables;
- high structuring cost (although interest rates were below those normally applying to companies from these countries, as the transaction structures allowed to "pierce the sovereign ceiling" and borrow more cheaply than these countries' risk rating would have warranted); and
- stringent loan covenants.

In consequence, countries interested in raising investment financing to ensure **future** export earnings growth could not rely on these forms of structured financing. They started looking for new ways to raise funds, and found them in the pre-financing of financial future flows. Financial future flow transactions rely upon, among others, non-commodity receivables such as migrant remittances, payments on credit cards or checks, as a source of repayment. They have become popular in some developing countries because they offer an opportunity for the borrowers to obtain hard currency loans on better financing terms in the form of lower loan pricing, and longer tenors. The first such

deal was concluded in 1987 (a telephone call receivables securitization in Mexico) but the market only started developing properly in the mid-1990s.[1]

The possibilities in this area are very much determined by the creativity of the financiers, albeit constrained by the general legal and regulatory environment of a country. What constitutes a future export receivable is in the eye of the beholder. In recent years, there have been a number of innovative international financings that use the standard techniques of structured commodity finance for non-traditional payment flows. Some of these flows were based on service-related payments – telephone receivables, for example, which are due to a country of which the citizens (to simplify) receive more incoming telephone calls than they make outgoing ones. Others were based on expenditures of foreign nationals in the country – namely credit card receivables, which provide a more or less predictable inflow into countries where tourists spend more money than that country's travellers spend on credit cards outside of the country. Yet others were based on the earnings of a country's nationals abroad (migrant remittances – the first deal of this nature was arranged in 1994), or even on the "right to be paid" for the exports that the country will surely make in the future (1999). Financings have also been made on the basis of the rights paid by foreign companies to overfly a country's territory, or to fish in its waters, or on the basis of future royalty payments or intellectual property rights.

What all these financings have in common is that they are based on "commoditized" future revenue flows, which makes it possible to make the standard analysis of performance risk on which structured commodity finance is based and to build in various risk management mechanisms. They can be used both the raise funds from banks and from the capital market. The latter tends to be much better documented as transactions are normally evaluated by rating agencies which publish their findings, but there have also been quite a few bank financings.

These financings have often been difficult to arrange because of problems with the borrowers and not with the entities that receive or manage the future receivables – they are normally expected to acknowledge assignment of the receivables, but may not be keen on doing so. The International Air Transport Association (IATA), for example, has a clearing house system that manages most of the payment flows that come with international air travel, but is reticent to acknowledge assignment of overfly rights or other payment flows that it manages unless the project for which the credit is destined is related to the aviation sector.[2]

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[1] There were almost the same number of deals in 1995 (around 20), was almost the same as the total of the preceding eight years —the number doubled again in 1996. See Dilip Ratha, "Financing development through future-flow securitization", *PREM Notes,* No. 69, World Bank, June 2002.

[2] See for an overview of possibilities in this sector Moody's, *Moody's Approach to Rating Obligations Backed by International Airline Ticket Receivables: The Sky's the Limit*, 9 April 1999.

This paper discusses in some detail the use that has been made in a few countries of two types of future payment flows: migrant remittances and future payment rights.[3] Both are highly relevant for developing countries. In many countries, migrant remittances are already the major source of hard currency revenue and remittances are bound to continue gaining importance. And all countries have future payment rights, even if they are not defined as such. Despite the potential of these two future flows to underwrite financings (at a much lower cost than that commonly experienced by a developing country borrower), financings based on these underlyings are extremely rare. Many financial sector decision makers in developing countries are not even aware of the structures which can make these financings possible – which, it should be said, are only really well understood by only a handful of persons even in a typical large international bank.

It is hoped that this report will provide clear guidelines to developing country bankers on how to structure international financings backed by migrant remittances and future trade payment flows, tapping into the bank or capital market – and that it encourages decision makers in governments and international agencies to recognize the importance of this area and the potential for successful developmental efforts. The general principle that it is a waste if a predictable revenue stream is only used as a revenue stream – and not as a tool to reduce financing cost, applies clearly in cases of migrant remittances and future payment rights; a conscious effort by developing country bankers is necessary to remedy this situation. In many cases, this will bring large gains to their banks, and even more so to their countries.

As an illustration, the World Bank estimates that for migrant remittances finance alone, the potential is $9 billion a year, of which one-third would be for low-income countries. Compared to unsecured finance, use of such a financing mechanism would save developing countries at least $90 million a year in interest rate charges, and probably two-three times more than this. Potential gains from trade payment flow financing are several times higher.[4]

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[3] This was also the subject of a brief section in an earlier UNCTAD paper, *Potential applications of structured commodity financing techniques for banks in developing countries*, UNCTAD/ITCD/COM/31, 29 August 2001.

[4] World Bank (2006), *Global Economic Prospects - economic implications of remittances and migration*. The paper mentions that for the diversified payment rights securitizations in Brazil (discussed later in this paper), interest rate costs for the issuing banks were reduced by as much as 700 basis points (7 per cent). Of course, banks had to pay an extra insurance premium, but this was probably only around a third of their interest rate savings.

Chapter I
MIGRANT REMITTANCES FINANCE

A. Potential

Official statistics recorded $80 billion in migrant remittances to developing countries in 2002. Taking into account informal flows and underreporting of official data, estimates put the value much higher, at between $100 and $200 billion. They have been increasing steadily since, and in 2004, official statistics recorded over $120 billion. "This steady flow represents an under-used asset that offers promise for medium and long term funding from international capital markets through the process of remittances securitization."[5]

Despite its benefits, this technique of raising international financing has been rare. Available data, however, indicates that migrant remittances can be an important base on which developing countries can source much-needed longer-tenored and lower-priced hard currency loans. Table 1 shows that in many countries, there are significant underlying migrant remittances flows.

Brazil accounts for about a third of migrant remittances securitizations that have been concluded to date, Mexico accounts for around a quarter of such securitizations.[6] Turkey has traditionally been the largest beneficiary, accounting for just over a third of the total. Kazakhstan, Panama, Peru and the Philippines have also seen such securitizations.

Most migrant remittances financings so far have been in just four countries in Central and Latin America: Brazil, El Salvador, Mexico and Peru. In total, some 40 remittances securitizations were arranged there over a ten-year period, for a total of $6.5 billion. Table 2 lists the principal transactions.[7]

Migrant remittance financings can be structured around a multiple pool of origins, or can be tailored to capture remittances flows from specific countries (e.g., Japan) or groups of countries (e.g. the Middle East). In recent years there have been a number of securitizations that aim to capture only specific migrant remittances flows. For example, several transactions have been structured on the back of remittances from Japan to Brazil and Peru. It is estimated that there are some 305,000 Latin American immigrants living in Japan who send $2.65 billion to their families on a yearly basis.[8] Of these, 70,000 are Peruvians, who together send some $365 million home each year. In 2001, a local bank (Banco de Crédito del Perú) structured a $100 million bond finance on the back of these remittances, despite the fact that the country (after the then-President Alberto Fujimoro

[5] UNDP, *The Potential Role of Remittances in Achieving the Millennium Development Goals – An Exploration*, Background note to the round table on remittances and the MDGs, 10 October 2005.
[6] This represents data up to mid-2004. Suhas Ketkar, Royal Bank of Scotland with Dilip Ratha, World Bank, *Securitization of Future Remittance Flows: A Global Overview,* Inter-American Development Bank International Forum on Remittances, 30 June 2005.
[7] Several of these transactions are described in UNDP El Salvador, *Worker remittance as an instrument for development*, December 2003.
[8] Max Chion, *Banco del Trabajo - Peru*, MIF Remittance Conference, IADB, June 2005.

had fled) was in a severe political crisis. A SPV was set up in the Bahamas to anchor the transaction. In 2005, another bank (Banco del Trabajo, part of a Chile-headquartered banking network in Latin America), benefited from an Inter-American Development Bank pilot project, under which IADB lent $7 million to the Banco del Trabajo, which was secured through the use of a master trust account from which the debt was serviced (no SPV was used). This allowed the bank to develop new medium-term loan products.

Table 1: Workers' remittances (receipts) in 2000 and 2004

Country	Total amount (millions of US$)		As percentage of imports of goods and services	
	2000	**2004**	**2000**	**2004**
Top-15				
India	12 890	21 727*	21.5	26.3*
Mexico	7 525	18 143	4.2	9.0
Philippines	6 175	11 634	15.0	27.2
China	758	4 625*	0.3	1.0*
Morocco	2 161	4 218	20.7	25.4
Pakistan	1 075	3 945	10.6	24.5
Egypt	2 852	3 341	16.9	12.6
Bangladesh	1 968	3 192*	27.3	39.6*
Colombia	1 610	3 190	10.2	16.4
Brazil	1 350	2 813	2.1	2.6
Guatemala	596	2 591	15.4	56.2
El Salvador	1 764	2 563	48.2	59.6
Dominican Republic	1 839	2 325*	20.5	26.2 *
Jordan	1 845	2 287	52.2	38.2
Thailand	1 697	1 622	2.1	1.4
Other countries with share in imports of goods and services > 10 per cent				
Ecuador	1 322	1 545*	22.1	21.8*
Sri Lanka	1 154	1 423*	18.1	21.8*
Tunisia	796	1 432	9.2	10.8
Yemen	1 288	1 283	32.1	25.4
Jamaica	878	1 380*	24.5	39.2*
Sudan	641	1 403	34.9	36.7
Honduras	416	1 142	16.7	37.2
Haiti	578	811*	114.8	172.9*
Nepal	111	785*	8.7	73.7*
Nicaragua	320	519	29.0	33.5
Uganda	238	291	35.9	25.2
Senegal	233	..	17.9	..
Lesotho	252	355	99.4	46.0
Mali	73	154*	11.4	13.3*
Togo	34	149*	8.1	21.5*
Cape Verde	87	92*	59.6	33.3*

* 2003 figures

Source: *UNCTAD Handbook of Statistics*, 2005, Table 6.3A – data based on IMF Balance of Payment Statistics. Note that IMF statistics strongly underestimate migrant remittances

particularly for countries with a poorly developed banking system where such remittances are often made through an international money transfer company such as Western Union or similar services, or through other less formal means. Countries such as Somalia (where migrant remittances amount to over $150 million a year), Eritrea and Samoa, all with significant and regular inflows of migrant remittances, are therefore not included in the table.[9]

Table 2: Principal migrant remittances-backed securitizations concluded in Central and Latin America up to June 2005

Originator (no. of deals)	Country	Size ($ millions)
Banamex (4)	Mexico	871
Banorte (2)	Mexico	400
Bital (1)	Mexico	100
Remesas (2)	Mexico	200
Banco do Brazil (6)	Brazil	1 360
Santander Banespa (1)	Brazil	400
Itau (6)	Brazil	810
Bradesco (3)	Brazil	500
Unibanco (6)	Brazil	1 151
Agricola (2)	El Salvador	160
Cuscatlan (5)	El Salvador	350
Salvadoreno (1)	El Salvador	100
Banco de Credito del Peru (1)	Peru	100

Source: FitchRatings, *Structured Finance in Latin America: A Look at Cross-Border Remittance Securitizations*, IADB, 30 June 2005.

B. A case study: bank finance for Ghana[10]

The first ever-financial future flow transaction concluded in Africa was conducted in the late 1990s in a sub-Saharan African country. The country was interested in raising cheaper hard currency funding to fund agricultural development, especially new plantings of its important export crop. Local interest rates were too high to support such lending through local financing. There was also a local scarcity of medium-term money.

The country's government recognized the need to modernize its agriculture if it hoped to continue to be a major exporter of an important commodity. Thus, it encouraged one of its (state-owned) development banks to work with some international banks to design a financing structure that enabled the development bank to raise a larger sum of hard currency financing than it could otherwise have raised, for a longer tenor (3 years), and at

[9] . See Shivani Puri and Tineke Ritzema, *Migrant Worker Remittances, Micro-finance and the Informal Economy: Prospects and Issues,* ILO, Social Finance Unit Working Paper No. 21, 1998.
[10] An earlier version of this section was published in Spanish in John MacNamara (ed.), *Financiación estructurada de operaciones de comercio exterior*, Instituto Español de Comercio Exterior (ICEX), 2001.

a very competitive pricing, given the tenor and African market practice. The development bank was then able to use the funding to expand its lending to agriculture.

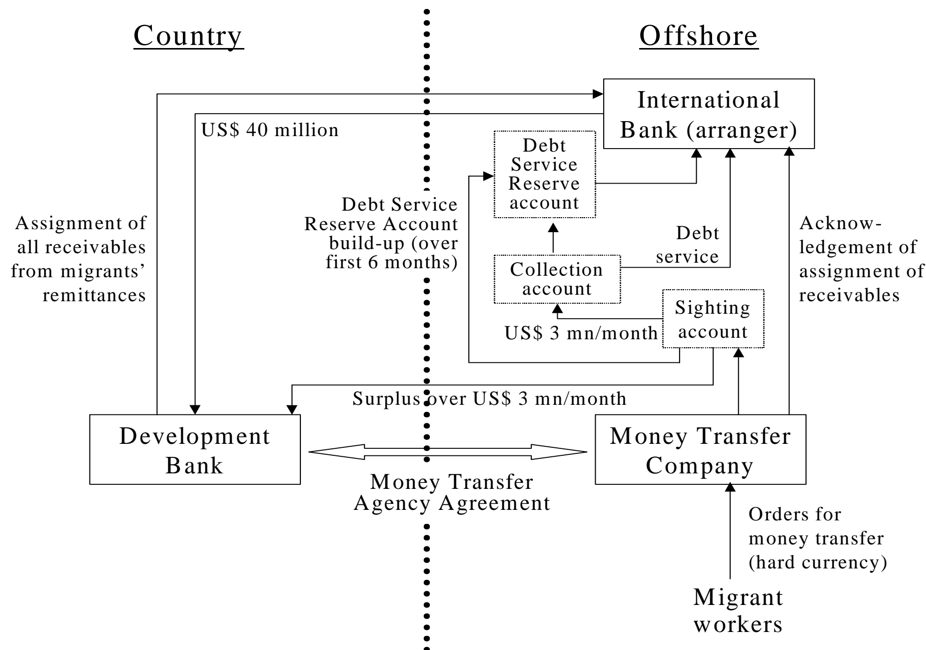
The deal took advantage of a rising level of migrant remittances made possible by the large number of people who had emigrated to Europe and the Americas during a period of severe economic difficulties many years earlier.

Prior to the deal, home remittances from this pool had become sufficiently important for the development bank in question to enter into a money transfer agency agreement with one of the major international money transfer companies. By the time the deal was being arranged, amounts handled had increased to more than $50 million per annum, some ten per cent of total officially recorded remittances. The key elements of the transaction were as follows:

Amount	$40 million
Final maturity	Three years
Purpose	Proceeds to be used in financing government agricultural development projects
Interest rate	1.50 per cent over the London Interbank Offered Rate (LIBOR)
Security	(i) Assignment and acknowledgement of remittance receivables from a leading international money transfer company in a minimum amount of $3 million per month. (ii) Routing of remittance receivables through a sighting account held with arrangers. (iii) Charge over the Collection and Sighting Accounts (iv) Charge over a Debt Service Reserve Account holding a minimum balance of 10 per cent of the loan balance. This Account to be fully funded six months from loan signature date, from the sighting account.

Figure 1 gives an overview of the transaction structure.

Figure 1
Migrant remittances finance in Ghana



To execute transactions which are secured on "future receivables" requires that lenders consider, and be satisfied with, the ability of the deal to generate sufficient cash flow to repay the debt. In particular, they should be satisfied that:

a) The borrower is a market leader in the business generating the "future receivables". In this regard, it must be the only provider of the product or if there are competitors, it must have the competitive edge that will ensure that – at worse – it retains its market share of the business over the loan period.

b) The borrower is essentially healthy to mitigate the risk of financial collapse.

c) The business must be important to the borrower in terms of earnings, the opportunity it offers for cross-selling of other products, other spin-off business it generates or other considerations that will make it difficult for the borrower to want to discontinue offering the service.

d) The service has a tendency of being in increased demand. There is no, or limited scope for, substitute services with superior technology; the product is therefore not threatened by obsolescence.

e) The source of the future flow should be such as to ensure a steady growth in remittances. In other words, the political and economic environment in the countries where most of the flows originate must be stable to ensure that

exchange control would not stop remittances. In addition, it is preferable to have a diversified source of such flows.

f) The risk of diversion of remittances is under control.

g) There is little or no risk of the host government interfering in the transfer of remittances, e.g. by ordering the surrender of all such remittances in exchange for local currency.

With respect to the transaction in question, these issues were adequately addressed, and the borrower bank was considered a good candidate for financial future flow debt offering. In this regard, it was found that:

a) The bank was the only provider of the service in the country with an exclusive agency contract with a leading global remittance company. No other bank in that country at that time had a competing product as agents of other international remittance companies. The bank also had a very good rural branching network, which was critical in securing remittances mainly destined to rural relatives of migrants.

b) The remittance business was extremely important to the bank for two reasons. First, it was important to the government, the owners of the bank. Second, it represented a low cost source of foreign currency for the bank, making the bank a leader in the important foreign exchange market. Due to the persistent depreciation of the exchange rate, the foreign currency from the service provided opportunity for making much money on the sale of foreign exchange. It also offered the bank a big advantage in the letters of credit (L/C) business. This is because it provided the much-needed foreign currency liquidity for cash-collateralizing import L/Cs (imports are quite important for the country). As a result of their strength in the foreign exchange and L/C markets, they also attracted large local currency deposits which were considered crucial in meeting local currency payments arising from future remittances which had been pre-assigned to lenders. Accordingly, it provided the bank with a tremendous opportunity for cross-selling and generation of lucrative spin-off business.

c) The bank had undergone very extensive restructuring and begun posting strong financial performance. By the time the deal was done, it had become the most profitable bank in the country and was the third largest bank in terms of assets.

d) The remittance business in the country was showing an annual growth estimated between 10 and 15 per cent. Annual earnings then were in excess of $400 million. Before the agency arrangement with the remittance company, remittances came through largely unofficial means and remitters were in many cases defrauded. The opportunity offered by the bank provided a safe way for risk conscious migrants

to remit funds. There were no other agencies in direct competition with the bank for a formalized and organized remittance flow.

e) Since most flows came from the U.S. and the European Union, they were considered sound and reasonably well-diversified sources. The economies were also growing and there was a very low risk of those countries introducing exchange controls that would have affected the inflow of future remittances. Besides, the loan amount was only 37 per cent of the future flow dedicated to servicing the debt.

f) The concern about diversion of proceeds of remittances was covered by the fact that the international remittance company was a leading global remittance firm with a sound reputation. The transaction structure was also used to mitigate the risk by ensuring that the future receivables were assigned to the lenders. A collection account where they were to be collected was also charged and located off-shore. These were also sufficient to protect the lenders against possible third party interference with future remittance flows that may arise from the borrower becoming distressed financially.

g) Transfer and convertibility risks were also found acceptable because of a number of reasons:
   - The amount of future flows dedicated to cover the debt was only $108 million, spread over 3 years, which was an infinitesimal amount compared to the country's total foreign exchange receipts thereby reducing the temptation for government to order a redirection of the flows.[11]
   - The government encouraged the transaction. It considered that by channeling remittances inflows through an official institution, it would be better able to monitor foreign exchange flows, and manage them.
   - The transaction generated foreign currency resources used in implementing agricultural projects, a priority of the government.
   - The government was the owner of the bank so government would not think the deal was a clever way of diverting foreign exchange away from the country by unscrupulous private operators.
   - Given the structure of the transaction, especially the fact that the remittances were generated offshore and assigned to a charged offshore account as well as prior written government approval of the deal, it would also be legally difficult for the government to intervene.

[11] Deals of this nature are generally strongly over-collateralized not because the arranger wants to have a sufficiently large safety margin against revenue declines, but because it provides protection against the risk of Government intervention. The idea is that governments will hesitate to divert payment flows at large reputation and legal risk; if at the end, this will only free up a relatively small amount of money. See Duff & Phelps Credit Rating Co., *Special report: an analysis: DCR's approach to rating future flow securitizations*, 23 November 1998.

C. A case study: migrant-remittances-backed capital market finance for Brazil[12]

Brazilian migrant workers send home some $2.2 billion annually from Japan alone.[13] The first transaction based on this flow was done in 2001, when Banco de Brasil completed a $300 million bond issue securitized with future Yen remittance flows from Brazilian workers in Japan. This bond issue received a BBB+ rating, considerably above Brazil's BB- rating.

This securitization used a double SPV structure. Banco do Brasil (which processes around 70 per cent of all remittances flows from Japan) sold its rights to the Japanese remittances to a Cayman Islands SPV called Nikkei Remittance Rights Finance Co. ("Nikkei" is the name for Brazilians working in Japan). This SPV issued a note purchased by a US Trust, which in return issued securities to investors.

The analysis undertaken before the deal was very much in line with that described for the case of Ghana above. The structure that was set up was also quite similar, with payments received in Japan swept each end of the day into a collection account in the US, from which the obligations under the securities issue were serviced.

D. Moving forward

There is much scope for expansion in this area, both in terms of country coverage, as well as in the terms of the nature of the financing. Financings of this nature can be structured in many more countries; not only on the basis of remittances from Europe and the United States, but also on the basis of regional flows (for example, the Middle East to some African and Asian countries, Gabon to several West African countries, South Africa to Lesotho or Mozambique). As experience with these deals grows, fixed costs are falling, which should make it possible to capture many of the smaller migrant remittances flows for purposes of arranging a financing.

Because the risk of these financings is based on the credit rating of the country from where the migrants send the funds, rather than on the credit risk of the receiving country, the savings in interest rates can be high. Tighter restrictions on informal means of international money transfer and lower banking fees are likely to lead to an increasing use of the formal financial system for money transfers, making it ever easier to structure financings against future migrant remittances.[14] Given the growth in migrant populations and corresponding increase in migrant remittances, it makes sense for many countries to begin an active examination of using such receivable in financing their medium-term economic development and thereby begin to break away from over-dependency on aid and short-term commodity finance as major sources of hard currency financing.

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[12] Based on Standard & Poor's Ratings Direct, *Presale Research: Nikkei Remittance Trust*, 27 July 2001, and the issue's offering circular, in http://www.bb.com.br/portal/ri/eng/dce/dwn/Nikkei2001.pdf.
[13] Inter-American Development Bank, Multilateral Investment Fund, *Remittances to Latin America from Japan*, IADB Annual Meeting of the Board of Governors, 6 April 2005
[14] World Bank, *Global Development Finance Report 2003.*

Chapter II
TRADE PAYMENT FLOW FINANCE

A. Developments

Using trade payment flows to underwrite international financings is, in principle, feasible in all countries, and can enable all banks involved in export transactions to overcome difficult country risk conditions. This form of finance is very recent – the first deal was concluded in June 1999 – but once one recognizes the possibility, the structure is relatively straightforward. The ability to raise relatively low-cost finance on the back of future payment flows is relevant to all countries with a relatively poor rating, but with a sound banking system and a reasonably sized and reasonably stable flow of exports. It is hoped that the discussion in this chapter will inspire banks to look at opportunities in this domain and governments and international development agencies to support relevant capacity and institution-building.

Many banks process a large volume of trade-related payments. To recognize that this has inherent potential to create a new financing instrument for an individual bank, one has to take a few logical steps:

1. One has to establish that the bank will continue this business in the future.
2. Then, the crucial aspect is recognizing that when a foreign client of an exporter opens a letter of credit, or agrees to a cash-against-documents payment procedure, this leads to a payment obligation, or more specifically trade payment rights, of a foreign bank to the local bank which acts for the exporter.
3. Therefore, the local bank has a future flow of receivables, assuming that it will continue its business as usual.
4. Therefore, by committing this future flow of receivables the bank eliminates most of the risk of its not being able to obtain sufficient foreign exchange to service its foreign debt.
5. As a consequence, if foreign financiers are willing to accept the pledge of these future receivables, the local bank can eliminate most of the "country risk" part of its rating and can pierce the sovereign ceiling, reducing its credit costs, perhaps quite significantly.

The next step is to consider what is necessary to ensure that foreign financiers feel comfortable with these trade payment rights as an underlying source of repayment for a financing. The principle is the same as the one discussed earlier for structured finance: the domestic bank cannot be allow to control the payments made under these trade payments rights.

B. The first transaction: Garanti Bankasi, Turkey[15]

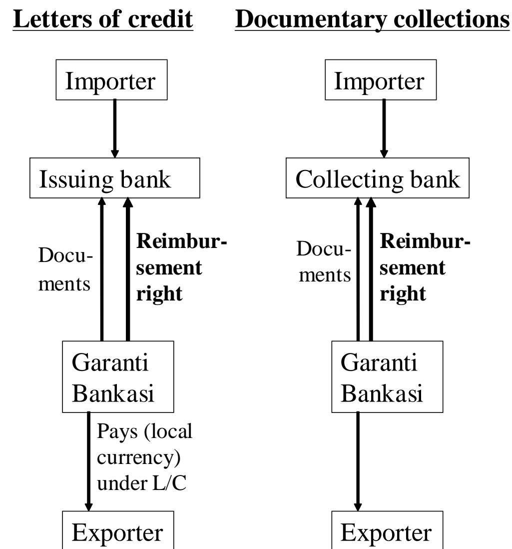
In the first ever future payment flows securitization in Turkey, Garanti Bankasi, a local bank, sold its trade payment rights to an overseas SPV, which in turn sold them to another trust in the United States. The latter thus had first title to the proceeds from Garanti's trade payment rights and it was able to issue securities worth $200 million. The risks inherent in this transaction were deemed small by the foreign financiers, enabling Garanti to obtain funds at very favourable terms. Not surprisingly, a similar transaction was set up later in the same year by another Turkish bank, and similar transactions followed in later years. The mechanics of this first transaction are described below.

The beneficiary

Garanti Bank, one of the largest private banks in Turkey, belongs to a large group which includes four other banks, as well as other companies. It is considered to be an efficient bank with good profitability and a healthy growth rate. The percentage of non-performing loans in its total loan portfolio is well below the Turkish industry average. At the time of the transaction, the bank had a local currency rating of BBB and a foreign currency rating of BB- (which was constrained by Turkey's BB- rating).

Garanti is a major provider of pre-export finance to Turkish exporters (on average, in 1998, it had an outstanding portfolio of $900 million). In Turkey, exporters generally process their foreign currency receipts through the bank providing the pre-export loans. In 1998, Garanti's total flows related to exports were about $3.2 billion, 12 per cent of the country's total exports. It had a market share of about 8 per cent of Turkish letter of credit and cash against documents inflows, with an average volume of $862 million from 1995 to 1998.

Figure 2
The crucial conceptual step: standard international trade payment systems give rise to future payment rights



The logic of the deal

Turkish exporters generally export on the basis of L/Cs, cash against documents (CAD), cash against goods, or advance collections. In the case of a L/C, the importer opens the L/C through its bank; Garanti will

[15] Based on Douglas A. Doetsch and Denis Petcovic, *Securitization of Garanti Bank's Trade Flows*, Mayer Brown & Platt, 2000 and Duff & Phelps Credit Rating Co., *Garanti Trade Payment Rights Master Trust*, August 1999.

then act as the advising, confirming or negotiating bank. The exporter sends the bill of lading, title documents and other documents to Garanti, which will forward them to the issuing bank. In the case of CAD, the exporter and importer agree on a documentary collection. This means that when the exporter presents certain documents through the remitting bank (Garanti) and the collecting bank, payment is to be made.

In both L/Cs and CAD, a payment obligation is incurred by the foreign (L/C issuing or cash collecting) bank at the moment that Garanti transmits the appropriate documents. In other words, Garanti's flow of documents creates a flow of foreign exchange: submitting the documents creates a **reimbursement right**.

Turning reimbursement rights into a financing vehicle

What is necessary to ensure that foreign financiers feel comfortable with these trade payment rights as an underlying for a financing? The principle is simple: Garanti needs to be removed from the control over the payments made under these trade payments rights. The mechanism chosen was for Garanti to sell the trade payment rights to an overseas SPV (in the Cayman Islands), which in turn sold them to another overseas Trust (in the USA). The latter thus had first title to the proceeds from the trade payment rights.

Box 1
Specifics of the Garanti Bank future payment flows securitization

Details of the transaction
Amount: $200 million fixed- and floating-rate certificates, due in June 2004
Rating: BBB
Closing date: 24 June 1999
Issuer: Garanti Trade Payment Rights Master Trust (New York)
Special Purpose Company: Garanti Trade Payment Rights Finance Co. (Cayman Islands)
Originator: Turkiye Garanti Bankasi A.S.
Credit enhancement: Letter of credit for benefit of the trustee in the amount of 3 months interest and existing trade payment rights
Assets of the SPC:

- Ownership of all existing and future eligible trade payment rights due to Garanti from eligible banks;
- Interest in the concentration account
- Ownership of monies in the collateral account
- Ownership of the letter of credit facility

On this basis, it was able to issue securities worth $200 million, which was the transferred to Garanti as payment for the sale of the receivables.

The banks making payments to Garanti were instructed to use certain correspondent banks, which signed an agreement and acknowledgement to deposit such funds into concentration accounts (held in each bank). These funds were transferred at the end of

each day to a collateral account held by a Trustee. They were used to meet quarterly debt service payments and the remainder was transferred to Garanti.

Not all trade payment rights were sold to the SPV: only the rights to payments:

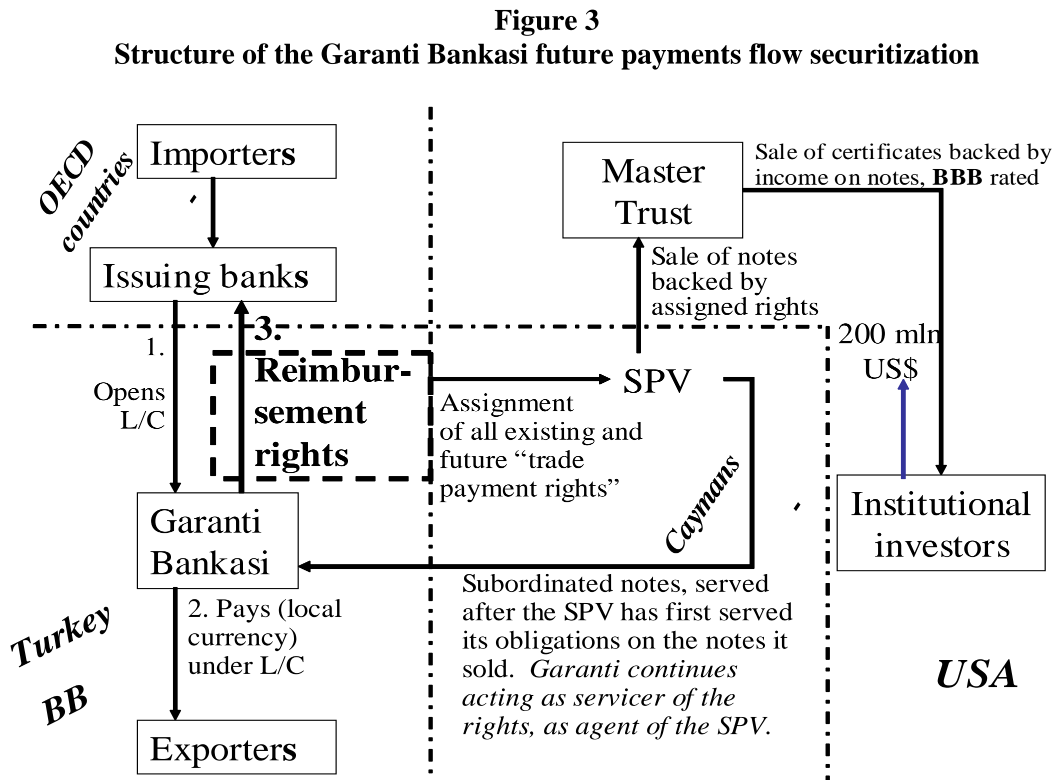
a. by issuing banks/remittance banks (for L/C transactions) or by collecting banks (for CAD transactions) in investment grade jurisdictions; or
b. expressed in US$, Pounds Sterling, Euros or their constituent currencies, with the payment to be made through an eligible correspondent bank.

These were sufficiently large to provide a cash flow 13 times as high as the obligations under the securitization, a ratio of 10 or over is normal future flow transactions. Under the terms of the transaction, Garanti was not allowed to pledge or sell more of its trade payment rights.

Garanti is to redirect its L/C and CAD processing through corresponding banks which have signed the acknowledgement to pay into the trust collateral account, and the trustee has the right to inform other banks that the trade payment rights have been sold and that they should desist from processing them.

Figure 3 below gives an overview of the transaction structure.

Figure 3
Structure of the Garanti Bankasi future payments flow securitization



Dealing with the transaction risks

It was necessary to understand and to the extent possible, mitigate the various risks in this transaction. The following were the major risks:

The risk that Garanti could experience major problems leading to insolvency

Garanti is among the strongest banks in Turkey. Its balance sheet, capital adequacy ratio, non-performing loans and exposure to risky areas, profitability, international borrowings, deposit base, technological infrastructure, range of activities and strength of management were all examined as part of the process of rating the financing transaction.

The bank's strong management and its strong strategic focus were important factors in the evaluation. The bank was seen as pro-active, making concerted efforts to grow in target markets.

It also helped that the bank is part of the large Dogus Group, which has 80 per cent of its assets in financial companies, but is also engaged in tourism, construction, food processing, car dealerships, supermarkets, and media.

Nevertheless, Garanti's local BBB rating provided an overall constraint on the transaction rating: after all, if Garanti becomes insolvent and no longer able to pay its clients their dues even in local currency, exporters will stop using the bank and no more payment flows will be generated.

The risk that Garanti stops generating sufficient trade receivables

A first risk was that a handful of exporters account for a large part of business. They can easily move to another bank. However, this concentration risk was small. Garanti serves a wide range of exporters. At the end of 1998, the 10 largest exporters only accounted for less than 5 per cent of total outstanding export-related loans. The average size of Garanti's L/Cs was $71 376 and $33 274 for CADs.

There was also the wider risk that Turkey's exports collapse. However, the total volume of exports from Turkey had been growing fast – average annual growth from 1994 to 1998 was 10 per cent. Monetary policies and the pace of devaluation had improved the competitive advantage of Turkish exporters. The only risk was that world demand weakened and that products such as textiles (a major export) suffer from increased world market competition.

Furthermore, Garanti's clients were unlikely to move en masse to its competitors. Garanti had an effective client-focused strategy and correspondent banking relationships in almost 170 countries. Nevertheless, given the importance of pre-export credits in generating trade receivables, an obligation was included in the transaction to allow

Garanti to maintain pre-export loans of two times the outstanding principal amount of the notes.

Finally, there was a risk that exporters decide to bypass banks altogether to move instead to other means of payment. In practice, though, this diversion risk was small, as other types of payment were not likely to become more popular any time soon. Garanti already made its transfers electronically and this was quite efficient.

The risk that the Turkish government intervenes in the flow of foreign exchange

There was the risk that in case of a severe foreign currency shortage, the Turkish government or Central Bank may try to centralize and ration access to foreign exchange. They could then instruct Garanti to remit all foreign currency flows to the Central Bank, or they could instruct all Turkish exporters (or the importers) to make payments only through state banks.

This risk, however, was thought to be limited, for the following reasons:

- More than 90 per cent of the trade receivables are not used to service debt and are remitted to Turkey on a regular basis.
- The commitment from corresponding banks to transfer collections to the collection account was irrevocable. It would be difficult to find other banks able to act as corresponding banks (among others because they may not have proper credit lines).
- If other banks are asked to process the payments, this does not alter the title of the trustee over the payment rights. So the trustee would have legal claims to the funds involved, and few banks would be willing to take such legal risk.
- Diverted trade payment rights can easily be identified, as they're quite large, and processed by not too many banks.
- If exporters are told no longer to use Garanti, they lose access to pre-export finance. The government would be reluctant to cause such hardships.
- Turkish state banks do not have the resources and technical capabilities to process a huge volume of flows, or to provide much pre-export finance. Also, there were only four such banks in 1999, and a trend towards further privatization.
- Garanti has a well-established correspondent banking network, which it also uses to establish letters of credit for Turkish **importers**. Interference in the export transactions would damage Garanti's relations with its correspondent banks and thus make life more difficult for these importers.
- Additional securities had been built in. Among other things, the existing trade payment rights already account for 30 per cent of the value of the financing. In addition, a letter of credit facility for 3 months of interest payments was established.
- The contractual arrangements in the securitization are enforceable under Turkish law.

In conclusion, the government would have great difficulty in diverting the trade payment flows. And even if it tried, there was a good likelihood that it would not be successful.

The risk that the sale of the trade payment rights would not be recognized as a "true sale"

If the sale is not recognized as a "true sale", but is considered by the courts as a loan, note holders have no priority over other creditors in the case of insolvency or bankruptcy.

To deal with this risk, a structure was set up with two special SPVs, one in the Cayman Islands and one in the United States. Both SPVs were only used for this single transaction. Only the note holders of the US SPV could ask for the SPV's bankruptcy, and only the US SPV could file for the bankruptcy of the Caymans Islands entity. The risk that both SPVs would be declared bankrupt was considered low, and as a result, the "true sale" character of the transaction was unlikely to come up in a court of law. Furthermore, legal counsel in Turkey advised that this was a true sale; the transfer is not deemed a secured financing in the United States. Legal counsels in the three jurisdications considered that the documents are enforceable, that the rights were perfected and that the various parties had the right to engage in this transaction.

The aftermath

Following the success of this transaction, more securitizations quickly followed with other Turkish banks, which gave rise to further innovations. In March 2000, Finansbank had a securitization in which, in addition to future cash flows from L/Cs and CADs, SWIFT payment remittances were sold to a SPV (this was the world's first diversified payments rights securitization, and was quickly copied in quite a few countries). Türkiye Is Bankasi had a 3-5 years issue backed by SWIFT payments made to five clearing banks in the United States. Iktisat Bankasi had a 5-year BBB-rated transaction denominated in Euros, backed by payments for exports of Turkish goods to G7 countries. HalkBank had a securitization backed by worker remittances, payments to clear foreign cheques and payment for exports of Turkish goods, made at corresponding banks in US and Europe.

Then, in 2001, the Turkish economy fell into a deep crisis. Despite this, most of these securitizations continued performing well and did not even need to be downgraded. Only in two cases (Iktisat and Disbank) the deterioration of the financial data of the banks was so strong that the deals' safety measures were triggered, forcing the early repayment of the securities. All of the assigned payment flows were trapped on offshore accounts, and this proved sufficient to retire the securities in a matter of a few months, without any losses to investors.

C. Payment flow finance in Brazil

After Turkey, the country where most future payment flow financings have been structured is Brazil. After 2000, the diversified payments rights structure introduced in Turkey was often used, but the major structural innovation used in this country was that

of including monoliners in the transactions (Garanti Bankasi's 2003 diversified payments rights securitization is an example that this was followed in Turkey).

Monoliners are highly rated specialized insurance companies that "wrap" whole financing deals: that is to say, against the payment of a fee, they can guarantee a whole transaction. From a financier's point of view, then, the risk of the transaction becomes that of the monoliner – normally AAA, sometimes AA.

To give one example of a typical structure used in Brazil, the case of Banco Itaú, the country's second-largest private bank, is discussed here.[16] Banco Itaú created in 2002 a Cayman Islands SPV called (not very imaginatively) "Brazilian Diversified Payment Rights Finance Co.", which then started issuing a series of floating-rate notes; there were four issues in 2002 and 2003, totaling $600 million (in comparison, Banco Itaú's annual foreign currency payment flows exceed $6 billion). These notes benefited from full financial guaranty insurance policies issued by different AAA-rated monoliners, including MBIA Insurance Corp. and XL Capital Assurance Inc. The insurance policy guarantees timely payment of accrued interest and scheduled principal.

The SPV bought from Banco Itaú all dollar-denominated payment orders generated through its international banking operations and remitted to it by its foreign correspondent banks. This includes non-documentary trade payments, foreign direct investment payments, worker remittances, interest income payments, and certain tourism-related receipts.

The notes issues benefited from two levels of credit quality upgrading. Firstly, the effect of the deal structure itself; and second, the effect of the monoliner guarantee.

As to the impact of the deal structure, Standard & Poor's (S&P) rated the transactions as BBB (not taking into account the insurance policy), which is three notches above Itaú's BB local currency rating and five notches above its 'B+' foreign currency rating. The fact that this rating is above Itaú's local currency rating is remarkable, but it is explained by S&P's assessment that, given the bank's importance, the Brazilian government would probably step in to ensure its survival in case of a crisis. S&P thus assessed a "survivability rating" of BBB, and as this ultimately determines the likelihood that Itaú would have sufficient local currency to meet its local obligations, this rating set the transaction rating.

Apart from that, the ratings agency made risk assessments similar to those described for the Garanti Bankasi deal described above. What is the likelihood that payment flows will fall dramatically? What is the risk that Bank Itaú will see its share in these payment flows decline? What is the risk of sovereign interference? All these risks were considered sufficiently low.

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[16] Based on various Standard & Poor's Ratings Direct Presale Notes. Several other Brazilian banks used similar structures, as did El Salvador's Banagricola in 2002 and Bank Salvadoreño in 2004.

The credit upgrading effect of the transaction structure was important, as monoliners by and large only provide wraps for investment-grade risks. As it was, MBIA was willing to cover this BBB-rated risk, and as a consequence, the notes became AAA-rated. Interest rate savings for Bank Itaú were in the 7 per cent range or more than $40 million a year.

D. Challenges

Trade payment flow financings, including securitizations, show great potential for developing countries and countries with economies in transition. It remains to be seen whether these financings will be structured just on the back of trade payment flows, as in the case of Garanti Bankasi, or for more diversified payment flows.

The use of monoliners to further upgrade credit quality (beyond the intrinsic impact of the strong transaction structure) is likely to become a standard feature of deals, where possible; but it will not become exclusive. Institutional investors are developing an increasingly sophisticated understanding of international finance risks, and are looking for a variety of risk exposures to optimize their portfolios.

Many of the more recent deals are backed by diversified payment flows and wrapped by a monoliner. For example, in December 2005 Kazkommerzbank, a large bank in Kazakhstan, closed a $300 million diversified payments rights securitization, which was backed by the assignment of its dollar-denominated payment flows through the SWIFT system. The largest tranche of the transaction, for $200 million, was wrapped by Ambac Assurance Corp., a US monoliner, and as a result received an AAA rating. The other two tranches, for $50 million each, were not wrapped and received a BBB rating. These tranches were placed with institutional investors who were happy to take on this investment-grade risk. These deal characteristics are probably indicative of the structures to come.

CONCLUSION:
IMPLICATIONS FOR DEVELOPING COUNTRY DECISION-MAKERS

A major opportunity for financial sector decision makers in developing countries lies in identifying revenue streams that can be used to underwrite financing, but are currently only used as a source of income generation. Regular revenue streams give rise to the expectancy of future receivables, which can be assigned to the reimbursement of loans, thus reducing the credit risk of the lender. Interest savings can be very large.

What constitutes a receivable is "in the eye of the beholder." In earlier publications, UNCTAD has extensively discussed commodity-based financings. But many of the more innovative financings of the last decade were based on the recognition of a receivable where earlier, financiers had not seen any. Imbalanced telecommunication flows (leading to systematic payments from country A to B), obligatory use of local facilities/services by companies which generate hard currency (airline overflights over a country, use of airports and ports), services provided by local companies to multinationals active in the country (e.g. to the oil, mining and tourist industries), continuing sales of records made by successful artists, continuing ticket sales and advertising income from successful sports teams, even continuing federal subsidies to loss-making municipalities, were all recognized as receivables, enabling the receivers to obtain up-front credits against the "sale" or pledging of funds to be received in the future.

Financial sector decision-makers should identify such opportunities, and then to capture these streams in such a way that they can be used as a tool to obtain cheaper, longer-term international finance, to be used for local on-lending for example to the agricultural sector or to small- and medium-sized enterprises (SMEs). The international community should recognize the importance of this issue, strengthen its activities in this domain and, through agencies such as UNCTAD, make greater effort to assist in the process.

Some organizations have started with this. The African Export Import Bank structured the migrant remittances deal in West Africa discussed in this paper years before the other development or export-import banks started working on this issue. The Inter-American Development Bank (IADB), more recently, has decided to try and bring migrant remittances finance to countries that have sub-investment grade ratings (it is looking at Guatemala, Honduras and Jamaica). One of its major goals is to use the remittances flows to leverage financing to SMEs and to microfinance institutions.[17] The benefits that it identifies – greater lending by local banks, better and lower cost services for remittances senders and receivers, increased access to international capital markets for non-investment grade countries, and an improvement in the financial condition of local banks[18] – also apply to other parts of the world. In the image of IADB, other regional development banks and international development agencies should develop similar pilot

[17] Pedro de Vasconcelos, *Sending Money Home - Remittances as a Development Tool in Latin America and the Caribbean*, IADB, New York, June 6-8 2005.
[18] Pedro de Vasconcelos, *The Multilateral Investment Fund of the Inter-American Development Bank and Remittances,* Fourth Coordination Meeting on International Migration, United Nations, UN/POP/MIG-FCM/2005/10, 14 October 2005.

projects and other projects of this nature, preferably encompassing not only migrant remittances but also other future payment flows. While expertise in these areas is rare, such organizations can tap into the technical skills of organizations like UNCTAD, which over the past decade has built up significant experience in many areas of structured finance. These organizations and bilateral donors could even consider to provide guarantees to securities issued on the back of future payment flows, as has been suggested in the UK House of Commons for the case of remittances-backed bonds.[19]

Other organizations, in particular the World Bank and the IMF, have some doubts on this issue. Both have from time to time come out against the commitment of future receivables to obtain lower-cost funding, primarily because of two reasons. First, in their own loans, they do not ask for such assignments, and thus, if countries assign a significant part of their loans to service debt to others, these two organizations risk to become subordinated lenders. Second, these loan structures allow countries that would otherwise have to rely on the World Bank and IMF for loans (because as unsecured lender, they are not acceptable to the international capital market) to bypass these two institutions, thus weakening their influence on policy making in these countries.

They also make other arguments against the use of these future flow financings. The IMF, for example, suggest that the "immediate cost advantages of CFR [Collateralized Future flow Receivables] borrowing may be offset by raising the cost of non-CFR borrowing in the future".[20] This would seem a somewhat theoretical fear, especially as in an earlier World Bank/IMF publication, it was argued that "the present issuance of securitized debt does not appear to have approached this critical level [where it jeopardizes creditworthiness]. For instance, rating agencies have not downgraded sovereign credit ratings of either Mexico or Venezuela on account of their rising securitized debt. (…). Thus, it appears that securitized debt can rise to around 15 per cent of a developing country's total debt without necessarily jeopardizing the sovereign's overall creditworthiness." [21] The IMF report also recognizes that "for some countries with low credit ratings, collateralized debt has been the only way to raise external financing".

On the side of developing countries, governments need to make more effort to improve their legal and regulatory framework, e.g. with respect to bankruptcy procedures, the assignment of receivables, or the cost of registration of assignment. Governments should also stimulate the emergence of local rating agencies (the more so as the mechanisms described here for international financings can also be used for domestic securitizations). They should make an effort to ensure that all relevant decision-makers in the government are aware of the financial techniques discussed in this report, and they should encourage and support efforts to make private sector decision-makers aware of the possibilities that exist in this area.

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[19] United Kingdom Government, *Migration and Development: How to Make Migration Work for Poverty Reduction*, Vol. 1, House of Commons International Development Committee, London 2004.
[20] IMF, *Assessing Public Sector Borrowing Collateralized on Future Flow Receivables*, 11 June 2003.
[21] Suhas Ketkar and Dilip Ratha, *Securitization of Future Flow Receivables: A Useful Tool for Developing Countries, Finance & Development,* March 2001, Volume 38, Nr. 1.