Chapter 6 International Experience

Experience in Developed Markets

6.1 United States

6.1.1 Securitisation market in the US

The United States is the largest securitisation market in the world. In terms of depth, it is the only market where the securitisation market draws participation from institutional as well as individual investors. In terms of width, the US market has far more applications of securitisation than any other market. Approximately 75%, or more of the global volumes in securitisation are originated from the US. Apart from this, securitisation issues originating from other countries like Japan, Europe and some of the EMs, draw investors from the US.

The residential mortgage market of the United States has been subject to successive transformations in financial institutions and instruments.

6.1.2 Background:

(a) With the federal Government having demonstrated the financial viability of home mortgage lending, a private system of mortgage origination, insurance and financing eventually developed to serve markets that were not reached by the Government programs. Partly in recognition of this phenomenon, the U.S. Congress in 1968 split the erstwhile FNMA into two parts - a new FNMA (Fannie Mae) and the Ginnie Mae. Thus, while it rechartered Fannie Mae as a private shareholder-owned corporation to carry out secondary market functions on behalf of Originators of home mortgages that did not carry Government guarantees, the Congress also created Ginnie Mae to securitise Government-guaranteed loans and handle Fannie Mae's policy related tasks. Thus the newly instituted Fannie Mae was moved off budget and set up as a private, Government-sponsored corporation. Ginnie Mae, on the other hand, continues to remain on the federal budget and is a part of the Department of Housing and Urban Development.

(b) During the 20 years following the re-chartering of Fannie Mae, the Government created a competitor corporation to Fannie Mae in the form of the Federal Home Loan Mortgage Corporation (Freddie Mac). Freddie Mac was created in 1970 and like Fannie Mae, it is a private, Government-sponsored corporation (i.e. off budget). Together these three organisations viz. Fannie Mae, Freddie Mac and Ginnie Mae - have emerged the major operators in the US secondary mortgage market.

6.1.3 The rise of secondary market institutions in the US:

(a) The rise in the secondary markets starting from the 1970s and especially in the 1980s came about largely because of standardisation of pools of mortgages brought on by three Government/Government-sponsored agencies – referred to above. More than 40% of the outstanding stock of mortgages in the US is now in pools that trade with the secondary markets.

(b) In particular, a significant institutional development over the past two decades has been the emergence of two dominant Government-sponsored enterprises (GSEs) in the secondary mortgage market - Fannie Mae and Freddie Mac. The financial advantage conferred by their federal charters have permitted both the GSEs to hold or securitise one and a half trillion dollars of mortgages.

(c) Both Freddie Mac and Fannie Mae deal overwhelmingly in pools of conventional (i.e. not federally insured) mortgages. In sharp contrast, Ginnie Mae deals only in federally insured mortgages. It's guarantee on MBS is on top of the federal insurance, and therefore mainly amounts to a guarantee of 'timely' payment. Though all three agencies

guarantee their issues against default losses, however, because unlike Ginnie Mae, Fannie Mae deals primarily with conventional mortgages, its risk exposure is larger than that of Ginnie Mae (though they have some protection from private mortgage insurance and from regional diversification).

(d) Because Ginnie Mae is 'on budget' it has a 'full faith and credit' federal guarantee. And because Freddie Mac and Fannie Mae are separate corporations, they both have a nebulous, implicit guarantee and are (or soon will be) regulated by the Department of Housing and Urban Development.

(e) To examine the reasons behind the growth of Fannie Mae and Freddie Mac to become the dominant institutions in the residential mortgage market it is important to note that these institutions are Government sponsored enterprises (i.e. were originally created by the Government). A Government-sponsored institution can be defined as a privately owned, federally chartered financial institution with nationwide scope and specialised lending powers that benefits from an implicit federal guarantee to enhance its ability to borrow money. Fannie Mae and Freddie Mac each are chartered by an Act of Congress to serve as a secondary market institution that purchases and otherwise deals in residential mortgages of a specified size. *The two companies are among the largest financial institutions in the world and purchase roughly half of all residential mortgage debt originated in the US each year.* It should be noted that in the case of these enterprises - the distinction between the primary and secondary market is rooted in law rather than in the marketplace; Fannie Mae and Freddie Mac are authorised to purchase, sell and otherwise deal in residential mortgages but are not permitted to 'originate' them.

(f) In return for the limitations upon the business activities in which they may lawfully engage, and since their activities are considered to embody public purpose, the GSEs receive special benefits. These include various tax and regulatory benefits.

(g) While thrifts are required to hold at least 4% capital to back the residential mortgages they hold, 1992 legislation imposes minimum capital requirements for Fannie Mae and Freddie Mac of 2.5% of total on-balance sheet assets and of 0.45% of MBS guaranteed by the GSEs.

(h) However, the most important benefit enjoyed by GSEs is that while the law provides for a highly competitive primary market (including thrifts, commercial banks and mortgage bankers), by contrast, Fannie Mae and Freddie Mac constitute a duopoly in the secondary market for mortgages and thus wield considerable market power.

6.1.4 Growth of the MBS market: Role of GSEs

(a) MBS are created in two ways. One version (called "Cash") involves selling mortgages (e.g. conventional mortgages made by a savings and loan or a mortgage banker) to either Fannie Mae or Freddie Mac in return for cash. The agencies then form pools out of these loans (sizes vary, some pools are over $ 100 million) and sell shares in the loans to dealers, who in turn sell them to investors. The second way (called "Guarantor" or Swap") involves less work by the Government-sponsored agencies.

(b) For a standard pool of fixed-rate mortgages the fee charged by Fannie Mae and Freddie Mac is around 15 to 20 basis points (0.15% to 0.20%). This fee includes a

charge for credit risk and processing, administrating and other costs, net of some "float" income received by the issuer. Ginnie Mae charges a smaller fee, largely because it faces less credit risk, since its loans are federally insured to begin with.

(c) Thus, Ginnie Mae was responsible for the major innovation in secondary markets. Though the FNMA is the oldest of the US Government secondary mortgage market institutions, it was the last to enter the securitisation market. The first FNMA MBS was issued in 1981. SMME Act was passed in 1985 to enable private issuers of securities to compete more effectively with Government-related agencies by removing some of the legal impediments as described in para 5.1.1.

6.1.5 Size of the Securitisation Market:

By 1998, the total volume of securitisation (MBS and ABS) in the USA was estimated at $2.5 trillion with the bulk of it ($1.9 trillion) attributable to Government-sponsored cousins viz. Fannie Mae, Freddie Mac, and Ginnie Mae (which together account for $9 of every $10 of MBS issued).

The other major components of the ABS market include:

(i) Commercial mortgages ($ 200 billion)
(ii) Credit Card and Home equity loans ($ 220 billion)
(iii) Automobile loans ($75 billion)

By the end of 1998, the MBS Outstanding had exceeded the $ 2 trillion mark, whereas ABS were estimated to have reached $ 600 billion. Fannie Mae accounted for the bulk ($ 834.5 billion) of outstanding MBS supply, followed by Freddie Mac and Ginnie Mae at $645.5 billion and $ 538 billion respectively.

6.1.6 Leveraging effects of Government-sponsorship

(a) The federal Government, through implicit and explicit guarantees plays an important role in mortgage markets. It is by virtue of this backing that throughout their more-than-60-year existence, the SMM institutions in the US have managed to play an important and ever-changing role in financing housing. During this period, secondary market organisations have managed to evolve from a single entity that was a part of the national Government to a series of institutions that include private corporations, which retain certain ties to the Government.

(b) Some of the characteristics of Fannie Mae and the strengths it derives from the Federal charter are mentioned below:

(i) The Secretary of the Treasury has discretionary authority to purchase upto $2.25 billion of the corporation's obligations. This treasury authority has never been used.

(ii) The President of the US appoints 5 of Fannies Mae's 18 directors.

(iii) Fannie Mae MBS are acceptable as security for the deposit of public monies subject to the control of the US or any of its officers.

(iv) The Open Market Committee of the Federal Reserve System is authorised to buy and sell Fannie Mae securities in its day-today implementation of monetary policy.

(v) The Secretary of the Treasury must approve the timing and terms of issuance of Fannie Mae debt.

(vi) Like Treasury securities, US national banks and state-chartered banks that are members of the Federal Reserve System may deal in, purchase and hold for their own accounts Fannie Mae securities without limitation.

(vii) Fannie Mae MBS are eligible as security for advances to depository institutions by Federal Reserve banks.

(viii) Fannie Mae debt and MBS generally have the status of securities issued by a 'US Government-sponsored agency' under US risk-based capital regulatory guidelines, which were adopted following the Basle Accord.

It would, thus, appear that there is a strong Government presence in the housing finance sector. The Government, however, does not directly participate in the secondary mortgage market. The backing of the federal Government and the implied Government guarantee to a large proportion of the MBS outstanding has generated confidence among the investors and given stability and growth to the market. *Government sponsorship has leveraged the activities of both Fannie Mae and Freddie Mac, and their success in turn, has spurred the growth of private mortgage securitisation all across the US.*

What is of particular interest is how both Fannie Mae and Freddie Mac, which are stockholder-owned private corporations yet federally chartered and with a public mission to fulfill, have successfully steered the US housing finance sector to its present preeminent position. It may be worthwhile to incorporate these lessons in experience into the Indian mortgage securitisation context.

6.1.7 Non-Performing Assets (NPA):

Box Securitisation of impaired assets[i]

A major extension of application of securitisation has been the activity of Resolution Trust Company (RTC) during 1992 to deal with the problem of insolvent saving and loan institutions (S&Ls or thrifts). After using variety of techniques to dispose off failed institutions, including sales of entire institutions, and of individual securities, other assets including consumer receivables, were securitised. These securities received credit enhancement through subordinated paper and overcollateralisation and through reserve funds which RTC was pledged to maintain. A number of somewhat more difficult claims were eventually securitised in large numbers, including single-family mortgages with high delinquency rates and pools of residential multiunit residential mortgages. Most RTC securitisation of this kind have been rated AA or AAA.

Having disposed of easily saleable assets in this manner, it was necessary to turn to assets that were progressively harder to sell. In doing so, RTC encountered problems similar to those that have hampered securitisation of commercial mortgages, including the large size of individual loans, highly specific terms which limit homogeneity and transferability, problems in developing statistically credible payment histories, and difficulties in obtaining acceptable diversification. Nevertheless, RTC was able to securitise pools of commercial mortgages with enhancement. The different tranches of these securities have been rated from AAA to BBB. Some have been done at fixed rates, and others at floating rates.

RTC had to sell still less liquid assets. There was a large number of non-performing or underperforming mortgages, which required foreclosure, or renegotiations of terms, as well as real estate directly owned by RTC as a result of foreclosures. The property was sold at market value, which was obviously below book value and the investor assumed control in

return for an asset with potential for appreciation, provided that the assets were managed properly. While the senior tranches, which were rated AA or AAA, were widely distributed, the "hard to sell" assets, particularly subordinated tranches, were mainly sold to single investors who wished to maintain control over properties.

The technique developed in liquidating failed thrifts may have wider applicability especially in assets of FIs in EMs. It was possible to sell large amounts of assets , many of which were not easily marketable, in a comparatively short time. By selling assets relatively quickly, the need for Federal support was limited. RTC retained equity to sell large amounts of assets, many of which were not easily marketable, in a comparatively short time. By selling assets relatively quickly, the need for Federal support was limited. RTC retained equity position in many subordinated debts. Many agreements provided for sharing of any gains on sale of the assets. Many of the deals were structured so as to provide investors with marginal control and strong incentives to maximise rates of recovery on assets.

It is interesting to note that NPAs of FIs have also been securitised in USA. One of the issues for the EMs is how to deal with a substantial portfolio of NPAs. As has been experienced in the case of the securitisation of the assets of Resolution Trust Company in the US, these assets can be securitised if they are managed well, have the potential for appreciation and the buyers get opportunity to participate in management. Securitisation can be part of a general programme to rehabilitate financial system. As the experience so suggests, securitisation can be used both to sell good assets held by bad FIs and to dispose off assets that are themselves impaired. The decline in the quality of bank balance sheets and the overhang of bank claims on distressed sectors (e.g. priority sectors in India) mean that banks in several countries are intent upon reducing the size of their balance sheets and making as many assets as possible tradable.

6.1.8 General

The growth in securitisation in developed markets like the US has been concurrent with several other linked developments. These are:

- Increased competition amongst financial intermediaries following de-regulation;
- Regional and sectoral imbalances in capital distribution;
- Regional imbalances in risk profile of borrowers'
- Imposition of capital adequacy standards and increased emphasis on returns on capital;
- Uneconomical spreads leading to a search for fee rather than margin income;
- The deterioration in credit ratings due to weak credit controls and competition;

The US markets have historically been more liquid, innovative and sophisticated. Developing markets on the other hand, are fragmented and small. Nevertheless, the imperatives that acted as principal drivers in the US markets have either already arrived or are beginning to become visible in developing markets also.

6.1.9 US assets securitised outside USA

Issuers of securities backed by assets in US have accessed Euro and Japanese markets with increasing frequency. This phenomenon parallels the broader globalisation of capital markets in general, which has enabled issuers to optimise pricing and terms of securities issued, sometimes through overseas issuance of a security with a particular currency and type of interest rate (fixed or floating), combined with currency or interest rate swaps.

6.1.10 Securitisation outside USA

Australia has a market size of A$ 10 bn. and is dominated by residential mortgages and commercial property leases. In Japan, securitisation is largely undeveloped with transactions

confined to about US$ 4.8 bn.[ii]. In Asia, assets worth only US$ 2 bn. have been securitised, half of which were in Hongkong[iii]. India, Indonesia, and Thailand are the future markets on horizon with a few deals of low volume having been concluded in each country. In Latin America, securitisation transactions were up from about US $ 3.67 bn. in 1995 to 10.3 bn. in 1996. In South Africa, very few transactions have taken place although the Government has enacted a special law in 1992.

6.2 Europe

6.2.1 Growth of the market:

(a) Securitisation originated not in the United States but in Denmark - a mortgage credit system has existed in Denmark for over 200 years now. There is also pfandbrief market in Germany, which is a secondary mortgage market, but the Danish mortgage trading system is very close to the US concept of pass throughs.

(b) Securitisation in the modern sense emerged in Europe in the mid-1980s with the issuance of MBSs in the UK. The early mortgage-backed market was driven by a new breed of so called centralised mortgage lenders which had mortgage origination capabilities far in excess of what they could book on their own balance sheets. Securitisation proved to be a natural and tailor-made option in this situation.

(c) For MBS, the UK has been the major source of collateral; in fact, till recently; three countries (the UK, France and Spain) provided the collateral for almost all MBS issues. A notable entry into the MBS market was Germany, the largest mortgage market on the continent in terms of amount of loans outstanding, where three large deals were issued in 1998. In recent years, securitised instruments in Germany are reckoned as amongst the best debt securities, with the German market absorbing the securitisation process into its financial system well.

(d) Asset classes securitised in Europe have largely fallen into three main categories: residential mortgages, other small ticket consumer and corporate financial obligations, and Government supported flows. Suppliers of goods and services to Governments have taken to repackaging their sovereign debtors into tradable notes and bonds. Credit card receivables, property rentals and utility contracts have also been favoured asset classes.

(e) According to estimates by Moody's Investors Services, annual issuance of European MBS/ABS was less than $10 billion until 1996, when it jumped to $30 billion, then further increased to $45.4 billion in 1997. Volume for 1998, however, was about the same as 1997, at $46.6 billion, as the flight to quality towards the end of 1998 led to a dramatic widening in ABS spreads and reduced issuance to a trickle. The total outstanding volume of European MBS/ABS has been estimated to be about $130 billion, of which perhaps half is MBS.

6.2.2 Regulatory initiatives to promote securitisation:

Enabling laws and regulations in France, Italy, Spain and Belgium have been the leading factors in the growth and spread of proprietary European securitisation since the early 1990s. The most significant regulatory change that Europe has seen took place in May 1998 when German banks were given authorisation to securitise their own loans.

6.2.3 The problems hindering the growth of securitisation in Europe are:

- Many institutions have not faced strong incentives to remove assets from balance sheets, because of favourable funding rates and excess capital;
- The severe recession in Europe in the early 1990s led to a sharp drop in loan origination, further diminishing pressure on balance sheets;
- A lack of legal and regulatory frameworks;

- Few analytic tools and an infrastructure exist for timely reporting of deal information to investors;
- A diversity of mortgage terms and conditions from country to country, such as different prepayment penalties, diminish the appeal of MBS backed by loans from one country to investors in other countries;
- Currency differences have hindered cross-border transactions in the past; and
- Many European investors have tended to focus on sovereign debt, rather than spread products.

6.2.4 Future of securitisation in Europe:

(a) With Europe representing the largest international market opportunity for increased securitisation deals, bankers predict that activity in the region is likely to expand, both in value and scope, over the next five years. The financial community is extremely optimistic about the prospects of ABS issues after the introduction of Euro.

(b) The following factors point to the growing market for securitisation in Europe:
   - The introduction of the Euro is expected to have a major impact, because it will gradually eliminate much of the existing sovereign bond markets, shift investor attention to spread products, especially MBS and ABS because of their high credit quality, and eliminate currency concerns;
   - In the past few years, various countries have made legal and regulatory changes that facilitate securitisation, and this trend is expected to continue;
   - Competitive and regulatory pressures on institutions are mounting, leading to more focus on measures such as return on equity and on efficient balance sheet management;
   - Gradual improvements in MBS deal information reporting systems and more familiarity with cash-flow characteristics should contribute to increasing investor comfort levels with MBS and ABS products; and
   - There has been a continuing broadening of the types of assets being securitised - for example, sub-prime mortgages, student loans, soccer receivables, pub leases, and so on.

Commentators lament that there is no equivalent of the US-type Ginnie Mae or Fannie Mae in Europe - so if securitisation markets have to grow, it is solely out of the needs of the savvy issuers and investors.

6.3 Japan

6.3.1 As late as 1998, the Japanese Diet enacted several laws that are likely to speed the development of a thriving securitisation industry in Japan. Regulators, too have lent their assistance by promulgating regulations that will help clarify some of the outstanding issues that have, so far, plagued the development of Japanese asset securitisation as a viable means of finance.

6.3.2 The Japanese Government has high expectations from securitisation and sees its proliferation as an integral part of the financial liberalisation programme it is instituting. Interestingly, the Japanese Government also sees securitisation as the solution to Japan's bad loan crisis, which has reached the $ 1 trillion mark. While as recently as 1996, over-regulation and the consequent prohibitive costs of securitisation had led many observers to conclude that securitisation may not take off in Japan, the pessimistic sentiments have undergone a complete reversal with these new developments in place.

6..3.3 As securitisation-related financial techniques continued to develop, the development of a general legal framework, which provided measures for investor protection, was necessary. For this purpose, structural reform legislation amended the Japanese Securities and Exchange Law (SEL) to expand the definition of a "security." In April 1996, the Cabinet Order that accompanied the Miti Law was revised to permit an SPV organised under the Miti Law to issue true ABSs.

6.4 Australia

Government sponsored mortgage programme was initiated in Australia during mid 1980s. Reserve Bank of Australia released prudential guidelines for securitisation during 1995. Banks and their subsidiaries have the largest pool of assets, which can be securitised. Australia has well defined foreclosure laws. The securitised instrument ranges from tenure of 30 days (commercial paper) to MBS bond with a legal life of 30 years. There is a clear separation between the Originator and SPV; an Originator cannot own or control the SPV. The credit enhancement facility is limited in amount and time frame. Regarding the SPV structure, there is a complete tax exemption in case of trusts. In the case of corporate, the tax exemption is given in case the inflow and outflows are matching. During 1998, the share of offshore issues increased significantly compared with the domestic issues.

Experience in EMs

6.5 Thailand

The first Thai securitisation transaction took place in the autumn of 1996 involving auto receivables. The Asian crisis resulted in the demise of most of the finance companies and a number of financial intermediaries. This affected the progress of securitisation temporarily, till the enactment of the securitisation law (discussed below).

6.5.1 Legal initiatives to promote securitisation:

Recently, the Thai Government enacted a long-awaited securitisation law called Specific Juristic Person for Securitisation Enactment. The law primarily has the following features:

(a) It defines securitisation and the assets that can be securitised. The regulation of securitisation transactions has been handed over to the Securities and Exchange Commission (SEC). *The law clarifies that the business of the SPV was not a finance business, which would have required a licence.* Entities that can benefit from the law include commercial banks, finance companies, credit financiers, securities companies, etc. Conduct of securitisation transaction would require the approval of the SPV by the SEC. One of the most important effects of the new law is that it overcomes a basic problem of Thai law that requires an assignment of a debt to be backed by notice to the debtor. *The present law eliminates the notification requirement, if the Originator is also the collector.*

(b) Another very important impact of the new law is that the transfer of assets from the Originator to the SPV, backed by mortgage, pledge or guarantee, will be exempt from tax on transfer. Thus, the VAT problem, discussed below, is resolved as far as mortgage-securitisations or other asset-backed securitisations are concerned.

(c) Again, one of the problem areas in Thai securitisation was the possible annulment of the transfer of assets upon the bankruptcy of the Originator. The source of the problem was Sec. 114 of Thai Bankruptcy Code. This problem is resolved by making the Bankruptcy Code inapplicable in case there is a qualifying transfer of assets from the Originator to the SPV. In order for the transfer to qualify, the following are the conditions: (a) the transaction is done at fair market values; (b) the risks and rewards in the assets are transferred to the SPV; and (c) the collateral backing up the assets are also transferred to the SPV.

(d) Though the implementation of the securitisation law has resolved a number of problems inherent in Thai law, the problems remain, in cases where the law does not apply. *For*

example, lease transactions may not be covered by the provision, which exempts the VAT application to transfer of assets. This apart, the law applies only to securitisation by financial entities.

(e) Outside of the securitisation law, a securitisation transaction in Thailand is fraught with many problems - to begin with, the very concept of trust is alien to Thai law, which is different from the English common law system and closer to Civil Law. Assignment of receivables not only requires notification to the debtor, in fact, sec. 306 of the Civil Code provides for a prior sanction of the debtor in order to lawfully assign a receivable, unless the notice of assignment has been served in a proper manner. Registered post is considered as a proper mode of servicing the notice.

(f) Since the Thai law does not recognise trusts, there *are legal issues relating to commingling of cashflows where the Originator also acts as the servicer.*

6.5.2 Taxation of securitisation:

Two taxes that affect a securitisation deal in Thailand are - the Value-added Tax (VAT) and the Specific Business Tax (SBT).

(a) VAT leads to a 10% levy on all sales of goods and services. The definition of "goods" is wide enough to cover incorporeal rights having value. Therefore, transfer of receivables under securitisation transactions are easily trapped by the definition. As noted earlier, the applicability of this tax is exempted on transactions covered by the securitisation law. However, transactions not exempted will be hit, and the tax would really make a transaction unworkable, since the VAT paid at the time of transfer will be irrecoverable. To circumvent this problem, some of the transactions in the past were structured as loans, i.e., the assignment of the receivables from the Originator was taken as a collateral to secure a loan. This solution, obviously, kills the very purpose of securitisation, which is to isolate the assets from the Originator and achieve predominant rights therein with the investors rather than the Originator.

(b) Another tax, applicable on specific businesses, is the SBT. The scheme of the revenue is that on specific businesses, VAT would not apply, and SBT will. SBT is applicable on financial businesses such as banking, finance companies, credit financiers, etc. The levy is 3% of the receipt by way of interest, discount, etc. In case of securitisations by financial entities, it is felt that this levy is applicable rather than VAT, and the impact of this levy is far lesser than that of VAT. SBT is applicable, on the profit from the transfer of receivables, that is, the difference between the discounting rate and the inherent rate of return in the portfolio. This tax can be staggered by transferring the receivables at their inherent rate of return, and extracting profit later by way of either servicing charges (in which case the income may suffer VAT rather than SBT!) or residuary income. However, the tax is only deferred, not avoided.

Withholding tax is applicable to interest payments to individual investors, exempt in case of corporate investors.

6.6 Indonesia

6.6.1 The first securitisation transaction in Indonesia was in August 1996 by PT Astra Sedaya Finance involving an unregulated finance company's auto loan receivables. There were two more transactions involving auto receivables in 1996 and 1997. Besides, there were some credit card securitisations. Even as the market was poised for substantial growth, the Asian currency crisis of 1997 crashed all potential deals. There has been a lull in activity since then.

6.6.2 Legal initiatives to promote securitisation:

(a) In general, the Indonesian legal environment, with a Roman-Dutch system, is friendly towards securitisation. Receivables can be assigned in such a way that they would not be treated as part of the seller's estate if it becomes bankrupt.

(b) Being a civil law jurisdiction, an assignment of a receivable under Indonesian law will be treated as bilateral contract between the assignor and the assignee and will be binding upon the Obligor only when a written notification has been given to the Obligor or the Obligor has consented to the assignment. The formal method of notification permitted under law is reflective of the archaic Roman system: the notice will be delivered by the offices of the Court. This being impractical in most cases the assignee mostly keeps the assignment incomplete by not giving a notice of assignment upfront, but reserving the right to give the notice, either in his own capacity or as holder of power of attorney of the assignor, at a later date if the trigger of default arise.

(c) Indonesia also has some difficulty in defining the legal structure of the SPV. Trusts are not known in Indonesian law; some of the securitisation SPVs have been incorporated as "multifinance companies", an Indonesian version of finance companies engaging in several financial services.

(d) Indonesia embarked on a plan to encourage securitisation, particularly in the local market. BAPEPAM, the capital markets regulator, produced a set of proposals for the regulation of on-shore securitisation including a mechanism for establishing on-shore SPV using some form of mutual fund.

6.6.3 Taxation of securitisation:

Two tax issues continued to prove problematic.

VAT: Thought there is no VAT on the sale price of the receivables, VAT @ 10% is imposed on fees including any servicing fee, and therefore in most deals the excess spread in the transaction is paid to the Originator as deferred purchase price.

Withholding tax: A more difficult structuring challenge involves the issue of withholding tax on interest payments off shore. There are conditions for exemption from this requirement that require creation of taxable SPV in Indonesia. The transactions in the past have circumvented withholding tax by bringing an exempt entity and selling the interest as a separate strip to such exempt entity. However, it is doubtful if such a structure would be permitted by the tax authorities.

6.7 Argentina

6.7.1 Among Latin American markets, Argentina takes a lead: both in terms of the maturity of the market, depth and width of transactions and a generally well defined legal system that permits and promotes securitisation. The Government's policies have generally been receptive. The passage of the Trust Law in 1995 has been an important contributor to the growth of securitisation markets in Argentina.

6.7.2 On the mortgage loans front, the Argentina market is characterised by large market share in mortgage loans with just one bank, Banco Hipotecario Nacional (BHN). With a permissive environment being laid out by changes in securities and banking laws (discussed below), BHN completed the country’s first two securitisations in 1997. The first was a US$93 million issue with a 76:24 blend of variable rate and fixed rate mortgage respectively. The second issue was US$106 million with at 47:53 blend of variable and fixed rate mortgages. The senior securities achieved an investment grade rating in the US (higher than the Argentine sovereign rating at the time of issue) through the use of senior subordination and reserve funds for credit enhancement. There have been some securitisation deals in export receivables as well - YPF Sociedad Anonima has closed some issues relating to export receivables for sale of oil to Chile. Oil royalties have also been securitised by one of the State Governments. In 1998, there were 4 international securitisation deals from Argentina: Banco Mayo's personal loans, Oil Enterprises future oil sales, a third deal of coparticipation tax

revenue receivables, and lastly a credit card receivables securitisation. Domestically, there were about a dozen transactions.

6.7.3 Securitisation law:

(a) In view of the growing investor interest in securitisation transactions, the Argentine Government adopted in 1995 a law on securitisation transactions. The Housing and construction law [no 24,441], actually a Trust law, adopted on January 9, 1995 (an umbrella legislation) contains comprehensive provisions relating to securitisation transactions which, together with Resolution No. 271 of National Securities Commission –CNV (published on September 1, 1995 – similar to rules framed by SEBI in India) delegates to the CNV power of regulation of securitisation transactions.

(b) The Trust law states that the property transferred in trust constitutes a separate estate from that of either the trustor or the trustee. Further, the trust property is exempt from any claims of the trustee's creditors and, except in the case of fraud, the trustor's creditors. The obligations of the trust may only be satisfied from the trust property.

(c) The trustee is a financial institution or an entity authorised by the CNV to act as financial trustee and the beneficiaries are the holders of certificates of participation in the trust property ('certificates") or the debt instruments guaranteed by the trust property ('debt instruments"). The certificates and debt instruments may be issued in bearer form or registered in the holder's name, may or may not be endorseable, may be issued in definitive form or book entry form, or may be issued in global form for centralised depository purposes.

(d) In Regulation 271, CNV provided that financial trustees may be financial entities authorised under Argentine law, entities registered in the Register of Financial trustees held by CNV and the financial institutions chartered by the Central Bank of the Argentine Republic. In order to be included in the Register of Financial Trustees, an entity must be a corporation or, in the case of foreign company, must have a branch or other form of representation in Argentina; its legal purpose must include serving as a trustee; it must have a net worth of at least 100,000 pesos; and it must have an adequate administrative organisation to perform its duties as financial trustees, although administrative services may be contracted out.

(e) The Trust by law provides that interest payments made in respect of debt instruments and certificates to foreign beneficiaries are exempt form Argentinean income tax so long as the trust is created with *the purpose of securitising assets, the public offering of those securities is authorised by the CNV, and the securities are publicly offered in Argentina.*

6.7.4 Other provisions :

- Upon or after signing the trust agreement, and in accordance with its terms, the trustee will be the transferee of the assets or rights which are the subject of securitisation and as of that moment, the trustee will be endowed with title, in trust, to the rights to such principal, interest fees, collateral security etc., which title and rights may not be challenged by third parties if the transfer and the registration are carried out in accordance with the formalities required by the applicable law.
- The transfer of the rights to receive payments to the trustee is binding on the third parties, including the original debtor, as of the moment such party is notified except in the case the debtor has previously agreed by contract to be bound without prior notice.
- The portfolio of loans that may be transferred and held by a trustee will at no time be considered part of the trustee's assets for bankruptcy or other purposes. The transfer may only be challenged by the original debtor in the event the transferor transferred invalid loans or that payment by the original debtor was effected prior to the transfer.

- The Trust Law also establishes certain requirements for the creation of loans, which are guaranteed by mortgage notes. For instance, origination expenses for mortgage loans may not exceed 2% of the price of the sale or of an independent valuation.
- The securities if issued pursuant to the public offering regulations and approved by the CNV, will be exempt from various taxes including the VAT, interest withholding tax, income and capital gains, as well as other taxes.
- Under the Argentine **bankruptcy** code, the court will set a period of suspicion as existing prior to the request for bankruptcy, in which certain transfers will be set aside if, at the time of the transfer, it was reasonably evident that the entity (in this case the transferor company) was unable to pay its debts in a timely manner and, among other indicators, if the purchase price was not for fair value. This period fixed by the bankruptcy judge at no greater than two years before the declaration of bankruptcy, is determined by the court to have begun when the debtor has suspended its payment obligations. Article 86 of the bankruptcy code of Argentina indicates a number of criteria which the court may consider as evidence of the date upon which the debtor can be considered to have entered into such a suspension of payment obligations, in order to fix the date of suspension period, including delay in compliance with obligations, the closing of the administrative offices of the debtor, fraudulent transfers or transfer of goods in payment of obligations or their sale at an unseemly price, and fraudulent attempts to obtain funds.

6.7.5 The special procedure for the **foreclosure** on mortgages established under the trust law may be utilised for mortgage notes and all other mortgage loans in all cases so long as there was no express agreement by the borrower to be bound by the provisions of title V of the trust law. Under such procedure, when there is a delay of 60 days in the payment of the principal or interest, the creditor may notify the debtor of the default, allowing 15 additional days for the delayed payment in full to be received, after which the process of extra judicial foreclosure on the mortgage through an auction may begin. The debtors should also be notified that the extra judicial foreclosure might occur. Thereafter,

- ❖ The creditor may then proceed to present before the appropriate court an action by presenting the mortgage note. After allowing 5 days, the court may proceed to set period of 10 days to vacate the premises, after which the debtor may be forcefully evicted. The creditor would then seek a report from the property registry as to whether any other liens exist and their order of priority to determine if there are claims on the property. The creditor may avoid using the courts altogether and utilise the extra judicial mechanism after requesting the property registry issue a report verifying if there are any liens or other claim outstanding.
- ❖ Specific public notification requirements to foreclose on the mortgage are stipulated prior to the auction and 7-day notification requirements in the case of debtor holding title to the mortgaged property also apply.
- ❖ In the auction, the initial bid must be the amount of the debt in default, and once the property is sold and paid for, expenses related to the sale may not exceed 3% of the loan. Proceeds from the sale along with pertinent documentation shall be deposited with the competent court within 5 days of the auction, which will give the debtor 5 days to challenge or accept the liquidation of the proceeds.
- ❖ After the sale of the property and full payment of the offered price, the sale may not be challenged by third parties.
- ❖ The only defences available to the defaulting debtor are:

-default has not occurred
-payment was not demanded
-the methodology used had not been agreed upon
-lack of proper notice

- ❖ If the loan is not paid in full from the proceeds of the auction and sale, creditors may seek judicial assistance to liquidate any remaining debt

6.7.6 The securitisation law allows the creation of two different types of securitisation structures. In the first case, the pool of securities is held by an SPV, which in turn issues certificates of participation including debt securities, backed by underlying receivables. In alternative form, a third party buys the entire pool of receivables and places them in a trust, which can be used as collateral for debt securities issued and guaranteed by the buying party. CNV regulations impose certain requirements on the appointment of trustees for the SPV. There are certain minimum capital requirements also in order to be appointed as a trustee.

6.8 Hong Kong

6.8.1 Hong Kong is in the forefront of the Asian securitisation scenario, as it is also probably the most securitisation-friendly jurisdiction in Asia. The regulatory environment including the set of guidelines for regulatory off-balance sheet treatment for regulated institutions largely follows the Bank of England model.

6.8.2 The Hong Kong Mortgage Corporation (HKMC), wholly owned by the Government through the Exchange Fund, was incorporated in March 1997 with the mission of developing Hong Kong's secondary mortgage market. The HKMC is a public limited company incorporated under the Companies Ordinance. Its business is being developed in two phases. The initial phase involves the purchase of mortgage loans for its own portfolio and funds the purchases largely through the issuance of unsecured debt securities. In the second phase, the HKMC will securitise the mortgages into MBS and offer them for sale to investors.

In July 1999, the Board of Directors of the HKMC gave its approval in principle for the Corporation to launch MBSs under a pilot scheme. Under the proposed scheme, the HKMC will purchase mortgages from individual banks and then transfer the mortgage pool to an SPV. The SPV will then issue MBSs back to the originating bank with the HKMC's guarantee of the timely payment of principal and interest in return for a guarantee fee. The bank can either hold the MBS in its own portfolio or on-sale the securities to other investors. The experience to be gained from this relatively simple structure will be valuable for the subsequent launch of more complicated MBS products.

6.9 Morocco

6.9.1 Umbrella legislation has been enacted in Morocco encompassing all the aspects of and facilitating securitisation of ABS and MBS through a debt investment fund, SPV. The only operations authorised under this law are:

- ♦ limited securitisation operations comprising transfer of housing mortgage receivables, provided these operations are carried out by a credit institution with a minimum capital of DH 1,000,000; and
- ♦ other securitisation operations including a public offer specifically covered by order of the finance minister or by an implementing law authorising these operations in each specific case.

6.9.2 Structure

The SPVs can be (i) institutional investors in debt or (ii) other entities which are governed by the legislative or regulatory systems of either Morocco or other foreign countries. The SPV is a separate and autonomous body (not a legal entity – commercial or a non-commercial company) and has the capacity of a natural person. All its functions are administered by its management depository institution, akin to asset management company (AMC) in India. It has been considered advisable that for each securitisation operation by an Originator, a separate SPV is created exclusively for that operation.

6.9.3 Rules of formation of SPV

The minimum framework of rules within which the SPV is founded has been specified in the Act covering the duration of the SPV, particulars of its AMC and the financial intermediary, a description of the planned securitisation operation, nature of assets to be transferred to it, minimum and maximum amounts of intended issue, frequency and nature of mandatory information to be provided to its investors, procedures for meetings with its investors, dissolution of the SPV, etc. As a result of its exclusive purpose for securitisation operation, an SPV cannot undertake any activity or assume any responsibilities other than those prescribed in the rules of its formation.

6.9.4 Minimum disclosure norms

The Act specifies that the rules of formation of the SPV must include the frequency and the nature of mandatory information to the provided to the investors irrespective of whether it is a limited securitisation operation or a public offering. Any Originator or the financial intermediary holding or acquiring direct or indirect interest in the AMC must disclose the fact in the rules of the SPV and the information to be furnished to the investors. The AMCs are required to furnish a copy of the annual report on the SPV and if required by the rules at a greater frequency, duly certified by an auditor.

6.9.5 Separation from the assets of its Originator and AMC

The transfer of the receivables is absolute and cannot be cancelled for any reason even if the Originator becomes insolvent or enters liquidation. The receivables once transferred to the SPV are to be removed from the balance sheet of the Originator. Further there is no guarantee from the Originator about the solvency of the debtors.

6.9.6 Issue of shares or bonds

It can issue shares or bonds fully or partly secured by its patrimony, which includes all the assets acquired by it through the securitisation process and all other rights. The rules also permit ranking, preferences or priorities among the bondholders but no other guarantee is provided to them except the assets of the SPV. However, they cannot distribute the assets of the SPV among themselves during the currency of its existence, thus making it immune to liquidation proceedings from its debtors or investors. The shares and bonds issued by the SPV are permissible and approved investments for the institutional investors, financial companies, credit institutions, enterprises governed by insurance and reinsurance legislation, retirement and pension agencies, etc. The Government can also make it mandatory for any one of the aforesaid institutions, enterprises or agencies to keep a part of their assets in these securities. However, these securities can be transferred only among the permitted investors.

6.9.7 Notice to the debtors

There is no mandatory requirement of notice to the debtors of the transfer of receivables to the SPV. It can be reported to the debtors by a simple letter and comes into force from the date it is posted and the debtor is required to pay the person indicated in the notice. *However, as long as the debtor is not notified of the transfer of the receivables to the SPV, he may make payment directly to the Originator and discharge any obligation vis-à-vis the SPV. In such an event, the Originator is required to keep the amounts so received in a separate bank account opened in the name of the AMC. Such balances are separate from the asset of the Originator or any other person and can be claimed by the AMC at any time without regard for the customary or legal priorities or privileges which means that even the revenue authorities cannot appropriate such sums towards their dues.*

6.9.8 Transfer of mortgage debts

The recording of transfers of mortgage receivables in the real estate matters is to be governed, notwithstanding any laws or regulations contrary to the provisions of this law. Even the requirement of prior conveyance of the real estate in favour of the Originator in respect of mortgage receivables being transferred as a part of the securitisation operation is waived and the conveyance can take place and produce effect between the Originator and the AMC on the same date against the third parties whether or not the conveyance was recorded. This recording takes precedence over any other request concerning the property in question which is submitted on the same date and is performed despite any attachment of the property encumbered by the mortgage in question. All doubts or conflicts are to be decided in favour of the SPV and against the debtor of the mortgage receivable transferred. The transfer of mortgage receivables is exempt from the application of time limits stipulated in the relative laws. However, every registrar of the landed property, the debtor and the third parties responsible to make payment to the account of the debtor should be notified of the transfer of a mortgage receivable by registered post.

6.9.9 Transfer of other assets

The transfer of other assets would also be in conformity with the principles set forth in this law and would take into account the adjustment required as a result of the specific nature of the assets in question subject, however, to the conditions and procedures for their transfer to the regulations or implementing legislation or by the applicable rules of common law. However, the provisions of this law would have an over-riding effect, in relation to the transfer of the legal rights and the conditions of their transfer, if such agreements or legislation or regulations were inconsistent with this law.

6.9.10 Accounting principles and Auditors' responsibilities

The SPV is required to follow the accounting rules approved by Government in consultation with National Accounting Council equivalent to ICAI in India or failing this, those, which are in conformity with the accounting rules generally accepted in Morocco. The auditor has been assigned a permanent role in the auditing of the books of the SPV, verification of the consistency and the authenticity of its accounts as also the information related to its financial position prior to its being released.

6.9.11 Exemptions from the costs

The SPVs, the AMCs and their appointed administrator, as well as holders of shares and bonds and distributions and payments to these holders, are completely exempt from the following taxes and fees :

- the fee levied, if any, on the registration of landed property and other assignments ;
- registration fees and stamp duties payable on the instruments related to their formation and their acquisition of assets, the issue and transfer of shares and bonds, other instruments related to the operations of SPVs;
- the VAT on services provided by AMC and all other taxes, payments, or operations which are part of a securitisation operation, including but not limited to hedging operations, distributions to shareholders, and payments to bondholders;
- the corporate tax and contributions to national solidarity for all payments received as assets sold or transferred and for all distributions to shareholders or payments to bondholders;
- the tax on stock dividends, partnership shares and the proceeds from fixed-income investments or similar other income; and

- the gains or losses realised by the Originator on the transfer to the SPV are spread over the Originator's financial years remaining till maturity on the receivables transferred.

6.10 General

6.10.1 EMs generally have a gap between their investment requirements and available savings. Saving rates are either low or don't get channelled to the investments due to the underdevelopment of the financial markets. The ability of an FI in an EM to borrow capital from international investors can be vital for its growth and survival. FIs can issue securitised debt to access international markets for funds otherwise unavailable, either locally or internationally. Long-term debt markets are particularly underdeveloped in EMs. It is predicted that MBSs can lower mortgage rates by 2% once efficiencies are achieved in this method of financing.

6.10.2 Investors for securitised paper are generally i) Fixed Funds: US life companies, money managers, pension funds; ii) Floating Funds-foreign banks. Majority of investors is from USA, UK, Continental Europe and Middle East . Investors from the developed countries are able to invest in the papers issued in the EMs due to credit enhancement and also higher yield. Notes from EMs attract higher spreads than the equivalent rated notes from developed markets . AA rated ABSs from EMs attracted 5 bp more than comparable AA paper from developed markets towards the end of December, 1997. The difference increased to 25 bp in July, 1998 due to the volatility in EMs. The higher volatility can decrease prices of underlying assets by 10 to 15%; if the structure involves 30% subordinated debt, and the prices drop by 15%, half of the cushion in the form of subordinated debt is wiped out.

---

[i] OECD. *Securitisation-An International Perspective.* France:Thompson, 1995.p.29.

[ii] Duff and Phelps Credit Rating India Private Ltd. *Securitisation in India : A position paper.* Mumbai, May 1997.

[iii] ibid.