WISE: Plan for Basel 2

01/02/2007

Dexia has completed its first securitisation of AAA-wrapped infrastructure bonds. The securitised portfolio amounts to £1.47 billion ($2.86 billion) and allows Dexia to free-up its balance sheet for further activity in this sector.

The deal is administered by Dexia's full branch Dexia Credit Local Dublin and co-arranged by Credit Suisse and Dexia Capital Markets. It is structured as a synthetic collateralised bond obligation (CBO), so the debt remains on Dexia's balance sheet.

The securitised portfolio comprises seven bonds issued in relation with PFI projects, and 21 bonds issued by regulated utilities in the water, electricity or gas sectors. The bonds are wrapped by seven monolines.

Dexia is transferring the credit risk related to the wrapped infrastructure portfolio to external parties by means of two credit default swaps (CDS): a non-funded super-senior credit default swap guaranteed by Assured Guaranty and a junior credit default swap with WISE 2006-1 Plc, a special purpose company registered in Ireland. WISE 2006-1 has issued three tranches, ranging from AAA/Aaa to AA-/ Aa3 (S&P and Moody's respectively), pricing from 30bp to 39bp over Euribor; a £30 million AAA-rated class A; a £22.5 million AA-rated class B; and a £11.25 million AA-rated class C. The notes have a scheduled maturity of October 2056. The tranches have been placed with several banks and insurance companies.

The deal was done for capital adequacy reasons. Despite being AAA-rated, wrapped debt under Basel I is 100% risk-weighted, which is onerous for large holders of wrapped PFI and utility paper. On securitisation, the debt's risk weighting on Dexia's book falls from 100% to about 20%, freeing up capital which will allow more of this type of lending, lowering the cost of capital and boosting Dexia's internal rate of return (IRR).

Under Basel I, loans such as those to utility or SPV PPP companies are weighted at 100%, whereas loans to governments are weighted at 0%, and local authorities 20%. Under the new capital adequacy rules ushered in under Basel II, the determining factor for the amount of ring fenced capital will be the actual credit rating of an individual loan.

Under Basel II, good credit structures which can achieve good ratings should be able to achieve commensurately lower pricing. With better ratings, the role of credit enhancement products such as monoline insurance will become more important for banks. There is unlikely to be a sharp downward movement in pricing of floating-rate AAA paper, in particular, as the move to Basel II is incremental and swap arbitrage players and banks employing a warehousing and conduit business model such as Dexia have boosted liquidity and pushed prices to a lower plateau.

Now this arbitrage opportunity in inflation swaps has all but disappeared. Still, following full implementation of Basel II project banks are likely to become more active purchasers of wrapped infrastructure bonds.

By transferring the risk of a £1.5 billion AAA paper portfolio, Dexia has effectively released some regulatory capital to reinvest. Due to an anomaly in the financial markets the cost of protection using the CDS market has been less than the interest yield on the bonds, resulting in an arbitrage situation – the negative basis trade. Given the unique nature of the underlying portfolio, a securitization on a portfolio of wrapped bonds is particularly efficient due to the very low probability of a double default. For there to be a loss in the CLNs, and/or the super-senior CDS, there needs to be a credit event on both the underlying PFI or utility bonds and the monoline wrap.

The reasons Dexia went for a synthetic structure rather than an outright securitisation are threefold: for a simple and straightforward execution; greater efficiency in terms of tranching and sell-down; and because the notes are callable. As Basel II comes fully online it may be more cost efficient for Dexia to bring the risk back on balance sheet.

Subject to certain eligibility tests the CBO portfolio can be replenished up to a maximum of £1.5 billion, although a spokesperson for Dexia says that the bank is likely to launch another CBO before Basel II is fully implemented. The tests include criteria such as that the portfolio must not comprise 50% or more of projects still in construction and no more than 20% debt can be sourced from projects or utilities outside the UK.

Synthetic-securitisations are likely to remain a mainstay of the business models of Dexia and Depfa because they provide a vital route to recycle capital while the Basel I regime runs its course (search EPIC and EPIC 2 for more on Depfa's deals). The securitisations effectively help lower the cost of capital enabling the banks to bid competitively for more debt.

The negative basis trades are also helped by the monolines appetite for wrapping infrastructure paper (particularly the US insurers' fondness for UK utility debt) and the current disparity between the pricing of uncovered project/utility debt and the pricing of wrapped debt. Institutions want new-issue BBB rated paper at around 100bp, but with monoline wraps falling from the 25-35bp range of two years ago to 15-20bp now, and AAA paper currently trading at 50-60bp, there is a 20-30bp arbitrage play on wrapping an underlying BBB.

In the background specialist departments in banks are readying themselves for a regime change. Basel II, which begins implementation this year, is being run in parallel alongside the existing Basel I regime. Basel II is being gradually implemented with an increasing annual cap applied on how much of a business can be put under the new regime. Dexia will have no Basel II component this financial year, and will have its entire business under Basel II on 1 January 2010.

WISE 2006-1 Plc
Status: Closed 21 December 2006
Description: A replenishable £1.5 billion synthetic CBO, securitising a portfolio of wrapped infrastructure bonds
CDS Counterparty: Dexia Crédit Local, Dublin
Co-arrangers: Credit Suisse; Dexia Capital Markets
Legal Counsel: Clifford Chance