Room to run?

A number of challenges continue to constrain multilateral development bank capital relief trade issuance. **Stelios Papadopoulos** investigates whether these obstacles can be overcome.

The African Development Bank's (AfDB) landmark Room2Run (R2R) transaction marked the first capital relief trade issued by a multilateral development bank (MDB) and heightened expectations for a boost in such issuance *(SCI 20 September 2018)*. However, the reality turned out to be very different, given several challenges – including the lack of performance data. Yet the key obstacle to further MDB issuances appears to be rating agency methodologies.

The introduction of the United Nation's Sustainable Development Goals (SDGs) in 2015 represented a commitment to an ambitious development agenda that underlined the need to unlock private capital to deliver on those goals. However, the reality is yet to match the high expectations set under that agenda.

According to OECD data, private capital mobilisation has grown substantially over the 2012-2019 period through guarantees, direct investments and shares in collective investment vehicles, although 2019 data signal a decrease in activity compared to 2018 (see Figure one). Overall, private finance is far from bridging the approximately US$3.7trn SDG financing gap.

MDBs play a key role in furthering the SDGs as providers of long-term development finance. However, their financing and lending model limit the amounts that can be mobilised.

The MDB model requires issuing large volumes of long-term debt securities on international markets at low yields to allow lending at competitive rates to borrowers in developing countries. The model is based on the assumption that investors and rating agencies consider MDB credit standing to be extremely high. However, this places a limit on the degree of leverage that can be achieved and makes it unrealistic to expect trillions to be mobilised simply through leveraging up, given current capital levels.

According to a November 2021 report for the Inter-American Development bank (IDB) that was co-authored by William Perraudin, director ▶

at Risk Control: "MDBs will need more capital to make a significant impact on the ambitious SDGs. At the same time, it is widely understood that MDBs should make the most of the capital that they do have."

The 2015 MDB action plan for balance sheet optimisation echoed this by highlighting the need for these banks to maximise their impact and enhance balance sheet efficiency. This is where risk transfer mechanisms – including synthetic securitisations – enter the picture.

The IDB report emphasises the fact that risk transfer allows private investors and public institutions to share in MDB loan portfolio risk in ways that are aligned with their respective risk appetites and development objectives. As they take development-related credit risk off MDB balance sheets, they allow MDBs to lend more for a given amount of capital.

size mismatches, lack of due diligence knowledge, lack of local presence, high transaction costs or high perceived risks", states the OECD report.

Consequently, risk transfer technology both helps MDBs manage their balance sheet more efficiently and attract private capital in developing countries. However, risk transfer issuance from MDBs – particularly synthetic securitisation volume – remains stagnant, despite the bullish projections following the execution of the AfDB's landmark R2R deal back in 2018.

The R2R transaction was the first-ever synthetic securitisation of an MDB's private sector loan portfolio and allowed the AfDB to offset US$1bn of credit risk. Commercial investors included the Mariner Investment Group as anchor investors. The European Commission provided credit enhancement in the form of a credit risk guarantee on the senior mezzanine notes.

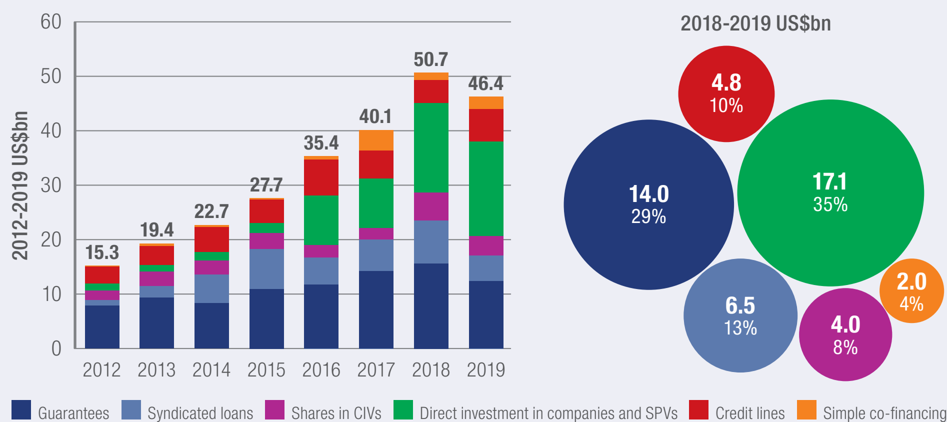
"MDBS WILL NEED MORE CAPITAL TO MAKE A SIGNIFICANT IMPACT ON THE AMBITIOUS SDGS"

Similarly, the OECD noted in a landmark report published last year *(SCI 28 September 2021)* that risk transfer mechanisms aggregate projects at the portfolio level and thereby link demand for finance from entrepreneurs and SMEs in developing countries with institutional investor capital. Effectively, these tools act as an intermediation mechanism that enable large-scale investors – both institutional investors and development financiers – to access a dedicated exposure that they normally would not consider due to "ticket

The challenges for MDBs are threefold and unless they are resolved, synthetic securitisation issuance from these institutions will remain heavily constrained. The first challenge pertains to the preferred creditor status of MDBs.

An important element of the MDB business model is the willingness of borrowing member states to treat MDBs as preferred creditors. The de facto seniority that these banks and other multilateral lenders like the IMF enjoy is commonly referred to as preferred creditor treatment (PCT).

Figure 1: Private capital mobilisation



Source: OECD

Suzana Sava-Montanari, Latham & Watkins

Bond markets – through high credit ratings or otherwise – implicitly recognise PCT, resulting in narrow spreads for MDB bonds. The favourable pricing, in turn, enables MDBs to finance themselves cheaply. As such, PCT status remains important for these institutions.

One criticism levelled against the use of synthetic securitisations, according to the IDB report, is that they could undermine the PCT status of MDBs – and this is something that rating agencies are unlikely to ignore. The logic here is that countries might selectively default on loans where the MDB has transferred the credit risk to a third party.

Alvise Lennkh, deputy head of sovereign and public sector ratings at Scope, remarks: "MDBs need to remain the lender of record and sanction borrowers in case of selective defaults. Retention of risk here will be key and should be substantive. Selective defaults would threaten our view of the transferability of the MDB's preferred creditor status and the rating of an SRT transaction."

Suzana Sava-Montanari, partner at Latham & Watkins, responds: "You can say this about any synthetic securitisation, but there are established practices to address this, such as Chinese walls that block information between departments and maintain confidentiality. Furthermore, the bank remains the lender of record and continues to manage the loans in the portfolio, as if the risk transfer had not occurred."

Indeed, the point of synthetic securitisations is that banks can continue to own and control their exposures. Daniel Bond, principal advisor at Mida Advisors, remarks: "For MDBs and other development finance institutions, synthetic risk transfer is a good way for them to expand their lending capacity because they can maintain control over their exposures while transferring credit risk. They have a special relationship with their borrowers that they want to maintain."

Another obstacle is the lack of data. "Performance data are crucial for issuance. The performance of MDB assets is strong, thanks in part to local knowledge and borrower relationships, but they're not granular enough," says Molly Whitehouse, md at Newmarket.

Yet the greatest challenge is rating agency methodologies. MDBs are unregulated, but

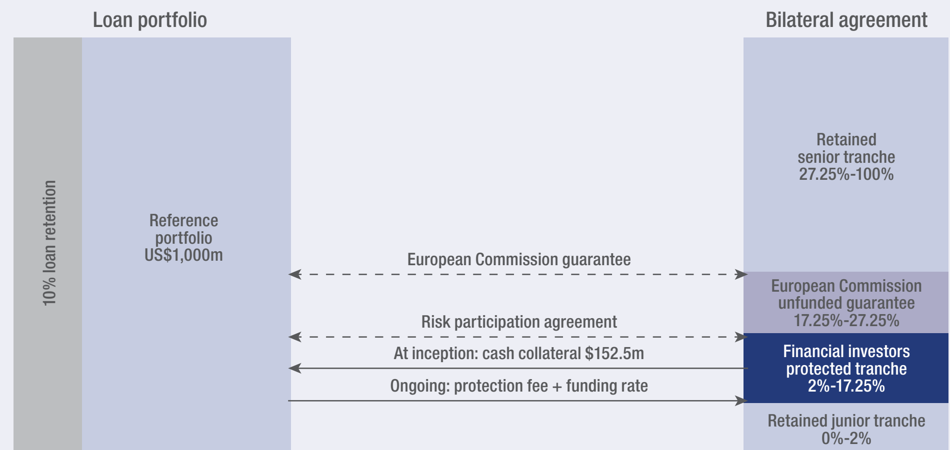
Molly Whitehouse, Newmarket

they typically issue significant amounts of debt in global markets, where the views of the rating agencies matter. The rating agencies therefore act as the de facto regulator.

According to the IDB report, rating agency methodologies do not fully consider "the superior credit performance of MDB loans" and the agencies do recognise the PCT status of MDBs to some extent when they rate them, but there is "insufficient reflection of PCT in the securitisation rating methodologies, relevant in evaluating the retained senior tranches of risk transfer transactions."

Hence, the capital consumption of the retained portions of synthetic securitisations are treated too conservatively. However, from the perspective of the rating agencies, the obstacle is the MDBs themselves.

Figure 2: Room2Run transaction diagram



Source: Risk Control

> "RATING ASSESSMENTS NEED TO LOOK AT DEFAULT RISK AND RECOVERY RATES"

Olivier Toutain, executive director at Scope, notes: "Rating assessments need to look at default risk and recovery rates. If there aren't enough historical data, then the rating agencies would need to take a conservative view using comparable information. This is normal and not specific to MDBs. MDBs though benefit from their preferred creditor status, but most information on credit defaults is linked to loans with no such status."

He continues: "In the corporate world, you have secured and unsecured debt – with secured having higher recoveries than unsecured – and there's plenty of data to show this. MDBs, on the other hand, will say that their preferred creditor status gives them priority in case of a default, so there's no need to disclose as much data. Yet we need more data."

Nevertheless, the case of the African Development Bank shows that the rating agencies can adapt their methodologies. Juan Carlos Martorell, consultant at Munich Re, was heavily involved in the transaction as a structurer at Mizuho. The Japanese bank acted as the arranger on the deal.

He explains: "In the R2R deal, S&P was able to capture the capital benefit by using a similar methodology used for SRTs from commercial banks, where the risk weights of retained tranches are rendered lower after the securitisation. The retained tranche becomes equivalent to the risk weight of a single-A rating."

Risk Control states in a report on the R2R transaction that a crucial factor in getting the green light from S&P was the agency's decision to apply its Risk Adjusted Capital Framework (RACF) in determining risk weights for the retained senior tranche, rather than the CDO Evaluator approach. The latter is essentially a simulation of correlated defaults.

"This decision may have been driven by concerns about the appropriateness of the parameters of the CDO Evaluator for emerging markets. It suggests that some reconsideration of risk parameters for emerging markets might be appropriate," says Risk Control.

Under the RACF, S&P applies risk weights to different tranches of securitisations according to tranche rating. Thus, a crucial consideration for the AfDB was the rating/risk weight that the agency would assign to the tranches that the bank would retain. Since the thin junior tranche is assigned a 1250% risk weight, the main issue is the treatment of the retained senior tranche.

Mizuho's analysis of the transaction shows that the crux of the solution is deriving a Scenario Loss Rate (SLR) for the portfolio, which is the basis for the tranching of the trade. The protected tranches need to detach above the SLR, with the retained senior tranche receiving a risk weight equivalent to a securitised position with an equivalent single-A rating.

However, R2R might have perhaps been the exception to the rule. Bond explains: "The AfDB is the most capital constrained of the MDBs. This led them to work with one of the major credit rating agencies to provide more space on their balance sheet to expand their lending without weakening their rating. Most MDBs are not capital constrained at this time and they have several other ways to expand their lending."

Looking ahead, tapping the rating agencies might not be a one-way street. Maurits Fliehe Boeschoten, senior advisor at FMO, concludes: "We avoid the rating agencies by setting up our own internal rating systems, although the choice of external or internal ratings will depend on investor preferences and sophistication. The position of the rating agencies is to some extent understandable, given the lack of data for emerging markets. We are aware of this and use alternative data, including benchmarking our portfolios to other jurisdictions." ■

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