

Leveraging Remittances for International Capital Market Access

Dilip Ratha¹

Migrant remittance flows to developing countries are likely to exceed \$167 billion in 2005. Their true size including unrecorded flows through informal channels is believed to be at least 50 percent larger. Remittances are the largest source of external financing in many developing countries, especially in poor countries. And they tend to be stable compared to other sources of external financing. They may even behave counter-cyclically with respect to the recipient economy.

This note briefly discusses two ways in which remittances can be leveraged to facilitate international capital market access of poor countries. First, it points out that hard currency remittances, properly accounted, can significantly improve country risk rating. It may even encourage many poor countries which are currently not rated to obtain a credit rating from major international rating agencies. Obtaining a rating is important for raising not only bond financing or bank loans, but also foreign direct investment and even official aid. Any improvement in sovereign rating is likely to translate into an improvement in the rating of sub-sovereign borrowers whose foreign currency borrowing is typically subject to the sovereign rating ceiling. Second, this note describes ways in which future flows of remittances can be used as collateral to improve the rating of the sub-sovereign borrowers, allowing them to pierce the sovereign rating ceiling.

Remittances improve country creditworthiness

Remittances can improve a country's creditworthiness and thereby enhance its access to international capital markets. The ratio of debt to exports of goods and services, a key indebtedness indicator, would increase significantly if remittances were excluded from the denominator (figure 1). Country credit ratings by major international rating agencies often fail to account for remittances.² Model-based calculations using debt-to-export ratios that include remittances in the denominator indicate that including remittances in creditworthiness assessments would improve credit ratings for Lebanon and Haiti by two notches; and result in implied sovereign spread reductions ranging from 130 to 334 basis points (table 1).³

¹ Senior Economist and Lead Author, *Global Economic Prospects 2006: Economic Implications of Remittances and Migration*, World Bank, Washington D.C. 20433. The paper reflects personal views of the author, not of the World Bank. This version dated November 18, 2005.

² This is likely to be the case in countries (such as the Philippines or Lebanon) where the headline worker remittance variable has underestimated or missing data.

³ Sovereign spread rises exponentially as credit ratings worsen along the rating scale. A one-notch improvement in credit ratings, therefore, results in higher spread saving for countries at the bottom of the rating scale.

Figure 1 Indebtedness of selected countries, with and without remittances

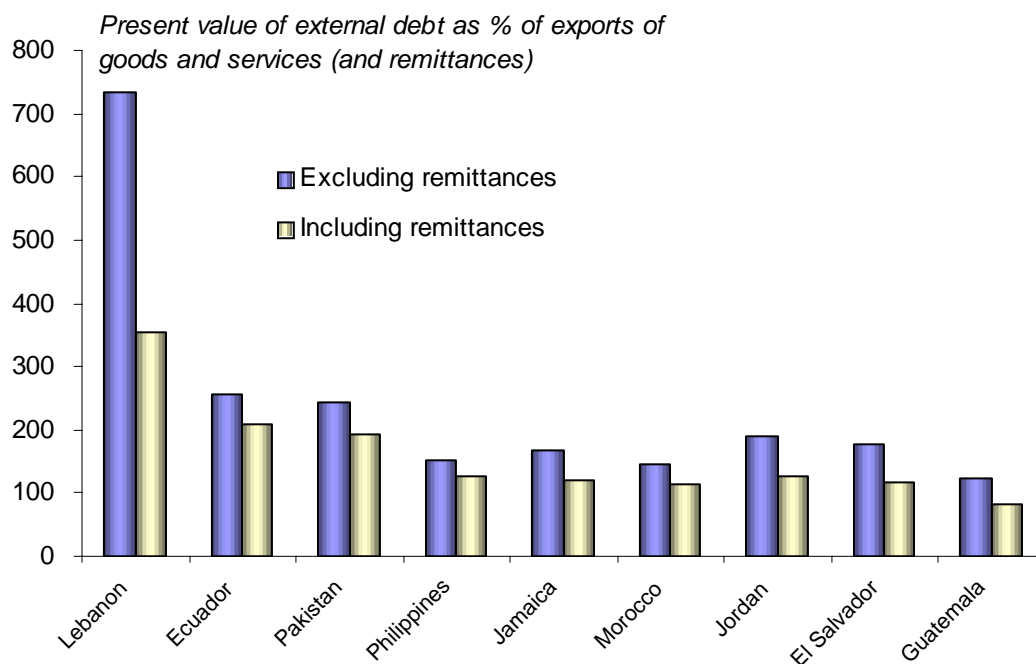


Table 1 Impact of remittances on country credit rating and sovereign spread

	Remittances as percent of GDP, 2004	Rating excluding remittances	Rating including remittances ^a	Spread saving (basis points)
Serbia and Montenegro	7	B+	BB-	150
Lebanon	14	B-	B+	130
Haiti ^a	28	CCC	B-	334
Nicaragua ^a	11	CCC+	B-	209
Uganda ^a	5	B-	B	161

a. Calculated using a model similar to Cantor and Packer (1995), see Ratha and De (2005).

Source: Standard and Poors, authors' calculations.

Remittance securitization can help countries raise external financing

Another way in which remittances affect international capital market access is through the use of structured finance techniques. Several banks in developing countries (e.g., Brazil) have been able to raise cheaper and longer-term financing from international capital markets via securitization of future remittance flows.

Remittance securitization typically involves the borrowing entity (such as a bank – see below for an example involving Banco do Brasil) pledging its future remittance receivables to an offshore Special Purpose Vehicle (SPV). The SPV issues the debt. Designated correspondent banks are directed to channel remittance flows of the borrowing bank through an offshore collection account managed by a trustee. The collection agent makes principal and interest payments to the investors and sends excess collections to the borrowing bank. Since remittances do not enter the issuer’s home country, the rating agencies believe that the structure mitigates the usual sovereign transfer and convertibility risks. Such transactions also often resort to excess coverage to mitigate the risk of volatility and seasonality in remittances.

By mitigating currency convertibility risk, a key component of sovereign risk, the future flow securitization structure allows securities to be rated better than the sovereign credit rating. These securities are typically structured to obtain an investment grade rating. In the case of El Salvador, for example, the remittance-backed securities were rated investment grade, two to four notches above the sub-investment grade sovereign rating (table 2). Investment-grade rating makes these transactions attractive to a wider range of “buy-and-hold” investors (for example, insurance companies) that face limitations on buying sub-investment grade. As a result, the issuer can access international capital markets at a lower interest rate spread and longer maturity. Moreover, by establishing a credit history for the borrower, these deals enhance the ability and reduce the costs of accessing capital markets in the future.

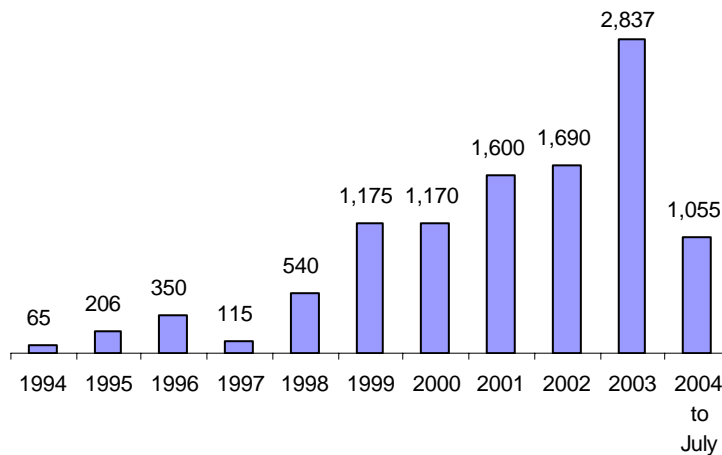
Table 2 Remittance-backed future-flow transactions are rated higher than the sovereign

Year	Issuer	\$ million	Flow	Transaction rating	Sovereign rating
1998	Banco Cuscatlan	50	Remittances	BBB	BB
2002	Banco du Brasil	250	Remittances	BBB+	BB-
2004	Banco Salvadoreño	25	Diversified payment rights	BBB	BB+

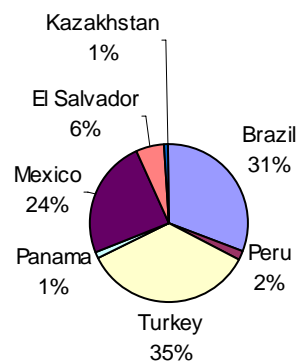
The first major securitization deal involving international migrant remittances occurred in 1994 in Mexico. The volume of remittance securitization has grown rapidly since then (figure 2a). Using this instrument, Mexico, Turkey and El Salvador raised about \$2.3 billion during 1994-2000. As electronic transfers became more widespread it became easier to track complex transactions, and remittances securitization gave way to securitization of diversified payment rights (DPRs) including migrant remittances, but also payments related to exports and FDI. During 2000-2004, a total of \$10.4 billion was raised through securitization of DPRs by Brazil (\$5.3 billion), Turkey (\$4.1 billion), El Salvador, Kazakhstan, Mexico, and Peru (figure 2b). Following a sharp increase in borrowing costs in 2002 (due in part to election-year uncertainties), Brazil has raised over \$4 billion by issuing bonds backed by diversified payment rights. These bonds resulted in a spread saving of over 700 basis points compared to Brazil’s sovereign spread.

Figure 2 Securitization of remittances, 1994–2004

a. Millions of dollars



b. By country



Source: Fitch, Standard and Poor's, Moody's Investor Services.

As experience with this instrument broadens, and investors become more comfortable with its characteristics, it is possible that it could be used by a wider range of countries (including poor countries) and for a broader range of external flows (remittances, tourism receipts, commodity earnings). It is not easy to estimate the potential size of such future-flow securitization. But preliminary calculations, assuming an over-collateralization ratio of 5:1 and using migrant remittance figures for 2003, show that developing countries could potentially issue nearly \$9 billion and low-income countries could raise up to \$3 billion annually from international capital markets.

Several policy hurdles need to be addressed before securitization deals can proceed. High fixed costs of legal, investment banking and credit rating services and long lead times can pose difficulties for developing countries with few large entities and high borrowing needs. A master trust arrangement can permit issuers to structure a large deal but tap the market in several tranches. Pooling receivables of several branches (or even several borrowers) could also help increase the deal size to justify large fixed costs. While absence of an appropriate legal infrastructure can also constrain issuance, this need not require an overhaul of the entire legal system. A more focused approach that concentrates on bankruptcy law may suffice, by making sure that pledged assets remain pledged in the event of default. Issuers should be cautioned, however, that such transactions tend to reduce the government's flexibility in managing its external payments. Moreover, remittance securitization can potentially conflict with the negative pledge provision included in the multilateral agencies' loan and guarantee agreements, which prohibit the establishment of a priority for other debts over the multilateral debts. But as the recent upsurge in securitization suggests, none of these hurdles is insurmountable.

Example 1 Banco do Brasil's (BdB) Nikkei Remittance Trust Securitization⁴

Amount: US\$250 million. Collateral: US dollar- or Japanese yen-denominated worker remittances. Transaction Rating BBB+ versus BdB's and Republic of Brazil's local currency rating of BB+ /Stable and foreign currency rating of BB-/Stable.

This deal involved Banco do Brasil (BdB) selling its future remittance receivables from Brazilian workers in Japan directly or indirectly to a Cayman Island-based offshore Special Purpose Vehicle (SPV) named Nikkei Remittance Rights Finance Company. A New York City based SPV issued and sold the debt instrument to investors, receiving US\$250 million. BdB Japan was directed to transfer remittances directly to the collection account managed by the New York based Trust. The collection agent was to make principal and interest payments to the investors. Excess collections were to be directed to the originator BdB via the SPV.

Since remittances did not enter Brazil, the rating agencies believed that the structure mitigated the usual sovereign transfer and convertibility risks. The structure also mitigated the bankruptcy risk because the SPV had no other creditors and hence could not go bankrupt. Of course, the risk of BdB going bankrupt existed. But such risk was minimal given the government-owned BdB's dominant position in Brazil. Furthermore, legal opinion held that

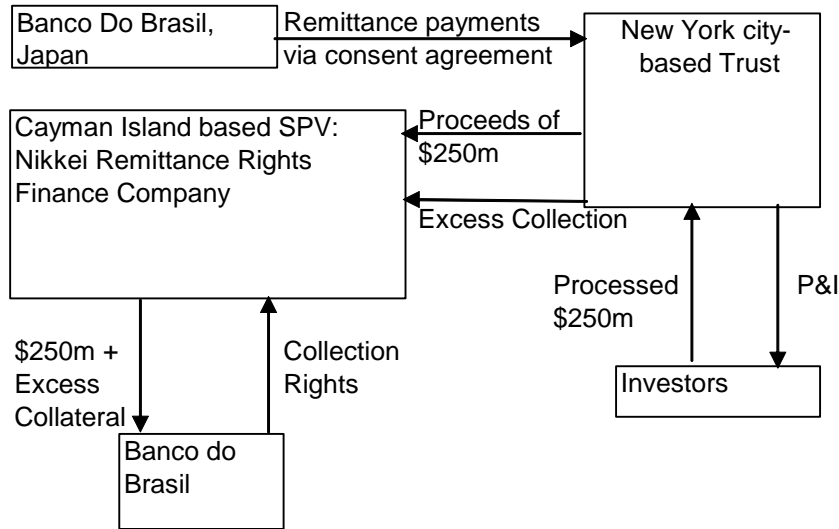
⁴ This example is taken from Ketkar, Suhas and Dilip Ratha, 2004, "Recent Advances in Future-Flow Securitization," Paper presented at the Annual Finance & Accounting International Conference - Managing Securitization for Lebanon and the MENA Region, December 3-4, 2004, Lebanese American University, School of Business, Beirut, Lebanon.

creditors would continue to have access to the pledged security (i.e. remittances) even if BdB were to file bankruptcy petition.

However, a number of residual risks remained and they were difficult to structure away. These included the performance risk - the ability and willingness of BdB to garner remittances and deliver them to the collection account managed by the New York based Trustee, the product risk – the ability and willingness of Japan to generate remittances, and the diversion risk - the possibility of BdB selling the remittance rights to another party. The performance risk is generally captured in the issuer's local currency rating. For entities such as banks, Fitch uses the going concern and S&P the "survival" assessment of the originating entity in rating an asset-backed transaction higher than the issuer's local currency rating. This was the case for the BdB's Nikkei Remittance Trust transaction, which was rated BBB+ versus BdB's BB+ local rating. In reaching this decision, S&P took into account BdB's position as the largest financial institution in Brazil (with a 2900 strong branch network) that makes it the most natural conduit for funds transfers, the long-established presence of BdB in Japan since 1972, and the importance of worker remittances in generating foreign exchange for the Brazilian government. The product risk from volatility and seasonal fluctuations in remittances was mitigated via over-collateralization or excess coverage, with a debt service coverage ratio (DSCR) of 7.64x.⁵ Another element of the product risk was partially mitigated by recognizing Japan's need for workers to supplement the native workforce, and the availability of Brazilians of Japanese decent to fill this demand. S&P, however, recognized as constraints on the rating the possibilities of Japan obtaining workers from countries other than Brazil and BdB selling remittance rights to another party. It expressly identified the latter as an event of default, triggering early amortization.

⁵ While excess coverage helps mitigate elements of product risk, it also reduces the total amount of funds that can be raised with future flow receivables.

Chart 1: Structure of BdB Remittance Securitization



Source: Standard and Poors (S&P)

Some elements of the sovereign risk also cannot be totally eliminated. For example, Banco Central do Brasil (BCB) can compel BdB to pay remittances directly to the Central Bank instead of the Trust. A degree of protection against this risk is provided by the fact that BdB is majority owned by the government of Brazil. In other instances, remittance securitized transactions have made designated correspondent banks sign a Notice and Acknowledgement, binding under the U.S. law (or the law of a highly rated country), that they will make payments to the offshore trust. That would make the sovereign reluctant to take the drastic step of requiring payments into the Central Bank. Currency devaluation is yet another element of sovereign risk that cannot be totally eliminated even in structured transactions. For instance, currency devaluation may impact the size and timing of remittances, particularly through formal channels.