
RATING METHODOLOGY

International

Future-Flow Securitization Rating Methodology

EXECUTIVE SUMMARY

In a future-flow securitization, a company issues a debt instrument whose repayment of principal and interest to investors is secured by payments on future receivables the company expects to generate through its normal course of operation. The typical future-flow originator of the receivables has been an operationally strong company domiciled in an emerging market country. For sources of financing, such companies rely typically on bank loans or Eurobond debt. The pricing, term to maturity and, during periods of economic crisis or other market disruptions, overall availability of these internationally issued foreign currency-denominated debt instruments have, however, been constrained by con-

cerns that the sovereign government will interfere with a company's ability to make foreign currency payments to satisfy its debt obligations.

The application of securitization techniques to a company's future foreign receivables, though, helps to mitigate some sovereign risks and allows otherwise financially sound companies to access international capital markets at a lower cost of funds than would normally be available. In many cases, a future-flow securitization that encompasses strong legal and structural elements can achieve a rating that is above the sovereign ceiling otherwise applicable to foreign currency debt obligations issued directly by such company.



CHICAGO



NEW YORK



LONDON



HONG KONG

Market Trends

The vast majority of international future-flow securitizations have been privately placed. Consequently, reliable data on the size and nature of the market is limited. However, our research indicates that the first international future-flow transaction appeared in 1987 with the securitization of telephone receivables due to the Mexican telephone company, Telmex. Since then, Duff & Phelps Credit Rating Co. (DCR) has played a leading role in providing ratings for these types of transactions. DCR has rated 64 future-flow securitizations with an aggregate original principal amount totaling just over \$17 billion¹. The largest asset class of future-flow securitizations has been export receivables with approximately \$12.4 billion in original principal balance, or nearly 72% of total initial principal issuance. Credit card receivables and remittance receivables also account for significant segments of the market with approximately 17% and 7% of total initial principal issuances, respectively.

Types of International Future-Flow Transactions

- Credit Card Voucher Receivables
- Remittance Receivables
- Export Receivables
- Airline Ticket Receivables
- Net International Telephone Settlement Receivables

DCR continues to believe that international future-flow securitizations provide a viable funding option for companies located in countries whose sovereign ratings fall below investment grade ('BBB-' or higher) as well as for those with lower investment-grade sovereign ratings. As such, DCR anticipates an increase in future-flow transactions from near investment-grade countries in Central Europe and Southeast Asia in addition to those in Latin America.

DCR Rating Approach

Rating Philosophy

International future-flow securitizations are broadly defined as structured debt offerings sponsored by a foreign (non-U.S.) originator and secured by receivables due from designated international obligors. The future receivables generally are sold directly or indirectly by the originating company to an offshore trust or other issuing vehicle, which in turn issues a

debt instrument. In addition, the obligors are directed to make payments directly to an offshore collection account managed by a trustee. Since payments on the receivables do not enter the issuer's home country, DCR believes that this structure helps to mitigate, although not necessarily eliminate, the risk that the obligor's sovereign government will enact restrictions on the transfer or convertibility of foreign currency, which could adversely effect the transaction. (These risks are generally referred to in this report as transfer and convertibility risks and are defined further in the Sovereign Risk section).

DCR believes that in the event of a foreign currency crisis, properly structured future-flow transactions are likely to be among the last to be disrupted by the sovereign. This conclusion is based on the fact that major exporters are often an important source of foreign currency for a nation, and interference with the future-flow structure by the sovereign may potentially jeopardize this source of foreign funds. DCR believes that a sovereign would not want to damage its existing trade relationships.

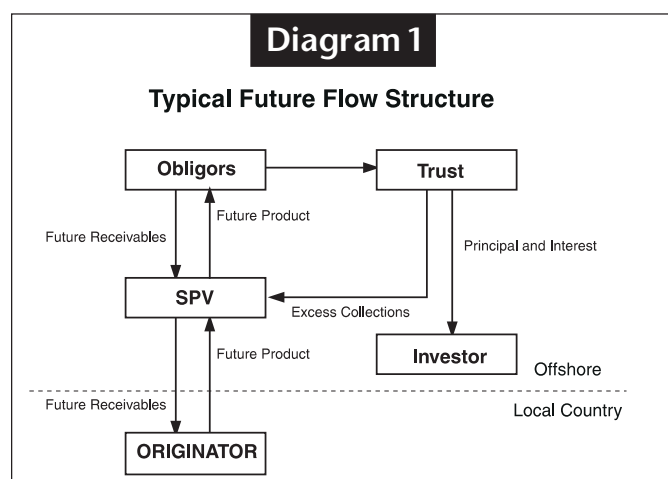
Further, future-flow transactions are usually structured so that the amount of foreign currency flowing back into the originator's home country is a multiple of the amount needed for the company's debt service payment. Thus an attempt to divert these funds would result in only a marginal additional amount of hard currency for the sovereign.

Although the legal structure of future-flow transactions varies, a common feature is that obligors are directed to pay an account under the control of the transaction's trustee. As such, the obligors are unlikely to comply with demands of the sovereign—directly or through the export company—to remit payments back to the affected jurisdiction due to the risk that investors, as the intended beneficiaries of such payment instructions, may commence legal action to prevent the obligors from doing so or may cause them to make a second payment to the trust account on the same receivable. Consequently, the ratings of certain future-flow transactions can exceed the sovereign ceiling.

However, future-flow structures generally do not eliminate sovereign risks completely, as, depending on the product or service involved and the transaction's structure, the sovereign may retain some ability to interfere with the transaction or may implement measures that adversely affect the originator's operating environment.

¹ All figures quoted are as of the end of 3Q'98.

² By way of example, the difference between a "BB-" rating and a "BB+" rating is two notches, while the difference between a "BB-" and a "BBB+" rating is five notches.



Additionally, in times of severe economic distress, a sovereign may determine that immediately obtaining all available amounts of hard currency is a paramount priority and therefore take extreme measures in an attempt to divert foreign currency cash flows. Therefore, DCR maintains a philosophy of limiting the ratings of such transactions generally to two to five notches² above the related sovereign's foreign currency rating. In a few exceptional cases, DCR has rated future-flow transactions more than five notches above the sovereign foreign currency rating, basing the rationale for these ratings on the transactions' strong fundamentals and structure.

Unlike traditional securitizations where a higher rating can be achieved through the isolation of quality assets from the credit of the originator, the ratings of international future-flow transactions are invariably linked (not tied) to the credit quality of the originator. Originating companies face performance risk in future-flow securitizations because they must deliver a product or service before the creation of the actual receivable and they must also continue to generate receivables even through periods of economic and/or political turmoil.

Therefore, when convertibility and transfer risks are largely mitigated, the ratings of international future-flow securitizations become closely related to the originating company's ability to service its local currency debt obligations (local currency rating). However, depending on the type of goods or services generating the receivables, the legal structure of the transaction and the existing debt profile of the company, an international future-flow securitization transaction can, under special

circumstances, achieve a rating that is generally one notch higher than the senior unsecured local currency rating of the originating company.

Specifically, if the receivables are likely to be generated even after the originating company has defaulted on its senior unsecured debt and a legal structure is utilized that is consistent with such analysis in each applicable jurisdiction, DCR will consider transaction ratings several notches³ higher than the originator's senior unsecured local currency rating.

Basic Structural Elements

Collections

Collection procedures should be established so that payments on receivables are directed to a collection account under the control of the transaction's trustee. In the absence of a default scenario or certain other triggers, excess collections generated by the receivables will be remitted to the originator. The sharing of collections on receivables with the originator during the collection period is acceptable only when there are significant coverage⁴ and payment mechanisms in place. These mechanisms ensure that debt service will be funded first in the event of deteriorating cash flows.

Currency and Basis Risk

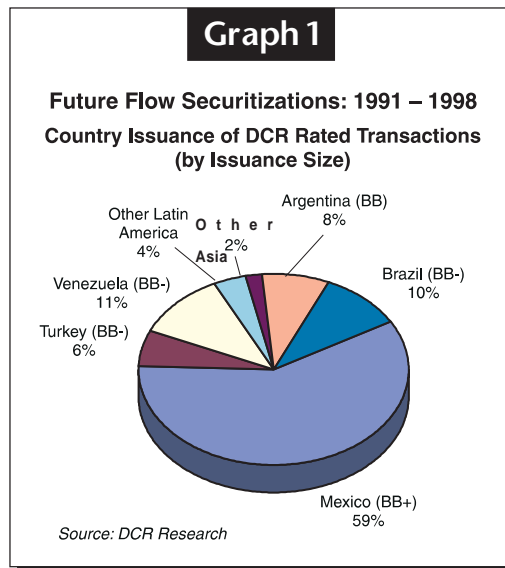
The structure of the transaction must isolate investors from as many external risks as possible. Therefore, the receivables generally must be denominated in, or swapped into, the same currency as the transactions to eliminate exchange rate risk. However, certain transactions have had a limited percentage of receivables denominated in currencies other than the currency of the transaction. In such a case, the foreign currency must be a hard currency such as the German Deutschmark, British Pound, Ecu., etc. In addition, floating-rate issues should employ either a hedging instrument, such as an interest rate swap or cap, or high coverage, in order to mitigate interest rate and basis risks.

Reserve Account

Where other external risks exist, a debt service reserve account may be appropriate to achieve a given rating category. The amount on deposit in this reserve account should be adequate to meet debt service payments in the event that the obligor is temporarily unable to generate receivables due to any government ac-

³ Pakistan Telecom is a good example of such a transaction. The major credit risk in this future-flow transaction is the risk that international long distance carriers (e.g., AT&T, Sprint, etc.) will not continue to place international long distance calls through Pakistan Telecom, the state-owned monopoly telephone company.

⁴ Throughout this methodology, coverage will generally refer to the ratio of the cash flows in a given collection period to the maximum debt service amount to occur during the life of a future-flow transaction. Typically, DCR analyzes the cash flows over a historical time frame when analyzing the transaction's proposed coverage.



tion, labor dispute, supply problem, natural catastrophe, or other potential temporary production interruptions.

The size of the reserve fund will be determined based on sovereign risks, the amount of coverage in the transaction, the servicer's collection procedures, the originator's history of production delays and the general risk profile of the issue. The size and permitted uses of the reserve account must be consistent with the terms of the rating.

For example, in transactions rated on the basis of timely payment of interest and ultimate payment of principal, the reserve account will be sized to reflect a stipulated number of interest payments, and amounts on deposit in it will be available only to make payments of interest until the final payment date, at which point any remaining amounts may be applied to the payment of principal. Historically, debt service reserves have been most common in export receivable transactions, where they have been sized at amounts equal to three to six months of debt service.

Term

If the transaction is dependent on a long-term contract, the issue should fully amortize by the contract's maturity date. In most other cases, future-flow securitization programs are structured with five to seven year maturities. Shorter tenors may be preferred if the product has an exceptionally short life cycle, the product has cash flows that are volatile, the likelihood of sovereign interference is high or if near-term market pressures are likely to restrict receivable flows. Likewise, longer tenors may be permitted in the case of an originator that demonstrates an exceptionally strong competitive position and an extremely low product obsolescence risk.

DCR does recognize that in the case of a specific debt issue, an especially short maturity, a rapid paydown of principal or a significant amount of existing receivables available at any point in time may lead to a material difference in the risk of default.

Trigger Events

Most transactions have specified event triggers that either accelerate amortization of the transaction or obligate the originator to repurchase receivables. Accelerated amortization triggers will prompt the trustee to trap all cash generated from the receivables. Events that can trigger an early amortization period can include a deterioration in the volume of receivables, breaches of debt covenants and representations and warranties of the originator or government action that adversely impact the generation of receivables. Higher trigger levels result in a faster acceleration of the debt repayments as well as a higher degree of debt service coverage. DCR is of the belief that these triggers provide protection for investors via the early detection of deteriorating credit qualities of the seller or its receivables.

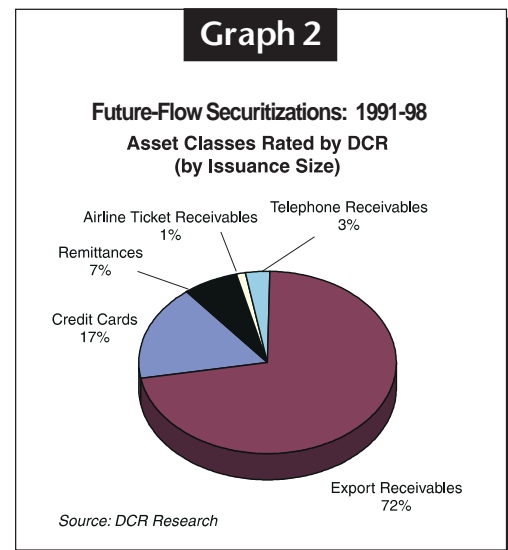
Covenants

In most future receivable transactions there are general corporate covenants that constrain the company's ability to take on additional debt and to pay dividends. The most common type of corporate financial covenant is the requirement for an exporter to maintain a total-debt-to-total-capital ratio that is less than a specified percent consistent with the rating assigned.

Excess Coverage

Other Credit Enhancements

Most future-flow transactions incorporate excess debt service coverage within their



structures. The excess cash flow associated with the additional coverage serves two functions. First, it acts as a buffer against decreases in cash flows associated with the generation of receivables. This decrease in cash flows may result from seasonality, a decrease in the price of the product, interruption in production due to strikes or events of nature or a general decline in the originator's business.

In addition, it is DCR's belief that a foreign government may be less likely to interfere with the debt service payments of a future-flow securitization if the amount of flows needed to make debt service payments represents a sufficiently small fraction of the total flows generated by the securitization program, as the excess flows (i.e., the actual cash flows are a multiple of the amount of funds needed for debt service payments), in the absence of an event of default or early amortization event, will be returned to the home country on a timely basis.

DCR believes that a sovereign will be less inclined to interfere with significant international trade relationships, in the face of almost certain legal challenges, when the amount of foreign currency it stands to gain is significantly less than what it already receives under the terms of the future-flow transaction. Consequently, transactions with more perceived sovereign diversion risk (due to the transaction structure and/or the nature of the company's product or service) generally will have higher coverage amounts than those with lower sovereign diversion risk profiles.

DCR's Rating Analysis Considers Many Factors

DCR employs a comprehensive rating approach when considering international future-flow transactions. Each transaction will invariably pose unique risks that cannot be anticipated or addressed within the scope of this report. Therefore, the following paragraphs discuss the most common rating factors associated with offshore receivable securitizations.

Future-Flow Rating Factors

- Originator Credit Quality
- Product Risk
- Obligor Credit Quality
- Sovereign Risk
- Legal Criteria

Originator Credit Quality

Local Currency Rating

Generally, the initial phase in considering

international future-flow ratings is to assess the originator's ability to service its local currency debt obligations (performance risk) by assigning a local currency rating to the originator. Local currency ratings reflect a company's ability to service debt obligations denominated in its local currency and consider all credit risks of the company except the risk of converting local currency into foreign currency.

DCR will consider those factors affecting the company's ability to generate the cash flow necessary to meet all of its debt service obligations. Such factors include the competitive advantages enjoyed by the company, the intensity of competition, business mix of the company, management expertise, profitability, and capital structure. DCR will also assess the effects of devaluation and economic disruptions on the viability of the company. Detailed descriptions of DCR's international corporate and bank rating methodologies are described fully in other methodology publications.

DCR must have a formal rating relationship with the originating entity to provide a credit rating of the securitization. The formal rating relationship ensures that adequate information is provided and all relevant risks are addressed in the initial review and subsequent monitoring process. This is especially important because many international future-flow transactions are issued from emerging markets where domestic demand may be volatile, the company may have been recently privatized and/or the company is undertaking sizable capital spending programs. Those entities sensitive to public corporate ratings may choose to keep their ratings private.

Generation Risk

The rating of a future-flow securitization structure also addresses the likelihood that the originator has the ability and inclination to generate the required volume of receivables. While the local currency rating adequately addresses the ability of the originator to stay in business, it does not ensure that the originator will maintain the business lines generating the receivables.

For example, there is no assurance that a banking entity will maintain its international Visa and Master Card voucher acquiring business or that an exporter will continue to export a specific product for an indefinite amount of time. Therefore, in many transactions there is recourse to the originator and/or debt covenants obligating the originator to maintain the business line or core operating assets generating the receivables.

The originator should have a consistent track record of generating receivables with steady or increasing growth in volumes. In

cases of cyclical products or industries or where long-term relationships with obligors do not exist, relatively higher coverage of scheduled debt service payments may be appropriate for given rating categories. In order to evaluate appropriate coverages for the assigned rating, DCR will analyze the historical sales levels of the originator and create several stress test scenarios based on such historical data and the desired rating level.

Competitiveness of Product Line

DCR will also assess the originator's competitiveness in the product line generating the international receivables. The originator should be a market leader in the product generating the receivables, and the product line ought to be a vital part of the originator's business and/or be difficult for the originator to discontinue. A steel company, for example, securitizing receivables from international sales of steel slabs should not be inclined to shift sales from the international market due to a higher demand and higher profit margins in the local market.

Alternatively, while the processing of international credit card vouchers is neither capital intensive nor the primary business line of banks, it is generally profitable, is an important source of foreign currency and is part of the diversified array of financial services provided for clients. Finally, the originator should be a low-cost producer and should have a competitive advantage in the generation of the good or service.

Other Debt of the Originator

DCR will also assess the credit quality of the specific securitization debt relative to the other debt obligations of the originator. In future-flow transactions, where continued performance by the originator is essential, DCR believes that there is an inherent risk that, in an originator bankruptcy/default scenario, pressure may be brought to bear to re-characterize the securitization as an unsecured obligation of the originator.

Therefore, DCR is cautious in differentiating the rating of the securitization from the unsecured, local currency debt rating of the originator even in cases where DCR believes that continuing performance by the originator is meaningfully stronger than its ability to meet unsecured obligations.

DCR further believes that it is appropriate to differentiate the rating of the securitization from the originator's unsecured, local currency obligations only in cases where the following factors, in combination, are considered strong enough: legal structure, triggers, term, covenants, debt service coverage and the ratio of secured debt to non-secured debt.

In addition to the legal status and terms and conditions of the different classes of debt, DCR must consider the proportions of the different classes of debt in order to determine the relative credit strength of the transaction. For example, the position of the unsecured creditors is weakened as the proportion of secured creditors, with specific claims over the company's assets, increases. At a high enough level of secured debt, the position of unsecured creditors is weakened sufficiently to result in a downgrade of their instruments' credit quality, reflecting an effective and meaningful subordination.

For this reason, if an issuer wishes to engage in a future receivables securitization without impacting its unsecured debt rating, DCR inevitably must constrain the magnitude of securitization debt and the ability of the company to enter into other secured indebtedness. The constraint on the magnitude of securitization debt will depend on a variety of factors, but generally will ensure that the future-flow-related debt and other secured indebtedness represent a small minority of the company's total indebtedness.

Product Risk

Generally

The originator's ability to generate sufficient future receivables to cover debt service is as important as the originator's credit quality in the rating of international future-flow securitizations. The product should have a stable or increasing demand profile, low possibility of obsolescence and a large, stable international market. In addition, the exporter should have a competitive advantage both domestically and globally in its production. In this regard, the impact of known substitutes for the product, changing consumer preferences, technological forces and other demand factors will be considered. Seasonality of the receivables will also be assessed to evaluate whether sufficient receivables will be generated during periods of traditionally low volumes.

Obligor Base

Products for which demand is from highly rated industrialized countries and for which there generally exists a stable volume of demand, as evidenced by an organized commodities exchange, are viewed favorably from a product risk point of view by DCR. However, transactions involving a product where the demand factors generating the receivables are thin will be viewed much less favorably. For example, the demand factors in an international credit card transaction emanating from a remote tourist destination are highly suscep-

tible to changing consumer preferences. DCR will also evaluate the diversification of product demand.

Again, for export receivable transactions, commodities are ideal from the product risk point of view since the demand for these generally comes from many different industries and countries. Conversely, such products present a greater sovereign diversion risk profile.

Unique and Custom Products

Originators wishing to securitize receivables from a unique or custom product should demonstrate a strong historical commercial relationship with its obligors or have in place a long-term sales contract. For example, in the Rassini Receivables Master Trust, where the originator has securitized its export sales of automobile parts, Rassini utilizes long-term sales contracts with the Big Three automotive companies in the United States. Generally, the long-term unsecured credit quality of this sole obligor is at least equal to that of the transaction's rating. DCR believes that specialty products provide for better sovereign risk protection than do commodities because of the importance that a country places on an export product with no or few substitutes.

Price

DCR will also assess the impact of price volatility of the product involved in export receivable transactions. While international demand for the originator's product may be stable, lower prices can reduce receivables volumes. Price risk typically is addressed by dedicating excess receivables to the transaction, resulting in a higher debt service coverage. If higher coverages are utilized, a stress test using a historically low price for the product will be performed to judge the adequacy of the coverage. Alternatively, long-term sales contracts can be used to ensure minimum volumes of receivables and to address other risks. Variations on these structures including the use of swaps, options and/or hedge agreements have been used successfully to mitigate price risk.

Domestic Demand

High domestic demand for a product generating export receivables can also be problematic in the event that it is advantageous for an originator to sell products domestically rather than export them. In future-flow transactions, DCR evaluates the market trends (i.e. production, consumption, imports, exports, etc.) experienced by the products in the seller's home country as well as in the global market. DCR would be concerned with a decreasing trend in the gap between the

product's domestic production and consumption since this could suggest either a decrease in the product's production or an increase in the domestic demand for the product, possibly signaling that the exporter would find it economically beneficial to sell the product domestically. DCR also examines trends in the home country's historical use of imposed export restrictions and controls. Brazil, for example, in times of domestic shortage has imposed restrictions on the exporting of soy oil. More recently, Indonesia has imposed export restrictions on some cooking oils.

International Demand

International demand must also emanate from countries with sovereign ratings equal to or higher than the desired transaction rating. This helps to mitigate obligor sovereign risks, especially transfer risk. In addition, the originator's country should have a natural competitive advantage globally in the generation of the product, such as the production of paper pulp in Brazil. Commodity exporters are especially suited in this regard.

Financial Future Flows and Currency Exposure

Financial future-flow transactions do not have price risk in the same sense as export receivable transactions. However, exchange-rate risk inherent in international credit card securitizations poses an analogous hazard. The value of dollar expenditures will rise and fall in relation to the volatility in the exchange rate. Thus, unless the price of goods and services rises, or overall tourism expenditures rise in response to a weak currency, receivable volumes will decline. Again, stress tests are used to measure the impact of exchange-rate risk in these transactions. DCR research indicates that the effects of adverse changes in exchange rates on credit card volumes is relatively short lived as local prices for hotels and other goods and services tend to recover rapidly to international levels.

Obligor Credit Quality

Generally

The obligor profile of international future-flow securitizations should be commensurate with the transaction's rating. The obligors of export receivable transactions are those purchasers of the originator's products or services. The obligors of financial future-flow transactions are the clearing entities, such as Visa or MasterCard in the case of credit card transactions. For the international telephone net settlement transactions, the obligors are the international telecommunications carriers such as AT&T, MCI, BT, etc. Securitizations have involved single or few dedicated obligors, multiple dedicated obligors, or all of the originator's obligors.

Few Obligor

The obligor(s) in a securitization involving only a single or few dedicated customers preferably should enter into long-term sales contracts and should have a senior unsecured credit rating at least equal to that of the transaction. In the event that the long-term contracts do not exist or have significant noncredit-related cancellation events, DCR will evaluate the strength of existing contracts, the originator's historical relationship with the obligor(s) and the economic incentives of the obligor to purchase from the originator.

For instance, in international credit card receivable transactions, an originator's standing as a member bank enabling it to process credit card vouchers with Visa and/or MasterCard can be withdrawn. Therefore, the originating bank should covenant to remain a member bank and there must be historical evidence and economic incentive to suggest that it can carry out this covenant.

Alternatively, a cancellable contract or a contract with a shorter term than the rated securities is more problematic. In such a case, there should be meaningful, noncontractual incentives for the customer to purchase from the originator. Such incentives would include, for instance, the high costs or delays that an auto manufacturer would incur when changing part suppliers.

Multiple Obligor

The obligors of a securitization involving multiple dedicated customers will be analyzed carefully. Not all such obligors need to be of equal or greater credit quality than the proposed transaction. Excess coverage, obligor substitution or diversification requirements can be used to achieve high transaction ratings. For example, remittance transactions, which often involve a group of clearing banks, should have a provision that ensures that at least one of the clearing banks has a credit rating equal to or greater than the transaction or that clearing banks with deteriorating credit ratings are replaced by clearing banks with strong ratings.

All Customers are Obligor

Securitizations involving all of an originator's customers typically involve commodity exporters whose obligors are usually numerous and well diversified. These transactions must have sufficient coverage to compensate for the ebb and flow of the originator's obligors. So long as the product has a ready international market, the obligor profile of these transactions generally is not constraining to the rating.

Other Factors

Other circumstances that help mitigate ob-

ligor risk are treaties that obligate the originator's central bank to make payments on exports in the event of obligor default and letter-of-credit backing or insurance on the export receivables. Although long-term contractual relations are viewed favorably by DCR, especially in the case of unique products or a limited number of obligors, they are not necessarily required so long as the originator has a strong long-term commercial relationship with its obligors.

*Sovereign Risk**Generally*

Nations continually face the challenge of maintaining sufficient foreign exchange to meet obligations denominated in foreign currency. To do so, a nation's exports, capital inflows and hard currency reserves must exceed its imports, debt service and other capital outflows. In analyzing cross-border corporate and structured transactions, DCR must assess the extent to which the risk that a severe disequilibrium of those foreign exchange flows could impact debt service payments to investors. Although DCR believes that several structural features in a future-flow transaction may serve to mitigate sovereign risk, they do not eliminate it because it may be difficult to eliminate completely the sovereign's ultimate ability to interfere with the transaction.

Transfer and Convertibility Risk

In response to shortages of foreign exchange, many governments have sought to limit outflows of foreign currency. For instance, governments have, in some cases, restricted the transfer of foreign currency out of the country (transfer risk) for certain categories of payments (principal payments, interest payments, dividend repatriation, trade payment, etc.) or for certain categories of payer (government entity, private sector, foreign-owned, etc.). For example, Venezuela imposed extensive capital controls in July 1994. While debt service payments were permitted, delays in obtaining authorizations resulted in missed payments by some corporate borrowers. Some governments have also restricted conversion of local currency to foreign currency (conversion risk) in order to limit speculative pressure on the local currency and economy. In August 1998, Russia, for example, imposed a moratorium on all private sector and commercial bank external debt payments.

Because receivable payments in future-flow securitizations do not enter the originator's home country, they are generally not subject to direct convertibility and transfer risks. DCR recognizes, however, that under extreme duress a government can direct

obligors to pay the central bank directly rather than the trust. To clarify why this concern is mitigated in these transactions, it is helpful to understand that governments generally avoid jeopardizing their sources of foreign currency which, if interrupted, could have negative implications for the country or provide only marginal economic benefit.

For example, in the past when some form of currency controls were imposed by the governments of several nations, DCR's research indicates that most countries exempted third-party contracts and trade financing from currency controls for fear that such interference would limit the levels of a nation's international trade. Brazil, as an example, excluded trade financings from its debt rescheduling in the 1980s. In addition, since the majority of the payments on the export receivables returns to the originator in a future-flow transaction, it is unlikely that a government would find it worthwhile to risk the potentially disruptive effects on trading relationships or even a lengthy and well-publicized litigation.

DCR believes that the rationale for the foreign government to avoid interfering with cross-border flow structures is valid so long as the debt service requirement of the transaction forms a small portion of the exporter's foreign exchange earnings potential and so long as the transaction's debt service requirement comprises a small portion of the sovereign's total foreign exchange liabilities.

Redirection Risk

In addition to transfer risk, a future-flow transaction faces sovereign redirection risk. DCR believes that there are two forms of sovereign redirection risk. The first of these is referred to as payment diversion risk. This is the risk of the sovereign government's directing an exporter to surrender all foreign currency earnings to the central bank or directing offshore obligors to effect payments to a designated account maintained by such central bank. This risk can be mitigated through the requirement that Notice and Acknowledgments be executed by a large percentage of an exporter's customers instructing the customers to enact payment to an offshore account that is registered in favor of the investors and is maintained by a corporate trustee. Ideally, the Notice and Acknowledgments should be broad in scope and extend payment instructions to any other entity through which purchases of the designated product may be made.

The other form of redirection risk is product diversion risk. One example of this risk would occur if a sovereign government were

to redirect a company's exports to customers who have not signed Notice and Acknowledgments and require that these customers pay a designated offshore collection account maintained by the sovereign's central bank.

Likewise, the sovereign may attempt to direct the originator's exports to a newly created shell company or trading company while the originator continued to sell the product to its existing clients through newly created contracts between the sovereign government and these existing obligors. This risk is often addressed by including possible exporter recourse performance covenants. Various economic disincentives to breaching such covenants also may exist, such as adverse international capital markets perceptions and negative effects on the exporter's short-term liquidity position.

Notice and Acknowledgments

The risk of sovereign redirection is reduced when obligors have irrevocably agreed to pay the trust pursuant to a Notice and Acknowledgment agreement. In the absence of a transaction's containing irrevocable Notice and Acknowledgment agreements, a nation's central bank may redirect payments on the future-flow receivables merely by directing the exporter to have the new receivables paid directly to the central bank.

DCR further believes that Notice and Acknowledgments are especially critical in transactions involving the sale of commodities not otherwise subject to sales contracts. A government may consider such situations more attractive targets for redirection because export volumes should not be adversely affected given the large universe of alternative buyers and because third-party contracts would not be disturbed.

Export/Import Controls

In addition to restricting the free exchange and movement of currencies, governments have also, at times, controlled the free exchange of goods through export or import controls, with the goal of easing a balance of payments disequilibrium.

Sovereign's Willingness to Pay

In general, DCR evaluates the likelihood of a country's imposing currency controls on trade financings or directing obligors to pay the central bank rather than the trust. DCR considers these risks in light of the country's history of similar actions and concern for international investment.

Sovereign Ceiling

As part of the sovereign foreign currency rating, DCR assesses the probability of a country's imposing currency and/or capital

controls. Generally, ratings of international transactions that do not sufficiently mitigate convertibility and transfer risk are constrained by the foreign currency rating of the originator's country (the sovereign ceiling).

Rating Above the Sovereign Ceiling

In certain cases it is possible for a future-flow transaction to achieve a foreign currency rating above the sovereign ceiling. Although not completely removed, sovereign transfer and convertibility risks can be adequately mitigated through certain structural elements. Therefore, properly structured transactions historically have received ratings from one to five notches above their respective sovereign ceilings.

There are several factors that contribute to the degree to which a transaction is rated over the sovereign ceiling. The type of future-flow transaction itself is an important factor since DCR believes that it is fundamentally more difficult for a sovereign to interfere with the cash flows of a credit card or telephone securitization than it is for it to do so in a remittance transaction. The underlying sovereign rating and underlying economic factors of the country are also considered.

To illustrate, DCR has rated transactions from Mexico further above the sovereign ceiling than transactions from lower-rated countries such as Indonesia. Finally, DCR analyzes other structural features such as the transaction's final maturity, offshore reserve account, legal protection, capability to generate U.S.-dollar cash flow and strength of the underlying corporation or bank.

Nature of the Product

The nature of the product will also be considered. Products that generate high volumes of foreign exchange, are not important to national security or are a significant source of domestic employment are, in general, less likely to be restricted by the sovereign. Conversely, products that are net imports to a country, important to the national defense or otherwise sensitive to trade disputes are more likely to be subject to export controls.

Other

Other sovereign risks include unique events within a particular country that could interfere with the originator's ability to generate receivables. Such risks include, but are not limited to: nationalization of a company or industry, domestic hyperinflation, civil unrest, terrorism and/or labor disturbances.

The primary goal of international future-flow structures is to safeguard asset cash flow from sovereign currency controls, thus allowing transaction ratings above the host

country's foreign currency rating. However, other sovereign considerations such as the risk of the government's interfering with export sales contracts, imposing export controls or nationalizing a company cannot be entirely mitigated. Therefore, DCR will limit the degree to which transactions are rated above the sovereign ceiling. The determination of this limiting factor will depend on all of the rating factors described herein.

Legal Criteria

Generally

DCR reviews a number of legal issues together with its outside legal counsel in the course of the transaction analysis to ensure that the assumptions that underlie the transaction's structure are supported by the legal documentation. In particular, DCR and its counsel rely on the legal opinions given by transaction counsel concerning the laws chosen to govern most of the legal documents (which is typically New York law) as well as local counsel in the originator's home country and, if applicable, local counsel from any relevant offshore jurisdictions.

All such opinions must be addressed to DCR or be accompanied by reliance letters allowing DCR to rely on such opinions. DCR believes that reliance on legal opinions in the originator's jurisdiction, in particular when novel structures are presented or originators are located in jurisdictions without a significant number of prior similar DCR-related transactions, is easier when more than one local counsel opinion is available to address issues of general application, such as the nature of the receivables transfer. Opinions as to the originator-specific matters, such as due organization and compliance with covenants, can be addressed adequately by one counsel.

DCR reserves the right to satisfy itself that counsel is either sufficiently experienced in such matters or, in regard to the originator's jurisdiction where directly applicable experience may not be available, is of sufficient sophistication so that DCR is justified fully in relying on the opinions of such counsel.

Receivables Transfer

DCR reviews future-flow transactions to determine the rights of the trustee, acting on behalf of investors, to collect on the receivables. In all but a few transactions, these rights have arisen from the sale of receivables. In reviewing these transfers, there exist two issues of principal importance: the priority of the trustee's rights, as compared to the rights of other parties to the cash collections and the timing of the exercise of those rights by the trustee as well as any potential legal delays related to the receipt of the collections. These two issues are of particular impor-

tance in two contexts, sovereign interference (which is discussed immediately following this section) and the creditors' rights/ bankruptcy issues.

In all future-flow transactions, DCR needs to be assured that the trustee has a superior interest in the receivables compared to the interest of other creditors and evaluates the risk that such interest may be subject to non-insolvency-related and timing delays, such as those that may arise due to sovereign or corporate reasons.

In transactions for which a rating above the local currency rating of the originator is sought and where bankruptcy laws in any of the related jurisdictions provide for a debt moratorium, automatic stay or other similar delays in the exercise of the creditors' rights, DCR will need to review the potential applicability of such laws to the transfer of the products and receivables prior to bankruptcy or, depending on the transaction and desired rating, prior to liquidation but after the onset of reorganization proceedings.

In general, it is difficult for most U.S. law firms to opine that the typically structured future-flow transaction meets the criteria to render a U.S. law true-sale opinion. Conversely, counsel in most foreign jurisdictions have been able to issue such opinions without qualification except as to customary fraudulent conveyance matters.

Therefore, where the risk of re-characterization of a true-sale transaction has existed in an applicable jurisdiction other than that of the originator, issuers generally have taken one of three approaches to insulate future-flow transactions from the bankruptcy risk of the issuer.

In each case, the law contractually chosen to govern the characterization of the true sale is one under which an appropriate opinion can be rendered. The first and most common method for most transactions is an intermediate true sale to a special purpose entity (SPE), with the SPE being either the issuer of the rated debt or the transferor to a U.S. trust.

Although the transfer from the SPE to the trust may be viewed as a financing for bankruptcy purposes, a filing for bankruptcy should not occur since the SPE should have no other creditors. This particular method is also utilized in similarly structured transactions in the United States.

A second alternative that permits the originator to transfer its rights in the receivables directly to a U.S. trust has been utilized when the originator is exempt from most applicable provisions of the U.S. Bankruptcy Code (the Code). The most common example of this approach has been foreign banks that are engaged in banking activities in the United States. U.S. counsel must

opine to the applicability of this exemption. As a further protection, DCR will require the transaction documents to contain covenants requiring the foreign bank to notify DCR in the event that the bank ceases those U.S. operations that originally provided for the exemption.

The third method is to move the collection account to a jurisdiction that does not have an automatic stay or comparable delay risk. In this case, DCR will require local counsel from such jurisdiction to advise of the absence of these legal processes.

Where any phase of a transaction is structured as a pledge of receivables, including a pledge by a SPE, DCR will expect to receive a first security interest opinion from counsel in each jurisdiction relevant to such analysis.

Sovereign Risk Issues

As noted above, DCR's analysis of sovereign risk issues is by necessity transaction-specific and is based on a complex matrix of both legal and nonlegal analysis. DCR views the following features in the legal documents and structure favorably when assessing sovereign risk:

- A sale structure rather than a pledge or unsecured right to cash flow structure.
- A forward-sale structure, meaning that counsel can opine that all existing and future transferred assets have been sold as of the closing date or at least when they come into existence without further action on the part of the originator.
- The creation of receivables offshore by an offshore entity rather than by the originator within its domestic jurisdiction.
- Sales of products to nonaffiliated customers and receivables to a nonaffiliated SPE or trust.
- Retention of significant excess cash flows by the originator (as discussed above), not only by way of restrictions on the use of future issuances collateralized by the same receivables, but also by way of similar restrictions on retained interests in the receivables (whether characterized as a seller certificate in a trust, a subordinated deferred purchase price or otherwise). Generally, for additional *pari passu* interests in such collections DCR requires a ratings confirmation on prior rated deals and for subordinated interests requires either a ratings confirmation or an acceptable overall limit on the ratio of total debt secured by the receivables to total collections over the same periods to be set forth in the original transaction documents. The remaining bottom piece of the receivables collections (that is, after all permitted *pari passu* and subordinated interests), or rights thereto,

retained by the originator cannot be sold but may be pledged subject to the requirement that collections first must reenter the originator's jurisdiction.

■ Notices to customers as to the sale and payment instructions, which are acknowledged by the customer. Due to the fact that these Notices and Acknowledgments are key requirements, they are discussed in more detail below.

In a typical future-flow transaction, the obligors of the receivables are delivered a written notice whereby the originator instructs the obligors to effect all payments to a collection account that is under the control of a trustee. The obligors acknowledge receipt of this notice by countersigning it. This form of written notice is commonly referred to as a Notice and Acknowledgment.

These Notice and Acknowledgments serve six principal functions. *The first* is that they inform the obligors that payments are to be made directly to an account held for the benefit of the investors rather than being remitted to the originator in its home country. Included in the Notice and Acknowledgments are the precise payment instructions for the relevant trust account.

Second, to the extent that U.S. law is relevant, the Notice and Acknowledgment may, in some circumstances, be necessary in order to protect the *interest* of the trustee in the receivables under the UCC by advising the obligors that the receivables have been sold or pledged. It should be noted that if the assignor of the receivables is located in a jurisdiction outside the United States or Canada and the receivables are properly characterized as an account or general intangible for the money due, the security interest of the trustee may be performed by notice. This method of perfection may be the only one relevant under the UCC in circumstances where the assignor's home country does not have a filing system and U.S. filings cannot be made because the assignor does not have a U.S. office.

Third, Notices and Acknowledgments may be necessary in order to enable counsel in certain foreign jurisdictions to provide opinions with respect to the sale of the receivables. Fourth and fifth, Notices and Acknowledgments may be necessary to mitigate product diversion risk and payment diversion risk, respectively. Sixth, Notices and Acknowledgments may be required (if U.S. law does not govern the issue) because of provisions with export customers restricting assignments of payments. However, regarding this latter point, in transactions with multiple obligors, DCR will generally rely on representations and

warranties and in some cases legal opinions as to such matters.

DCR is sometimes asked to consider the use of Notices without the need for customer Acknowledgments. Notices alone generally address the first three reasons for such documents as set forth above but do not necessarily provide comfort that the obligors are contractually obligated to pay the collection account, as mentioned in the fourth and fifth issues referenced to above.

In lieu of Acknowledgments in transactions with a highly diverse obligor base, DCR will consider the receipt of legal opinions from jurisdictions with high obligor concentrations as to the enforceability of the proposed form of Notice.

In all cases, DCR will require the receipt of legal opinions as to the enforceability of Notices and Acknowledgments against the originator from counsel in the originator's jurisdiction and the jurisdiction the laws of which are chosen to govern the Notice and Acknowledgment (which in transactions with many obligors may be as to the form thereof). In transactions with one or few obligors, DCR generally requires a full opinion on customary corporate organization, authorization, power and authority and due execution and delivery, as to such obligor or obligors.

Other Legal Matters

In a typical future-flow transaction, DCR receives various legal opinions from counsel in the originator's jurisdiction, from counsel in the jurisdiction of any SPE and where the collections are held and from counsel in the jurisdiction under which the transaction documents are governed. In addition to the matters discussed above regarding true sales, first priority security interests and Notice and Acknowledgments, opinions from each applicable jurisdiction for each transaction party address:

- The submission to foreign jurisdiction, or if this is not possible, international arbitration.
- Organization, power and authority, and due authorization, execution and delivery of transaction documents.
- Enforceability of transaction documents.
- Enforceability of foreign judgments.
- That no conflicts exist with organization documents or laws of jurisdiction.
- Withholding tax, transaction tax and taxation of SPE matters.
- All necessary governmental consents.

- That no material litigation is pending or threatened.
- That there is no immunity from legal process.

The specific requirements for a particular transaction may necessitate additional opin-

ions. Legal opinions may be subject to customary qualifications and assumptions. In addition to the matters discussed above, DCR may also require transaction documents to contain certain representations and warranties and covenants customary for transactions of this type. **DCR**

Authors

Christopher J. Donnelly
Group Vice President
Latin American Structured Finance
(212) 908-0237
donnelly@dcrco.com

Rohinton B. Dadina
Vice President
Latin American Structured Finance
(312) 368-3123

Michael C. Morcom
Analyst
Latin American Structured Finance
(212) 908-0321

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Chicago
55 East Monroe
Suite 3500
Chicago, IL 60603

New York
17 State Street
12th Floor
New York, NY 10004

London
P.O. Box 16777
St. Helens, 1 Undershaft
London, EC3A 8EE

Hong Kong
1702 Ruttonjee House
Ruttonjee Centre
11 Duddell Street
Central, Hong Kong

Rating Hotline (312) 368-3198
hotline@dcrco.com