



Securitization

Key Legal and Regulatory Issues

IFC TECHNICAL WORKING GROUP ON SECURITISATION IN RUSSIA
INTERNATIONAL FINANCE CORPORATION ■ GLOBAL FINANCIAL MARKET

IFC

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Alfa Bank

Baker & MacKenzie

Finamatics

Freshfields Bruckhaus Deringer

PriceWaterhouse Coopers

Standard & Poors

White & Case

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Global Financial Markets Department

Securities Markets Unit

Phone: 202.473.0846

Email: aharwood@ifc.org

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Acknowledgments

This paper was prepared by members of the Securitization Technical Working Group in Russia, as part of an IFC-sponsored project to help improve Russia's legal and regulatory environment for and support development of a domestic securitization market. Key contributors were from the Vienna (Fredrich Jergitsch) and London offices (Andrew MacLean) of Freshfields Bruckhaus Deringer, which was the advisor to the Working Group, and the Moscow offices of Alfa Bank (Simon Vine), Baker & MacKenzie (Vladimir Dragunov), Finamatics (Alexander Ivanchenko), PriceWaterhouseCoopers (Alex Bertolotti), Standard & Poors (Igor Iassanovets), and White & Case (Maya Melnikas).

The Working Paper is published by IFC's Global Financial Markets Department, Securities Market Unit led by Alison Harwood (project team leader). Aichin Jones provided graphics and layout.

PART I: General Overview

What is Securitisation?

There are many ways to describe securitisation but in essence, it is the financing or re-financing of income yielding assets by packaging them into a tradeable form through an issue of bonds or other securities.¹

Impact of Securitisation on Capital Markets and Other Markets

The development of the securitisation market over the last decades has had a number of beneficial effects on capital markets. By introducing a new class of debt instruments, and allowing access to new participants—corporates and others—to the market it has deepened the capital markets. Also, securitisation allows Originators to dispose of assets in an efficient way, and to achieve a more beneficial financing profile and better funding terms. It also allows investors to invest in assets, which they otherwise could not access and has greatly contributed to the availability of highly rated bonds to investors. Thus securitisation is a highly efficient tool for diversification for investors and Originators alike.

Securitisation has also helped to develop and promote other markets. For instance, in the United States, the government has, through two government agencies, the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”), been able to promote home ownership by stimulating the mortgage market. Fannie Mae and Freddie Mac buy mortgages from lenders and fund their activities by securitising those mortgages.

In the United Kingdom, the government has used securitisation techniques to fund its “private finance initiative”, a policy designed to privatise and outsource certain governmental functions such as building and operating prisons, hospitals and schools. Thus, for example, a number of hospitals in the UK have been built using funds raised in the capital markets by issuing asset-backed securities.

¹ There are three principal types of securitisation: true sale, synthetic and “whole business” (the latter primarily used in the United Kingdom and, to a lesser extent, continental Europe). In a true sale securitisation, a company sells assets to a special purpose vehicle/company (the SPV) which funds the purchase by issuing bonds to the capital markets. In a synthetic securitisation, the company does not sell any assets, but transfers the risk of loss associated with certain of its assets to an SPV or a bank against payment by such company of a premium or fee to the SPV. “Whole business” securitisation is essentially a secured loan granted by an SPV to the relevant company. To grant the loan, the SPV uses proceeds of bonds issued into the capital markets whereby the company grants security over most of its assets in favour of the bondholders.

This Position Paper deals primarily with true sale securitisation. Part II contains brief outlines of synthetic securitisation and “whole business” securitisation. Any reference in Part I to “securitisation” refers to true sale securitisation unless stated otherwise.

Types of Assets that Can Be Securitised

The securitisation market in the United States and Western Europe is dominated by a number of asset classes: residential mortgage receivables, commercial mortgage receivables, credit card receivables, auto loans, consumer loans, trade receivables and uncontracted future cashflows (such as toll receipts). However the type of assets that can be securitised continues to expand (some of the key innovators in Western Europe have been governments). In principle, any assets or entitlements representing future (predictable) cash flows can be securitised to the extent that they can be effectively transferred to the SPV through a true sale (or to the extent that the Originator is considered to be “bankruptcy remote”). These may, for instance, include tax revenues or utilities payments.

Brief Description of a Typical True Sale Securitisation

In a true sale securitisation, a company—the Originator or Seller—sells a pool of its assets (often, receivables generated in the ordinary course of its business) to an SPV. In order to finance the purchase of the assets, the SPV issues bonds into the capital markets. The bonds are referred to as “asset-backed securities” because the purchased assets typically represent the principal source of cash² to service the bonds.

It is imperative that once the sale and transfer of the assets to the SPV has been effected, it cannot be challenged, voided or otherwise reversed in an insolvency of the Originator or otherwise. This concept is referred to as true sale. Whether a transaction constitutes a true sale under the applicable law (notably, whether it will be recognized as such by the competent court in the Originator’s insolvency) must be established through a legal analysis of the transaction.

The legal insulation of assets from the Originator through a true sale may help to achieve one of the main benefits of securitisation, access to cheaper funding. If the credit quality of the securitised assets is higher than the credit quality of the Originator’s balance sheet as a whole, the true sale may allow the Originator to obtain funding at better terms than would be the case through an on-balance sheet loan or a corporate bond issue. Thus Originators who do not have a capital market rating of their own can obtain funding through asset-backed securities which have a relatively high rating by a rating agency or agencies.

Often, the sale and transfer of the securitised assets will not be disclosed to certain outside parties (such as, in the case of receivables, the relevant obligors). The Originator will often continue to “service” the assets (e.g., collect the receivables) on the same terms as before the securitisation, and transfer the relevant proceeds to the SPV. Also typically, in order to enhance the quality of the assets and obtain funding at better terms, the Originator will provide security—also called “credit enhancement”. Credit enhancement may be provided in a number of different forms some of which are described in Part II.

True sale securitisations can be split into two types—“standalone” and conduit transactions. These are described in Part II.

² Depending on the individual structure, further sources of cash may include a credit enhancement, a liquidity facility or proceeds from hedge contracts. These are described in more detail in Part II.

Role of the Rating Agencies

Most asset-backed securities are rated by international rating agencies to enhance their attractiveness to investors and provide a guideline for their pricing. The rating agencies will closely examine the legal structure of the transaction (notably, the true sale element), the quality of the securitised asset pool and the ability of the Originator to service the assets. Based on this analysis and the amount of the credit enhancement (and other supporting arrangements, if any), the rating of the securities will be determined.

Benefits of Securitisation to its Participants

Originators—including corporates, banks and public sector entities—securitise their assets for a variety of different reasons. The following is a non-exhaustive list of common reasons for securitisation:

- raise funding in the form of the purchase price to be paid by the SPV upon the sale and transfer of the securitised assets;
- limit credit exposure to assets. Typically, following securitisation the Originator's credit exposure will be limited to any credit enhancement it may provide. In the case of banks, this may allow them to obtain regulatory capital relief. At the same time, the Originator usually retains the ability to extract future profits from the assets;
- improve balance sheet efficiency. A true sale securitisation may move the assets off the Originator's balance sheet, contributing to an improvement of the relevant balance sheet ratios. For instance, to the extent that proceeds of the securitisation are used to repay existing liabilities, this may reduce the Originator's leverage;
- tap different funding sources. Securitisation allows the Originator to diversify its funding sources away from banks and tap the capital markets (almost) directly, without having to issue securities on its own. Originators who already have established direct access to the capital markets (e.g., companies who have already issued corporate bonds) sometimes enter into securitisations to demonstrate to the capital markets that securitisation is available to them as a source of funding and to access different types of investors;
- reduce funding costs. The weighted average cost of the securitisation may be lower than the cost of the Originator's current bank or other debt. Notably, this is often the case if the credit quality of the securitised assets is higher than the credit quality of the Originator's balance sheet as a whole; and
- match assets and liabilities (securitisation provides a more flexible method by which assets and liabilities can be matched).

Investors in asset-backed securities can benefit in a number of ways, including the following:

- through asset-backed securities, they can invest in asset classes and risk tranches of their choice and generate the associated returns. This offers investors the opportunity to optimise the structure their portfolios and access markets which otherwise they could not invest in;
- asset-backed securities have historically often been less volatile as compared to corporate bonds;
- asset-backed securities have been known to offer a yield premium over comparably rated government, bank and corporate bonds;
- asset-backed securities are usually not susceptible to event risk or the risk of a rating downgrade of a single borrower.

It is worthwhile to note that securitisation is generally not specifically perceived as a tax efficient structure. Typically, the parties seek to keep the effects of securitisation on the participants' tax position (including income and value added tax) neutral.

The Securitisation Market in Europe and the United States

The securitisation market began in the 1970's in the United States with the securitisation of residential mortgages by the Government National Mortgage Association. During the 1980's the market continued to develop in the United States with the introduction of new asset classes—in particular, auto loans and credit card receivables. It started to grow exponentially in the 1990's, expanding to virtually all types of assets which yield future cash flows. The market now represents one of the most prominent fixed income sectors in the United States, with annual new issues of approx. USD 450 billion.

In Western Europe the securitisation market developed in the late 1980's and early 1990's. The initial key asset classes were residential mortgages and consumer loans. It has rapidly developed in the 1990's particularly in the United Kingdom, France, Spain, the Netherlands, Belgium, Germany and Italy. New European issues in 2003 amounted to approx. EUR 160 billion. Lately, securitisation has also been increasingly used as funding instrument by a number of European governments and other public authorities.

Securitisation Laws Adopted by European Countries

In recognition of the benefits of securitisation, and the need of market participants to use securitisation as a funding and investment instrument, a number of European countries have adopted specific securitisation laws. These countries include France, Italy, Spain, Portugal and Greece. Further, Luxembourg and Poland have announced that they will adopt securitisation legislation in the imminent future. The content of these laws differs as each has been specifically designed to overcome legal obstacles which had previously prevented the use of securitisation in the relevant jurisdiction. A summary of some of these laws is provided in the Annex to this Position Paper.

PART II: Technical Aspects of Securitisation

Parties and their Roles

The key parties involved in a securitisation and their roles³ are as follows (further parties may be involved depending on the structure of the individual transaction):

- **Originator**—owner and “generator” of the assets to be securitised. Examples of Originators are: banks and other financial institutions, corporates, governments and municipalities;
- **Seller**—seller of the assets to be securitised. In many cases, the Seller and the Originator in a transaction are identical. This is however not necessarily the case. For instance, an entity may purchase assets from its affiliates and then act as central Seller in a securitisation;
- **Purchaser**—a special purpose vehicle (SPV) which purchases the assets to be securitised. The Purchaser funds the purchase price by issuing asset-backed securities into the capital markets (in this capacity, the Purchaser is also referred to as the *Issuer*);
- **Servicer**—services the assets to be securitised (frequently the Originator retains this role). Where receivables are securitised, the Servicer will collect, administer and, if necessary, enforce the receivables;
- **Back-up Servicer**—will service the assets in the event the Servicer is unable to service them, or in the event the Purchaser exercises its right to remove the Servicer (for instance, as a result of the insolvency of the Servicer);
- **Liquidity Facility Provider**—provides a liquidity facility in relation to certain tranches of the asset-backed securities. Typically, a liquidity facility is provided in conduit transactions⁴ where the Purchaser issues revolving short-term commercial paper to fund the purchase of the assets. The Purchaser may draw upon the liquidity facility if it is unable to refinance maturing commercial paper because of a market disruption. The liquidity facility thus secures commercial paper investors against a default in such a case. Liquidity facilities are also sometimes required in standalone securitisations;
- **Investors**—purchasers of the asset-backed securities. Examples of investors in the securitisation market are: pension funds, banks, mutual funds, hedge funds, insurance companies, central banks, international financial institutions and corporates;

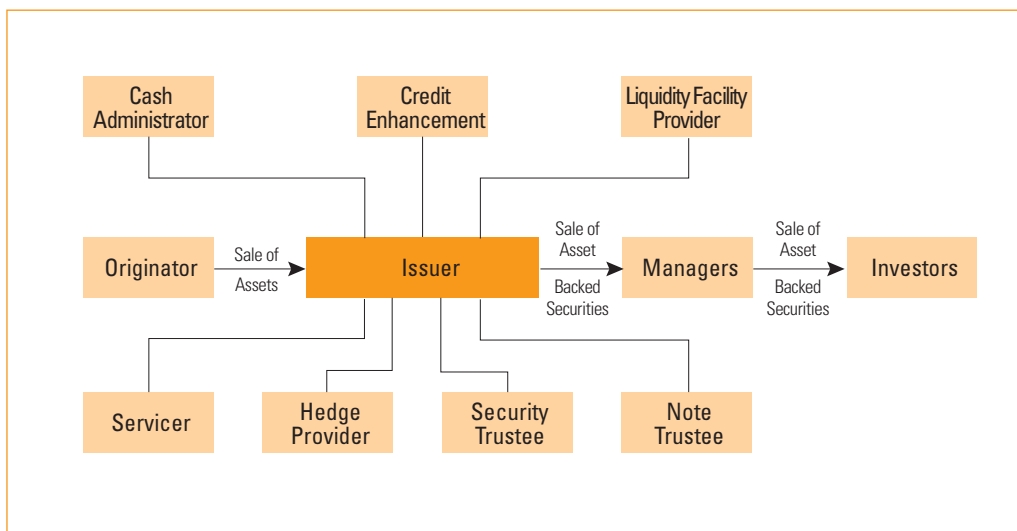
³ Further details of their roles will be set out in Paragraph 2 below.

⁴ See below for details.

- **Lead Manager**—arranger and structurer of the transaction (in the context of conduit transactions, also referred to as *Programme Administrator*). The Lead Manager is often the primary distributor of the asset-backed securities in a particular transaction. Individual distributors are also referred to as *Managers*;
- **Rating Agencies**—rate the asset-backed securities. The three key rating agencies in securitisation are Standard & Poor’s, Moody’s and Fitch;
- **Hedge Providers**—hedge any currency or interest rate exposures the Issuer may have;
- **Cash Administrator**—provides banking and cash administration services to the Issuer;
- **Security Trustee**—acts as a trustee for the secured creditors of the Issuer (notably, holds the Issuer’s assets granted to it as security for the Issuer’s obligations, on behalf of the Investors);
- **Note Trustee**—acts on behalf of the holders of the asset-backed securities;
- **Auditors**—if necessary they audit the asset pool as may be required under the documentation of the relevant transaction.

Typical Securitisation Structures

True Sale Securitisation



Description of the Structure

The above diagram shows a typical structure for a true sale securitisation. The Originator (for instance a bank selling mortgages) sells certain assets (the Assets) to the Issuer. The Assets will be serviced by the Servicer (often the Originator), for instance with respect to mortgages sold to the Issuer, the Originator will continue, on behalf of the Issuer, to collect principal and interest from borrowers on such mortgages and will, where appropriate, take enforcement action in respect of such defaulted mortgages. As the Issuer has no employees it will appoint a Cash Administrator to make all relevant payments on its behalf and is also likely to appoint a company to provide company secretarial and other administrative functions.

The Issuer funds the purchase of those assets by selling asset-backed securities (whose performance is dependent on the performance of the Assets) (the *Bonds*) to the Managers who will in turn sell those securities to the Investors. Investors will be free to sell the Bonds or retain them.

Cash Flow Types of Securitisation Structures

There are three most common types of securitisations from the perspective of cash flow: Collateralized Debt, Pass-Through and Pay-Trough structures.

Collateralized debt is the form most similar to traditional asset-based borrowing. The owner of assets borrows money and pledges assets to secure repayment. The assets pledged may be measured according to their market value upon sale or their ability to generate a cash flow stream. The debt instrument need not match the cash flow configuration of any of the assets pledged.

Pass through securitisation is the simplest way to securitise assets with a regular cash flow, by selling direct participations in the pool of assets. In other words, a pass-through certificate represents an ownership interest in the underlying assets and thus in the resulting cash flow. Principal and interest collected on the assets are “passed through” to the security holders; the seller acts primarily as a servicer.

A **pay-through debt instrument** is a borrowing instrument, not a participation. Under the pay-through structure, the assets are typically held by a limited purpose vehicle that issues debt collateralized by the assets. Like a pass-through, the debt service is met by cash flow “paid through” to investors out of the pledged collateral. Investors in a pay-through bond are not direct owners of the underlying assets; they have simply invested in a bond backed by some assets. Therefore, the issuing entity can manipulate the cash flows, into separate payment streams. Thus pay-through securities may be structured so that asset cash flows can be reconfigured to support forms of debt unlike those of the underlying assets.

Structure of the Issuer SPV

Issuers are usually incorporated as insolvency remote entities. By virtue of its corporate constitution, the Issuer may not engage into any transactions other than those necessary to effect the securitisation (“limited purpose–concept”). As a consequence of the “limited purpose-concept” the SPV will not be allowed to issue any additional debt or to enter into mergers or similar transactions. All parties to contracts with the Issuer agree that they will not petition for the winding up or insolvency of the Issuer, and the Issuer commits not to enter into a voluntary liquidation. In addition, the parties will acknowledge that the extent of any rights they may have is limited to the available assets of the Issuer, and subject to the order of priority (the “payment waterfall”) agreed in the transaction documents. Where the issuer is a company, it is often owned by a charitable trust, ensuring independent control of the Issuer. Often the Issuer’s assets will be pledged to the respective note holders.

Bonds: Listing and Investor Guidelines

Bonds are often listed on a stock exchange (in Europe the Irish Stock Exchange and the Luxembourg Stock Exchange are two of the most popular). One of the principal reasons for listing bonds is that Investors’ internal investment guidelines require them to invest in listed securities. In addition, such guidelines also require that the Bonds are rated

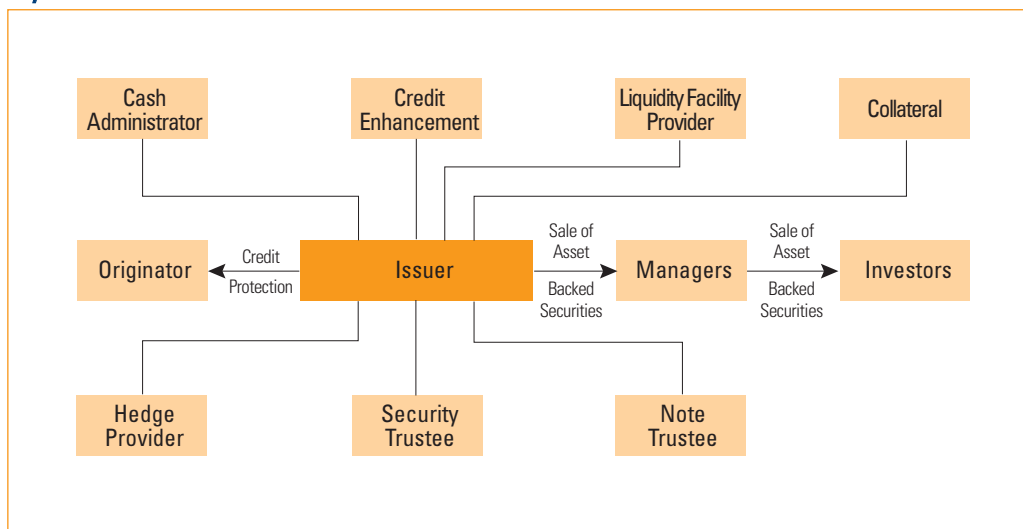
(many Investors require that Bonds are rated at least investment grade or above) by a rating agency. The higher the rating a Bond achieves the wider the potential investor base and the lower the interest rate payable on such Bond—a high rating indicates a high likelihood the Issuer will be able to pay interest and principal on the Bonds.

Conduit vs. Standalone Transactions

In conduit transactions, the Purchaser (also referred to as *Conduit*) usually purchases and securitises assets from a number of different Originators. The Purchaser refinances these purchases by issuing asset-backed commercial paper into the capital markets. Commercial paper are short-term fixed income securities, the interest component of which is typically reflected by a discount on the issue price. At maturity, commercial paper are redeemed at par. Depending on the structure, the Purchaser may also borrow the necessary funds from another entity (the *CP Issuer*) which issues the commercial paper. To address the risk of a disruption in the commercial paper markets, the Purchaser (or CP Issuer) must obtain stand-by funding through liquidity facilities from highly rated banks. Conduits are usually organised by banks who arrange securitisations for their clients. Those banks might also provide additional support to the Conduit, in the form of a “programme credit enhancement” if required by the Rating Agencies.

In a standalone transaction the Purchaser only purchases assets and issues asset-backed securities in the context of a single securitisation transaction. Typically, the Purchaser in a standalone transaction does not issue commercial paper, but securities with a term sufficiently long to cover the entire transaction. Investors are protected against the insolvency of the Purchaser through a security structure whereby the Purchaser pledges its entire assets to a Security Trustee, who holds the assets for the benefit of the Investors.

Synthetic Securitisation



The above diagram shows a typical structure for a synthetic securitisation. As you will note it is very similar to a “true sale” and most of the structural features are the same. The key difference is that the Originator does not sell any assets to the Issuer (and there-

fore, does not obtain any funding or liquidity under the transaction). Instead the Originator will enter into a credit default swap with the Issuer in respect of an asset or pool of assets. Under this contract the Issuer will pay the Originator an amount equal to any credit losses suffered in respect of such asset or pool of assets (less a minimum threshold amount—similar to an “excess” in insurance). The Originator’s exposure to those assets is therefore transferred to the Issuer. The Originator in return will pay a fixed amount to the Issuer, usually on a quarterly basis.

The Issuer will issue Bonds to Investors via the Managers. The Issuer’s ability to repay principal and pay interest under the Bonds will depend on whether the Issuer has to make payments under the credit default swap. The Issuer’s income streams in a synthetic transaction are the fixed amounts paid by the Originator under the credit default swap and interest amounts received on the collateral.

In order to collateralise its obligations under the credit default swap and the Bonds the Issuer usually purchases securities as collateral. These are normally highly rated government debt securities. They also need to be relatively liquid in order that they can be sold and the proceeds used to pay amounts under the credit default swap or Bonds, as the case may be.

“Whole Business” Securitisation

This type of securitisation originated in the United Kingdom. It involves the provision of a secured loan from an SPV to the relevant Originator. The SPV issues bonds into the capital markets and lends the proceeds to the Originator. The Originator services its obligations under the loan through the profits generated by its business. The Originator grants security over most of its assets in favour, ultimately, of the Investors. “Whole business” securitisation is sometimes used to finance a taking private or management buy out of the Originator.

Typical Elements of a Structure

The following describes structural features which are often used in transactions to improve the credit quality of the issued securities and better protect investors’ interests.

A key feature is that payments made by the Issuer to holders of Bonds and other relevant parties are made in strict sequence in accordance with a priority of payments (also commonly called a “payment waterfall”). Thus certain parties will be paid out in full before others.

The quality of the Bonds can be enhanced by issuing a number of tranches or classes of Bonds. For instance, if two tranches are issued Tranche A will be senior to Tranche B. Thus, payments on Tranche B will be subordinated to payments on Tranche A (payments are usually split between principal and interest with both types being subordinated) by way of the priority of payments. Therefore no payments can be made in respect of Tranche B until payments due on that date have been made in full in respect of Tranche A. Tranching of a bond issue is a form of credit enhancement (i.e. it enhances the credit of the more highly rated notes).

If the Originator is not able to allocate inflows of cash to its accounts receivable at the necessary speed, a pledge of the bank account at which proceeds from the Assets arrive, or the establishment of an escrow or blocked account structure could be used to mitigate commingling risk.

Other common forms of credit enhancement are cash deposits from Originators and reserve accounts, which may be formed of a deferred portion of the purchase price payable for the Assets. The Issuer will utilise the credit enhancement available when there is a payment default or other loss in respect of the Assets.

The Issuer should also hedge any currency or interest rate risk that it may have, through hedging contracts with highly rated counterparties. If, for instance, the Assets provide an income which is fixed rate but some or all of the Bonds are floating rate the Issuer will enter into an interest rate swap which will hedge its interest rate exposure (an increase in floating rates would lead to the Issuer having to pay more under the Bonds while receiving the same income from the Assets). The Issuer will pay the Hedge Provider a fixed rate and will receive a floating rate. Similar hedging arrangements are necessary if the currency of the Assets differs from that of the Bonds.

Typically the Hedge Provider is an investment bank (often the Lead Manager). The Hedge Provider will usually enter into what is called a “back-to-back” hedge with the Originator which will pass on the relevant risk onto the Originator.

Frequently a liquidity facility is put into place. A liquidity facility is a stand-by bank facility which may be drawn in the event that the Issuer is unable to repay maturing. Commonly, the liquidity facility may be drawn in case of a market disruption (if the securities are issued in the form of revolving commercial paper), but also if the quality of the Assets has decreased in such a way as to no longer allow for funding through issuance of highly rated asset-backed securities, or if cash flow shortages occur. Generally however, the liquidity facility may not be used to refinance defaulted Assets and thus, is not a credit enhancement.

In standalone securitisations⁵ the Issuer will typically grant security over the Assets together with all its rights under the contracts it enters into in favour of the holders of the Bonds (the Investors) and—if applicable—other parties to the transaction. The Security Trustee will act on behalf of these secured creditors. In order to facilitate communication with the holders of the Bonds a Note Trustee is appointed which acts on behalf of Investors.

Role of the Rating Agencies

Rating Agencies provide, in the context of the securitisation market, a credit rating of the asset-backed securities issued by the Issuer. A credit rating is (usually) an opinion on the likelihood that the issuer will be able to pay full principal and interest on the rated security in a timely manner in accordance with the terms of the security.

Rating agencies normally consider the type of assets to be securitised; the structure of the transaction and how it proposes to provide investors with payments of interests and principal; the risks in the transaction (including market, counterparty, sovereign and legal risks); the flow of funds including coverage of all the expenses of the transactions; and debt service coverage whether internal or from a third party credit and/or liquidity provider. The entire analysis is, typically, effected on the basis of criteria published by the respective rating agency.

Rating Agencies play an integral role in securitisations (at least those that are rated) and have a considerable degree of input with respect to how cash flows and the legal framework are structured in a securitisation.

⁵ Cf. Paragraph 2.2 above for an explanation of the term “stand-alone transaction”.

Impact of Basel II

Basel II is the name for the process of amending the current bank regulatory capital framework (the Basel Capital Accord originally signed in 1988). In essence, under Basel II banks will have to allocate regulatory capital to their assets based on a sophisticated system of individual ratings (rather than based on the relatively simple, global rules established under the 1988 Basel Capital Accord). Basel II is currently scheduled for implementation in late 2006.

The current proposals have specific sections on securitisation and will have an impact on securitisation. Basel II will determine to what extent, and under which conditions a bank may obtain regulatory capital relief if it securitises its assets, as well as how much regulatory capital must be allocated by a bank purchasing asset-backed securities. Basel II will also contain rules on how much regulatory capital should be provided for the provision of liquidity facilities.

Whether Basel II will have a direct impact on domestic investors and originators in the Russian Federation will depend on whether Russia becomes a signatory of Basel II or if it enacts equivalent legislation. Irrespective of this, Basel II will impact the ability of investors which are subject to Basel II to invest in Russian asset-backed securities.

Accounting Rules

Depending on the accounting rules applying in the individual case, true—sale securitisation will in many cases have an impact on the financial statements of the transaction participants, notably the Originator. For instance, the sale of assets might result in those assets being removed from the Originator's balance sheet. At the same time, the Originator would record an increase of its cash position, reflecting receipt by it of the purchase price. Also, in certain cases the Originator might have to consolidate the SPV.

The effects of securitisation on the Originator's financial statements will vary depending on the jurisdiction and the accounting rules which have to be applied. The following gives a brief overview of the treatment of securitisation under IAS⁶, because in a large number of jurisdictions consolidated financial statements of large corporations are prepared in accordance with IAS. One of the standards which is particularly applicable to securitisation under IAS ("IAS 39") has changed only recently, in December 2003, and therefore, the following description is subject to further review based on developing common practice of the new rules.

For consolidated financial statements, the first step is to consolidate any SPE in accordance with SIC 12. In essence, the SPV will have to be consolidated if its activities are conducted on behalf of the Originator; if decision making powers with respect to the SPV have been retained by the Originator or delegated via an "auto-pilot" mechanism; if the majority of any economic benefits which will be distributed by the SPV, have been retained by the Originator; and/or if the majority of the residual or ownership risks have been retained by the Originator. The next step is to determine whether an asset has been transferred to a third party. The assumption of a contractual obligation to pay the cash-flows to a third party, for example through the issue of securities by a securitisation SPE, can in some circumstances qualify as a transfer, subject to certain conditions.

The next step is to consider whether the group has retained substantially all the risks and rewards. If it has, the assets remain on balance sheet. If not, then one considers whether control has been retained. If the group has not retained control it derecognises

⁶ "International Accounting Standards"

the asset and recognises any new rights or obligations arising, i.e. ‘components approach’. If the group retains control it continues to recognise the asset to the extent of its continuing involvement.

Securitisations in particular will be affected by the new rules and typically existing structures will fail to qualify as a result of the transfer of the risks and rewards test. Consequently securitised assets will remain on an originating entity’s consolidated balance sheet. If, however, they do pass the risks and reward and control tests, the continuing involvement provisions will require a complex calculation to determine the amounts to be retained on balance sheet and the extent of any gain or loss on sale.

Key Requirements for a Legal System to Allow for Securitisation Transactions

There are a number of key legal issues which arise in most securitisations. A positive answer or a workable solution with respect to those issues is a prerequisite for a successful securitisation. Set out below is a brief list of some of the key issues that arise or must be considered. At the same time, this list summarizes which requirements a legal system should meet for securitisation to be legally feasible.

- Generally, only assets capable of being transferred can be securitised. Any obstacles to a valid transfer—such as prohibitions of assignment of receivables or data protection or banking secrecy rules, where these can prevent the validity of a transfer—reduce the scope of assets eligible for securitisation;
- Ability to effect a true sale: the sale and transfer of assets which are to be securitised should be irreversible. It should not be affected by an insolvency of the Originator. Notably, it should not be subject to a re-characterisation or insolvency claw-back;
- The transfer should not be overly costly or cumbersome. For instance, any cumbersome perfection requirements, such as the need to notify an obligor of the assignment in order for the assignment to be effective, or the need to register the transfer, may reduce the scope for securitisation and increase transaction costs;
- Effecting assignments of receivables without notification to the obligor should be possible. The Originator should be allowed to service securitised assets for the Purchaser;
- The Purchaser should be able to enforce its ownership rights with respect to securitised assets efficiently and should be allowed to appoint a Back-up Servicer if necessary;
- The parties should be able to enter into effective security arrangements, to provide credit enhancements, mitigate commingling risk and/or install a security trustee. Cash, bank accounts and marketable securities as well as securitised assets should be capable of being effectively pledged. The pledge should be capable of giving the pledgee an enforceable, first ranking right in the insolvency of the pledgor or Originator (or, as the case may be, Issuer). Enforcement of security must be transparent and relatively efficient;
- In order to achieve insolvency remoteness of the Issuer, limited recourse provisions and nonpetition covenants agreed between the parties should be enforceable;
- Subordination arrangements should be enforceable. For instance, an agreement whereby the rights of Investors in a “junior” tranche of asset-backed securities are subordinated to the rights of Investors in “senior” tranches, should be enforceable in the insolvency of the Issuer;

- Securitisation should be capable of being effected in a tax-neutral way. Any transfer taxes or stamp duties, or similar levies increase transaction costs and make securitisation less feasible. The participants should not suffer any adverse income tax or VAT consequences as a result of securitisation.

Tax Treatment of Securitisation

Creating a securitisation transaction typically results in new revenue flows and transfer of rights or asset. In a typical transaction, the Originator of the asset pool has to sell the portfolio to a new owner (often an SPV) and this new owner, known as the Issuer (or Purchaser), will then seek funding via notes and bond issuance. Ensuring that the tax consequences of a securitisation transaction are known with certainty in relation to both the Originator and the Issuer is a vital aspect of any securitisation structure.

The key tax objective in a securitisation transaction is to achieve tax neutrality. This means to ensure as far as possible that the securitisation transaction does not lead to any additional tax liabilities arising nor to any acceleration of tax liabilities than would have been the case had the securitisation not taken place. In practice, in many cases a securitisation transaction may lead to some level of tax cost, although in these cases it is important that such costs are known with certainty in advance such that a decision can be taken by the Originator on whether the costs can be considered as acceptable deal costs having regard to the overall commercial benefits of the transaction.

Achieving a high degree of certainty in relation to the tax position of the Issuer is also a pre-requisite of any securitisation transaction since the market will require a high degree of assurance that there will be non unexpected tax charges arising in the Issuer. Indeed, in some cases an indemnity may be required from the Originator in respect of any unforeseen tax charges which may arise.

ANNEX:

Summaries of European Securitisation Laws

For purposes of illustration please find a brief abstract of securitisation laws enacted in Italy, Spain, France, Greece and Portugal, and legislation to be adopted in the near future in Poland. This abstract does not purport to be a complete analysis of the respective securitisation laws.

Italy

The Italian Law Nr. 130 dated April 4, 1999 is designed to facilitate securitisation transactions in Italy. The Law allows for the securitisation of receivables through thinly capitalised special purpose companies (“SPVs”) incorporated in Italy. The Law creates an exception to the general rule that an Italian company may only issue debt up to the amount of its nominal capital. Also, interest payments to holders of asset - backed securities, which are not resident in Italy are (under certain conditions) exempt from withholding tax. The SPVs’ shareholders and directors are subject to certain integrity requirements, similar to those of banks. SPVs are subject to supervision by the Bank of Italy and are required to submit certain information on their securitisation transactions to the Bank of Italy.

SPVs may not engage in any business other than securitisation transactions. In the insolvency of the SPV the securitised assets are ring-fenced for the benefit of the holders of asset-backed securities (and, if applicable, a trustee, a liquidity provider or a swap counter - party, as well as a credit enhancer).

The Law also provides that an assignment of receivables to an SPV may be perfected by publication in the Italian official gazette, rather than by notification of each individual debtor (as would normally be the case). Any security or other collateral attached to the receivable will be automatically transferred with the assignment. As a result, the transfer of a mortgage does not require a filing with the land registry, which would otherwise trigger a court fee.

Spain

The three laws which form the legal environment for securitisation in Spain are: the Royal Decree 926/1998 dated May 14, 1998 (the “Royal Decree”), which regulates asset securitisation funds and securitisation funds management companies; Law 19/1992 regarding the regulation of real estate companies and investment funds and of mortgage securitisation funds; the Spanish Finance Act (the “Finance Act”) promulgated by Law 44/2002 on November 22, 2002; and the New Insolvency Act, which was approved by the Spanish central parliament on July 9, 2003 to come into force on September 1 2004.

The Royal Decree defines securitisation funds as separate estates without legal personality made up (as regards their assets) of financial assets and other rights and (as regards their liabilities) of debt securities and loans granted to them by credit institutions. Securitisation funds must obtain at least 50% of their funding by issuing debt instruments. In addition, securitisation funds may raise subordinated funding from institutional investors.

According to the Royal Decree, both existing and future receivables may be securitised. The Royal Decree specifically mentions the right of the concessionaire to motorway toll collections and other analogous rights to be determined by Orders of the Ministry of Economy and Finance.

The Royal Decree requires that (in principle) originators must have available audited accounts for at least the most recent three financial years, and must file their annual accounts with the Securities Market Commission. Originators must include certain information in their annual accounts on the assignment of future receivables. Generally (unless the parties agree otherwise) the originator retains the administration and collection of the securitised receivables. Originators must assign their receivables unconditionally and without recourse.

The Royal Decree distinguishes between Closed Funds (whose assets and liabilities may, generally, not be modified except in specific circumstances) and Open Funds (through which, for instance, revolving assets can be securitised).

The Securities Market Commission supervises compliance with the provisions of the Royal Decree. The Securities Market Commission may request audits of securitisation funds and their assets. There is a general rating requirement for securitisation funds. Management companies of securitisation funds are subject to a number of special regulations regarding their purpose, authorisation and activities.

The Finance Act created a new type of debt security (so-called “territorial bonds”) that may be issued by credit institutions in order to refinance receivables against public—sector borrowers. These receivables are ring-fenced in favour of the holders of the territorial bonds. The Finance Act also exempts receivables from public-sector entities from certain bankruptcy avoidance rules.

The New Insolvency Act creates a new insolvency regime for Spain. Amongst other provisions, it will abolish the severe claw back risk currently associated with bankruptcy.

France

In France, the legal grounds for securitisation transactions (“titrisations”) were established as early as in the beginning of 1988.

The securitisation of receivables occurs through so-called “Fonds communs de créances” (“FCCs”), which are funds without legal personality. An FCC is represented and managed by a management company. The FCC issues units, which in turn, represent a claim for payment of the proceeds from the FCC’s assets in favour of the holder of the unit.

An FCC may acquire receivables from different originators. Either the originator or a credit institution may act as servicer. Since 1998, FCCs may not only securitise the receivables of credit institutions, but also of other types of originators. Future receivables, as well as defaulted receivables may be the subject of a securitisation, although there are restrictions on eligible investors for these.

Being pools of assets without legal personality, FCCs cannot become subject to insolvency proceedings. The insolvency of any other participant in a securitisation transaction

is dealt with in accordance with the general principles of French insolvency law.

Under an amendment of the FCC law in 1999, it was clarified that the creation of umbrella FCCs comprising several distinct compartments with separate assets and liabilities, and limited recourse between each other, is possible.

The loi de sécurité financière n°2003-706 of August 1, 2003 (the “Financial Security Law”) ranks among the major improvements of the FCC legal framework. Amongst others, the Financial Security Law entitles FCCs to issue debt instruments (in addition to co-ownership units). This allows to forego the two-tier structures previously used by market participants in order to be able to purchase debt securities typically issued by offshore special purpose vehicles, which in turn held the units in the FCC. The Financial Security Law also increases protection of FCCs against commingling risk by allowing the FCC’s management company and the receivables’ servicer to agree that funds collected on behalf of the FCC will be credited to a bank account dedicated to the FCC and beyond the reach of the servicer’s creditors. Finally, under a future decree, FCCs will be granted more flexibility to enter into derivatives, allowing them to act as credit protection sellers and as issuers in synthetic CDO transactions.

The Financial Security Law also specifies that the assignment of a receivable entails the transfer of security interests, guarantees and other ancillary rights attached to the receivable. The transfer is enforceable against third parties without any further formalities.

Portugal

The Portuguese government enacted the Securitisation Law (Decree—Law 453/99) on November 5 1999, amended on April 5 2002 by Decree—Law 82/2002 (the “Securitisation Law”). On August 4, 2001, the Securitisation Tax Law (Decree—Law 219/2001) was approved setting out the tax regime for securitisation in Portugal (the “Securitisation Tax Law”). As of December 6, 2003 Law 103/2003 and as of December 5, 2003 Decree Law 303/2003 came into force mainly setting out the framework for securitising receivables held by the Portuguese state and other public entities and broadening the scope of securitisable assets.

The Securitisation Law provides for two types of special purpose vehicles, namely securitisation funds [Fundos de Titularizaeco—FTCs] and securitisation companies [Sociedades de Titlarizaeco—STCs]. These are the only entities that can purchase receivables and issue securities under the Securitisation Law.

FTCs are collective investment funds and can be closed or open-ended. Only limited liability companies incorporated in Portugal may be managers of FTCs. They are subject to a number of regulatory requirements.

An STC must be a limited liability company. The law stipulates certain minimum capital requirements for STCs, limits their capacity to enter into certain transactions, imposes various registration and authorization requirements (implemented by the Securities Commission), and states that STCs may only engage in the business of securitisation.

The Securitisation Law defines securitisable assets as receivables that derive from a contractual or other legal relationship. Furthermore, the Securitisation Law requires that receivables must be of pecuniary nature, freely assignable and unconditional. A receivable which is to be securitised may not be encumbered, pledged or seized. Receivables can only be sold if they arise from an existing or predictable legal or contractual relationship.

In principal, under the Securitisation Law, an assignment will only be effective against the debtor upon notification. However, if the originator is a bank, a financial company, an insurance company, a pension fund or a pension fund manager, the assignment of a receivable does not require any acknowledgement or acceptance by, or notification of the debtor.

Pursuant to Law 103/2003 the State and other public entities may securitise tax receivables, social security receivables as well as court fees and legal fees owed to the state. The law contains detailed rules on the assignment and servicing of such receivables. Furthermore, the new law allows for the securitisation of overdue receivables, conditional or disputed receivables, and receivables under litigation. Also, the new law admits assets other than receivables to securitisation, such as bonds. The Securities Commission is given the authority to add new types of securitisable assets by promulgating additional implementing rules. Finally, the new law also eases rules on the use of proceeds of securities assets, and allows for appointment of a common representative of bondholders.

The Securitisation Tax Law establishes a special tax regime for STCs that are incorporated under the Securitisation Law. Notably, interest paid by FTCs and STCs to investors resident outside Portugal will be exempt from withholding tax, and certain payments associated with FTCs and STCs are exempt from stamp duty.

Greece

In 2003 the Greek government enacted Law L3156/2003, which facilitates asset-backed securitisation in Greece. The Greek law introduces the concept of a special purpose securitisation vehicle (“SPV”), which must be a Greek company with registered shares. The SPV’s exclusive purpose is to acquire receivables under the law, to issue debt and to enter into insurance and hedging contracts (including derivative contracts) for the purposes of securitisation. It is however not mandatory to use a Greek SPV in order to securitise a Greek originator’s assets.

Notes offered by a Greek SPV may only be offered in a private placement, to not more than 150 persons.

The receivables, which may constitute claims against any third party including consumers, may be existing and/or future receivables, as long as they are identifiable (even if they are conditional). Certain rights that are accessory to the receivables, such as guarantees, mortgages and pledges, may also be transferred. Ancillary rights to the receivables, contractual rights, rights of set-off or even certain rights to procedural preferential treatment may also be transferred.

The law introduces new formalities as to how to validly perfect an assignment. Firstly, unless the parties agree otherwise, the transfer contract must be registered in a specifically created public register (the “Registration”) for the receivables to be transferred. Secondly, the SPV or the originator must notify the debtors about the transfer, although notification is deemed to have occurred with the Registration. Furthermore, on registration, all registrable and registered security interests accessory to the receivables, such as mortgages, can be transferred to the SPV. Registering the transfer contract gives rise to a statutory security interest over the receivables and the monies standing to the credit of the collection accounts. The statutory security interest arises in favour of the noteholders and other secured creditors, such as swap counter-parties, a liquidity provider or a monoline insurer. The claims of such creditors rank ahead of any statutory preferential creditors set out in article 976 of the Greek Civil Procedure Code, includ-

ing tax authorities. After registration, the receivables cannot be validly encumbered until the security taken for the securitisation is released.

The originator, a credit institution that operates in the European Economic Area or any third party (if it has guaranteed the receivables or had already been servicing them prior to the transfer) may act as servicer, provided that the servicing agreement is executed in writing and appropriately registered. The servicer must promptly deposit all collections in a separate interest bearing account and a mandatory note on the account ledgers must state that the monies standing to the credit of the account do not constitute property of the servicer or account bank.

Furthermore, the law provides for exemptions from banking confidentiality and data protection laws to allow for the receivables to be transferred free of any requirements to obtain the consent of the debtors or the Data Protection Authority. The duty of confidentiality is disapplied in the context of the relationship between the originator and the SPV and in the context of the relationship between the SPV and its creditors, but not with respect to any other third parties.

Poland

Currently, three Polish draft laws address aspects of securitisation:

- an amendment to the Banking Law, setting out conditions under which banks may securitise their receivables. Notably, the entity issuing asset-backed receivables must not conduct any business other than the purchase of receivables and the issuing of securities backed by those receivables, and related activities. The originating bank must not have any exposure to the securities issued by the purchaser, and may repurchase receivables sold to the purchaser only within strict limitations. The amendment is set to enter into force as of May 1, 2004 (the effective date of Poland's accession to the European Union);
- an amendment to the Act on Investment Funds, which introduces special “securitisation funds” as new types of investment funds; and
- a Securitisation Act which will comprehensively regulate all issues relating to securitisation. This draft law is currently in its early stages of discussion in the lower house of the Polish parliament (the Sejm).



International Finance Corporation
2121 Pennsylvania Avenue, NW
Washington, DC 20433, USA
www.ifc.org