

TRIPLE-A GUARANTEED ROUTE



FINANCIAL GUARANTEES ATTRACT QUALITY-HUNGRY INVESTORS. **PHILIPPE TROMP** OF FINANCIAL SECURITY ASSURANCE SPELLS OUT WHO CAN USE THEM AND WHY THEY WORK.

When Boots shifted its entire £2.3bn pension fund from equities into Aaa/AAA debt last year (Making the switch to bonds, *The Treasurer*, December 2001), it highlighted the growing demand for Aaa/AAA securities. As pension funds move to reduce volatility in their assets and achieve better asset-liability matching, the demand for long-dated Aaa/AAA bonds has grown. At the same time, the global economic uncertainty (aggravated by geopolitical turmoil) has prompted a general flight to quality by all types of investors.

In this environment, credit spreads have widened, creating significant advantages for borrowers who can tap the demand for high-quality paper. Of course, few companies have balance sheets that would allow them to issue Aaa/AAA debt – and few would want such balance sheets, as an unleveraged balance sheet is a luxury that usually deprives shareholders of significant returns.

There is therefore a large mismatch between what many investors want and what most companies can offer. Bridging such a gap is the function of financial guaranty insurance. Known also as bond insurance or 'Aaa/AAA wraps', these guarantors are an under-utilised resource in Europe for lowering corporate capital costs.

THE MONOLINE FINANCIAL GUARANTY INDUSTRY: THREE DECADES OF HISTORY. Third-party financial guarantees have obviously been around for as long as there has been debt, but in the early 1970s, a new type of company was formed specifically to raise the credit quality of debt obligations. These companies are called monoline financial guarantors, as they have no businesses unrelated to insuring debt obligations. Originally developed for US municipal bonds, financial guaranty insurance was first offered in the corporate sector by Financial Security Assurance (FSA), which was created in 1985 to guarantee asset securitisations. Today, all the major bond insurers (including FSA, MBIA and AMBAC in Europe) are active in both public and corporate finance, as well as in private finance initiative (PFI) and other public-private partnership transactions.

A typical policy guarantees timely payment of all principal and interest as scheduled. Monolines waive all defences to payment, including fraud and non-payment of premiums. As a result, bonds issued with the insurance carry the financial strength rating of the

guarantor, instead of the credit rating of the issuer. The leading monolines all have three or more triple-A ratings from major rating agencies. Unlike almost any other type of company, these high ratings are inherent to the monolines' business franchises, providing the strongest incentive to remain triple-A.

THE ROLE OF MONOLINE GUARANTORS IN CORPORATE FINANCE. Guarantors are not alchemists capable of turning any corporate credit to gold. In fact, they generally do not guarantee direct, unsecured corporate debt at all. But they can provide significant benefits to borrowers in the public infrastructure sector and to financial institutions and corporates that have assets with predictable cashflows. The insured obligation must be of at least investment-grade quality and secured either by revenue from essential public services or by appropriate assets segregated in a bankruptcy-remote vehicle. Depending on the transaction, the company ultimately benefiting from the insured transaction may not itself have to be investment-grade or even rated.

For those who qualify, financial guarantees are a way to increase leverage and lower the cost of funds by issuing Aaa/AAA securities. Investors are attracted not only to the Aaa/AAA rating but to the added value arising from the guarantor's analysis, due diligence and surveillance. They are also protected from a downgrade of the underlying obligor. These features support the liquidity and trading value of insured bonds.

GUARANTEES IN INFRASTRUCTURE FINANCE. Financial guarantees can help reduce the cost of medium- and long-term financing for private utilities and project developers and operators in many sectors of infrastructure finance, including government accommodation, education, healthcare, transportation (such as motorways, airports and mass transit), social housing, environmental services and water systems.

For example, guarantors assist private utility companies that are typically regulated monopoly (or near-monopoly) providers of essential services. Last year, Sutton & East Surrey Water plc used an FSA guaranty to become the first UK water utility to issue index-linked bonds to capitalise its business more efficiently within the

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OFWAT regulatory environment. The principal of the guaranteed bonds, originally £100m, is adjusted annually and linked to the UK retail price index (RPI), the same index that governs the regulated rates charged by the utility. While the index-linkage made the issue particularly efficient, it also made capital market access essential, because the banking sector does not provide index-linked debt on attractive terms. The guaranty made a strong bond execution possible.

Construction and service contractors in PFI and other project financings also have much to gain by including insured senior bonds in the capital structure. In the UK, more than £2bn of PFI bonds have been issued, and almost all of those were issued with financial guarantees.

The largest PFI bond to date helped finance the design and construction of the UK's new Government Communications Headquarters (GCHQ) office building in Cheltenham. The concessionaire, Integrated Accommodation Services PLC (IAS), issued £406.9m of FSA-guaranteed senior secured bonds. The holding company for IAS is owned by financial subsidiaries of three experienced, high-quality subcontractors, Carillion, Group 4 Securitas NV Group and BT PLC, which also provided about £22m to IAS through subordinated loan stock. Although the ultimate revenue source is the UK central government, the financing could not be rated triple-A because its credit quality also depends on the contractors' ability to provide contracted services throughout the life of the concession. Therefore, the best execution called for a triple-A guarantee.

The IAS issue demonstrates the capacity of the capital markets to absorb public-private partnership issues of great size and complexity when guarantees are involved. This is significant because huge infrastructure financings of more than €1bn each are on the horizon. The London Underground, for example, will require both insured bonds and bank loans to meet its capital needs. Others include major road financings or refinancings in the Czech Republic, Greece and Portugal, as well as motorway and airport privatisations in Europe. Although banks have begun to offer long-term debt commensurate with 20- or 30-year concession contracts, the bank market cannot be expected to offer acceptable terms or the capacity for single projects on the scale of these mega-projects. At the same time, the single-currency environment has made broad capital market distribution more feasible and desirable for euro-denominated issues. Under these circumstances, equity holders will almost certainly look to insured bond executions as a means to enhance returns.

ASSET-BACKED AND MORTGAGE-BACKED SECURITIES. Monolines have played an important role in expanding the US asset-backed securities (ABS) market and are developing products for the fast-growing European market. The European asset-backed market has matured from one used primarily by financial institutions seeking

additional liquidity to a viable funding channel attractive to both financial institutions and corporates. The market has become more liquid as investors have discovered greater price and rating stability in ABS and mortgage-backed securities (MBS) than in senior unsecured corporate debt.

For corporates, securitisation can be a cost-efficient financing alternative: by segregating assets from its own credit risk, the corporate originator reduces the borrowing risk premium and thereby obtains capital market funding at more attractive pricing than banks offer, disintermediating its lenders in the process. This, in turn, leads to price tension between the competing sources. Securitisation can also serve as an alternative form of acquisition finance, providing longer tenor and cheaper pricing than traditional bank loan markets.

Asset-backed funding is usually available to companies that generate or acquire relatively large pools of well-diversified, homogeneous assets such as consumer receivables (automobile loans, secured or unsecured personal installment loans, credit card debt), residential mortgage receivables, equipment leases, trade receivables or pools of marketable securities (in collateralised debt obligations).

European companies are securitising a growing variety of assets. We have seen securitisations of champagne inventory in France and non-performing loans in Italy, for example. In the UK, with its lender-friendly environment for secured loans, corporate or whole business securitisations have appeared. In this type of structure, the non-contractual free cashflows of a company are securitised. Normally, companies which qualify for this type of financing hold a monopolistic position in their respective industry, have access to a unique operating asset unattainable elsewhere in the market and can demonstrate historical data of highly sustainable cashflows.

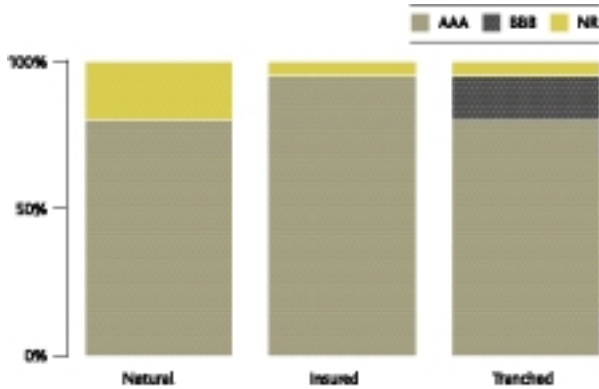
STRUCTURING A SECURITISATION. In a typical securitisation structure, a corporate (the seller and usually originator of the assets) transfers the collateral to a special-purpose corporation or trust, which issues the asset-backed securities. This isolates the assets from any potential insolvency of the seller. The transfer can be structured as a discrete sale of a certain pool of assets or as a continuous sale mechanism as new assets are generated (known as a 'revolving' feature).

Although the seller usually retains some exposure to the first losses in the underlying assets, a securitisation can be structured for off-balance sheet accounting treatment by limiting the size of that exposure. The company has legally accomplished a true sale and can use the proceeds to originate new assets or to repay more expensive long-term debt. Gearing is reduced and existing credit lines are released for future business.

COMPARING INSURED AND UNINSURED EXECUTIONS. A triple-A guaranty is a cost-effective means of obtaining a triple-A rating, and it helps the transaction achieve greater economic leverage by reducing the size of the lower-rated or equity portion (see *Figure 1*). In basic terms, if the cost of the insurance premium is less than the cost of either selling a subordinated tranche or carrying its equivalent on the asset seller's balance sheet, then a wrap is preferred.

In addition to the benefits of the guaranty itself, the value of a guarantor's expertise in credit analysis and transaction structuring should not be underestimated. The greater the guarantor's experience in the asset-backed market, the more likely it will be able to find creative solutions for a borrower's specific needs. When choosing a guarantor, it is a good idea to consider its track record as

FIGURE 1
METHODOLOGY FOR ANALYSING ISSUER'S COST
(80-20 ASSET-BACKED STRUCTURE).



Assume a £100m asset portfolio that has a five year average life, requiring 20% of first loss protection (in the form of unrated debt or equity) to create a triple-A senior ABS issue without insurance. The illustration shows the calculation for comparing this 'natural' triple-A structure with two alternatives: a trunched structure (80% Aaa/AAA, 15% Baa/BBB, 5% unrated) and a guaranteed structure (95% insured Aaa/AAA, 5% unrated).

| Tranches (Snr/Mez/Eq) | Natural 80-0-20 | Insured 95-0-5 | Trunched 80-15-5 |
|-----------------------|--------------------|-------------------|---------------------|
| Interest coupon | 6% | 6% | 6%/8.50% |
| Insurance premium | – | 25bps | – |
| Cost of equity | 12% | 12% | 12% |
| Interest coupon | \$4,800 | \$5,700 | \$6,075 |
| Insurance premium | \$0 | \$238 | \$0 |
| Cost of equity | \$2,400 | \$600 | \$600 |
| Annual cost | \$7,200 | \$6,538 | \$6,675 |
| Annual cost % debt | 7.20% | 6.54% | 6.68% |

a problem-solver.

OTHER APPLICATIONS, FUTURE APPLICATIONS. Some of the most interesting applications of financial guaranty insurance are beyond the scope of this article. For example, FSA administers a reverse-inquiry European medium-term note (MTN) vehicle, which can create custom-tailored securities to meet an investor's specific rate and tenor requirements. More applications are being developed all the time, as guarantors explore new ways to help corporates and institutions attract low-cost capital, manage risk effectively and overcome financial challenges.

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