

ANNEX VII.

Securitization of SME bonds

An example of the use of securitization to promote Asian bond markets is the two-tier securitization scheme for SME financing proposed by the Republic of Korea's Ministry of Finance and Economy and Oh and Park.¹ As shown in annex figure VII.1, this securitization scheme entails two steps in the securitization process: the first step takes place in each of the capital-importing countries and the second in the capital-exporting country.

In the first step, a local special-purpose company (SPC) is set up in each of the capital-importing countries to securitize SME loans or bonds. The loans and bonds to be collateralized may be denominated in the local currency in order to eliminate the currency mismatch problem. In order to minimize the moral hazard problem, the junior tranche bonds are absorbed by local institutions that are in charge of selecting the firms to be included in the collateralized loan obligation or collateralized bond obligation (CBO) pool. The senior tranche bonds are sold in the local bond markets and the remainder are transferred to the second SPC established in the capital-exporting country. The senior tranche bonds may be guaranteed by the local credit guarantee agency to increase their marketability.

In the second step of the securitization, the SPC established in the capital-exporting country issues CBOs using the senior bonds it acquired from SPCs located in the capital-importing countries as collateral. Once again, different tranches of bonds are issued to better satisfy the diverse preferences of investors. In order to further enhance creditworthiness and marketability, the senior tranche bonds may acquire credit guarantees.

The securities issued by the special-purpose company can be denominated in one of the international vehicle currencies, in the currency of the capital-abundant East Asian country, or in a basket currency unit, as proposed by Chaipravat² and Ito.³ The underlying assets can be expanded to include non-performing loans, project bonds and government bonds.

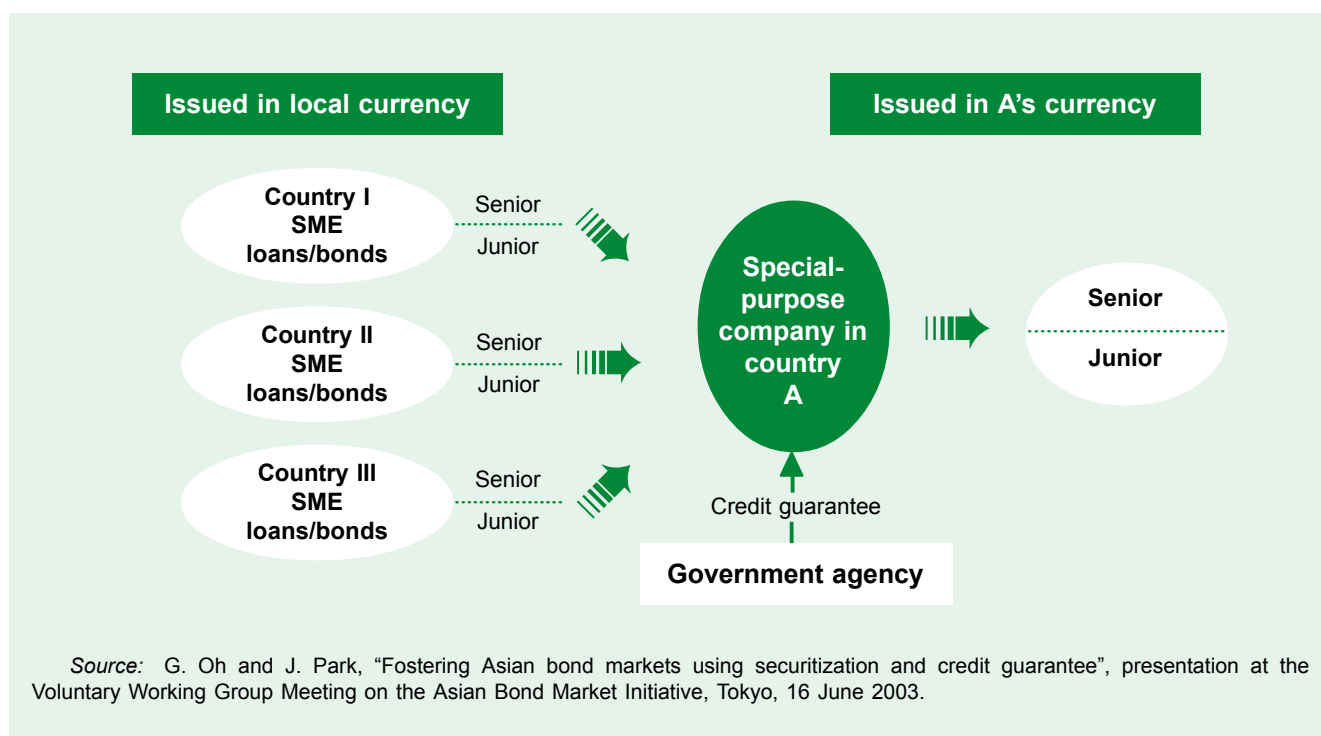
Of course, there is a cost in overcoming the maturity/credit mismatch problem through securitization. Whereas senior bonds acquire better credit risk profiles, subordinated bonds have to absorb the remaining credit risks, thereby becoming unattractive. In addition, there are various charges, including underlying fees, legal fees, custodian fees and so on.

¹ G. Oh and J. Park, "Fostering Asian bond markets using securitization and credit guarantee", presentation at the Voluntary Working Group Meeting on the Asian Bond Market Initiative, Tokyo, 16 June 2003.

² O. Chaipravat, "Asian bond status report", presentation at the ASEAN+3 High-Level Seminar on "Fostering Bond Markets in Asia", Tokyo, 1 March 2003.

³ T. Ito, "Asian basket currency (ABC) bonds", paper prepared for the ASEAN+3 High-Level Seminar on "Fostering Bond Markets in Asia", Tokyo, 1 March 2003, and "Promoting Asian basket currency (ABC) bonds", presentation at the ASEAN+3 High-Level Seminar on "Fostering Bond Markets in Asia", Tokyo, 1 March 2003.

Annex figure VII.1. Two-tier securitization scheme for SME financing

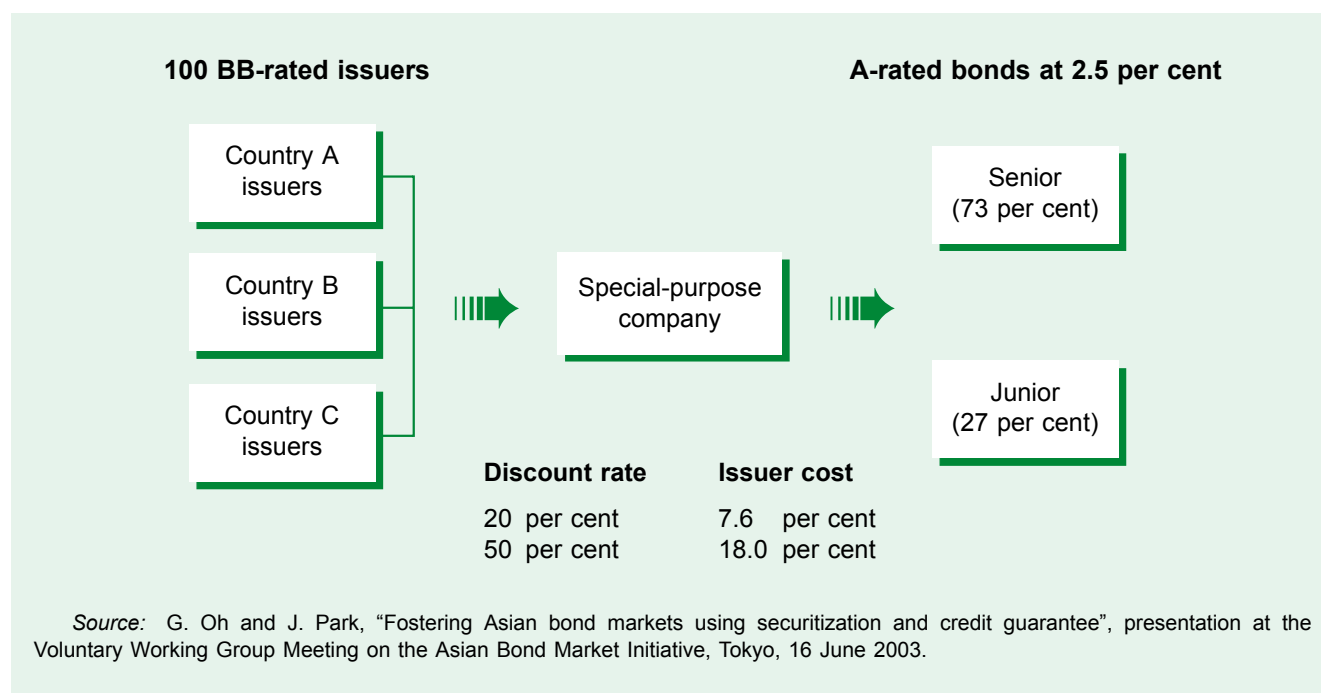


The interest cost to be borne by the issuers participating in a CBO scheme depends on the proportion of the subordinated tranche and the price at which subordinated bonds are disposed of. To see how the issuer cost is determined, it is worth examining a simple case of a one-tier CBO scheme, as shown in annex figure VII.2. For the sake of simplicity, it is assumed that the underlying asset pool consists of only one-year yen-denominated bonds issued by 100 BB-rated firms, each raising 100 million yen. The most important element in designing a securitization deal is the target credit rating of the senior bonds. In order to create higher-rated senior bonds out of a given asset pool, the portion of the senior tranche should become smaller. Since it is the credit-rating agencies that determine the rating of the senior bonds, the same criteria as those used by credit-rating agencies are also applied in designing a securitization structure. If we follow the rating criteria of Fitch IBCA, Inc., the proportion of the senior tranche should not exceed 73 per cent in order to create an A-rated senior tranche out of a well-diversified asset pool with an average rating of BB. That means at least 27 per cent of the bonds issued must belong to the subordinated tranche.⁴

Suppose that the proportion of the senior tranche is 73 per cent and that the annual market yield on A-rated yen-denominated bonds is 2.5 per cent. Then, the interest rate each issuer has to pay depends on the price at which the

⁴ The proportion of the subordinated tranche for a concentrated asset pool must be larger than that for a well-diversified asset pool.

Annex figure VII.2. An example of securitization



subordinated bonds are disposed of. For example, the interest rate equals 7.6 per cent if the subordinated bonds are sold at a 20 per cent discount. At a 50 per cent discount, the interest rate goes up to 18 per cent.

The proportion of the subordinated tranche can be reduced by purchasing credit guarantees. For example, the proportion of the junior tranche can be reduced to 10 per cent if a partial guarantee is applied to the senior tranche up to the amount of 1.7 billion yen or 17 per cent of the total amount of CBOs issued. The use of credit guarantees, however, does not necessarily reduce the cost to the issuer. If the market is efficient, the credit guarantee fee will equal the difference in the yields of the senior bonds and the subordinated bonds. Credit guarantees, however, make it easier to dispose of the subordinated bonds. In many CBO deals, it is usually the issuers that absorb the subordinated bonds that cannot be absorbed by the market. By absorbing the subordinated tranche, issuers expose themselves to credit risk. Decreasing the size of the junior tranche through the use of credit guarantees reduces the credit risk issuers have to bear.

There are, however, a few stumbling blocks in making use of securitization schemes to develop Asian bond markets. First of all, there are wide differences in the legal frameworks for securitization among East Asian economies. For example, while the common practice of Hong Kong, China; Singapore; and Malaysia that acknowledges trusts already provides the institutional foundation required for securitization, civil law countries need to enact a securitization law that recognizes the true-sale nature of the transactions between asset originators

and special-purpose companies and grants pass-through status to special-purpose companies. Other stumbling blocks can be found in different accounting standards and tax treatments for special-purpose companies in different countries. With the exceptions of Japan; the Republic of Korea; Hong Kong, China; and Singapore, issuers and investors are not familiar with securitization schemes. The scarcity of a previous record or historical performance data is also a stumbling block for the success of securitization deals in the region.

