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Overcoming obstacles to CEE securitisation: the Golden Middle approach

The financial foundations for a thriving CEE securitisation market already exist. Below the various existing markets in EU accession states in Central and South Eastern Europe are considered, along with the obstacles currently preventing the development of a larger market. This article argues that a "golden middle" legislative and regulatory approach could potentially find a way through the existing legal obstacles and facilitate a successful securitisation market in CEE.

Where is the market now?

In 2007 we saw the first true sale securitisations in Kazakhstan and Ukraine. Despite market participants' and rating agencies' previous expectations of a securitisation boom, Central European markets, even before the global credit crunch, still fall far short of their potential. This could be attributed to several market and legal factors.

Obstacles to a robust securitisation market developing predominately fall into two categories: market obstacles and legal obstacles.

Market obstacles

In Central Europe most banks are rich in liquidity. Their ratios far exceed their capital requirements, meaning that they have virtually no need for external funding. Typically their funding relies on customer deposits and covered bonds. This is aggravated by large international groups owning many of the bigger banks in the region and potentially providing an additional cheaper source of parent funding.

Local investors often have limited experience of structured finance products whilst foreign investors, who have knowledge about these products and would like to invest, have limited knowledge about the underlying new markets.

Local capital markets also lack maturity and have either no or poor quality hedging products available. The biggest problem for originators, however, is volume. Originators face difficulties in packaging a significant volume of eligible assets in one jurisdiction. A cross border transaction would be a solution but it is difficult to package together portfolios where the assets are governed by different laws and enforcement regimes.

However, with retail banking taking off, consumer assets could easily reach volumes where securitisation becomes a desirable financing tool. After implementing Basel II, bank originators might want to diversify their financing options or seek capital relief and efficient assets and liability management. Non-bank entities could achieve risk transfers and lower borrowing costs. Investors would be able to benefit from securitisation transactions by receiving a higher return compared to rated government, bank and corporate bonds. In summary, market participants expect that these factors combined with general economic growth will drive the market forward and unblock market obstacles.

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Legal obstacles

Legal uncertainty as a result of the untested nature of the legal environment provides a major obstacle to successful securitisation. It results in not only the absence of an adequate legal framework, but also means that there is no securitisation precedent and that judges are unfamiliar with complex financing techniques. Further legal obstacles include regulatory, licensing requirements for originators/servicers, formalities, notification, debtors' consent required to affect a valid true sale, unfavourable tax treatment, and difficulties in achieving bankruptcy remoteness for securitisation companies.

Legislating with a light touch

With the market moving forward the local jurisdictions must facilitate future transactions. Some think that the legal obstacles could be eliminated through legislation. Others believe it would be efficient to amend existing legislation related to, for example, capital markets or credit institutions in order to enable securitisation transactions.

Anglo-Saxon participants believe that special securitisation legislation is unnecessary citing the lack of securitisation legislation in the US and the UK as evidence that such environment fosters the development of market innovation.

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Market experience shows that the type of very prescriptive and detailed legislation seen in Bulgaria and Romania make any legal framework rigid and unable to adapt to market innovation and result in a less attractive legal environment for market participants.

Any proposed legislation should follow the "golden middle approach" which means that securitisation laws should set out the general principles of a successful securitisation, keeping the law as flexible as it can be, rather than attempting to offer a detailed legislative framework.

The legal framework in any Central European country must be assessed to ensure that the legal system meets the requirements for securitisation to take place. Such requirements include allowing true sale of eligible assets without burdensome notification or registration requirements and offering favourable tax treatment and bankruptcy remoteness for securitisation companies.

Defining securitisation

Securitisation is the process of transferring a pool of assets and/or the risk associated with that pool. The financing of these transactions can be provided by issuing a number of types and tranches of debt securities including commercial paper and covered bonds. Structures may require the replenishment of assets, active pool management, warehousing, whole business transactions and multi-issuance of securities. Any legislation should be drafted as widely as possible to ensure that none of these are precluded.

Securitisation entities (SPVs)

▸ Legal forms

Securitisation entities are organised either to be as a (i) company (securitisation special purpose companies in Bulgarian legislation) or (ii) as a fund (securitisation funds proposed under the draft Serbian law). Investors appreciate the simplicity of fund structures and, as a fund is a separate estate without legal personality, it is easy to construe it as a bankruptcy-remote and tax neutral entity. Company structures could be used for more complex transactions, such as whole business securitisations. Laws should allow both structures (as exists in Romanian law) allowing participants flexibility in choosing the most appropriate structure.

▸ Incorporation

Local regulators evidently want to oversee the incorporation process of any SPV. Ideally, prior authorisation should not be required from a regulator, but if it is required, the process should not be costly or time consuming (for example, in Ireland it takes just days to set up securitisation vehicles).

▸ Capital requirements

It seems that the biggest barrier in Romanian law is the level of mandatory capital required to be injected into a securitisation fund at the time of its incorporation. By way of example, the required capital of an SPV under Romanian law is around €250,000, under Italian law €10,000 and €1,000 in Ireland. As the portfolio assets are segregated and investors have limited recourse against those assets, which are represented by the securities held by them, the capital required does not serve the purpose of protecting the investors.

▸ Activities

In Western European jurisdictions limiting the activities of the SPV for investor protection purposes is accepted in order to eliminate any risk or losses arising from any additional activities of an SPV. The law could follow the Italian approach which states that an SPV's sole corporate objective is to undertake securitisation transactions. Limiting the activities of an SPV in this way would permit innovation in the market.

▸ Supervision

In many jurisdictions even in Western Europe regulators require SPVs to hold a banking license. The application of banking laws to SPVs and their activities raises legal uncertainty. Pursuant to the EU Banking Directive, to qualify as a credit institution an entity must receive deposits or other repayable funds from the public and grant credits for its own account. SPVs don't meet these criteria, so requiring them to obtain a banking license would certainly add time and cost in structuring and performing transactions or would force transactions offshore.

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The supervision of SPVs should primarily focus on regulating the issuance of securities. In a public transaction it should be subject to capital markets supervision. Private deals, however, are not expected to receive a significant level of supervision as the securitisation procedure and operations of the SPV would be covered in the transaction documents themselves.

▸ Offshore SPVs

In order to facilitate cross-border transactions, local jurisdictions should expressly permit or, at least, not place any restrictions on the transfer of assets to foreign SPVs. This would avoid two-stage asset transfer structures, which add additional legal complexity and cost to a transaction. Both Romanian and Bulgarian legislation applies only to onshore entities. That is presumably one of the main reasons why no offshore transaction has yet taken place under the special regimes. It is thus beneficial that securitisation laws expressly recognise offshore SPVs or provide for beneficial taxation, bankruptcy remoteness or ring-fencing provisions to the offshore SPVs.

Securitisation assets

Assets eligible for securitisation can include any asset or pool of assets capable of producing a recurring income stream including performing, non-performing, current, future assets, receivables, debts and claims. It may be advisable not to legislate on this particu-

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lar issue at all thus allowing the market to decide the transferable assets types.

Securitisation participants

▸ Originator

In order to facilitate all types of securitisation structures, including multi-jurisdictional transactions, it is helpful if the law does not exclude any potential type of originator. Securitisation is not however an appropriate form of financing for individuals.

▸ Servicer

In order to facilitate multi-jurisdictional transactions with a two-tier servicing structure, the law should recognise servicers appointed or authorised in other jurisdictions.

The supervision and licensing of servicers is very different across Europe. The originator in almost all cases is authorised to service its own portfolio of assets. This is important, as it is usually the originator who is in the best position to service that portfolio and maintain relationships with the underlying debtors, thus facilitating collections and supporting the ongoing business.

Some countries such as Italy and France restrict third-party servicing to licensed financial institutions. This "bank monopoly" model does not facilitate competition among market participants. A liberal approach to third-party servicing would promote competition and improve efficiencies within the servicing market.

Allowing the transfer of necessary personal data on the underlying assets for third party services without breaching data protection, bank secrecy or consumer laws also needs to be adequately addressed by legislation.

Transfer of assets

▸ Transfer of receivables

(i) Efficient securitisation legislation must facilitate the true sale of assets in the following ways: (A) permitting isolation of the transferred assets, including their ancillary rights, by removing them from the legal reach of the originator, its creditors and its insolvency administration officers; (B) not imposing costly or time-consuming formalities or registration for the transfer and (C) ensuring that the assets are enforceable directly by the SPV or the servicer without the involvement of the originator.

(ii) In order to facilitate timely and cost-efficient transactions, laws should not require onerous formalities or registrations to make the transfer of the assets effective. Ideally an assignment of receivables may be effected without any formalities. The draft Serbian law however currently requires court certification in order for the transfer to take place. Such a requirement makes frequent assignments burdensome, if not impossible.

▸ Transfer of ancillary rights

The ancillary rights in the most flexible jurisdictions are simultaneously and automatically transferred with the transfer of assets. With regard to mortgage backed assets, legislation needs to make sure that the underlying local law on mortgages does not include onerous provisions regarding registration and that the transfer of mortgage backed assets becomes legally effective upon the execution of the assignment agreement rather than on the submission of application for re-registration.

▸ Notifying the debtors

It is important that the transfer of assets should not be conditional upon the debtor's consent. Most jurisdictions require some form of notification to debtors in order that the claims of the SPV can be enforced against them directly; however, where there are a large number of debtors, delivery of notice is burdensome. French law does not require any notification to debtors regarding the valid true sale, which would be the ideal position, but it may be possible to consider the Italian solution where a public announcement of the transfer of the assets is made in an official publication rather than notifying the debtors individually.

Under the law of most European jurisdictions, notification of the transfer is also required in order to ensure that the debtor loses its right to discharge the obligation with the originator by payment or set-off.

Bankruptcy laws and bankruptcy remoteness

Isolation of the assets from the originator so that a bankruptcy of an originator does not adversely affect the payment of principal and interest on the securities is the key element of all securitisation transactions. To achieve bankruptcy remoteness assets are transferred by means of a true sale to a bankruptcy remote SPV.

As a fund is a separate estate without legal personality, bankruptcy remoteness is easily achievable. If the securitisation vehicle is organised as a company, in order to achieve bankruptcy remoteness the SPV must comply with certain criteria, such as limiting its activities and debts related to securitisation, appointing independent directors and building in covenants separating it from its parent.

Also important is whether general bankruptcy law applies to the securitisation vehicle. Where the SPV takes the form of a fund, it is normally not subject to general bankruptcy laws by virtue of the securitisation law that created it. Where the chosen structure incorporates the use of a company, however, the SPV will be subject to general bankruptcy laws. In this case, consideration should be given to whether the applicable bankruptcy regime would facilitate a transaction.

Techniques enhancing the bankruptcy remoteness of the SPV include the recognition of non-petition and limited recourse provisions in the transaction documents. Under a non-petition clause the parties~ agree not to petition for the winding-up of the SPV whilst it has outstanding obligations to the investors. Such clauses are enforceable under English, Dutch and German law.

Investors are usually keen to ensure that non-petition clauses would be valid and enforceable under local law. In practice however, it is a general civil law principle that the parties cannot waive their rights in advance, before such rights arise. In summary, securitisation laws should expressly recognise the validity of non-petition clauses, otherwise the parties must turn to foreign laws if they wish to incorporate a valid non-petition clause.

Another method of enhancing the bankruptcy remoteness of the SPV is limiting the investors' rights towards the securitisation company exclusively to the portfolio of assets backing the securities or other interest held by such investors. Such limited recourse provisions are generally used in transactions in England.

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The future

With the rapid growth of emerging market economies, the banking markets of Central Europe will overcome the obstacles to securitisation transactions. Carefully drafted legislation incorporating the general principles of a successful securitisation is the key to overcoming the legal obstacles and permitting these transactions to take place.

Agnes Molnar is a dual Hungarian and English lawyer. Further jurisdiction-specific information on true sale securitisation in CEE is available on www.securitization.net, a securitisation-specific website maintained by Mayer Brown International LLP.