

# **Letter from the Editors**

Vol. 2, No. 2 & 3, 1999

## **Engineering a Way Around the Sovereign Ceiling**

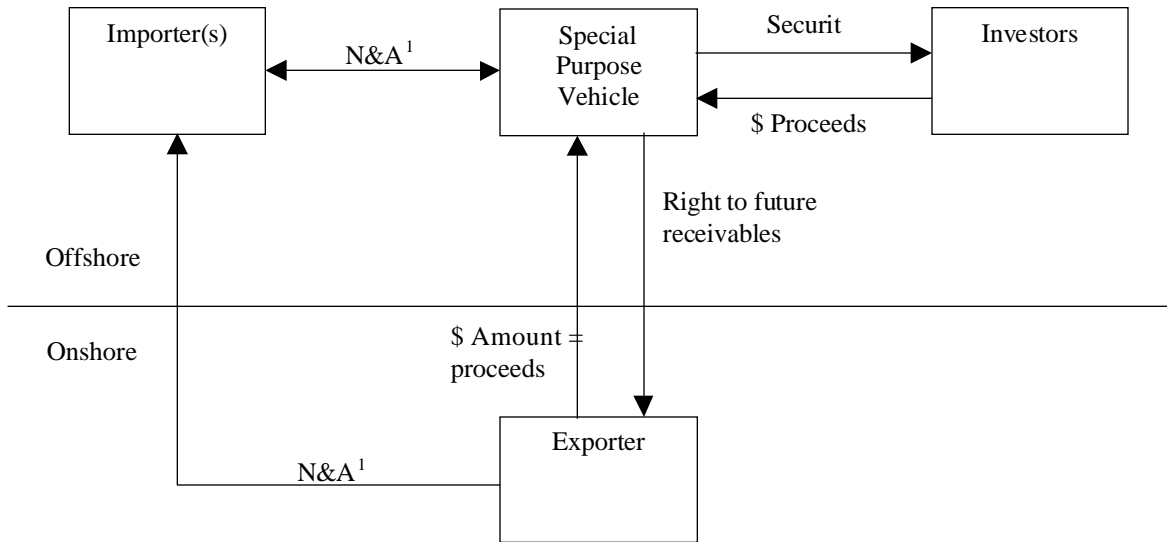
A financial innovation lowers the cost of capital available to a class of firms in a market. Reduced funding costs come from a new financial product or structure that exploits a regulatory, legal, tax or market inefficiency. In 1987 Citibank structured an innovative transaction for Telmex, then the monopoly phone company in Mexico. At the time, Mexico was restructuring its sovereign debt. Capital markets were essentially inaccessible to Mexican corporations. Despite the barriers to the capital markets, Telmex was able to issue investment-grade bonds via a securitization of its future flow of net international settlement receivables. These receivables arose when Telmex would complete more calls for AT&T customers calling into Mexico than AT&T would complete for Telmex customers calling from Mexico to the U.S. Telmex was expected to be a net exporter of services to AT&T. Forecasting the magnitude of the exports was relatively easy given the market positions of AT&T and Telmex at the time. The crux of the innovation was to enable Telmex to capitalize a future flow of receivables through a Eurobond offering that was priced to reflect Telmex's ability to complete calls for AT&T and AT&T's ability to pay for these services. Currency conversion and exchange rate risk were mitigated by having Telmex sell its receivables to a U.S. trust and instructing AT&T to pay their Telmex invoices to the collection account in which the trustee had a security interest for the benefit of the owners of the trust certificates. Telmex notified AT&T (the importer) that their receivables had been sold and AT&T was required to acknowledge the sale. Acknowledgment of the notification was binding upon AT&T. The trust had become AT&T's new creditor with respect to the invoices owed to Telmex. Overcollateralization of the trust provided a layer of protection to the investors against variation in the value of Telmex's exports to AT&T. As the receivables liquidated and the notes issued by the trust amortized, the residual in the trust flowed back to Telmex. Exhibits 1 and 2 illustrate the basic structure of the transaction<sup>1</sup>.

The securitization scheme designed by Citibank in

1987, has since been exploited by financial companies, mining companies, industrial companies and other telecommunications companies. Fine points of each structure will differ due to differences in collateral, obligor risk, local and foreign laws, and the financial and operational characteristics of the originator.

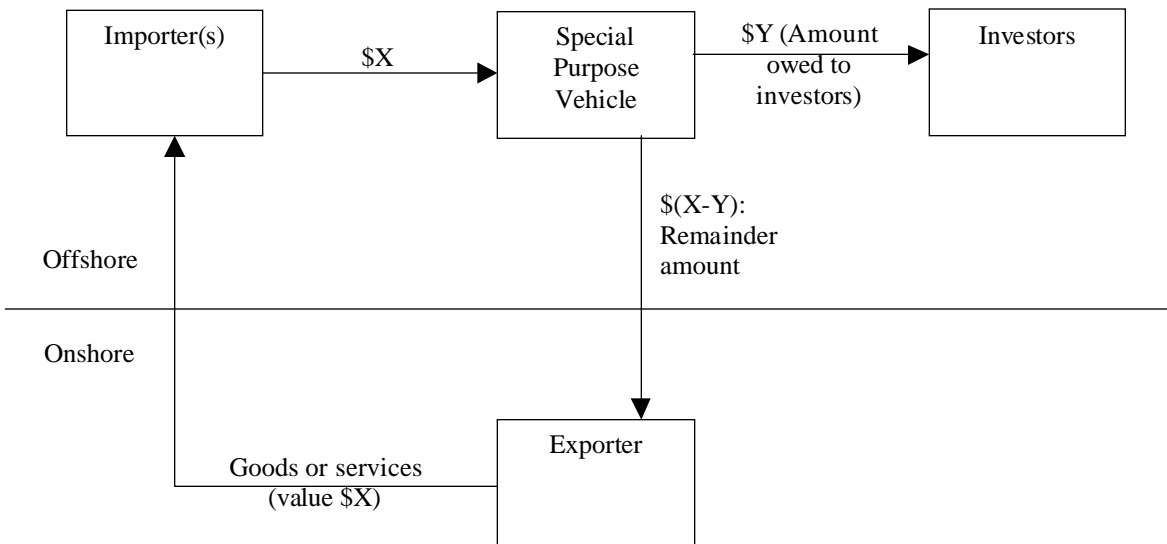
In a similar transaction Telefónica del Peru (TDP) securitized its international net settlement receivables in 1999<sup>2</sup>. Credit enhancement for the notes is provided through overcollateralization of the trust and a six-month interest reserve account. Duff and Phelps rated the notes A-, while Peru had a foreign currency rating of BB (a difference of five rating notches), and a local currency rating of BBB-. TDP sold 88% of its existing and future international net settlement receivables to a U.S. trust. Approximately 70% of the receivables are from obligors in the U.S., and 9% from obligors in Japan, the obligors are phone companies that import services of (TDP) when they must complete calls for their customers to Peru. The credit quality of the obligors feeds back into the credit quality of the trust certificates. Phone companies that are generating the receivables that have been transferred to the U.S. trust are directed to settle their invoices in the collection account opened by the trustee in the Cayman Islands. Placing the collection account in the Cayman Islands offers protection from a U.S. bankruptcy court's possible recharacterization of the sale of receivables to the trust as a secured financing, should Telefónica del Peru go into bankruptcy. The A-rating assigned by Duff & Phelps is an opinion about the timely payment of interest and ultimate payment of principal by the final payment date of December 15<sup>th</sup>, 2008. Duff & Phelps' approach to rating future-flow securitizations considers the following factors: originator credit quality, product risk, obligor credit quality, sovereign risk and legal criteria<sup>3</sup>. For TDP's securitization of net international settlement receivables the A- rating assigned by Duff & Phelps was "based primarily on the credit quality of the originator, Telefónica del Peru (TDP); the strength of TDP's international long distance

**Exhibit 1. Basic Future-Flow Securitization Structure**



<sup>1</sup>N&A: Notice to importer(s) of sale of receivables and acknowledgement by importer(s) of same.

**Exhibit 2. Repayment Flows**



<sup>1</sup>N&A: Notice to importer(s) of sale of receivables and acknowledgement by importer(s) of same.

business; its ability to generate net international settlement flows; and the nature of the securitization's structure, which mitigates certain sovereign risks"<sup>4</sup>

The principle feature that distinguishes a "future flow" securitization from a securitization of future receivables is that in the former, receivables are sold before they exist while in the latter all receivables created from designated accounts will be sold over a future period as they are created. In a future flow securitization the credit performance of the securities depends on the ability of the originator to continue to produce and sell products and services. In a traditional securitization of current or future receivables only the payment timing not the credit performance of the asset-backed securities should be affected by the originator's inability to generate new receivables.

In a well structured transaction investors will be shielded from sovereign actions that restrict the exchange and flow of currency. So long as the exporter produces and sells its product or service for a sufficient price and so long as the importers pay for the product, investors who buy the securities issued by the securitization vehicle should be paid in full and on time. Securities backed by export receivables are not completely disconnected from the risks of operating a business in an emerging market or

for that matter a developed market. Political actions may disrupt the production and delivery of the export. Commodity prices may decline. Demand for the product may decrease. A currency devaluation may push firms into default on their debt. If default impairs production, the credit quality of the securities backed by the firm's export receivables may be jeopardized.

## END NOTES

<sup>1</sup>International Securitization for the Emerging Economies by Alexandre Hayek, published in the Global Asset Backed Securities Market; Structuring and Allocating Risk edited by Charles Stone, Anne Zissu and Jess Lederman, Probus publishing 1993.

<sup>2</sup>The Overseas Private Investment Corporation (OPIC) a U.S. Government agency offers an insurance policy to protect bond investors against convertibility and transfer risk. TDP issued \$200 million of bonds in a 144A private placement in September of 1999. The bonds were insured against transfer and inconvertibility risk by OPIC.

<sup>3</sup>Future-Flow Securitization rating methodology", Duff & Phelps Credit rating Co., November 1998.

<sup>4</sup>Telefónica del Peru Grantor Trust: US \$150MM International Settlement-Backed Certificates, Duff & Phelps, International New Financing Report, January, 1999.

**Charles A. Stone, *Université Paris Dauphine***  
**Anne Zissu, *Temple University***