

The CDFS Short Read – December 2023
A Sense of Securitisation



This CDFS Short Read in Brief

Risk transfer has at long last been admitted to the development finance conversation. As stakeholders seek to identify the means of its advent, the term securitisation has itself become a feature of the debate. Never a particularly mainstream corner of capital markets and owing at least some awareness to its contribution to the global financial crisis, any mention of securitisation in development finance circles is typically met with a varying mix of excitement and concern. It may therefore prove useful to demystify a comparatively straightforward mechanism and to assess the potential and the challenges of its use to accelerate the financing of sustainable development.

Having reviewed some of the key relevant concepts, this CDFS Short Read provides a description of the rationale and the high-level characteristics for both true-sale and synthetic securitisation techniques. Though there are clear commonalities, they offer differentiated inputs, outputs and suitability. This in turn means that they in combination offer a toolkit capable of delivering risk-transfer-based mobilisation for the development finance system.

The focus then shifts to the opportunity and the challenges linked to MDBs and DFIs seeking to implement either variety directly. While the former is comprised of higher capital velocity, balance sheet optimisation and the basis for an originate-to-distribute (or share) model, the latter includes the required skillset, the size and diversification of portfolios and the crucial redeployment question.

The merits of an intermediated, warehouse-based true-sale approach and of the synthetic route to securitisation are then discussed. This would delegate much of the workstreams to specialised third parties and allow a wider set of development finance actors to participate.

The consequences of MDB and DFI loan securitisation for impact creation and preservation, as well as those on the much-vaunted preferred creditor status are explored and the methodologies most apt to mitigate risks are identified. Synthetic securitisation, which does not see a change in the lender of record is of course particularly relevant.

Commercial banks, by dint of the sheer size of their balance sheets and origination capacity, must necessarily play a central role in the financing of sustainable development and supporting the

accelerated 'greening' of their loan books should be seen as an important activity by all development finance stakeholders.

This Short Read presents precedents for such support and offers a range of means through which it can be further delivered, be it through equity investments or the provision of guarantees.

It further directs the conversation towards the need to ensure that the cash and risk budgets thus freed are indeed redirected to the funding of sustainable development assets. Whilst synthetic securitisation readily lends itself to the incentivisation of 'good' behaviour, more work is needed to create solutions applicable to the true-sale approach.

The reader is finally invited to consider the concrete steps that should be taken to deliver on the promises of securitisation. Its benefits and its technology need to be better understood, its adoption and replication encouraged, and the disincentives built into the relevant regulatory frameworks interrogated.

Securitisation does, as an instrument, carry a significant amount of baggage. It should be remembered that a tool cannot be blamed for its misuse. It is quite simply a technology capable of addressing the specific challenges faced by the development finance community. It is incumbent on its stakeholders to ensure that its necessary deployment is associated with equally necessary safeguards.

1. Why, what, how?

Seen through the lens of development finance, securitisation does as an instrument present the opportunity to simultaneously help frontline actors such as MDBs and DFIs to optimise their balance sheets and recycle their capital through the transfer of risk to private sector investors they thus mobilise.

1.1. Back to Basics

securitisation

/sɪˌkjʊəɪtɪʃn, sɪˌkjɔːrɪtɪʃn/

noun

noun: securitisation

The conversion of an asset, especially a loan, (or a basket thereof), into marketable securities, typically for the purpose of raising cash (and/or transferring risk) by selling them to other investors.

Output

The most intuitive aspect of the securitisation process is its output: it results in the issuance of securities.

This is crucially important in the context of the development finance system's ongoing and hitherto largely unsuccessful attempts at mobilising private capital in support of sustainable development objectives.

Institutional investors and the fund managers they invest through need to be presented with the simple, standardised instruments they are familiar with and use as the building blocks for their portfolios.

Bonds are such instruments. MDBs have indeed long relied on bond markets as the basis of their leveraged funding models. This recourse to basic securities has proved its worth, and it stands to reason that securitisation should therefore prove a potent mobilisation tool.

Input

Let us turn our gaze to the input side of the securitisation process. Although securitisation

technology has over the years evolved to the point that most underlying financial assets are capable of securitisation, for the purpose of this conversation, it is sufficient to consider pools of loans as the underlying assets.

Development finance is, by and large, a lending game. MDBs and DFIs focus on direct lending, and apart from limited syndication efforts that see them lending alongside commercial banks, this is not conducive to large-scale mobilisation. Pension funds do not routinely lend. Neither do insurance companies.

Securitisation essentially takes a portfolio of loans, for example, loans originated by and sitting on the balance sheet of an MDB and transforms this portfolio into simple fixed-income securities or bonds that institutional investors can easily buy.

Risk and Tranches

Beyond this ability to act as a bridge between balance sheets full of illiquid direct loans and investors in need of securities, securitisation offers the means to, out of a pool of loans with risk-return profiles that investors cannot accept, fashion instruments with a risk-return profile they can.

Picture the liabilities side of any company's balance sheet. There lies equity at the bottom, junior debt in the middle and senior debt at the top. The risk associated with each tranche is higher than that of the tranches senior to it, and the return investors will demand in exchange is commensurately higher. Equity and debt investors are exposed to the same asset side of the company's balance sheet, but the risk they shoulder and the return they derive are very different.



Securitisation, in its simplest form, does nothing more than replicate this structure and apply it to one specific asset: most typically, a pool of loans.

As often in finance, it was deemed desirable to come up with exotic jargon, and the French word for slice 'la tranche' was selected to refer to these different layers of liabilities.

The important thing is that out of a portfolio of loans to emerging market businesses, none of which attract an investment grade credit rating, given the right amount of equity and potentially junior debt, it is possible to create a 'tranche' of AAA-rated bonds.

1.2. Time really is money.

Much of the debate surrounding efforts to reform the multilateral development finance system is focussed on equipping MDBs with more capital or emboldening them to take more risks with that already at their disposal.

Although risk transfer does get the occasional mention, more attention should be paid to the potential to enhance the velocity of said capital.

Finance is concerned with cash, risk, and time. MDBs, when lending to businesses, part with cash and take on the risk of never seeing it again for a specific period of time.

Trying increasingly obscure means to obtain more cash from their shareholders is of course always a worthy endeavour, and taking another hard look at the various ratios behind risk budgets will address the corresponding constraints.

There is however also value in trying to establish whether, having for example originated a bunch of 20-year loans to infrastructure projects, a given MDB really must wait for 20 years before it can redeploy this cash, or whether it has to bear the full

associated risk exposure, immobilising scarce regulatory capital, for 20 years.

Securitisation has long helped banks deal with this vexing situation. Two methodologies, which we will introduce below can be employed. **True-sale securitisation** involves the lending institution actually (in fact truly) selling loans, thereby removing them from its balance sheet. Its somewhat confusingly named cousin **synthetic securitisation** sees the loans remain on the lender's balance sheets, but part (a tranche) of the risk they come with is transferred to a third party.

Either can deliver on what most will have heard referred to as originate-to-distribute or originate-to-share business models. As we will discuss, these are not without their challenges in the development finance context.

1.3. Securitisation models

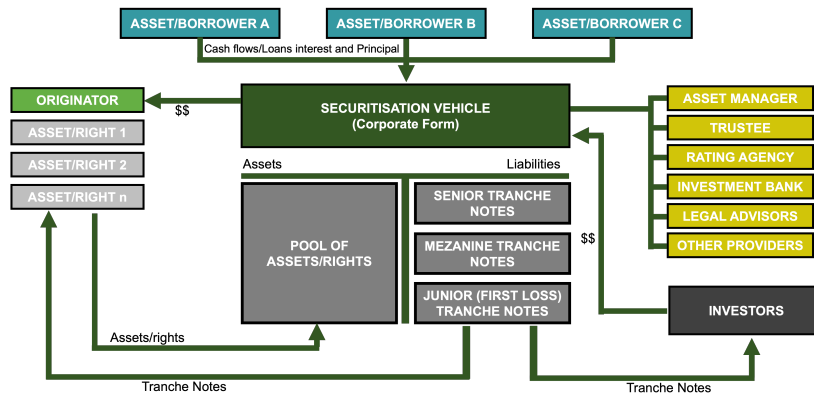
1.3.1. True Sale

True sale is conceptually the simpler form of securitisation.

In this scenario, the entity (or entities as we will discuss later) that originated the loans and sold them as assets on their balance sheets sells these instruments, which as a result are removed from their balance sheet.

A separate entity (one of life's famous special purpose vehicles or 'SPVs') is set up for the special purpose of buying these loans. It can be set up either by the originating entity or by a third party.

In turn, this SPV is capitalised through the issuance of equity and tranches of fixed income securities with different levels of seniority, which essentially refers to the relative order of priority of their claims to the cash flows generated by the SPV's assets, *in extenso* the portfolio of loans.



True-Sale securitisation - Source: Deloitte

It is important to note that various regulatory frameworks require the securitisation's sponsor to retain a minimum level of exposure to the SPV's portfolio. The European Union's securitisation framework for example requires sponsors to retain a 5% material net economic interest in the securitisation. This can be structured in a number of ways but generally and for the purpose of this discussion it means the sponsor needs to keep at least a 5% equity or first loss position in the SPV.

For the more senior fixed-income securities issued by the SPV to attract institutional investors, there is then a need for these securities to attract a credit rating. This is of course awarded by a credit rating agency ('CRA'). The CRA will study the underlying credit quality of the pool of loans that make up the SPV's assets, including any diversification benefits, and will importantly take into consideration the 'thickness' of each tranche on the liabilities side, including the equity tranche.

This is important because it does mean the sponsor may need to retain, or alternatively raise, more than the 5% tranche it is regulatorily required to in order to achieve the desired credit ratings for the other tranches. A key concept is that the more senior the tranche and the thicker the tranches whose claims are junior to this tranche's the higher its credit rating will be.

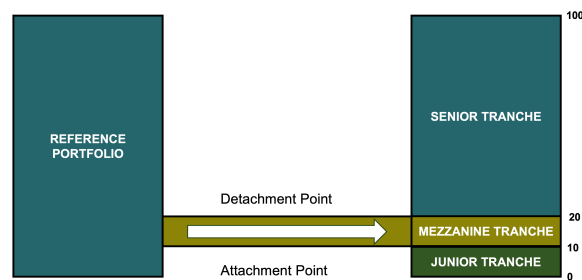
1.3.2. Synthetic

The reader will of course have gathered that if there be a need to highlight the 'true' nature of

the sale associated with the above-described model, there must be a model where the sale is not quite so true.

Enter the high-tech-sounding synthetic securitisation model.

Here, instead of physically transferring the pool of loans from the lending entity's balance sheet into an SPV, the loans remain where they are, but this specific pool of loans is virtually ringfenced from the rest of the portfolio and equally virtually sliced into tranches. To make it more interesting, the tranche is defined by its attachment point, its detachment point, and its thickness as graphically illustrated below.



Risk Participation Agreement Tranching – Source: Eighteen East

What happens then is that the lending entity buys credit protection from a third party. Essentially it buys insurance against losses resulting from defaults in the pool of loans and affecting this specific tranche. Let us assume a USD 100 million pool of loans sliced into three tranches. Let us further assume that we use a risk participation agreement ('RPA') approach, noting their other options.

The first loss junior tranche has an attachment point at 0 and a detachment point at 10, the mezzanine tranche (more exotic jargon, this



time helpfully shared with home improvement programs) an attachment point at 10 and a detachment point at 20 and a senior tranche with an attachment point at 20 and a detachment point at 100. At the risk of oversimplifying, a synthetic securitisation of the mezzanine tranche would see the investor, who plays the role of the seller of protection, make good the lending entity (the buyer of the same protection) for losses on the portfolio in excess of 10 million and with a maximum of 20 million.

Once again looking at the thickness of the tranches with more junior claims and at the credit quality of the underlying pool of loans, it is possible to assess the credit risk of the tranche and therefore the risk incurred by the seller of protection.

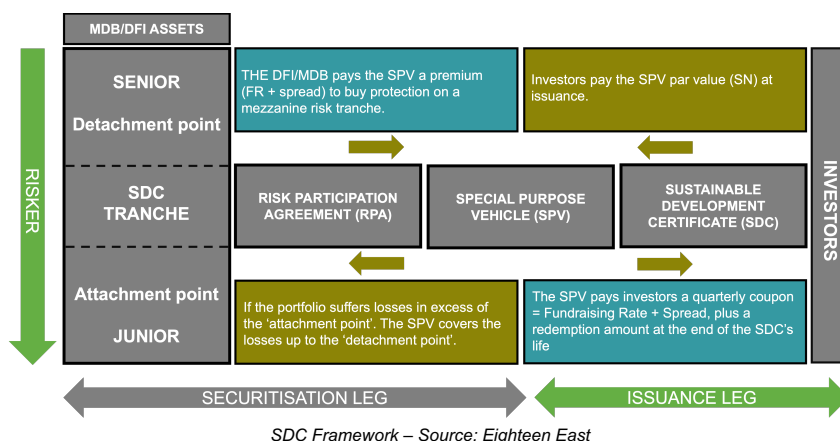
The seller will in turn insist on being compensated for this risk through the payment of what effectively constitutes an insurance premium. There are of course further layers of complexity, and as hinted at above different credit derivatives one can deploy to execute a synthetic securitisation (total return swap instead of risk participation agreement, etc...).

Whilst such a synthetic securitisation does result in risk being transferred from the balance sheet of the lending institution, it must be noted that it does not result in a liquidity injection. The reader will in addition have noticed that the exercise described above does not directly result in the creation of a readily tradable security. For this to happen, there is a need to

transform the risk exposure and the cash flows resulting from the synthetic securitisation into a security. This can be done either through the creation of an SPV which acts as the seller of protection and issues the securities, or through the intermediation of a bank. The SDC, an SPV-based model¹ developed in 2020 by Eighteen East with the support of the Rockefeller Foundation, is illustrated below.

One advantage in the latter scenario is that there is no need to create an SPV. This can facilitate multi-issuance programmes and a recognised investment bank acting as the issuer of the securities can enhance their attractiveness. The problem is however that although the investment bank is essentially only passing the risk and returns between the original lending institution and investors, in a development finance context it would most likely incur a significant capital charge because of the nature of the underlying assets. Even assuming they are prepared to enter such a transaction, the cost of compensating the bank for this capital charge may prove uneconomical.

There may not always be a need to go through this second issuance leg. In the case of the famed if dated original AfDB Room2Run transaction, the seller of protection was an investment fund with the technical acumen to enter in a bespoke transaction. Such market participants are rare however and the mobilisation potential of synthetic securitisation absent the actual issuance of securities is unquestionably lower.



SDC Framework – Source: Eighteen East

¹ https://www.18eastcapital.com/wp-content/uploads/18E_SDCReport03202020.pdf



2. Where to apply?

Securitisation is for DFIs and MDBs a multifaceted opportunity. Beyond the securitisation of their own assets, its possible applications range from an additional means of supporting the emerging markets financial institutions they have long used as intermediaries to the accelerated 'greening' of commercial banks' balance sheets.

2.1. Securitisation of DFI/MDB Assets

2.1.1. Direct

The most obvious application is of course the securitisation of the portfolios of loans originated by MDBs and DFIs. The potential benefits of such an approach are multiple:

- Enhancing the velocity of their capital, effectively increasing the quantum of capital per unit of time at their disposal.
- Facilitating the optimisation of balance sheets, addressing exposure limits and headroom constraints, whether they be linked to capital adequacy frameworks, credit ratings or regulatory compliance in the case of some bilateral DFIs.
- Mobilising the capital of institutional investors by transforming loans they cannot make into securities they can buy.
- Forming the basis for an originate-to-distribute model that focusses on the real value add of MDBs and DFIs. To wit, their origination capacity, not their comparatively limited capital.

This is of course not without challenges, the nature and magnitude of which varies from one institution to another.

Whilst securitisation does not present levels of complexity akin to those generally associated with the design of space-bound rockets, it does require specific technical know-how. Given the relatively niche nature of the concept and the fact that development finance has to date made little use of it, it is unlikely that this know-how be found within current DFI and MDB teams. External help can of course be hired, but the smaller institutions, least likely to organically

possess the required capabilities, are also the least able to meet the associated costs.

Another size-linked limiting factor is the lack of the large and diversified portfolios ideally needed to form the basis for securitisation.

An increasingly well-understood point is the fact that whether risk be transferred synthetically or through a true-sale SPV-based process, so is return. In an environment where redeployment is slow and arduous, this will most likely result in negative consequences for profitability.

A connected issue is that portfolios carefully crafted without securitisation in mind might not lend themselves to the carving out of baskets for this purpose.

In short, there are some tangible benefits to be derived by DFIs and MDBs but conducting securitisation themselves may prove too tall an ask for the time being.

2.1.2. Indirect

It might therefore be more opportune to rely on an intermediated approach to the securitisation of development finance assets.

In a true-sale scenario, a third-party sponsor would buy a portfolio of loans from a DFI or an MDB, or alternatively from multiple such institutions, acting as a central counterparty.

This would present the advantage of delegating much of the heavy lifting, ranging from the SPV structuring to the marketing of the issued securities to a commercially motivated actor. In the latter setting, it would also allow DFIs and MDBs to only part with selected loans.



Should synthetic securitisation be employed the DFI would need to deal with its side of the number crunching to ensure it is being dealt with fairly. It would nonetheless benefit from the expertise of a bona fide counterparty and delegate the re-securitisation or fundraising. In the case of Room2Run, institutional investor capital was indeed mobilised, albeit through a fund structure rather than through the issuance of securities.

Development finance actors have not historically engaged with private sector investors. It is unlikely that they will be able to catch up in anything like a relevant timeline and should therefore wherever possible leverage off-market infrastructure. Securitisation is no exception.

2.1.3. Impact and PCS

Two themes usually raise concern when the transfer of anything from development finance to the private sector is discussed: impact and preferred creditor status ('PCS'). The fear is that both may be lost should assets be allowed to forego the caring warmth of an MDB balance sheet for the ruthless clutches of private sector investors.

Neither need be an obstacle. In a true sale warehoused scenario, the impact can be protected, particularly if a development finance actor is an equity investor in the sponsor or the SPV. The relevant impact policies that are not already built into the loan documentation can simply be imported. Assuming that there is such a thing as PCS in a private sector context and that there exists a borrower short-sighted enough to think that defaulting on a loan originated but no longer held by an MDB will not have the same nefarious effects as if it had not been transferred to an SPV, then partial retention of such a loan or exposure to that borrower would mitigate the risk of losing PCS.

Synthetic securitisation addresses both the impact and the PCS concerns. The originating MDB or DFI remains the lender of record. There can therefore be no impact erosion or diminished incentive for the borrower to repay,

or loss of preferred access to foreign exchange.

2.2. Supporting commercial bank securitisation

The sheer size of both the challenges of sustainable development and climate change and of the balance sheets of commercial banks means that the latter are arguably collectively one of the very few realistic contenders for addressing the former.

Helping emerging markets commercial banks to recycle their capital into loans to green projects at a much faster pace is arguably one of the most effective ways to deploy development capital.

Green securitisation has become a feature of developed markets but is still anecdotal across most developing countries. Development finance actors can play a catalytic role in the increased deployment of this technology.

Bayfront, a Singapore-based true sale securitisation sponsor provides a useful case study. It operates a warehouse-based system and acquires infrastructure loans from a network of several dozen commercial banks. These loans are then transferred to securitisation SPVs at regular intervals. These vehicles in turn issue debt securities listed on the SGX. Institutional investors local and global buy these notes, thereby delivering on the recycling/mobilisation dual impact described above.

Bayfront receives catalytic support from official sector actors across multiple dimensions and can therefore be a source of inspiration for applications further afield.

The warehouse is financed through a leveraged equity model. Part of the equity is held by the AIIB. The debt it raises benefits from a guarantee from the Government of Singapore.



In addition, each time a sponsor launches a true sale securitisation SPV, it is required to inject equity into the vehicle since:

- various regulatory frameworks requiring sponsors to retain exposure to the portfolio they sell to investors and;
- credit rating agencies may require an equity tranche in excess of regulatory requirements to ensure the debt instruments issued by the SPV achieve the desired credit rating.

This model presents a range of opportunities for development finance to catalytically support the growth of an instrument endowed with tangible potential to accelerate climate finance flows.

Institutions with equity capital at their disposal can achieve an outsized mobilisation multiplier by:

- investing in the equity of the sponsor, thereby enhancing its ability to warehouse loans and to retain larger tranches of larger SPVs
- investing in the equity tranches of SPVs, bridging any gap between the equity sponsors must retain to comply with regulatory framework and that required to achieve the right credit ratings for the debt securities. This was for example done by the FCDO's MOBILIST programme in Bayfront's BIC IV.

Those mandated with the issuance of guarantees can help increase leverage and/or lower the cost of capital at the warehouse level.

For a true sale securitisation to be successful, the sponsor and its merry band of banking friends need to successfully place all tranches of debt securities. There may therefore be a role for development finance to play in picking up any small amount left on the table. Debt securities are the key mobilisation instruments and should therefore ideally be placed with private sector investors.

In a synthetic securitisation scenario, the EIB's participation in the original Room2Run transaction shows how taking on a relatively senior, low-risk tranche of a portfolio's risk can prove catalytic. In addition, the synthetic model means that the buyer of the protection (for example an MDB) is exposed to the credit risk of the seller of protection. In the first Room2Run, this was addressed by the seller of protection 'funding' the transaction through the purchase of an instrument issued by the AfDB. Another approach could be for an official sector actor to provide a guarantee to reassure both the buyer of protection and the credit rating agency that will need to grant capital relief that there will be no bad surprises.

Both the warehouse-based true-sale and the synthetic models allow for investors to gain immediate exposure to a diversified portfolio of loans. This should prove more attractive than the thus far used fund or ex-ante risk sharing models that necessarily inherit the slow deployment issue that is the hallmark of development finance.

2.3. Keeping them honest

The true-sale securitisation model clearly identifies the loans comprised in the securitised portfolio. The synthetic model, whilst conceptually slightly harder to grasp, does also offer visibility of the 'insured' portfolio. The whole exercise is however about what next happens to the freed-up cash and risk budget.

Where an MDB is the originator of the loans, and the beneficiary of the recycling, it is possible to convince oneself, at least for the sake of this conversation, that the new loans they will be able to extend as a result of the securitisation exercise will be aligned with sustainable development objectives.

What if, however, it is a commercial bank that is thus provided with newly dried powder?

Trusting that a commercially driven financial institution will invariably do the right thing is a demonstrably flawed basis for decision making.



Setting aside the fact that they more reliably respond to the production of a stick, let us turn to the more zeitgeist-friendly concept of alignment of interests. In a synthetic scenario, it has proven possible to incentivise the buyer of protection to demonstrate that it redeploys freed-up regulatory capital into loans greener by offering an ex-post rebate on the cost of this protection.

This is not immediately practical for true-sale securitisation, as the loans have already been bought.

In both cases, the reality is that balance sheet risk is fungible and that there will always be an element of doubt. It is however a worthwhile pursuit for securitisation actors to seek to develop a framework that helps demonstrate to potential investors and official sector supporters that securitisation is highly effective at greening balance sheets. Building on the Second Party Opinion ('SPO') based green bonds frameworks could be a useful stepping stone.



3. What next?

Securitisation holds great potential for our collective quest for sustainable development. Its application to emerging markets does however remain problematically anecdotal. Development actors can play a catalytic role in the scaling up of the sector and the delivery of this potential.

Educate

Commercial banks across advanced economies have long utilised securitisation solutions to optimise their balance sheet and implement originate-to-distribute business models. Whilst the same is true of leading emerging markets banks, more should be done to equip the next tier of financial institutions with an understanding of its benefits and the know-how necessary to capture them.

The same applies to MDBs and DFIs. Lack of familiarity is too often the true cause of the dismissal of an instrument of optimisation and mobilisation. Securitisation structuring skills are not all that widely available across mainstream capital markets, and it is therefore no blemish on an MDB's escutcheon not to possess them.

Help is at hand, and the IFC for example recently retained external assistance (in the unlikely shape of Blackrock) through an RFP process for the design of its Warehoused Enabled Securitization Platform ('WESP').

For those institutions who might struggle to meet the expense associated, there is significant goodwill around the theme and solutions can be found.

The MDB Challenge Fund jointly created by the Gates, Rockefeller and Open Society foundations for example funded a pilot securitisation workstream for the IADB.

This example does in fact raise an important point. How can a USD 140 billion multilateral financial institution possibly need to rely on the necessarily scarce generosity of philanthropic organisations to fund such important work? Do MDBs really not have the research and

development budgets necessary to advance their stated mobilisation agendas?

In a time of reform, ensuring that they are capable of creativity should be a priority for shareholders.

In turn, if external actors are to participate in the creation of a securitisation market for MDB and DFI loans, there is an urgent need for higher transparency on their historical financial performance data.

The GEMS drum has been beaten within an inch of its life. The reality is that having access to the data gathered by a handful of its largest members should suffice. The convenience of hiding behind the necessity of consensus among over 20 institutions with countless shareholders should be circumvented.

Stimulate and replicate

The world needs more of the type of actors currently pioneering the use of true-sale and synthetic securitisation in a development finance concept.

At a time where the 'platform' concept is increasingly part of the conversation, there should be a proactive drive to support and replicate such initiatives, whether they be true-sale sponsors or funds engaging in the sale of synthetic credit protection.

MDBs and DFIs should in addition be incentivised to seek to contribute assets to such initiatives where they cannot organically deliver securitisation.

They should be reassured that the associated loss in profitability is well understood and



accepted by shareholders as the price of higher capital velocity and increased mobilisation.

As a preparatory step, the legal documents used to extend loans, remnants of a hold-to-maturity era that needs to disappear over the horizon, will need to be adapted and standardised.

Regulate

It is a vexing feature of the mobilisation debate that financial institutions and institutional investors are asked by governments to increasingly do things that the regulatory and

prudential frameworks installed by the same governments explicitly ask them not to do.

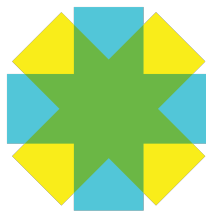
Securitisation is no exception, and punitive risk weights and less than generous regulatory capital relief are features of this debate.

It is the responsibility of the governments of advanced economies, who are both the proponents of the mobilisation thesis and of the prevailing frameworks governing financial markets, to address the contradictions they have created, and to create the conditions for a thriving securitisation market for development finance assets.

Securitisation is a textbook example of a tried and tested capital markets instrument that should be adopted and adapted to accelerate the financing of sustainable development. Mistakes made on the path to the financial crisis should be construed as valuable lessons, not as damning evidence of perceived danger. There exist pioneers, but their hard work will be in waste should the development finance system fail to, at long last, build on their shoulders.



Centre for Development Finance Studies



For more information:

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