



CRISIS OR OPPORTUNITY? FIVE LESSONS LEARNED ON ASSET-BACKED LENDING

Asset-backed debt is suddenly famous. Or perhaps, notorious would be a better word. Mortgage-backed securities are blamed for the collapse not just of a number of major banks, but even, for the (near-)collapse of the world financial system. As ACE is in the business of securing assets to support finance, primarily for export and import trade flows, a question easily comes to the mind: if real estate and other financial assets turned out to be “poisonous” for financiers, who is to say that the kind of assets that ACE manages are any better?

Until just before the first major bank, Bear Sterns (top-ranked in Fortune’s “America's Most Admired Companies” in the previous three years), collapsed in March 2008, few if any financiers saw any reason to worry. The securitized debt of which the investor community had put a huge amount in its books during the last decade or so was considered to be a liquid and therefore an easily tradable commodity. Investors would buy debt packages – and eventually reselling their participation when the package was showing performance below targets. There was always someone to buy a package, since there was confidence in continuous growth and the money flow was liquid itself – relatively low interest rates oiling the mechanism till a couple of years. But when interest rates rose, the countdown towards the “sub-prime” moment started clocking. Money became more expensive not only to investors, but also to home-owners who began defaulting on their mortgages. All of a sudden, lenders realized that the nature of the underlying asset did matter, and that all their previous assumptions on liquidity – the possible quick resale of the same asset at a value closest to its book value – were wrong.

While the assets that were so popularly used by financiers provided a much weaker fundament for finance than expected, credit backed by trade-related assets continued performing well. The current financial crisis effectively shows that the kind of assets that ACE manages are indeed superior to many other kinds of assets, and this note will argue why this is the case. The crisis shows that not all assets are equally good as credit support, but also, that the way in which these assets are handled is crucial for the success of the financing. In all, one can draw five important lessons for asset-backed lending.

Lesson 1: lenders have to keep hands-on control over the underlying asset.

Asset-backed debt – be it securitized or straight – works only if the underlying asset is managed properly. The lender has to ensure that, in case of default on the loan, he will be able to exercise his rights over the collateralized assets – and be able to convert the latter into cash, covering inasmuch as possible the principal, plus interest, plus fees. In the case of commodities, this involves proper structuring – including a legal due diligence with respect to the lender’s rights and legal procedures



necessary in order to take control over the pledged goods under a specific jurisdiction (usually, the country where the goods have been pledged). Additionally, the lender can seek to ensure his possession of the goods through collateral management. Through the latter, the financier will have the security that the underlying asset is not released without his consent – and that in the case of an adverse credit event, he will be able to take ownership over it. In certain jurisdictions, repo structures (where the financier buys the goods, with a simultaneous contract to re-sell them at some time in the future) provide superior security – but in this case also, the financier needs a third party for hands-on control over the physical asset.

What can ACE do?

With its splendid track-record in the field of credit support ACE is able to advise the lending party about all aspects related to financial structuring, including legal issues related to the pledge of goods in a specific country, as well as implement collateral management programmes, such as to alleviate the lender of the risks of collateral being altered.

Lesson 2: the financing structure has to be self-liquidating.

Lending against an asset whose sales proceeds are going to repay the debt is a self liquidating loan. The goods can be in the process of being shipped, or in store; the goods can be sold or unsold. The important issue here is the fact that financing has been granted against a specific asset class – and not against a balance sheet. Balance-sheet financing works in the case of corporations that have a wide real asset base (industrial estate, land, equipment, etc.), and provided the above mentioned is not already pledged / mortgaged / funded through leasing. Very few trading companies have a corporate consistency such as to properly allow the structuring of balance-sheet financing.

What can ACE do?

Our team is able to advise lenders or traders about the most appropriate commercial and financial structures applicable to certain deals or trade flows. Amongst us are bankers with long experience in trade finance, as well as commodities traders and operational risk managers.

This multi-disciplinary approach enables ACE to set up financing structures, package, manage or sell the risks attached to the deal in such a way as to ensure its self liquidating nature of it – and secure a guaranteed income to the financing party.

The highly competitive environment that has marked the trade finance business during the last few years has pushed quite a few lenders to extend financing to merchants, not even based on the balance sheet, but just with the backing of cashflow. A trader's cashflow can stall from literally one day to another due to counterparty defaults, cargo rejections or quality claims, or due to margin calls – which in volatile conditions (such as those prevailing since a while) are considerable. Throughout the last two decades, very few self-liquidating deals have triggered significant losses for the lender. The realized losses were rooted either in poor management of the collateral, or in unhedged adverse price movements.

**Lesson 3: make sure the financed asset is liquid.**

A main element in the realization of an asset attached to a defaulting loan is market liquidity. No one wants to own an asset which he doesn't know how to dispose of – this transforms the asset into a rampant liability. Many internationally traded commodities are, in this sense, a very good, liquid asset – consumption will continue, trade flows will sustain themselves even in difficult times, and the market never disappears. The wheat market is for sure more liquid than, for instance, coriander. While the returns on an “exotic” commodity financing structure are usually higher than on “mass” commodities, lenders often refrain from financing the former due to doubts related to the liquidity of the asset. Nevertheless, this can be achieved through over-the-counter offtake engineering – e.g., by incorporating a fall-back buyer who will come in if there is a systemic failure in the trade flow which was initially supported by the financing structure. Ironically, the real estate assets that in the eyes of so many credit committees are the best possible collateral – many banks in developing countries will still look for fixed assets as the main underlying for a credit – have the worst performance in terms of liquidity.

What can ACE do?

Through our trade flow facilitation program, we're able to bring to the structure alternative commodity offtake partners, herewith achieving liquidity in an illiquid environment.

We are able to engineer alternative trade flow mechanisms by embedding in the financing structure over-the-counter options.

Lesson 4: pricing / price-discovery has to be transparent ... or made transparent.

One of a trade financier's worst dreams is to have to dispose of the financed asset. Fire-sales have very seldom proven to be a profitable business. Finding an alternative offtaker is only one part of the solution. In order to keep proactively on top of events, financiers have to follow market tendencies and regularly benchmark the financed commodities - or commission a third party to do so on their behalf. Often the benchmarking is done basis screen or market letter prices. This works when the financed goods are located in one of the published delivery points. But very often they are not – and this necessitates the taking into account of freight differentials between published location price and the actual location / parity of the goods. These elements can make quite a difference in the benchmarking process – and have to be considered with utmost regularity and precision.

What can ACE do?

ACE can designing pricing formulas for different parities, and can provide regular benchmarking calculations.

Lesson 5: make the right strategic choice

While it's amply debatable what differentiates right and wrong in terms of corporate strategy, financial institutions have to be able to answer, for themselves (and to their shareholders) to the



questions: “is commodity trade finance one of my core businesses? If YES, then do I invest enough in deal origination, structuring and operational risk management? If NO, then do I drop it altogether – and with it the opportunities of relatively secure income? Or do I OUTSOURCE some of the key due diligence, structuring and risk management operations to a reputable third party, thus retaining income opportunities while reducing fixed costs?”

In the end, like any non-core business, part of the constituent components of commodity trade finance can be outsourced. Relative to other businesses, commodity trade finance is more labor-intensive and it may show relatively lower yields (although this can be more than

compensated by lower use of risk-weighted assets, in particular if proper financial structuring techniques are used). Outsourcing can thus make a lot of financial sense. Possibly the worst choice that a bank can make is to enter into commodity trade finance just because returns are high, but without investing in the required skills and systems, and without much outsourcing... when the cycle turns, such banks are the first to book losses. Not because the assets underlying such financings are poor, but because they have not yet learned the five lessons described above.

What can ACE do?

Through our extensive in-house and external network, we can originate a considerable amount of deals.

Given our in-house competencies which are commodity and market-specific, as well as our risk-assessment capability and tools – we are in a position to structure trade finance facilities as well as contract farming schemes.

We have the skills to manage the operational phase through our in-house risk management, including collateral management and disbursement / reimbursement operations.

About ACE

ACE Audit Control & Expertise Global Ltd provides highly specialized credit support and project and trade finance services across the entire asset-conversion spectrum, such as commercial engineering, financial structuring and risk management. Through customer-tailored solutions, ACE is creating or reinforcing the links that make value chains happen – even in highly challenging geographies or conditions.

This is possible through the core asset of the group, which is an extensive network of 1,200 highly skilled professional coming from a diversity of backgrounds – and operating in 30 offices throughout 24 countries.

Through its world-class systems and staff, ACE is able to secure commodities as well as a range of consumer goods (pharmaceuticals, vehicles etc.) in any location, providing comfort to industrial and commercial companies and the financial community alike. Since its inception in 1996, ACE has provided credit support services for commodity values in excess of US\$30 billion for more than 150 financial institutions and trading companies in more than 75 countries.

ACE is part of the Financial Technologies Group, a US\$2 billion corporate (market capitalization, July 2008) which is a global leader in providing technology solutions to the financial services industry, including digital market places and exchanges, brokerage houses and asset managers.