A question of credit enhancement

Geoffrey Knight of the Royal Bank of Canada unwraps the benefits of credit enhancement for some quasi-public sector and PPP borrowers.

Credit enhancement is the term generally used in the bond markets to refer to the structuring of cash flows supporting debt in order to reallocate risks and reduce the cost of funds.

Credit enhancement is nothing new, and in its widest sense it has been achieved either through structuring (using, say, security or controls) or financial support. In the sterling bond market, credit enhancement of quasi-public sector and public-private partnership (PPP) projects has most recently been provided by the AAA-rated US monoline insurers (often through their European subsidiaries) by the issue of irrevocable guarantees to pay principal and interest due on bonds insured.

With or without guarantees

The issue of the guarantee has allowed the rating agencies to assign AAA rating to the bonds insured, whatever the underlying credit rating of the project or borrower. Clearly there needs to be an economic benefit to the borrower in using credit enhancement, and in the sterling bond markets, at least for the last year or so, there has been a favourable arbitrage for BBB range borrowers between the margin payable with and without the guarantee, even after the guarantee fee is charged by the monoline insurers. Not surprisingly, the monoline insurers are conservative in the risks they will insure and, as a basic rule, look for investment grade credits of a public sector or quasi-public sector nature. However, this basic analysis ignores the less tangible benefits and drawbacks of using the services of a monoline insurer.

> Prospective public, or quasi-public sector borrowers should consider the benefits of credit enhancement

The merits of credit enhancement by way of a monoline guarantee do need careful consideration in each and every borrower's case because it has always been more appropriate to some areas of the public sector than others, particularly where other forms of credit enhancement have been available to the borrower. In the five years since monoline guarantees became established in the sterling bond market with the guarantee of GESB (a special purpose entity used to repackage some housing association bonds) by AMBAC, the relative benefits of a monoline guarantee have changed.

In economic terms, increased investor appetite further down the credit spectrum tends to put pressure on the credit arbitrage benefits for a borrower. Not surprisingly the economic benefits of a monoline guarantee tend to be most questionable in sectors where the risks are familiar to the investment community. There are other considerations, however. For example the intangible benefit of establishing a bilateral relationship may outweigh the drawback of needing to cede a higher level of surveillance to the insurer.

Case studies

The two recent credit-enhanced transactions launched by the Royal Bank of Canada (RBC) for the University of Greenwich last autumn, and Stirling Water this spring, are interesting cases of how the benefits of a monoline guarantee outweighed other considerations *(Figure 1)*.

The University of Greenwich is an upper-tier 'new' university which was offered the opportunity last summer to acquire a lease on the Royal Naval College at Greenwich. This provided the university with a chance to establish a significant presence at Greenwich.

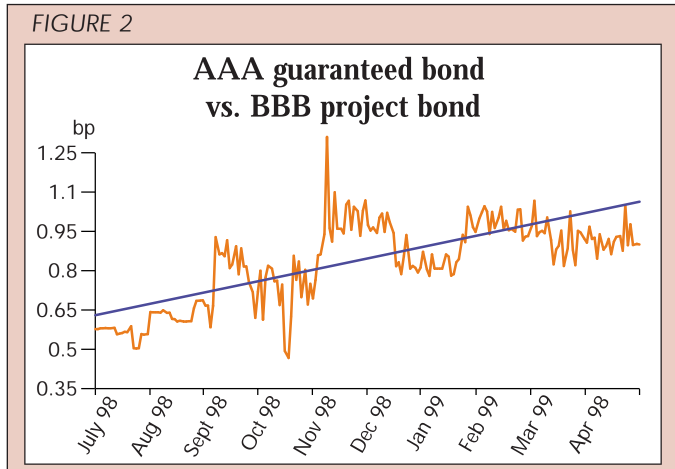
Timely delivery of funding was vital. Given the Asian economic crisis and the

FIGURE 1

Summary bond terms

Issuer	Nominal Amount £m	Guarantor	Terms	Maturity Date
University of Greenwich	£30m	AMBAC Insurance UK Limited	Coupon 6.36% Issue price 99.922% Flat semi-annual annuity from January 2004	31 July 2028
Stirling Water Seafield Finance Plc	£79.3m	MBIA Assurance S.A.	Coupon 5.822% Issue price 100% Issue spread to gilt 120bp Flat semi-annual annuity from September 2004	26 Sept 2026

FIGURE 2



general flight to quality assets, the university wisely decided that the issue of guaranteed bonds offered a level of funding more readily associated with a bank facility. Due to market volatility and uncertainty, RBC also offered to provide a bridge facility, which would be drawn if the market was closed when the bond was due to be launched.

In the university sector, however, credit enhancement offered more than just certainty and pricing advantage. The public markets were not receptive to bonds issued by universities because of well-publicised problems in the higher education sector. Moreover, there was wide recognition that traditional mortgage structures were not appropriate for universities that are cash flow businesses rather than institutions with property assets that have an alternative use.

AMBAC, the monoline insurer that guaranteed the Greenwich issue, took the major step of accepting a security package largely comprising academic assets and did not require a valuation covenant. As investors become more comfortable with the sector, it is not inconceivable that the Greenwich structure will be used for a university bond without credit enhancement. For most investors the time is not yet right, which highlights the reason why we believe the decision to use credit enhancement should depend on circumstances prevailing at the time of launch.

Stirling Water Seafield Finance Plc was a special purpose vehicle set up to issue bonds to finance a series of waste water and sludge treatment works in and around Edinburgh under the private finance initiative. The monoline insurer, MBIA, here through its French subsidiary, supported the bid for the project, together with RBC and Société Générale, over a long period. Stirling Water kept a variety of funding options open until a fairly late stage when it became clear that a credit enhanced bond offered the public sector the best value for money. (*Figure 2* represents typical margin differential between AAA-monoline guaranteed bond and unguaranteed project bond spreads.) RBC did, again, offer to provide bridging facilities if it was inappropriate to issue a bond on the chosen day, therefore ensuring the project could commence and the timetable would be met.

The value of MBIA in the Stirling Water transaction, as in the Greenwich transaction, was not purely economic arbitrage. This was the first UK water project bond financing and there were a number of risks inherent within the project that were not familiar to investors. These included volume and construction risks which the sterling bond markets find difficult to assess. It should be noted that monoline insurers also have a limited appetite for construction risk, but in common with recent monoline guaranteed deals, MBIA shared this risk and accepted a surety bond as third-party support for only a proportion of the liabilities of the contractor under the construction sub-contract.

Increasing potential investor pool

The use of credit enhancement increased the potential pool of investors, particularly those in continental Europe, and gave the public sector confidence that the funding solution could be delivered even in the most volatile of markets. In case of future water projects of this nature, with investors more comfortable with the sector and the risks, it may be that the sponsors of other water projects will choose not to use the services of a monoline guarantor.

That said, no project risks will be identical and contract terms in PPP projects are always developing. The higher yield offered by unguaranteed bonds has attractions to some investors, and borrowers may be attracted to financing covenants which may be less complex than those of a guaranteed bond. The drawback in choosing an unguaranteed route is the absence of a bilateral relationship with lenders, and the increased risk of non-delivery.

Social housing market

An example of a sector where application of guarantees was of particular value in its development as an investment class, but where their value is now more marginal, is the social housing market. From 1990 to 1994 unrated housing association issue margins were significantly wider than those for comparable corporate issuers. A significant pricing benefit could be gained with a guarantee. The difference between unguaranteed and guaranteed issue margins was as much as twice the insurance premium.

Since then the pricing advantage has been eroded. This is due to the continuing maturity of the housing association market, the increasing availability of very competitively priced long-term bank debt, the development of other enhanced structures and the increased confidence of investors in the basic housing association credit story. The current differential between the issue margins of non-AAA rated housing association bonds and those for guaranteed issues is narrower than the premium required to achieve the AAA level.

Also, in this mature and relatively straightforward market there is not the same advantage in involving a third-party insurer to supplement the more limited role of the bond trustee as in more complex project financing.

Conclusion

In conclusion, it is clear that prospective public, or quasi-public sector borrowers should consider the benefits of credit enhancement. The economic arbitrage and intangible benefits certainly do exist for some borrowers, as the two transactions described earlier show. However, credit enhancement through the provision of a monoline guarantee is not the right route for all borrowers, even if others in the same sector have previously chosen credit enhancement. ■

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