By Laurence Neville

From Russia with Love?

Slow off the blocks in opening up to securitization, Russia now accounts for more deals than any of its neighbors. This vast potential market is enticing investors both at home and abroad. But it is still in the throes of fitful growth.

Embracing securitization has been a slow process for Russia. Until recently this vast country stayed on the sidelines while neighbors from Kazakhstan to Ukraine demonstrated a more pioneering spirit in developing a market for asset-backed securities.

That has changed in the last couple of years. In fact, Russian issuers now account for the largest slice of the securitization market in central and eastern Europe by both number of deals and volume issued, according to data research firm Dealogic. Notes Francesco Dissera, executive director in the UBS securitization team in London: "Russia could eventually be one of the largest securitization markets in Europe — larger even than Portugal, Greece or Italy." (ASF held a panel discussion on Russia at its Vegas 2007 conference. Members can access the webinar on ASF's website)

But as enticing as this all sounds, getting there looks like it will be a slow process, requiring a good deal of patience. Russia's securitization market is still tiny. There have been just 16 public deals worth a total of $3.25 billion — and one transaction accounts for two-fifths of that. A host of factors from legal uncertainties to the lack of economic rationale for many issuers will limit the ability of this market to expand.

Initially, it was hoped that the country's oil and gas companies — by far Russia's strongest credits — would drive issuance. There was certainly a promising beginning. In July 2004 Gazprom raised a bumper $1.25 billion with a deal based on future gas exports. That sent ABS bankers scampering across the country to find other issuers.

It didn't happen. As oil and gas prices climbed steeply, these companies became richer and their credit ratings improved. The attraction of securitizing assets waned as the cost of raising capital in the unsecured bond market decreased.

Of course, energy assets aren't the only candidates for securitization. ABS bankers were already sizing up Russia's financial institutions. In October 2004 Rosbank completed a deal backed by the future flows from credit-card payments. Other banks soon followed, securitizing other consumer loans.

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Two different transaction formats have developed since Rosneft's deal. The more popular type is the onshore deal. This is a standard structure with a fully funded reserve to enable the issuer to obtain a rating enhancement and carry maturities of three years or less.

Offshore deals focus on future flows and require an issuer to establish a diversified payment rights (DPR) program. They make sense if an issuer has substantial income flows from outside Russia from remittances being channeled through its offshore deposit accounts. These can be captured and used as security for the issuance. They're not for everyone. "Offshore deals require scale and stability in flows, and must fulfil criteria such as debt service coverage ratios set down by the rating agencies," explains Fraser Malcolm, head of ABS syndicate at Dresdner Kleinwort. "They are therefore only viable for a limited number of banks." To date, only MDM and Alfa Bank have launched offshore deals.

But there is a limit to how many of Russia's financial institutions can or need to tap the asset-backed market. First, some of the country's largest banks have no financial incentive to do so. "The larger state banks [such as Sberbank] can borrow in the unsecured market at considerably less than 100 basis points," notes Dissera at UBS. To date, no Russian securitization, or indeed any emerging-market issuance, even with a monoline wrap, has priced its top-rated tranche tighter than 100bp. "So there is no sense in state-owned banks using the securitization market," he says.

Also, the banking market is so fragmented that either size or sophistication excludes many potential issuers. "There is a limit to how many banks can come to market: it is important to have legitimacy in terms of scale and western techniques in retail lending," says Malcolm. "The top 10 banks in the country could certainly do deals and there is likely to be consolidation in the market, including external investors coming into the market. That will enhance the pool of potential issuers."

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In the medium term, the number of Russian banks regularly issuing ABS could rise to 15, says Michael Strange, a director in the financial institutions group at Barclays Capital in London: "Many of them are currently putting the framework in place to do so."

The great hope for Russian ABS is mortgage-backed security issuance, though it has also been slow to develop. That might strike some as odd considering that Federal Law number 152-FZ, enacted in 2003, explicitly authorizes MBS deals. But the law has caused problems as well as solving them. "It was not well drafted," says one banker. "Finding out what it really means in terms of bankruptcy remoteness, for example, has been time consuming and confusing."

It was in part because of this that the market had to wait several years for the first mortgage bond deal. And when it came in July last year, it was small — an $88 million deal from state-owned bank Vneshtorgbank (VTB). Nonetheless, it marked an important breakthrough for the Russian market. CityMortgage, subsequently acquired by Morgan Stanley, and Gazprombank subsidiary Sovfintrade also sold deals in 2006 while SG subsidiary DeltaCredit completed an issue in April this year.

But Russia's mortgage market is a veritable minnow compared to its western counterparts. There are only about $5 billion in outstanding loans, mostly to the richest section of the population and in U.S. dollars. "But that is now changing," says Jean-David Cirotteau, an ABS analyst at SG in Paris. "The strength of the currency has given the banks the confidence to lend more in roubles and the growing wealth of a wider section of the population is expanding banks' customer base."

Other characteristics of the mortgage market have posed some problems for investment banks looking to originate MBS deals from Russia. "Almost all Russian mortgages are fixed-rate loans for 25 to 30 years," explains Strange. "The fact that most ABS investors require a floating rate of interest adds to transaction costs due to the cost of the swap." And borrowers have the unlimited right to pre-pay their loan as soon as three months after getting their hands on the money.

It is important to recognize that concerns remain about the surety of Russian MBS and ABS more generally: "There are problems relating to securitization in Russia such as co-mingling risk," says Cirotteau. Malcolm adds that "there are still some legal and jurisdictional issues to be resolved in the Russian market. For that reason alone Russia compares unfavorably to markets such as Kazakhstan which has a true-sale law that strips out the credit risk associated with a bankruptcy-remote special-purpose vehicle."

Of course, investors treat issuance from each country differently. "While an investor might be happy taking triple-B risk in the UK market, triple-B in Russia is a different matter. There is always an element of country risk," explains Malcolm. "Having said that, the rating trajectory of Russia has been consistently upward and the country is now comfortably investment grade. Lines have opened up that were not previously there."

There has been one attempt to defuse the country risk issue. Barclays Capital and HSBC worked with the International Finance Corporation to develop a product called an interest payment facility (IPF) for a deal they structured for VTB. This facility ensures that if the Russian government were ever to turn off the flow of money, costs and interest on the bonds would be paid for 18 months. The IPF allowed the top tranche in the VTB deal to pierce the sovereign rating, but the structure has not been used since.

It's almost a surprise that Russian companies have managed to securitize anything at all. But the baby steps the country's issuers and structurers have taken so far appear to have fostered a degree of comfort. To date, Gazprom aside, Russian securitizations have had small ticket sizes, limiting how much investors can buy while also whetting their appetite.

Bankers say that has laid the groundwork for bigger deals including several 144A deals of around $500 million that should play well with U.S. investors. "We have seen a steady rise in inquiries from U.S. funds about buying paper," says Barclays Capital's Strange. Malcolm says that roughly half the book of the offshore deals went to U.S. investors: "The interested investor base is a mix of insurance and mutual funds, most usually the sort of investors that would consider private placements and are comfortable with funkier assets."

So despite the limitations, Russia's ABS market is at least still growing. "There were six ABS deals from Russia in 2006 and we expect up to 12 this year —100% growth is pretty impressive," says Strange. But it's a long way from becoming a mainstream market.