Guide to Asset Securitisation in Malaysia

SAM CHAY

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Address all correspondence to
Pelanduk Publications (M) Sdn Bhd
P.O. Box 8265, 46785 Kelana Jaya
Selangor Darul Ehsan, Malaysia.

Visit our website at *www.pelanduk.com*
e-mail: *mypp@tm.net.my*

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Preface

ASSET SECURITISATION IS a relatively new and complex form of financing. As such, it is not uncommon for a company to undertake a transaction with limited familiarity with the securitisation process. The company is, to some extent, reliant upon the investment or merchant bank for education on the process of asset securitisation and for evaluating the suitability of the proposed transaction.

In order to insure that the issuer gains the most value from the securitisation, it is in the company's interest to designate specific individuals to develop an expertise in asset securitisation and represent the company throughout structuring and execution. As an alternative, issuers may find it more feasible to access the expertise of experienced securitisation professionals to act on the company's behalf throughout the transaction.

The book does not purport to provide comprehensive coverage of the subject matter and are not intended to provide legal advice. Readers should seek specific legal advice before taking any action with regard to the matters covered.

I am particularly grateful to my wife, Jiew Yan for without her patience and support the drafting of this book would not have been possible. I am also indebted to Dato' Ng Tieh Chuan for his support and early publication of this book.

Sam Chay

About the Author

Sam Chay works as a tax consultant in one of the Big Five international accounting firms. He has extensive experience in working with structured finance specialist teams in UBS Warburg, JP Morgan, Morgan Stanley, Merrill Lynch and Credit Suisse First Boston in the areas of tax planning, merger and acquisition, project finance, syndications, financial engineering, lease advisory and asset securitisation. He is a guest speaker and course leader for asset securitisation forums conducted by various financial institutions.

Glossary

ABCP	Asset-Backed Commercial Paper
ABS	Asset-Backed Securities
ABS Guidelines	Guidelines on the offering of Asset-Backed Debt Securities
BAFIA	Banking and Financial Institutions Act 1989
CBO	Collateralised Bond Obligation
CLN	Credit-linked Notes
CLO	Collateralised Loan Obligations
FAST	Fully Automated System for Tendering
FIC	Foreign Investment Committee
Issues Guidelines	Securities Commission's Policies and Guidelines on Issue/Offer of Securities
KLIBOR	Kuala Lumpur Interbank Offered Rate
LOBATA	Labuan Offshore Business Activity Tax Act 1990
MASB	Malaysian Accounting Standards Board
NBMC	National Bond Market Committee
NRCC	Non-Resident Controlled Company
PDS Guidelines	Securities Commission's Guidelines on the offering of Private Debt Securities
RENTAS	Read Time Electronic Transfer of Funds and Securities
RPC	Real Property Company
RPGT	Read Property Gains Tax
SPV	Special Purpose Vehicle

CHAPTER 1
History of Securitisation in Malaysia

ASSET SECURITISATION OR structured financing as it is also called means an arrangement, which involves the transfer of assets or risks to a third party where such transfer is funded by the issuance of debt securities called Asset-Backed Debt Securities ("ABS") to investors. Payments to investors in respect of such debt securities are principally derived, directly or indirectly, from the cash flows of the assets.

In order for an asset securitisation to work, such private debt securities shall exclude all debt securities that are capable of being converted into equity howsoever and whether redeemable or otherwise. Examples of such excluded debt securities include convertible bonds and private debt securities with attached warrants.

Traditionally people associate asset securitisation with banks but that does not have to be the case. Corporates, especially those that are highly indebted and are finding it difficult to access funds on an unsecured basis, could benefit substantially from asset securitisation. Asset securitisation is a product of larger macro changes in the world of finance such as institu-

tionalisation of savings and the moving of corporate customers away from banks over to the capital markets.

The conceptual development of the ABS market in Malaysia dates back to 1987 when Cagamas Berhad, the National Mortgage Corporation was established to promote the secondary mortgage market in Malaysia. It was established to function as an intermediary between banks and finance companies, the prime lenders and investors seeking long term investments. The securitisation of the housing loans has contributed to improved liquidity in the banking system and provided liquid, high quality paper to the market.

Asset securitisation is a significant source of value for prospective issuers. Deriving the maximum value is a function of aligning the issuer's business goals and current financial objectives with the structure of the transaction and the use of securitisation proceeds. In a recent report, the Asian Development Bank highlighted the need for mortgage-backed securitisation in eight Asian countries including Malaysia.

CHAPTER 2
What is Asset Securitisation?

ASSET SECURITISATION BASICALLY refers to the raising of funds whereby relatively illiquid or less marketable assets are converted into marketable securities. It provides cheaper, more efficient financing and liquidity to issuers while providing selection flexibility for investors and ensuring optimal capital allocation by capital markets.

The mechanics of the securitisation process is still poorly understood by many in the finance industry. Some tend to view it as an exercise that is unduly complicated. The perceived complexity of the process itself has tended to make some question the value of the method. But even to those who are quite familiar with the asset securitisation process, it may not always be clear why this method of structured financing gives rise to economic gains.

In other words, where does the value added to asset securitisation come from, what are the sources of its economic benefits? These are questions that are often raised and discussed among the practitioners.

The answers to these questions may not be always clear because the gains from asset securitisation can vary from case to case. It can be specific to each situation and context. But an analysis of these questions may provide the insights that are necessary to make a judgement on the magnitude of the possible gains from a structured financing deal to an initiator, based on the type of situation and the circumstances of the case.

Framework for asset securitisation

Effective 1 July 2000, the Securities Commission is the single approving and registering authority for prospectuses in respect of all private debt securities other than securities issued by unlisted recreational clubs.

In order to facilitate the issuance of ABS in the Malaysian capital market, the Securities Commission issued the Guidelines on the Offering of Asset-Backed Debt Securities ("ABS Guidelines") on 11 April 2001. The ABS Guidelines set out clear and transparent criteria for securitisation transactions as required by the Securities Commission pursuant to section 32 of the Securities Commission Act 1993.

In Malaysia, any person who wishes to issue, offer for subscription or purchase, or make an invitation to subscribe for or purchase ("issue, offer or invitation"), asset-backed debt securities must seek the Securities Commission's approval under section 32 of the Securities Commission Act 1993 by complying with the criteria under the ABS Guidelines as well as the Securities Commission's Guidelines on the Offering of Private Debt Securities ("PDS Guidelines").

The PDS Guidelines apply to any issue, offer or invitation in respect of private debt securities, including bonds, notes, loan stocks and commercial papers, whether convertible into equity or not and whether redeemable or otherwise.

The advent of this instrument is expected to widen the issuer base and broaden the spectrum of financial instruments available in the capital market.

CHAPTER 3
Basic Structure of Asset Securitisation

ASSET SECURITISATION TAKES on many forms, the majority are often based on a simple conventional structure i.e. the assets are transferred from their originating entity (the "Originator"), to a bankruptcy remote Special Purpose Vehicle ("SPV") (see Diagram 1).

The SPV in turn issues new securities such as bonds to investors using the assets as collateral. Since the debt securities are backed by the assets, the market in which the new securities are traded is called the secondary market for ABS. Such investors could include institutional investors like banks, pension funds, insurance companies, investment funds and other sophisticated investors.

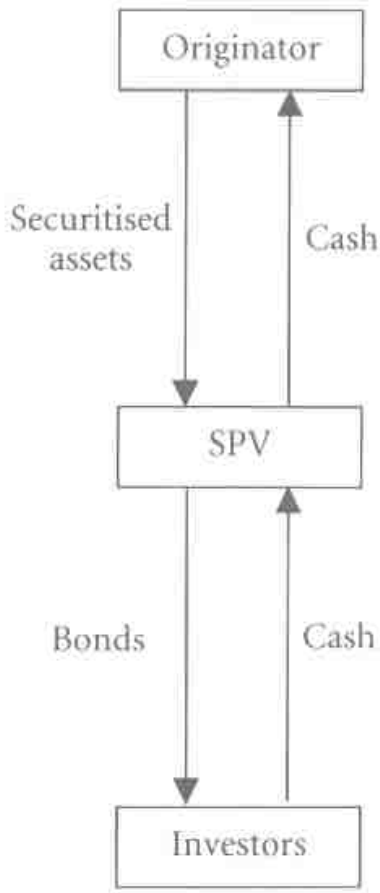
The proceeds from the sale of securities will be utilised to pay for the assets bought from the Originator. For the purpose of computing the risk and returns as well as the projection of cash flows, the SPV will hold a portfolio of similar assets.

ABS differ from most other kinds of bonds in that their creditworthiness (which is at the triple-A level for more than 90% of

outstanding issues) derives from sources other than the paying ability of the Originator of the underlying assets.

The debt securities (i.e. bonds) issued by the SPV are serviced by the income produced by the assets transferred from the Originator. The interest income may be fixed or floating, depending on the nature of the asset yield and the ability of the SPV to generate income from the assets.

Diagram 1



CHAPTER 4
Parties Involved

A SECURITISATION TRANSACTION normally involves the following parties:

ORIGINATOR

Who is an Originator?

Originator refers to any entity that is seeking to transfer or dispose of its assets to an SPV in a securitisation transaction and an Originator must be an entity incorporated in Malaysia. As such, a foreign branch registered in Malaysia cannot become an Originator.

In addition, an Originator must be a going concern at the date of transfer of any assets to an SPV. It should be noted that an Originator will not be considered as a going concern if it is unable to pay any of its debts as they fall due or when it suspends or defaults payment of any of its debt obligations.

Transfer of assets

The Foreign Investment Committee ("FIC") regulates the acquisition of assets or interest, mergers and takeovers of companies and businesses in Malaysia in order to ensure that changes in corporate ownership and control result in a better distribution of wealth. In general, FIC's approval is required for any proposed acquisition of substantial assets or any interests, mergers and takeovers of companies or business in Malaysia.

The securitisation of financial assets however, need not require the FIC's approval. The FIC's approval is only required for securitisation transactions involving real property or shares.

Investment in SPV

Where an Originator intends to subscribe or tender for the ABS, this must be clearly disclosed to investors.

The Originator may only purchase up to 10% of the original amount of the ABS issued by the SPV at market value at any time unless otherwise permitted by the Securities Commission. No restrictions however, are imposed on related companies of the Originator from investing in the ABS issued by the SPV. Therefore, the ABS can be sold to a parent or subsidiary of the Originator in or outside Malaysia.

Where an Originator is a licensed financial institution (such as banks or finance companies), investors must be clearly informed that the securities that they invest in do not represent deposits or continued liabilities of the licensed financial institution.

There is however, no limit with respect to the holdings of subordinated debt securities issued by the SPV by an Originator for credit enhancement purposes. Credit enhancement means an arrangement, which requires the Originator to compensate the SPV for a pre-determined amount of loss incurred as a means of insuring against the credit risks of the assets.

Investors must be clearly informed that an Originator does not in any way guarantee or stand behind the ABS issued by the SPV except to the extent specified in the asset securitisation documentation and such credit enhancement as may be provided by the Originator.

Where an Originator is the only primary subscriber resulting in the Originator holding more than 10% of the ABS, the Originator must make best endeavours to place out such excess ABS within a period of not more than 3 months from the date of issuance of such ABS.

Foreign Originator

In the case of a securitisation transaction involving a foreign Originator, it is subject to compliance with the Securities Commission's requirements on acquisition of foreign securities/assets.

The Securities Commission may consider granting an exemption from this requirement if the Originator is a foreign subsidiary of a Malaysian company, provided the Originator ensures compliance with all other requirements of the ABS Guidelines, particularly to mitigate any increased insolvency or bankruptcy risks which might arise in such a structure.

True sale criteria

The risk of insolvency is also minimised through the insulation of the different entities typically involved in an asset securitisation structure. If the assets of the Originator are sold to the SPV, the risk of the insolvency of the Originator adversely affecting the SPV is minimised as the assets are removed from the ownership of the Originator.

Any transfer of assets by an Originator to an SPV must comply with the true sale criteria. The underlying assets must have been isolated from an Originator i.e. put beyond the reach of the Originator and its creditors even in receivership or bankruptcy as far as possible.

The risk that a transfer of assets by an Originator to an SPV might be re-characterised as a financing transaction rather than a sale of assets should be minimised as far as possible. In this regard, the Originator must effectively transfer all rights and obligations in the underlying assets to the SPV and not retain any residual beneficial interest in the underlying assets.

An Originator must not hold any equity stake, directly or indirectly, in an SPV. Originators may however, hold preference shares in an SPV so long as such instruments do not entitle the holder to the right to vote at a general meeting or to any right to participate beyond a specified amount in any distribution whether by way of dividend, or on redemption, in a winding up or confer on the holder an ability to directly or indirectly exercise effective control over the SPV.

In addition, the Originator must not be in a position to exercise effective control and management over the decisions of the SPV in relation to the securitisation transaction.

An SPV must have no recourse to an Originator for losses arising from those securitised assets save for any credit enhancement provided by the Originator at the outset of the securitisation transaction. It should also be made clear to all investors that beyond these facilities, the Originator does not guarantee or stand in any way behind the capital value and/or future performance of the securities issued by the SPV, and of the underlying assets.

The Originator should not give any representation or warranty in respect of the capital value and/or future performance of the ABS issued by the SPV, and of the underlying assets. The Originator should have obtained opinions from its external auditors and legal advisors that the risks and rewards associated with the assets have been transferred to the SPV, and that it is not liable to investors in regard to the assets.

Where an Originator is also the paying agent, there must be no obligation imposed on the Originator to remit funds to the SPV unless and until they are received from the debtor of the Originator in respect of the underlying assets.

As provided for in the ABS Guidelines, Originators may retain a first right of refusal option, which serves as a "clean-up-option" of the remaining assets once the securitisation transaction becomes uneconomical to carry on upon maturity of the securitisation transaction. In addition, the Originator may also be obligated to repurchase assets from the SPV if the Originator

breaches any conditions, representations and warranties in respect of the securitisation transaction.

Advisers to the transaction (particularly legal advisers) should ensure that the use of call options in a securitisation transaction would not negate the achievement of true sale as required under the ABS Guidelines. A call option provides the holder the right to acquire an asset at an exercise or strike price, throughout the option term (American option) or at expiration of the contract (European option). The holder pays a premium for the right to benefit from the appreciation in the underlying.

Utilisation of proceeds

Funds raised from any issue, offer or invitation of ABS must not be channelled by the Originator and the SPV to finance such activities as may be announced by the National Bond Market Committee ("NBMC") from time to time. The NBMC was established to provide overall policy direction and to rationalise the regulatory framework for the orderly development of the corporate bond market.

The NBMC has identified various key issues for further development of the corporate bond market such as the need to widen the issuer and investor base, the need to improve liquidity in the secondary market and the introduction of risk management instruments. In addressing these issues, it was found that the dissemination of quality information to the market is critical for the benefit of promoting confidence among market participants in the bond market.

A mere increase in information without an equal commitment towards inculcating knowledge through education, especially in the case of investors, would not help in achieving the desired goals with respect to the bond market.

The Securities Commission has recently relaxed the restrictions on the use of private debt securities proceeds on up-market property developments, following the similar lifting of lending restrictions by Bank Negara Malaysia. Proceeds from private debt securities could now finance the development of residential properties priced above RM250,000 each, if they are used after the project has reached break-even in sales.

The private debt securities proceeds could also be used to finance the development of shop houses above RM250,000, if the shops are located within residential areas and if the proceeds are used after achieving break-even in sales. The private debt securities proceeds can also be used if the properties are in Putrajaya, Cyberjaya, Kulim Technology Park or in East Malaysia.

Exchange control

Funds raised in Malaysia by any person, including funds raised by any non-resident and non-resident controlled company, as defined under Exchange Control Notices 1 and 8 respectively, shall comply with any requirements and regulations as may be issued by the Controller of Foreign Exchange from time to time.

A non-resident controlled company ("NRCC") means a company in Malaysia where –

1. More than 50% of its shareholding is held by non-residents and/or NRCCs;

2. The majority shareholding is held by residents, but the ultimate right of control is held by non-residents and/or NRCCs; or

3. Although the ultimate right of control is held by residents, the majority shareholding is held by non-residents and/or NRCCs.

Notwithstanding the above, the Controller of Foreign Exchange may, if he deems fit, direct that a particular company be designated as NRCC.

Where doubt exists as to whether a company is a NRCC, the ruling of the Controller of Foreign Exchange shall be sought, giving details of the shareholding by residents, NRCCs and non-residents, residential status of the members of the board of directors and positions held by them and any other relevant information.

SPECIAL PURPOSE VEHICLE

Choice of entity

Special Purpose Vehicle ("SPV") means any entity which issues asset-backed debt securities and which satisfies all criteria stipulated under the ABS Guidelines. The ABS Guidelines are neutral on the legal form of an SPV and market participants are free to decide the most suitable SPV form in any securitisation

structure. This means an SPV can be established as either a company or as a trust structure.

A private limited company (i.e. Sendirian Berhad) is one which by its articles prohibits any invitation to the public to subscribe for any shares in or debentures of the company. A public company (i.e. Berhad) on the other hand can invite the public to subscribe for shares or debentures of the company. Debenture includes debenture stock, bonds, notes and any other securities of a corporation whether constituting a charge on the assets of the corporation or not.

If the SPV is a trust, the trustee whether an individual or an institution, must be independent of the asset Originator, while if the SPV is a corporate entity, it must be structured as an "orphan" corporation whose ownership is independent of the asset Originator. Where the SPV is established as a company, the amount of its paid-up capital would be determined by the promoters.

An SPV must have independent and professional directors or trustees as the case may be. The SPV and the ABS issued by the SPV must not carry the same name as the Originator or be similarly identified with the Originator.

Tax residency

An SPV must be resident in Malaysia for tax purposes. By virtue of section 8 of the Income Tax Act 1967, a company is resident in Malaysia for a basis year for a year of assessment if at any time during that basis year the management and control of its business or of any one of its businesses are exercised in Ma-

laysia. Where it has been established between the Director General of Inland Revenue and a company that a company is resident for a given basis year, then the company is resident in Malaysia for each subsequent year of assessment until the contrary is proved.

Labuan SPV

An SPV can also be incorporated in Labuan and be considered resident in Malaysia for tax purposes as required under the ABS Guidelines. However, the acquisition of Ringgit assets by the Labuan SPV and the issuance of Ringgit denominated asset-backed debt securities by it to domestic residents, would among others, be subject to the approval of the Controller of Foreign Exchange.

Under the Offshore Companies Act 1990, the Labuan SPV shall only carry on business in, from or through Labuan and shall not carry on business with residents of Malaysia except as permitted by the Labuan Offshore Financial Services Authority and approved by the Minister of Finance. The Labuan SPV shall not carry out transactions in Malaysian currency except for defraying its administrative and statutory expenses.

It should be noted that the Labuan SPV shall not be treated as carrying on a business with persons resident in Malaysia in the following circumstances :-

1. It makes or maintains deposits with a person carrying on a business within Malaysia.

2. It makes or maintains professional contact with any counsel and attorney, accountant, book-keeper, trust company (and its representatives), management company, investment advisor or other similar person carrying on business within Malaysia.

3. It prepares or maintains books and records within Malaysia.

4. It holds, within Malaysia, meetings of its directors or members.

5. It acquires or holds any lease of any property for the purposes of its operation or as accommodation for its officers or employees.

6. It holds shares, debt obligations or other securities in a domestic company (except a trust company) or an offshore company.

7. A resident of Malaysia holds shares in the Labuan SPV. However, where a Malaysian resident holds shares, debt obligations or other securities in the Labuan SPV, that Labuan SPV may not invest in a domestic company.

There are no restrictions in the ABS Guidelines on the issuance of foreign currency denominated bonds. In addition, such foreign currency denominated bonds would also be entitled to rely on Practice Note 1 issued under the PDS Guidelines which disapplies, varies or clarifies the application of the PDS Guidelines in relation to the offer, issue or invitation of foreign currency denominated private debt securities of a Malaysian public company made exclusively to persons outside of Malaysia.

However, such funds raised must comply with any requirements and regulations as may be issued by the Controller of Foreign Exchange from time to time.

Exchange control

The sale of foreign assets by non-resident Originators, the issuance of foreign currency securities by non-resident SPVs (including those in Labuan) and the purchase of such securities by non-residents are not under the Exchange Control purview.

The issuance of ABS by a resident SPV are also subject to compliance with the Exchange Control Guidelines On Private Debt Securities For Lead Arrangers.

Bankruptcy remote

In determining whether an SPV is sufficiently "bankruptcy remote", the following must be taken into account:

1. An SPV cannot include in its Memorandum and Articles of Associations, the power to enter into any other activities that are not incidental to its function as an SPV in relation to the securitisation transaction;

2. An SPV must sub-contract to third parties all services that may be required by it in order to maintain the SPV and its assets;

3. An SPV is not permitted to have employees or incur any fiduciary responsibilities to third parties other than to parties involved in the securitisation transaction; and

4. All the liabilities, present or future, of an SPV (including taxes) must be quantifiable and capable of being met out of resources available to it.

There can be currency/interest rate swap arrangements between the Originator and the SPV for the purpose of enabling the SPV to hedge against currency and basis risk. However, such transactions must be entered into at market rates.

An SPV must be responsible for the acts and omissions of all persons to whom it delegates any of its functions. Thus, an SPV is ultimately responsible to ensure that its assets are managed with due care and in the best interests of ABS holders.

Without prejudice to any applicable law, an SPV must cause to be maintained proper accounts and records to enable a complete and accurate view to be formed of its assets, liabilities, income and expenditure and to comply with all other regulatory reporting requirements in respect of the issue, offer or invitation of ABS.

Issuance of bonds

All private debt securities issues require mandatory rating and regulatory approval. The private debt securities must be rated by a domestic rating agency. The Securities Commission is not rushing to remove the mandatory ratings for companies seeking to raise money through the private debt securities market, as the latter is still under-developed.

The PDS Guidelines however, no longer imposes mandatory underwriting requirements nor a minimum investment grade

for all bond issues. The capital structure of an issuer is also left entirely to be determined by the issuer and its underwriters.

Underwriters are organisation, normally a merchant bank or a brokerage firm, that usually guarantees a minimum level of subscriptions to a share of debt issue. If public subscriptions fail to reach the minimum level the underwriter takes up the shortfall. Underwriters often have sub-underwriters who share the risk.

The Securities Commission conducts a post vetting system of approval, whereby the issuer and the lead manager need only to file a declaration of compliance with the Securities Commission's PDS Guidelines in order to secure an approval from the Securities Commission.

Private debt securities under a shelf registration scheme

The shelf registration scheme would be beneficial to good companies that intend issue bonds regularly in the market, as they would not have to apply for approval each time they wish to make an issue. Shelf registration will allow issuers of bonds to make several issues of securities under one shelf prospectus thus enable them speed and mobility to time their issues in relation to market conditions and interest rates.

Any issue, offer of invitation of private debt securities under a shelf registration scheme can only be made in respect of private debt securities which are not capable of being converted into equity howsoever and which have no warrants attached.

Where the SPV seeks to issue, offer or make an invitation for private debt securities under a shelf registration scheme, the SPV must comply with the PDS Guidelines as well as the Securities Commission (Shelf Registration Scheme for Debentures) Regulations 2000 and any guidelines in relation thereto.

A shelf prospectus approved by the Securities Commission would be valid for 2 years and would enable the multiple issuance of private debt securities to be carried out without the need for the issuer to seek prior regulatory approval from the Securities Commission for each issue of the securities.

Winding up of SPV

An SPV must be dissolved when the following circumstances arise:

1. The SPV refuses to accept transfers of the assets or issue ABS within 6 months from the date on which the securitisation transaction is approved by the Securities Commission or such other period as may be specified by the Securities Commission;

2. More than 70% of the ABS holders entitled to vote have resolved, in accordance with the terms and conditions agreed to by all the relevant parties in the securitisation transaction, that the SPV shall be dissolved and the Securities Commission has been notified of this resolution; or

3. Upon full repayment of the ABS in accordance with the terms and conditions of the securitisation transaction.

SERVICER

Who is a Servicer?

Servicer refers to any entity that is undertaking to administer the assets or perform such other services on behalf of the SPV as may be required in a securitisation transaction. The SPV can be set up with restrictive covenants in its financing documentation specifying which commercial activities that the SPV may or may not engage in.

As the SPV cannot have any employees, the management and administration of the SPV's assets has to be wholly subcontracted. One of the important documents which regulates the SPV is therefore the Administration and Management Agreement. This is a contract, normally between the SPV and the Originator (who acts also in an administrative capacity), which describes all of the different tasks and functions which are necessary to permit the SPV to conduct its business.

Duties of Servicer

The duties of any Servicer of the assets must include the following:

1. The Servicer must keep proper accounts i.e. collection of cash, maintenance of bank accounts etc.

2. The trustee must be informed of any change of Servicer;

3. The Servicer must have adequate operational systems and resources to administer the asset portfolio in relation to a securitisation transaction;

4. Where there is any change of Servicer, provision must be made in the legal documentation for the periodic transfer of the necessary information from the Originator to the substitute Servicer to enable the monitoring of the asset portfolio, its performance analysis and collections from debtors of the Originator; and

5. Enforcing agreements with the underlying debtors (e.g. collecting on security and chasing borrowers who are in arrears).

Can Originator become Servicer?

Where an Originator is also the Servicer, the Originator would also be able to preserve its existing relationships, for example, with its mortgagors. However, the services must be provided on an arm's length basis, on market terms and conditions. Funds that are due to the SPV need to be separated and "ring-fenced" as soon as they are received by the Originator, as far as possible.

If the Originator is undertaking the role of a fund manager for a service fee on behalf of the SPV, it is required to apply for a fund manager licence under the Securities Industry Act 1983 from the Securities Commission.

Fund manager means a person who under an agreement with any other person or persons, undertakes on behalf of that person or persons, whether on a discretionary authority granted by

such person or persons or otherwise, the management of a portfolio of securities (other than any arrangement made for the purpose, or having the effect, of providing facilities for the participation of persons as beneficiaries under a trust in profits or income arising from the trading in futures contracts) for the purposes of investment.

TRUSTEE

Subsection 69(2) of the Securities Commission Act 1993 states that a person cannot be appointed or act as a trustee without the approval of the Securities Commission if the person is a shareholder who beneficially holds shares in the borrower, is beneficially entitled to moneys owed by the borrower, has entered into a guarantee related to the amount secured or payable, or is a related corporation of the borrower or any of the categories of persons mentioned above.

The Guidelines on Trustees for Debenture Holders are meant to provide checks and balances to ensure that the interests of ABS holders are protected in the event that the trustee who seeks to act for ABS holders is related to the categories of persons set out in subsection 69(2) of the Securities Commission Act 1993.

The checks and balances mandated by the guidelines include the requirement that at least one third of the board of the trustee seeking approval under the guidelines are independent directors. Structural separation between the trustee and the connected persons as set out in subsection 69(2) is a further requirement of these guidelines. A trustee is also required to ensure that its non-financial resources are sufficiently independent of the connected persons mentioned above.

Under these guidelines, the Securities Commission shall grant a blanket approval to any trustee seeking to be appointed or to act as trustee under subsection 69(2) provided that the requirements of these guidelines are met. A condition of approval by the Securities Commission will be that the trustee must continue to meet these requirements while it acts as a trustee in respect of a particular ABS issue.

RATING AGENCIES

The critical role played by credit ratings in an efficient bond market is conventional wisdom. By providing information on default risk, and therefore, on the likely future performance of an issuer, ratings contribute to the efficiency of the capital markets. Ratings can help establish a more balanced information system in a market.

With ratings, investors have an additional source of information that they can use to establish benchmarks for comparing risks and returns. Rating agencies can also play a key role in educating investors about credit risk. Through its research and opinions, rating agencies can contribute to the development of a pool of sophisticated investors who are knowledgeable about credit risk and the tools of credit analysis.

At the issuers' end, a good rating can result in lower costs to the issuer and potential access to a wider investor pool. Indirectly, the rating process serves as a useful marketing tool for the issuer as it generates publicity and accords status for highly rated companies.

With a shift towards a disclosure-based system of regulation, the transparency and accountability of the rating process becomes even more critical.

While rating does to some extent serve as a gate-keeper to fend off sub-standard issues, it is not a guarantee against credit loss. The investors themselves must bear the credit risk. Rating is, therefore, not a substitute for investor protection. Because of this, investors need a regular flow of information from a broad range of sources in order to make informed investment decisions of their own.

There are two rating agencies who comment on asset securitisation transactions in Malaysia, namely Rating Agency Malaysia Berhad and Malaysian Rating Corporation Berhad. Their role is to provide investors with unbiased credit ratings of private debt securities throughout their tenure. Both of these rating agencies have their own distinctive styles and analytical approach.

A credit rating assesses the ability of issuers to withstand worst case scenarios. Therefore, to designate an AAA rating to the senior tranche of an ABS, the credit rating agencies demand that the overall structure is able to withstand a worst-case increase in defaults in the underlying portfolio, without the senior tranche being subject to default.

A rating normally covers the full and timely payment of interest and principal on the rated notes. The full part means that investors get all of their money back and the timely part means that the money is paid on time. These two elements equate to credit risk and liquidity risk. Due to the enhanced rating given to the bankruptcy-remote SPV and structural enhancements,

the Originator can effectively raise funds at a cheaper rate than on the basis of its stand-alone credit rating.

Is rating compulsory?

All issues, offers or invitations that come within the scope of the PDS Guidelines must be rated by a rating agency recognised by the Securities Commission unless otherwise allowed in writing by the Securities Commission. The mandatory rating requirement however, need not be complied with in regard to any issue, offer or invitation in respect of irredeemable convertible loan stocks.

However, as a continuous process of nurturing a more market-driven environment for fund raising, the Securities Commission envisages that a mandatory requirement for rating of domestic bond issues would be removed upon the development of a critical mass of risk management capabilities in the capital market.

Where the credit rating of any issue, offer or invitation is below investment grade, the issuer must disclose the extent of credit risk to investors and their professional advisers in order to evaluate the risks relating to the private debt securities.

Understanding why securitisation works is fundamental to understanding the nature of the task which has to be completed by the Originator. Securitisation works because rating agencies are prepared to assign ratings to the liabilities of the SPV. The performance of these liabilities is determined by the performance of the assets which the SPV owns. Hence the securities are normally described as "pass-through" securities (as the cash

flows and credit risks are passed through from the assets to the securities directly).

The starting point for the credit analysis is an analysis of the assets.

What are rating agencies looking for?

Credit risk

There are different grades of credit risk. The most obvious one is the risk of default. Default means that the SPV will not settle an obligation for full value, either when due or at any time thereafter. There are basically two steps in calculating credit risk: estimating the credit exposure and calculating the probability of default. Once the rating agencies have calculated these two statistics, they can quantify or make an assessment of the credit risk.

Solvency

Solvency risk relates to the risk that the SPV would not have the funds available to honour cash outflow commitments as they fall due. The rating agencies need to feel comfortable that the SPV is solvent and is expected to remain solvent for the period of the securitisation transaction. Proving solvency is not a straightforward exercise.

A true solvency analysis will also take into account contingent assets and liabilities (including deferred tax) which are not normally shown on the face of a balance sheet, and will require a

a comprehensive and detailed analysis of the balance sheet and projected cash flows.

Tax risks

Rating agencies normally require detailed opinions on the transaction addressing both legal and tax risks. These tax opinions are extremely difficult documents for lawyers or even tax experts to write, since the levels of comfort required are higher than those which would be necessary from a commercial perspective. This is one of the expensive and important elements of an asset securitisation transaction.

Since the Inland Revenue Board does not give advance rulings on the likely tax treatment of different structures, the rating agencies normally require the structures to be analysed across all potential tax treatments.

Legal risks

Legal risk refers to the risk of loss resulting from an unenforceable contract. Factors contributing to such risk include inadequate documentation, lack of authority for a counterparty to enter the contract, etc. The parties involved in an asset securitisation should consult their legal advisors about adequate documentation and other related legal issues of contracts before engaging in any such transactions.

In order for the SPV to acquire and subsequently dispose of assets, the SPV must possess the means to obtain and convey clear title to those assets subject only to a defined set of obligations and without unduly disturbing the interests of others.

Failure to do so would expose both the Originator and SPV to unacceptable financial and legal risk.

It is very important to ensure that nothing must be capable of upsetting the title to the assets which the SPV is acquiring. Based on my experience, dealing with these concerns is often not straightforward and therefore a thorough review of any likely source of implied right to the assets is required.

SPV Criteria

Rating agencies normally require that the SPV must adhere to a few important criteria, which are not attributes that apply to a normal company. Basically, these criteria relate to the "do" and "don't" which an SPV has to meet before a rating can be given to any ABS issued by it. These include:

1. The SPV must not carry on any other activity besides funding the assets and servicing the securities in order not to endanger the transaction by introducing new and different risk factors;

2. An SPV must sub-contract to third parties all services that may be required by it in order to maintain the SPV and its assets;

3. An SPV is not permitted to have employees or incur any fiduciary responsibilities to third parties other than to parties involved in the securitisation transaction;

4. All the liabilities, present or future, of an SPV (including taxes) must be quantifiable and capable of being met out of resources available to it;

5. The extent to which the SPV is reliant on third parties to meet its obligations should be minimised; and

6. Funds which are due to the SPV have to be separated and ring-fenced as soon as they are received.

By transferring the assets from the Originator to the SPV, the assets can be ring-fenced and put into a controlled environment, such that they are capable of supporting a AAA rating.

Steps involved

Review

The rating agencies will normally visit the Originator to assess the quality of its management, the business that the Originator is carrying on and to review the administrative procedures. Before the visit, the rating agencies will request for background information on the Originator such as financial information, company history, etc.

Asset analysis

The rating agencies will carry out an analysis on the asset pool to be securitised and review the performance of the assets based on certain assumptions. After carrying out the review process, the rating agencies will make an assessment of their worst case expectations as to the performance of the portfolio of asset.

Transaction analysis

This test involves determining the results of the structure in different stress environments. The variables used by rating agencies are credit loss levels, delinquency levels, interest rates, etc.

Legal and tax

Rating agencies normally require detailed opinions on the transaction addressing both legal and tax risks.

Summary

Finally, the credit report level required to obtain AAA status, depends on more qualitative data, which in turn depends on the nature of the assets and more generally on the technical and legal securitisation environment. Both the rating agencies have teams of analysts specialised in structured finance, and follow market developments with the publication of increasingly standardised quantitative and qualitative methods.

However, the rating agency still examines each transaction on an individual case basis, with a due diligence visit to the Originator, to guarantee reliability of the credit rating. In order to withstand the worst-case scenarios predicted by the rating agencies, a securitisation structure can use several credit enhancement techniques.

CHAPTER 5
Advantages of Asset Securitisation

HOW COULD A structured financing arrangement be more advantageous to a company than a direct financing scheme? The bottom line for the securitisation process, and its issuer, is to create a set of new securities that are worth more in the aggregate than the value of the underlying assets.

If the securitisation process is to be economically viable, the cash flows derived from the issue of securities must exceed the costs associated with creating and carrying out the securitisation process in present value terms. These costs will consist of the price paid for the underlying assets to the asset Originator, the costs of setting up the trust or SPV structure, cost of obtaining ratings for the debt, and the cost of other ancillary services necessary to carry out the process.

In order to correctly determine the overall value that a securitisation transaction can provide, the issuer must arrive at an accurate assessment of the value of these benefits, in addition to the appropriate evaluation of the direct and indirect transaction costs. A comprehensive examination of the resultant

cost/benefit ratio is a critical step in evaluating the timing for securitisation.

There are generally many reasons why companies consider securitisation.

Creation of liquidity

The advantage of asset securitisation is that it allows an Originator to convert an illiquid asset into a marketable security, thus improving the cash-flow of the Originator. This is particularly useful and beneficial to Originators who are financial institutions which are subject to statutory requirements in relation to prescribed minimum capital requirements.

The primary responsibility for the prudent participation by any bank, finance company, or merchant bank originating asset securitisations (the Originator) rests with the board and senior management. They should have clear strategies and board-approved policies governing these activities.

The assets sold to the SPV can be taken off from the financial institutions' balance sheets, and as such, excluded for the purpose of computing the risk weighted capital adequacy ratio. But the gain from avoiding capital adequacy requirements cannot be the sole reason for companies to opt for asset securitisation. If so, non-financial institutions will have little reason to securitise assets, because capital adequacy requirements do not apply to non-financial institutions.

It should be noted that any disposal of assets by an Originator (which is a financial institution) may require the approval of

the Minister of Finance on the recommendation of Bank Negara Malaysia under section 49 of the Banking and Financial Institutions Act 1989 ("BAFIA"). In addition, the financial institutions need to observe section 97 of BAFIA in relation to the disclosure of any information pertaining to the underlying assets.

Bank Negara Malaysia should also be consulted to ascertain any prudential requirements arising from the nature of the involvement of licensed institutions either as a servicer, liquidity provider, adviser etc. Any required approval of Bank Negara Malaysia should be obtained prior to any submission to the Securities Commission under its ABS Guidelines.

In order for banks to receive favourable capital treatment for asset securitisation transactions, they are required to disclose publicly certain quantitative and qualitative information. *The New Basel Capital Accord* outlines required disclosures that must be made by originating banks, sponsoring banks and SPVs established by banks. Many of the proposed disclosure requirements reflect the level of information currently disclosed to the market.

Another advantage of securitisation is that it increases the liquidity of the asset portfolio of financial institutions. Once a certain asset class is securitised, any unsecuritised assets of the same class remaining on the financial institution's balance sheet become a more liquid asset.

For the less leveraged banks, there is really no compelling reason for them to look at off-balance sheet options. Therefore, I

do not think in this context it is proper to look at regulatory relief for banks as a major driver for asset securitisation.

The major benefit one needs to emphasise here is the possibility of reducing cost of funding, whether it be in mortgage or non-mortgage markets, and avoiding asset liability mismatches. For this reason, asset securitisation in Malaysia for some years to come will remain centered on non-bank issuers and arbitrageurs rather than banks.

Matching of funds

Asset securitisation can be an effective tool for managing the composition of the balance sheet for both bank and non-bank financial institutions. For example, a financial institution may have assets that mature over a long period and deposits and liabilities that mature over a shorter time span. This results in a maturity mismatch between the institution's assets and liabilities.

This kind of maturity mismatch leads to financial risk exposure. This means that if interest rates rise, the assets with longer durations will reduce more in value than the liabilities with shorter durations. Similarly, the increase in the interest income on assets will be lower than the increase on the interest payments on liabilities and deposits. To avoid this kind of exposure to financial risk, the institution may wish to off load some of its long duration assets. This may be achieved by the securitisation of the long duration assets.

Flexibility

The types of assets which may be securitised are extremely wide. Theoretically, any asset that has a revenue stream can be transformed into a marketable debt security. These would include real estate mortgage loans, credit card receivables, automobile loans, aircraft lease receivables, lottery winnings, royalty fees, etc.

In practical terms, the vast majority of ABS are collateralised by loans and other financial assets. Revolving securitisation structures, such as the securitisation of credit card receivables, are also permitted under the ABS Guidelines. It should however, be noted that not all receivables can be securitised.

Increased profits

Banks can increase their profits by utilising the funds obtained to grant further housing loans or other loans by selling their long-term mortgages and house financing debts to the SPV.

Diversification of funding

ABS issuers, both bank and non-bank, view the diversification of funding sources as a major benefit of securitisation. ABS as a class of securities, is well differentiated from other classes of securities, such as debentures and equity.

Furthermore, ABS, unlike equity and debentures, are not necessarily closely linked to the credit quality of the issuing institution. These two factor enable issuers of ABS to attract not only investors who are existing debt and equity holders, but also new

classes of investors who may wish to invest in ABS but not in straight debt or equity. Existing debt and equity holders who may have a limit on the investment exposure in the debt or equity of the issuing institution may be willing to invest further in ABS.

Increased business without new capital

An Originator can release equity associated with its loan or mortgage book in order to generate further business without raising fresh capital.

Return on equity

Securitisation can be used by financial issuers to transform the spread income generated as a portfolio lender into fee income. Securitisation of portfolio assets such as credit cards or auto loans involves the sale of the income stream, but creates a new stream of fee income in the form of servicing fees and excess servicing.

In addition, moving from a portfolio lending to an origination and servicing focus allows the issuer to rethink both pricing and credit philosophies. Rather than only originating product appropriate for a portfolio, the issuer can now look to maximise the origination capabilities of the organisation, retaining appropriate product in the portfolio while securitising the remaining product and earning fee income.

Transfer of risk

If a particular class of lending becomes large in relation to the balance sheet as a whole, then securitisation can remove some of the assets from the balance sheet, thus effectively reduces credit exposure to a particular class of assets.

If the assets include a loan that is rescheduled or renegotiated, the SPV and not the Originator would be subject to the rescheduled or renegotiated terms.

Raising finance

An Originator that is restricted from accessing additional debt or equity financing under the terms of existing funding agreements may be able to use securitisation to generate funds. Because an asset securitisation transaction is usually characterised as a sale of assets, the Originator will not create an additional liability on its balance sheet, generally avoiding any violation of existing leverage tests or prohibitions on additional debt. In order to achieve this result, the securitisation transaction must be characterised correctly according to the terms of the relevant financing agreement.

Specialisation

Asset securitisation also enables a financial institution to specialise its activities. A financial institution such as a bank, often achieves expertise and efficiency in specific activities, such as in loan origination and loan monitoring, by virtue of information gathered on customer credit quality and the bank's expertise in these activities. By securitising loans, banks can concentrate on

the loan origination function without having to engage in the activity of funding the loan.

More choices for investors

An ABS issue, within itself can be carefully differentiated into several different risk classes of bonds. By carefully selecting the degree of credit enhancement, liquidity and the bid price for each class of security, several classes of bonds can be created to cater to different segments of the debt market and thereby attract different classes of investors.

From the standpoint of investors, securitised instruments offer significant yield premiums over sovereign government issues of comparable maturities. The magnitude of this premium depends on a number of factors, but is most directly related to the credit quality of the particular ABS.

Securitised instruments typically are traded on the basis of a spread above a bench-mark rate such as the Kuala Lumpur Interbank Offered Rate ("KLIBOR"), in the case of floating rate instruments. As such, they can help meet investors' demands for alternative spread-based investment product, while simultaneously serving basic investment goals of diversification and the risk reduction that may result.

On the fixed-rate side, pension funds constitute a large investor segment for certain types of ABS due to their relatively high credit ratings and predictable cash flow. Given their constituency, pension funds tend to be conservative in their investment strategy, and ABS provides a wide variety of product choices at attractive spreads.

On the other hand, insurance companies and money managers tend to focus on total return. The ABS market offers generous spreads in comparison to the corporate debt markets, allowing total return accounts to focus on incremental spread characteristics. Accordingly, the bulk of low investment-grade rated ABS products tend to be purchased by insurance company and money manager accounts.

The significant and virtually limitless variety and flexibility of credit, maturity and payment structures and terms made possible via securitisation techniques allows investment products to be tailored in a manner that responds to specific, and sometimes unique, investor needs. This variety and flexibility are the hallmarks of securitisation structures and instruments, and is a key investor consideration.

And, as the secondary market for broad categories of securitised instruments matures, and adds greater breadth and depth, investors are also likely to benefit from increasing levels of liquidity and a corresponding tightening of spreads.

CHAPTER 6

Requirements for Assets that may be Securitised

THE ASSETS THAT are the subject matter of a securitisation transaction must fulfil all of the following criteria:

Cash-flow

An important characteristic of the asset is the right to receive a cash flow from a debtor in certain amounts (or amounts defined by reference to a market or administered rate) on certain dates i.e. the assets must generate cash flow.

Furthermore, the Originator must have a valid and enforceable interest in the assets and in the cash flows of the assets prior to any securitisation transaction.

Security

If the security available to collateralise the cash flows is valuable, then this security can be realised by the SPV. For example, in a mortgage loan, there is security over the property and

other collateral, which will make a significant contribution towards recovering any losses which might otherwise arise.

In the event that there is a default, an effective method of ensuring that the SPV can gain the benefit of the security will be required (otherwise securitisation will be an uneconomic way of arranging funding).

Homogeneity

The assets have to be relatively homogeneous. This means that there are not wide variations in documentation, product type or origination methodology. Otherwise, it will become more difficult to consider the assets as a single portfolio.

Where the issue, offer or invitation of ABS are Islamic in nature, the assets that are the subject matter of the securitisation transaction must be acceptable in accordance with Syariah principles. In the event of doubt, clarification should be sought from the Syariah Advisory Council of the Securities Commission.

The Syariah Advisory Council of Securities Commission is the body with the responsibility ensuring that the operation of the Islamic capital market fulfils Syariah principles. The members of the body consist of muftis, academicians, Islamic scholars and corporate figures.

No executory clauses

The contracts to be securitised must work, even if the Originator goes bankrupt. Certain clauses are therefore difficult to in-

clude in a securitisation contract. For example, in an equipment lease, the inclusion of a clause stating that the Originator will maintain the equipment would make that lease difficult to securitise. These kind of contract are normally referred to as "executory contracts".

Capacity

It must be possible for the necessary transactions which are needed for the securitisation to take place in relation to the assets concerned. For example, if the assets contain specific prohibitions against assignment, then the assets will not be securitisable in the traditional sense.

The ABS Guidelines do not stipulate the jurisdiction of the assets involved in a securitisation transaction. Therefore, the assets in a securitisation transaction can be foreign based. However, the legal opinion that is provided in relation to the securitisation transaction would be important to ensure that the requirements for such assets as stated in the ABS Guidelines are complied with.

Independence from Originator

The on-going performance of the assets must be independent of the existence of the Originator. This tends to be a wider restriction than the example given above about executory contracts. A number of technical matters can arise, for example, if asset yields are quoted only by reference to the Originator (e.g. as the Originator's rate), then this will cause a structural difficulty in the event of the Originator's insolvency (i.e. what now is the rate that the assets yield?).

There are no impediments (contractual or otherwise) that prevent the effective transfer of the assets or the rights in relation to such assets from an Originator to an SPV. For example:

1. That the necessary regulatory or contractual consents have been obtained in order to effect the transfer of such assets from an Originator to an SPV;

2. That the Originator has not done or omitted to do any act which enables a debtor of the Originator to exercise the right of set-off in relation to such assets;

3. The assets are transferred at a fair value. "Fair value" under the ABS Guidelines would equate with its market value where there is a market for the underlying asset (for example, real property). In the absence of a market value for the asset, fair value would be based on what a willing buyer and a willing seller would agree upon.

4. No trust or third party's interest appears to exist in competition with an Originator's interest over the assets; and

5. Where the interest of an Originator in the assets is as a chargee, the charge must have been created for a period of more than 6 months before the transfer.

CHAPTER 7

Types of Securitisation Contracts

SECURITISATION CONTRACTS CAN be structured in many forms to serve a variety of purposes. Innovations in securitisation processes are taking place continually as financing needs of the Originators vary. Only 2 variations of securitisation structures are discussed – the pass-through structure and the asset backed commercial paper.

Pass Through Structure

Pass through structure is one of the earliest and the most common structures. In a pass through structure the investors of the securities issued by the trust structure have a direct ownership in the underlying portfolio of assets through an equitable assignment.

The Originator or the Servicer collects interest and principal payments on the original loans and passes them on direct to the investors after deducting a commission for this service function. This arrangement has given rise to the name "pass through".

Pass through structures may be set up as either static pool pass through or dynamic pool pass through structures. The pool of loans is fixed in a static pool pass through structure. On the other hand, the loans in the pool are short term in a dynamic pool pass through structure so that they turn over through substitution of the loans.

The structure of the asset pool is therefore dynamic and changes its composition. An example of this type of pool is credit card receivables, which are of a revolving nature. In the typical pass through structure the trust or corporate vehicle is independent of the Originator, and the loans do not appear any longer in the Originator's Balance Sheet.

Asset Backed Commercial Paper ("ABCP")

In an ABCP programme, an SPV is set up under the sponsorship of a financial institution, such as a bank. The SPV will purchase assets such as receivables or mortgage backed bonds from institutions that require financing. The SPV will issue commercial paper secured by the assets to finance the purchase.

To enable the commercial paper to attract a high credit rating, the sponsoring financial institution may add its backing to the commercial paper by providing a standby liquidity facility, the extent of which depending on the quality of the assets and the rating of the other liquidity providers.

ABCP conduits usually have two levels of credit protection. The first is pool-specific reserves established by the selling organisation, e.g. over-collateralisation, or recourse back to the seller.

The pool-specific enhancement generally covers defaults and absorbs subsequent credit losses, as well as dilution of assets.

Each asset pool that the conduit acquires must be structured to the credit quality level consistent with the program's rating. This enhancement only cover defaults on a specific asset pool and may not be used to absorb losses on other pools in the conduit.

The amount of the first-loss pool-specific enhancement for each particular pool is dependent upon the Originator's risk profile and covers a multiple of historical losses and dilution. Consideration is given to the Originator's quality as a servicer; obligor concentrations; the largest obligor's credit quality; and, possibly, whether the credit enhancement is dynamic (i.e. increases as the asset pool's performance deteriorates) or static (i.e. a fixed percentage).

The second level of credit protection is the program-wide enhancement, which may take the form of an irrevocable loan facility, standby letter of credit, surety bond or subordinated debt. In the ABS market, a surety bond is an insurance policy typically provided by a rated and regulated monoline insurance company to guarantee securities holders against default.

As with the pool-specific enhancements, the program-wide credit protection is sized based on a multiple of losses on the portfolio of pools in the conduit; multiple of largest seller and, if necessary, excess over the obligor concentration limits. In addition, the rating agencies consider the stress tests performed on the conduit's portfolio when determining the appropriate amount of overall credit protection.

CHAPTER 8
Structural Considerations

THIS IS A brief over view of the sorts of decisions which face a potential issuer of an asset- backed security.

Credit enhancement

When ABS are purchased by investors, the investment risk they undertake directly relates to the credit quality of the original borrowers whose loan contracts are offered as collateral for the securities. In order to offer the security purchasers with a further enhancement to the credit quality, the issuer of the securities may wish to provide further payment guarantees obtained from a third party insurer or through a process of what is termed 'overcollateralisation'.

In a third party insurance scheme, an independent insurer would guarantee timely payment of interest and principal of the securities in the event of default by the original borrowers. Such credit enhancement will serve to raise the credit quality of the securities above that of the underlying loans offered as collateral. When an insurance company provides such insurance to a securitisation scheme originated by a bank or non-bank fi-

nancial institution there is an effective transfer of risk from the banking to the insurance sector.

Overcollateralisation is another means by which the safety of a class of bonds to the investor can be increased. For example, in a situation where there are several classes or tranches of securities being issued, a subordinated class of securities could be designed to absorb the losses due to collateral defaults prior to a senior class of securities.

Then the senior class of securities is shielded from default risk. The senior class is now overcollateralised and as a result, will attract an enhanced credit quality. Often, securitisation schemes will build in combinations of third party support, tranching and overcollateralisation to optimise the marketability of the issue.

Credit enhancement can also take the form of servicing fees. Originating banks typically serve as loan servicers (servicing agents) and providers of credit enhancements. To minimise the risk of association, the originating banks should not provide support that exceeds their contractual obligations and the enhancement must only be provided at the outset of the scheme.

The minimum capital requirements for credit enhancements are based on the risk-weight schedule described in *The New Basel Capital Accord*. Because credit enhancements are typically the unrated or lowest rated tranches of a securitisation, they would be fully deducted from the originating bank's regulatory capital.

Credit enhancement facilities include all arrangements that, in form or substance, provide for an Originator or a third party agent (the "enhancer") to absorb the losses of an SPV and investors. An enhancer which provides credit enhancement facilities must ensure the following conditions are fulfilled:-

a) The nature of the credit enhancement provided to an SPV and investors is clearly specified in a written agreement at the origination of the securitisation transaction and disclosed in any offering circular. There must be no recourse to the enhancer beyond the fixed contractual obligations so specified. In particular, the enhancer must not bear any of the recurring expenses of the securitisation;

b) The facility is provided on an arm's length basis, and is subject to the enhancer's normal credit approval and review processes. The facility must be transacted on market terms and conditions;

c) The facility is limited to a specified amount and duration; and

d) In the case where the enhancer is the Originator, the credit enhancement facility must be documented in a way that clearly separates it from any other facility provided by the Originator.

Originators and loan servicers that provide credit enhancement to a securitisation transaction must deduct the full amount of the enhancement from capital, taking into account the risk-based capital charge that would have been assessed if the assets were held on the balance sheet.

There may also be additional requirements that a credit enhancement must meet to be accorded this treatment. Otherwise, the bank providing the enhancement may not have achieved a clean break and, as such, would not be permitted to remove the assets from the calculation of its risk-based capital ratios.

Achieving a clean break

In the case of a bank, certain minimum criteria must be met before a bank can remove securitised assets from the calculation of its risk-based capital ratio. In order for an Originating bank to remove a pool of securitised assets from its balance sheet for purposes of calculating risk-based capital, the bank must transfer the assets legally or economically via a true sale, e.g. novation, assignment, declaration of trust, or sub-participation.

More specifically, a clean break has occurred only if:

1. The transferred assets have been legally isolated from the bank; that is, the assets are put beyond the reach of the bank and its creditors, even in bankruptcy or receivership. This must be supported by a legal opinion;

2. The SPV and the holders of the beneficial interests in that entity have the right to pledge or exchange those interests; and

3. The bank does not maintain effective or indirect control over the transferred assets.

If the minimum requirements described above are not met, then the securitised assets must remain in the Originating bank's risk-weighted assets for purposes of calculating its risk-based capital ratios even if the transaction otherwise would be treated as a "true sale" under the accounting or legal systems.

Revolving asset securitisation

Revolving asset securitisations, such as credit card receivables and several collateralised loan obligations ("CLO") securitisations, carry additional risks due to the early amortisation triggers they entail.

In most revolving asset securitisations, the SPV grants a sort of a revolving credit to the Originator with which the Originator continues generating and selling loans. An early amortisation trigger is a common feature which is applied if certain events, e.g., deterioration in the credit quality of the portfolio or generation of fresh accounts, security cover, etc., change adversely. If these triggers are pressed, the SPV will use the cash flows to pay down the investors instead of revolving the amount back to the Originator.

Early amortisation is a sort of credit enhancements in securitisation, and therefore, early amortisation is a risk for several reasons. Firstly, if the credit quality of the portfolio falls, the Originator faces withdrawal of revolving credit from the SPV. Secondly, since the payment waterfall mechanism allows the trustees to use the cash to first pay off the investors, the Originator's claim in the collections is subordinated to the investors – this is a sort of an implicit recourse. A bad scenario may become a worse scenario if the early amortisation triggers are hit.

Transaction costs

The most obvious of these costs is the coupon on the ABS issued to investors, or the interest rate necessary to attract investors to purchase the ABS. The amount of the coupon is generally a function of several factors, including the rating received for the ABS (if any), the credit and other risks inherent in the asset pool, expected prepayments and timing of the various cash flows, and other transaction risks such as servicer risk and potential forms of event risk.

In the case of interest-bearing assets, the coupon is normally paid from the interest payments, or yield, received from obligors. In the case of assets that do not bear interest or whose yield is insufficient, the coupon is generated in the form of a discount upon issuance. In addition to the interest coupon, the transaction will incur ongoing costs for liquidity and credit enhancement facilities, as well as servicing fees for the portfolio.

An additional element to be considered is the excess spread, which is the net amount of interest payments from the underlying assets after bondholders and expenses are paid and after all losses are covered. Excess spread may be paid into a reserve account and used as a partial credit enhancement or it may be released to the seller or the Originator of the assets.

In addition to yield, securitisation can alter the amount or timing of credit losses taken on the assets sold. At the time of sale, the issuer will compare the current reserves for losses and book value of assets to the proceeds received from the securitisation.

In many cases, the valuation of assets through the securitisation process may differ from the method utilised to establish reserves and, as a result, adjustments must be taken. In addition, with interest-bearing assets the expected value of servicing fee and excess servicing fee income may differ from the current value reflected on the issuer's books for expected spread income, and adjustments will be required in this area as well.

In addition to the costs that the Originator will incur throughout the life of the transaction, an analysis of the all-in cost of asset securitisation must consider the initial costs of the transaction. Specifically, a cost comparison must take into account the impact of underwriting or placement fees, legal costs, ratings agency fees, and other ancillary up-front or on-going expenses.

Cost of funds vs cost of capital

Securitisation structures can be designed to achieve different aims. A key structural issue is the extent to which the Originator of the assets is prepared to sacrifice return on assets for taking less risk (and therefore putting up less capital).

Profit extraction

There are many ways to extract profit from a securitisation. These include use of receivables trusts, dividends, super-interest on loans, parallel loans, swaps, and simple fees. The key issues are corporation tax, service tax and the timing and accounting treatment of the payments.

This is never a simple matter, profit extraction has to be considered for both the payer and receiver of the cash flows. It is generally possible for a "profit stall" to arise (as a result of the combination of a cash based profit extraction mechanism and initial delinquencies), which can cause adverse consequences for Originators. Inevitably there are compromises to be made.

Hedging

Whatever the characteristics of the assets, sufficient hedging has to be in place to permit the full and timely payment of the SPV's rated obligations. With fixed rate leases and floating rate notes, for instance, a number of hedging structures are required to ensure that the SPV is not exposed to interest rate movements.

Cost/benefit analysis

In any securitisation pricing discussions, the issuers will compare the cost of a proposed asset securitisation transaction to their marginal cost of debt. Although this may be an effective negotiating technique, it is not a replacement for a thorough valuation of the transaction for internal purposes.

As it is wise to negotiate the best price for something your company needs, it is also imperative to determine what it is worth to the company. In addition, a full understanding of the potential and desired benefits will definitely assist the issuer in choosing between structural alternatives or competing proposals.

As discussed earlier, asset securitisation can add value to a company in numerous ways. Ideally, the issuer will first determine the various ways a securitisation can benefit the company, and then quantify the value of these benefits to the company. From this analysis, the Originator is able to determine the cost point at which the transaction becomes undesirable for the company.

To the extent there is significant value in these benefits, the issuer's goal should be to maximise the benefit/cost ratio of a securitisation transaction, rather than minimise the cost. Often companies will express difficulty in valuing some of these benefits, particularly ratio benefits resulting from securitisation. In many cases, however, these same companies distribute incentive compensation on the basis of these same ratios, which demonstrates that improving this measurement is of tangible value.

In order to quantify the ability of asset securitisation to add significant value as an alternative form of financing, the Originator must determine the appropriate benchmark funding cost against which to compare the cost of securitisation.

The appropriate benchmark depends upon the benefits that the Originator will receive from the securitisation. The total cost of securitisation may be compared to the marginal cost of debt, the company's cost of equity, or the weighted average cost of capital for the company.

In the majority of cases, the most appropriate comparison is the weighted average cost of capital, given that the assets to be securitised are currently supported at the company's blended cost of capital. However, if, as for a financial institution, a key

benefit is the ability to increase the capital of the company without issuing additional equity shares, the most meaningful comparison of the cost of securitisation may be to the cost of issuing the equity necessary to achieve the same result.

In the somewhat unusual situation where a company will receive no benefits from securitisation other than an alternative to debt issuance to raise funds, the most valid benchmark is to the company's marginal cost of debt. Implicit in this comparison is the assumption that the company is under-leveraged or receives no negative impact from increasing leverage.

Risk allocation

While benefits accrue to banks that engage in securitisation activities, these activities have the potential of increasing the overall risk profile of the bank if they are not carried out in a prudent manner. Generally, the risk exposures that banks encounter in securitisation are identical to those that they face in traditional lending.

These involve credit risk, concentration risk, operational risk, liquidity risk, interest rate risk (including prepayment risk), and reputational risk. However, since securitisation unbundles the traditional lending function into several limited roles, such as originator, servicer, sponsor, credit enhancer, liquidity provider, swap counterparty, underwriter, trustee, and investor, these types of risks may be less obvious and more complex than when encountered in the traditional lending process.

The SPV will normally only assume the credit risk on the receivables. All other risks usually remain with the Originator.

The warranties given on the sale of the receivables to the SPV are therefore normally rather more extensive than those given on a commercial transaction. For instance, warranties are given about legal risks and enforceability (that the contracts are enforceable in accordance with their terms). The Originator therefore often needs to be prepared to concede what appears to be a variety of unreasonable and non- commercial points.

The exact allocation of risk between Originator and SPV is also a function of the type of credit enhancement chosen. If a senior- subordinated structure is used, then the amount of risk which remains with the Originator is normally higher than if, for instance, a financial guarantee structure is used. If the Originator is paying a premium to a third party specifically to assume risk in the transaction, it would be reasonable to expect the assumption of more than mere credit risk by that party.

However, it should always be remembered that in commercial terms, the SPV is an extension of the Originator – and so fighting risk allocation battles can often mean taking funds from one pocket and putting them in the other. Getting the balance right is the key – too little risk transfer, and the transaction will be on-balance sheet, too great and the transaction may not complete.

Prepayment risk

Investors in ABS are typically concerned about the likelihood and extent of prepayment on the financial assets underlying the ABS. Prepayment risk describes the risk of receiving all or part of the principal of the underlying debt before it is due (in the

case of amortising assets) or before it is expected (in the case of non-amortising assets).

Determining the most likely prepayment scenario is critical to making an investment decision with a reasonable expectation about a security's life which, in turn, affects the likely yield. For certain asset types, such as residential mortgages, increasing prepayment activity is linked to corresponding declines in market interest rates.

This means that more principal may be returned, and must be reinvested, at rates of interest that are lower than those in existence at the time of the original ABS investment. This aspect of prepayment risk is sometimes referred to as "reinvestment risk."

Interest rate risk

As with all fixed-income securities, the prices of ABS fluctuate in response to changing interest rates in the general economy. When interest rates fall, prices rise, and vice versa. Prices of ABS with floating rates are, of course, much less affected, because the index against which the ABS rate adjusts reflects external interest rate changes.

Some ABS are subject to another type of interest rate risk, the risk that a change in rates may influence the pace of prepayments of the underlying loans, which, in turn, affects yields. As a general rule, non-mortgage consumer assets, including credit card receivables, auto loans, student loans and so on, are not highly sensitive to fluctuations in interest rates.

Thus, ABS backed by such assets are not particularly subject to prepayment acceleration due to declines in interest rates. On the other hand, as noted above, residential mortgage loans may exhibit a high correlation between prepayment activity and interest rate movements.

Default risk

The risk of default is most often thought of as a borrower's failure to make timely interest and principal payments when due, but default may result from a borrower's failure to meet other obligations as well. One such obligation critical in the ABS market is the maintenance of a required amount or quality of financial assets as specified in the governing documents for a transaction.

As discussed earlier, an extremely reliable indicator of the likelihood of a security's default is its credit rating, assigned by a rating agency. Because of the credit enhancements required for ABS by the rating agencies, the senior classes of most issues receive a triple-A, the highest rating available. The likelihood of failure to receive principal and interest payments for such securities is remote. The ABS sector has, in fact, performed remarkably well from a credit perspective.

The double-A, single-A, B, C and any lower classes of an ABS issue are lower-rated or unrated and are designed to absorb any losses before the senior tranche. Prospective buyers of these pieces of an issue must decide if the increased risk of default is balanced by the higher yields these classes may offer.

Liquidity risk

Liquidity risk involves the relative ease with which a particular ABS can be traded and sold at any point in time at a price that reasonably approximates its intrinsic value. The level of liquidity for any given ABS depends on a variety of factors, including its perceived supply and demand characteristics and the broader market and interest rate environment.

One of the main measures of liquidity is the size of the spread between the bid price and the offer price quoted by a dealer for the ABS. The greater this spread, the greater the liquidity risk. For investors who plan to hold an ABS until maturity, liquidity risk is less important.

CHAPTER 9
Sales of Loan Assets

THERE ARE THREE methods by which a loan asset may be sold to achieve release of regulatory capital. The three methods are novation, assignment and participation. Each of these three methods is briefly described below.

Novation

One of the methods used to transfer loan asset and obligation in an asset securitisation transaction is by novation. This method can be used to transfer an ongoing commitment in the context of loan securitisation.

Novation will normally involve a tripartite arrangement in which the Originator and the debtor to the original contract agree with the SPV that the SPV shall become a substitute for the Originator. Subsequently, the SPV will assume the Originator's obligations and rights under the original contract.

As a result, the original contract will be terminated and a new contract will be created between the debtor and the SPV. Before such an arrangement can be implemented, consent from the

debtor must be obtained and there is adequate consideration for the new contract between the SPV and the debtor.

Although the mechanics of it is easily understood, there are a few reasons why novation is rarely used in securitisation transactions.

Firstly, banks have an obligation to safeguard the confidentiality of their customers' records and they do not want their customers to know that they are securitising their assets. Based on experience, some customers have objected to their assets being securitised. The majority of those who objected are those with ongoing funding requirements with the banks and concerns about the SPV's ability to fund such requirements in a timely manner.

The second reason is because if the loan asset is secured by collateral, the novation will automatically terminate the original security interest. In such instance, the original security interest must be replaced by a new security interest. The effect would be back to square one if the facility was guaranteed. The reason is because a novation extinguishes the original contract between the Originator and the debtor and replaces it with a new contract between the debtor and the SPV.

In addition, new agreements/contracts and additional filings must be effected in order to perfect the new security interest. It should also be noted that the avoidance period has also been reset. The asset or security for the asset may become vulnerable to challenge if the debtor becomes subject to bankruptcy or other insolvency proceedings if the avoidance periods do start to run again.

Assignment

The two methods commonly used to assign debt are legal assignment and equitable assignment.

A legal assignment is an assignment that satisfies the following criteria, namely that the assignment

1. is an absolute assignment (i.e., not purported to be by way of charge only);

2. is in writing;

3. is of the whole of the debt, and

4. is notified expressly in writing to the underlying debtor.

For assignment that does not satisfy all four criteria will normally be given effect as an equitable assignment.

In an asset securitisation transaction, an assignment, irrespective whether legal or equitable, operates to transfer a proprietary interest in the asset in question.

A legal assignment operates from the date on which notice is given to the underlying debtor to transfer:

1. the legal right to the debt;

2. the legal and other remedies for the same; and

3. the power for the assignee to give a good discharge for the debt without the concurrence of the assignor.

Unlike a legal assignment, an equitable assignment operates to transfer only the beneficial interest in the asset. The legal title will remain with the assignor in an equitable assignment. This method is used mainly because the Originator does not want its customers to know that their assets are being securitised. This method will result in some procedural inconvenience, because the holder of the equitable title generally may not sue on the asset.

It should be noted that an assignment operates only to transfer rights in the assets, it is not possible to assign obligations without obtaining the consent of the debtor. There will be additional legal risks if the debtors are not informed of the transfer of their assets.

For example, if the debtors have not been informed, they will continue to pay the Originator, and expect to receive a good discharge of their debt. If the Originator becomes insolvent immediately after receiving payments from the debtors and prior to paying the SPV, the SPV will have no recourse against the debtor.

In addition, the failure to notify the debtor of the assignment may allow the debtor to set off claims that it has against the Originator against obligations it owes to the Originator. Once the assignee notifies the debtor of the assignments, any future right to set-off will be lost. The future right of set-off will be lost in this case because once notice of assignment has been

given, the debtor cannot do anything to take away or diminish the rights of the assignee as they stood at the time of the notice.

In securitising corporate loans, only the rights under the existing loan assets are capable of being assigned. The obligations to fund undrawn commitments must be transferred by other methods because they cannot be assigned. In practice, such commitments have been transferred under participation structures rather than by novation.

Sub-participation

There is really no distinct legal connotation for the word participation. It can be used to mean a number of different things. Sub-participation, on the other hand, has a distinct meaning. The term sub-participation means a contractual funding arrangement, in which the sub-participant agrees to fund a loan asset of another institution, the Originator.

There are two types of funding arrangement. Firstly, we have the "funded" sub-participation, where the sub-participant deposits money with the Originator, which may only be repaid as and when the underlying asset pays interest or principal. The second type is called "unfunded" sub-participation, whereby the sub-participant pays no money up-front to the Originator, but agrees to pay either as the related loan is drawn down, or if and when the underlying asset defaults.

In both arrangements, the sub-participant never acquires any proprietary interest in the underlying asset. The rights of the sub-participant are represented by its contract with the Originator. If the Originator becomes insolvent, the sub-participant

cannot claim any interest in either the loan asset or any of the proceeds realised from the asset.

The sub-participant remains vulnerable to rights of set-off available to the underlying debtors against the bank selling the participation. In order to give some protection to sub-participants, banks may be asked by the sub-participant to declare a trust over the proceeds received from underlying debtors.

It may also be possible for banks to declare a trust over both the loan assets and the proceeds of those assets, subject to the provisions of the underlying documents and to the bank's existing funding documents.

CHAPTER 10
Tax Issues

ONE WOULD PROBABLY be contemplating a transaction size of RM100 million to RM200 million to achieve optimal benefits from a securitisation issue. It is obvious then that fiscal certainty is critical for the counterparties. An unexpected tax exposure could cause the commercial failure of a large transaction.

There is no specific legislation in Malaysia to deal with the tax treatment of asset securitisation transactions. Tax consultants instead have to rely on basic tax principles to determine what the tax treatment should be. Besides relying on basic tax principles, the availability of case law too provides some guidance. The Securities Commission is also in active discussion with the tax authorities to address the need for certainty and neutrality of tax treatment on securitisation transactions.

The first issue is ensuring that the existence of the SPV, and the contractual arrangements contemplated, do not involve either significant tax advantages or costs. Tax advantages are likely to give the Inland Revenue Board the excuse to challenge the

structure, and these tend to give the rating agencies the opportunity to raise concerns about the structure as a whole.

Tax planning is a large part of the structuring process. The rating agencies will assume that the worst possible tax treatment of the SPV will apply in their analysis.

Originator

Sale of assets

Profits to the Originator arising from the sale of assets may be subject to income tax as gains or profits from a trade or business under section 4(a) of the Income Tax Act 1967. On the other hand, if it is a capital gain, then the gain may not be subject to income tax. Based on the ABS Guidelines, the assets must be transferred at their fair value i.e. at market value. In the absence of a market value for the asset, fair value would be based on what a willing buyer and a willing seller would agree upon.

Provision of services

Where an Originator is also the Servicer, the Originator would charge a fee to the SPV on a monthly basis for the management and administration of the assets sold to the SPV. The fees received by the Originator arising from the provision of services is subject to income tax.

Service tax

The Originator, acting as a provider of management services is required to be licensed and charged service tax under the Service Tax Act 1975 if its annual turnover from the provision of such services is RM150,000 and above. The definition of management service is not defined in the Service Tax Act 1975 and the Customs authorities have issued a guideline setting out the types and scope of services regarded as management services. It was indicated in the Guideline that the types of services regarded as management services falling within the ambit of service tax are unlimited. At 5% of the service fee, this represents a real cost to the structure.

SPV

SPV will be taxed as per the general law applicable to taxation of companies or trusts, whichever way the SPV is organised.

Is the SPV an investment holding company or an investment dealing company?

If the SPV is an investment holding company, gains arising from the sale of assets will be regarded as capital gains, hence not subject to income tax. On the other hand, if a loss arises, the loss would not be deductible to the SPV. The deductibility of expenses incurred is also restricted in that only revenue expenses directly incurred in producing the investment income are deductible for tax purposes. In the event that the SPV is treated as an investment holding company, section 60F of the Income Tax Act 1967 applies and therefore, the deduction of administrative expenses is severely restricted.

If the SPV operates as an investment dealing company, then the gains from the disposal of assets would be taxable and any losses would be deductible in arriving at the chargeable income of the SPV. Business losses of the SPV not utilised during the current basis year can be used against future business income.

Lenders and investors in Malaysia have also wrestled for years with the strict realisation principles that underpin our income tax legislation. Persistent issues include the deductibility of suspended interest on non-performing loans, the deductibility of provisions for diminution in value of marketable securities held as inventory and the deductibility of amortised premiums paid on debt securities held. It is therefore prudent for the issuer to obtain professional tax advice in respect of the above issues.

In an asset securitisation transaction, it is unlikely that the SPV will dispose of the assets concerned in the short-term as the ABS it issues are secured on that asset, and those ABS are serviced by the income produced by the asset. This may have a bearing on the taxability of income and deductibility of expenses of the SPV.

Labuan SPV

The tax laws relating to income tax on a Labuan SPV are set out in the Labuan Offshore Business Activity Tax Act 1990 ("LOBATA"). Section 4(1) of LOBATA provides that tax shall be charged at a rate of 3% for a year of assessment on the chargeable profits of an offshore company carrying on an offshore business activity which is an offshore trading activity.

The chargeable profits of the Labuan SPV carrying on an offshore trading activity for a year of assessment shall be the net profits reflected in the audited financial statements in respect of such offshore trading activity of the Labuan SPV. The Labuan SPV carrying on an offshore trading activity may elect pursuant to section 7(1) of LOBATA, to be charged for a year of assessment to tax of RM20,000.

It should be noted that the dealings between the Labuan SPV and the Originator, which is a Malaysian resident, would be treated as non-offshore business activity and therefore the Labuan SPV does not enjoy the concessionary tax regime, unless approval from the Minister of Finance is obtained.

ABS investors

Investors in ABS should determine if the revenue derived from the securities is assessable for income tax. The principal activity of the ABS investors would determine whether or not the interest income be treated as a business source income under section 4(a) of the Income Tax Act 1967 or assessed as an investment income under section 4(c) of the Income Tax Act 1967.

If the transaction is an adventure in the nature of a trade, ABS investors who derive a profit from the disposal of their ABS may be treated as being in the business of dealing in ABS and are potentially liable to income tax. On the other hand, if the investment in the ABS are for long-term purposes in order to derive investment income, then the gains arising from the disposal of the ABS should be on capital account and not subject to income tax.

Withholding tax

Non-residents ABS investors and persons who do not have any place of business in Malaysia are liable to tax at 15% (or less, under certain Double Taxation Agreements) on the gross interest. The payer of the interest, in this case, the SPV is required to withhold the tax and pay this to the Inland Revenue Board within one month of paying or crediting the interest.

If the bonds, other than convertible loan stock, issued by the SPV are rated by either Rating Agency Malaysia Berhad or Malaysian Rating Corporation Berhad, then interest paid or credited to any individual, unit trust and listed closed-end fund is exempted from income tax. However, this exemption is only applicable if the SPV is a company.

Interest paid by a Labuan SPV to non-resident ABS investors or to another offshore company are not subject to withholding tax.

Trusts

The income of a trust body is assessed and charged to tax separately from the income of a beneficiary from any source of his in relation to the trust. The chargeable income of a trust body, irrespective of resident status, is assessed to tax at a flat rate of 28%. The beneficiaries are however, given a set-off for a proportion of the tax charged on the trust body.

The significance of residence lies in ascertaining the income that is taxable on the trust. By virtue of section 61 of the Income Tax Act 1967 a trust body is resident for a given basis year

if any one trustee of the trust body is resident for that given basis year.

Stamp duty

Stamp duty is a crucial issue for securitisation transactions as it can add up to a substantial cost. The origin of the stamp duty issue lies in the fact that a securitisation transaction represents an assignment or transfer of assets from the Originator for the benefit of the investors.

However, pursuant to the Stamp Duty (Exemption) (No. 12) Order 2001, the following instruments executed on or after 1 January 2001 for the purpose of a securitisation transaction are exempted from stamp duty:

1. Any instrument that operates to transfer, convey, assign, vest, effect or complete a disposition of any legal or equitable right or interest in or title to any asset or charge or mortgage to or in favour of an SPV.

2. Any instrument that operates to create or effect any charge, assignment, trust deed or letter of guarantee or any other instrument or document for the purposes of credit enhancement.

3. Any instrument that operates to transfer, convey, assign, vest, effect or complete a disposition of any of the rights in connection with the repurchase of the rights from an SPV to or in favour of the person from whom the rights were acquired.

4. Any other instrument or document in which an SPV is a party to.

In addition to the above exemption order, all instruments relating to the issue and transfer of company bonds are exempted from stamp duty under the Stamp Duty (Exemption) (No.2) Order 2000.

Company bonds means any private debt securities issued by a company with the approval of the Central Bank of Malaysia or the Securities Commission which includes bonds, loan stocks, loan notes and any private debt securities issued under Syariah Law entitling the bearer or registered holder to payment of the amount expressed upon the face of the instrument as at a specified date or grants to the registered holder a right to convert the value of the instrument for stock or registered shares of the company.

Real property gains tax ("RPGT")

RPGT is a capital gains tax imposed on gains on disposal of real property or shares in a Real Property Company ("RPC") in Malaysia and is embodied in the Real Property Gains Tax Act 1976.

RPGT is chargeable on all gains made on disposal of real property situated in Malaysia, including the transfer of any interest, option or other right in or over such property. RPGT is also imposed on the gains arising from the disposal of shares in a RPC notwithstanding that the Company ceases to be a RPC at the time of disposal.

However, pursuant to the Real Property Gains Tax (Exemption) (No. 6) Order 2000, the Minister of Finance exempts any person from the payment of real property gains tax in respect of chargeable gains accruing on the disposal of any chargeable assets to or in favour of an SPV or in connection with the repurchase of the chargeable assets, to or in favour of the person from whom those assets were acquired, for the purpose of securitisation.

CHAPTER 11
Accounting Issues

THE MALAYSIAN ACCOUNTING Standards Board ("MASB") is established under the Financial Reporting Act 1997, with the primary responsibility to continually improve the quality of external financial reporting in Malaysia and to contribute directly to the international development of financial reporting. By virtue of Section 7 of the Financial Reporting Act 1997, it is the function of MASB to issue accounting standards. Where financial statements are required to be prepared or lodged under any law administered by the Securities Commission, the Central Bank or the Registrar of Companies, such financial statements shall be prepared in accordance with MASB Standards.

Current Malaysian accounting standards do not directly deal with accounting for securitisations but Malaysia has generally adopted international accounting standards. The key decisions relate to whether the transaction is to be on- balance sheet or to have a linked presentation, and how the investment (if any) in the SPV is to be shown on the Originator's balance sheet. This can become a critical area, particularly for banks, since the

regulators normally follow the accounts in their treatment of the transaction, and for companies concerned about gearing.

The appropriate treatment for asset securitisation scheme depends on the answer to two questions:

1. Do the receivables qualify for derecognition under the requirements of IAS 39 – Financial Instruments: Recognition and Measurement/MASB 24 – Financial Instruments: Disclosure and Presentation; and

2. Should the SPV be consolidated under MASB 11 – Consolidated Financial Statements and Investments in Subsidiaries and SIC 12 – Consolidation of Special Purpose Entities?

MASB 24 is effective for financial periods commencing 1 January 2002. In the case of compound instruments, the component part classification as required by MASB 24 need not be complied with until reporting period beginning on or after 1 January 2003.

As discussed in earlier chapters, it is relatively straightforward to remove an asset from the balance sheet under IAS 39/MASB 24, as long as the value of the retained credit risk is recognised separately. However, SIC-12 fundamentally follows a risks and rewards basis. Therefore retaining all the credit risk in the only asset held by an SPV is likely to lead to the conclusion that the SPV should be consolidated.

An SPV should be consolidated when the substance of the relationship between the Originator and the SPV indicates that the SPV is controlled by the Originator. Control may arise throug

the predetermination of the activities of the SPV (operating on autopilot) or otherwise.

The Originator has control over an SPV and obtains the benefits if it is exposed to the significant risks and rewards incident to the activities of the SPV. The application of the control concept requires, in each case, professional judgement in the context of all relevant factors.

Any of the following circumstances may, for example, indicate that the Originator should consolidate an SPV:

1. the SPV, in substance, is structured in a way that its activities are being conducted on behalf of the Originator;

2. the Originator, in substance, has the decision-making powers to obtain control of the SPV or its assets;

3. the Originator, in substance, has rights to obtain the majority of the benefits of the SPV; or

4. the Originator, in substance, bears significant residual risks related to the SPV.

A technical release will soon be formulated by MASB to provide clarity on issues in relation to the derecognition of assets and consolidation of accounts of an SPV and an Originator.

CHAPTER 12
Trust Deed Requirements

THE ISSUANCE OF a trust deed in any issue or offer of private debt securities is a requirement under the Securities Commission Act 1993. Whether a private debt securities issue is made by public or private limited companies, there is a requirement to have a trust deed that complies with the Guidelines on Minimum Content Requirements for Trust Deeds. The Guidelines provide for extensive content requirements and ensure flexibility of application in regard to each private debt securities transaction.

Hence, these Guidelines set out the minimum contents of trust deeds entered into between a borrower and a trustee(s) in relation to private debt securities. The key areas, in which the Guidelines require provision under the trust deed, include the following:

1. The borrower's covenant to pay principal and interest due on private debt securities and compliance with other covenants contained in trust deed;

2. Additional borrowers covenants and powers and responsibilities of trustees; and

3. Events constituting default and remedy of such default.

The minimum content requirements for trust deeds would strengthen protection to bondholders in the form of clear obligations and responsibilities imposed on borrowers and trustees.

In addition to the requirements imposed under the Guidelines, the trust deed documentation in any securitisation transaction must also provide for the following:

1. Covenants should be imposed on an SPV which give effect to the requirements of these Guidelines on the "bankruptcy remoteness" status of the SPV; and

2. That the trustee shall be entitled to appoint a receiver in respect of the underlying assets of the SPV in default circumstances as may be provided for in the trust deed.

CHAPTER 13
Disclosure Requirements

THE SECURITIES COMMISSION (Amendment) Act 2000 which came into effect in July 2000 made some far-reaching changes to the regulatory framework governing fund-raising activities in Malaysia, broadly resulting in positioning the Securities Commission as the sole regulator for such activities.

Under the amendments, the Securities Commission was mandated as the approving and registering authority for prospectuses in respect of all securities (other than shares and debentures issued by unlisted recreational clubs). This has resulted in greater legal and regulatory certainty in the area of public offerings of securities, a move towards promoting a more efficient and competitive capital market.

The new legislation ensures that it is now incumbent on issuers to provide sufficient and accurate disclosure of all material information to investors and their advisers to enable them to evaluate the risks and merits of their investment.

In addition, new Guidelines on Contents of Prospectus for Debentures have also been issued in order to set out the Securities

Commission's minimum disclosure requirements. The legislative amendments also underscore the Securities Commission's stance that those who play a role in the fund-raising exercise must be held to high standards of conduct when carrying out their respective functions.

These reforms also open up significant new opportunities for issuers, in terms of allowing greater variety and innovation in their fund-raising activities. The advertising provisions, for example, seek to provide for a wider range of information that can be contained in post-prospectus advertisements.

Preliminary or red-herring prospectuses are now allowed thus facilitating the book building process for issuers. In the future, the Securities Commission looks forward to introducing short-form prospectuses and profile statements in order to enhance the readability and comprehensibility of prospectuses by investors. Registration and filing fees have also been reduced in order to facilitate the issuers' needs for cost efficient means of raising capital.

Section 41 of the Securities Commission Act 1993 provided that no person should issue, offer for subscription or purchase or issue an invitation to subscribe for or purchase, any securities unless a prospectus had been registered by the Securities Commission. The penalty for failure to comply with this provision would be a fine not exceeding RM10 million or imprisonment for a term not exceeding 10 years or both. This requirement to register the prospectus should not apply to an excluded offer, excluded invitation or excluded issue.

Excluded issues, offers and invitations

Under the Companies Act 1965, a prospectus was required whenever there was an offer of shares or debentures to the public. In contrast, the scheme under the Securities Commission Act 1993 would be triggered whenever any person makes an issue of, offer for subscription or purchase of, or invitation to subscribe for or purchase, securities.

In the abolition of the concept of "public offer," the range of securities issues, offers or invitations which require the registration of prospectuses was widened. However, the scheme under the Securities Commission Act 1993 acknowledged that there would be various legitimate commercial transactions where an issue, offer or invitation should not require a prospectus.

Hence, the new sections 38 and 39 and Schedules 2 and 3 of the Securities Commission Act 1993 set out the list of excluded issues, offers and invitations on which the requirement to register a prospectus would not apply.

Where a prospectus is not required, an information memorandum must be made available to the investors in relation to any issue, offer of invitation of ABS. The information memorandum must contain the following minimum information:

1. Risk factors of investing in the ABS;

2. Detailed description of the structure of the asset securitisation transaction and all significant agreements relevant to the structure;

3. Corporate profile of all parties involved;

4. Detailed description of the securitised assets including the cash flow profile, ageing of cash flows, and (if available) historic levels of arrears or rates of default for the portfolio of assets and stress levels of cash flows;

5. An explanation on the flow of funds stating:

   - how the cash flow from the assets is expected to meet an SPV's obligations to ABS holders;
   - an indication of any investment parameters for the investment of temporary liquidity surpluses;
   - how payments are collected in respect of the assets;
   - the order of priority of payments to the holders of different classes of private debt securities;
   - details of any other arrangements upon which payments of interest and principal to investors are dependent;
   - information regarding the accumulation of surpluses in an SPV; and
   - details of any subordinated debt securities;

6. Measurement of the fair value of securitised assets including the methodology used in determining such fair value and the key assumptions involved;

7. Terms and conditions of the ABS;

8. Information on credit enhancement and liquidity facilities, if any, provided to the securitisation transaction including

an indication of where material potential shortfalls are expected to occur;

9. A summary of the rating report which, among others, shall highlight the key risk factors in the securitisation transaction;

10. Any fee payable by an SPV including management fees and expenses charged by the servicer; and

11. An explanation of any matter of significance to investors relating to the issue, offer or invitation of ABS that would enable investors to make an informed decision.

CHAPTER 14
Submission of Application to the Securities Commission

THE APPLICATION FOR approval of the asset securitisation transaction must, in addition to the requirements specified in the Securities Commission's PDS Guidelines, include the following:

1. a description of the structure of the securitisation transaction;

2. the preliminary rating report;

3. a copy of the constituent document, such as the Memorandum and Articles of Association of an SPV;

4. a legal opinion as to whether the true sale criteria has been met;

5. a copy of all other required regulatory approvals;

6. a valuation report by independant, registered valuers in the event that the assets which are the subject matter of a securitisation transaction include real property;

7. compliance checklist on the ABS and PDS Guidelines by advisers; and

8. all duly executed declarations as required under the ABS Guidelines which shall supersede the required declarations under the PDS Guidelines.

Time frame for Securities Commission's approval

The Securities Commission is committed to granting an approval under both the ABS and the PDS Guidelines within 28 working days upon receipt of an ABS submission which fully complies with all requirements under both Guidelines.

In the case of private debt securities by public companies which are capable of being converted into equity howsoever, the submission of a proposal and information as stipulated in the Securities Commission's Policies and Guidelines on Issue/Offer of Securities ("Issues Guidelines") will also apply. Where the Issues Guidelines would also apply to a securitisation transaction, the time frame of 28 working days shall not apply.

Other regulatory approvals

All necessary approvals in relation to the issue, offer or invitation of ABS from other regulatory bodies must be applied for prior to the submission of any written declarations and information made to the Securities Commission under the ABS

Guidelines. Any condition imposed by such regulatory bodies, if applicable, must continue to be complied with throughout the tenor of the ABS approved under the ABS Guidelines.

The Securities Commission may also require additional information from the issuer and its adviser, including due-diligence reports and rating reports if applicable, for post-vetting purposes at any time.

Underwriting

The underwriting of any issue, offer or invitation shall be decided by the issuer and its adviser. In the event that the issuer and its adviser should decide that no underwriting is required, the issuer must state the minimum level of subscription necessary to achieve the funding objectives of the issuer.

Unless otherwise allowed in writing by the Securities Commission, where any issue, offer or invitation is under-subscribed and cannot meet the minimum level of subscription, the issue, offer or invitation must be aborted and any consideration received for the purposes of subscription, where applicable, must be immediately returned to all subscribers.

Minimum denomination

Except for Islamic private debt securities any issue, offer or invitation in respect of private debt securities in Malaysia must be denominated in an amount not less than RM1,000, and in multiples of RM1,000 at the time of issuance.

Mode of issue

All issues of private debt securities under these Guidelines must be reported and/or tendered on the Fully Automated System for Tendering ("FAST") unless a listing is sought on any Malaysian stock exchange. Issuers and advisers must ensure that such issues must comply with all rules and requirements of the FAST.

FAST, is an automated tendering system whereby invitations to tender, bids submission and processing of tender for *scripless book entry system* instruments and short term private debt securities are done electronically.

Except for commercial papers and medium term note programmes, all issues of private debt securities under these Guidelines must be made under the Real Time Electronic Transfer of Funds and Securities ("RENTAS") system unless a listing is sought on any Malaysian stock exchange. Issuers and advisers must ensure that such issues must comply with all rules and requirements of the RENTAS system.

Additional requirements for medium term notes and commercial paper programmes

The tenor for medium-term notes and commercial paper programmes must not exceed 7 years.

Additional requirements for Islamic private debt securities

In relation to Islamic private debt securities which come within the ambit of these Guidelines, the issuer must appoint either:

1. An independent Syariah adviser(s) who has been approved by the Securities Commission and who meets the following criteria –

   - is not an undischarged bankrupt;
   - has not been convicted for any offence arising out of a criminal proceeding;
   - is of good repute;
   - possesses the relevant qualifications and expertise, particularly in fiqh muamalah and Islamic jurisprudence, and has a minimum of 3 years working experience or exposure in Islamic finance; or

2. the Syariah Committee of an Islamic bank or a licensed institution approved by Bank Negara Malaysia to carry out Islamic Banking Scheme or Skim Perbankan Islam, to advise on all aspects of the Islamic private debt securities including documentation, structuring, investment as well as other administrative and operational matters in relation to the Islamic private debt securities.

Where the Syariah adviser proposed to be appointed is a company, such company must have, in its employment, a minimum of one individual who meets the criteria stipulated in point 1 above. In addition, the company should not have breached any securities or banking laws since the date of its incorporation nor have a winding up order or resolution passed against the company.

Any Syariah principle and concept adopted in order to structure an Islamic private debt securities must be based on such

principles and concepts as approved by the Securities Commission's Syariah Advisory Council.

CHAPTER 15
Summary

ASSET SECURITISATION IS time- consuming, complicated and can be expensive. Avoiding some of the costs, ensuring that timetables are adhered to and getting a transaction which meets the Originator's needs is a question of organisation and preparation. The variety of issues, and the amounts of work involved mean that it is inevitable that a large number of advisers are needed to complete any transaction.

Although there are both high internal and external costs associated with any transaction on this scale - securitisation does offer access to large amounts of funding, and once programmes are set up, they can be repeated relatively cheaply and easily. Select your advisers carefully – and ensure that the advice which is received covers all aspects of the transaction, and includes systems, accounting, legal, tax, banking, rating and general administration.

The securitisation process is complex and involves banks playing a wide range of roles. Banks may act as the Originator of the assets to be transferred, as the servicing agent to the securitised assets, or as sponsors or managers to securitisation pro-

grams that securitise third party assets. In addition, banks may act as a trustee for third-party securitisations, provide credit enhancement or liquidity facilities, act as a swap counterparty, underwrite or place the ABS, or invest in the securities.

A main cause for the current illiquidity in the ABS market is the imbalance between supply and demand. Individual issues tended to be small and this has resulted in buyers holding on tightly to many issues. Furthermore, investors generally tended to be reluctant to sell or trade the papers as they may wish to avoid reinvestment risk.

As such, more good quality names (i.e. issuers) are needed to tap the capital markets to broaden the supply. Issuers should also be willing to go into the market on their own "stand-alone" credit risk rather than depend on bank-guaranteed basis. If our market has a large proportion of bank-guaranteed papers, then we have not really developed the ABS market as investors are taking the guaranteeing bank's risk and the banks in turn are still bearing the credit risk of the borrower.

The ability to anticipate and accurately quantify the favourable and unfavourable effects of an asset securitisation transaction allows the issuer to forecast when a securitisation will add the most value to the company. Viewing securitisation on these terms, and retaining it on the planning agenda as a corporate finance alternative, will result in high value, opportunistic transactions that address several corporate finance needs simultaneously.

The Securities Commission has set up the Asset Securitisation Consultative Committee comprising market participants such

as lead managers, lawyers, accountants, rating agencies and the national mortgage corporation. The responsibilities of the Consultative Committee are to make recommendations to the Securities Commission and the National Bond Market Committee on a comprehensive framework dealing with legal, regulatory, tax and accounting issues that could facilitate the development of asset securitisation in Malaysia.

CHAPTER 16
Done Deals — ABS

ASSET SECURITISATION IN Malaysia has not taken off even though the necessary legal structure and framework are in place for the use of such instruments to flourish. A trigger was still lacking to kick-start asset securitisation in Malaysia. It is always very difficult to seal the first deal as a lot of issues need to be ironed out. However, once there is one or two large deals done in the market, the momentum would start picking up.

Arab-Malaysian Merchant Bank Bhd

Arab-Malaysian Merchant Bank Bhd ("AMMB") launched an asset securitisation deal called the collateralised bond obligation ("CBO") programme under which two classes of bonds valued at RM255 million were issued. A CBO is an asset securitisation transaction where the underlying assets are private debt securities. Prisma Assets Bhd, an independent SPV, issued a senior tranche of RM225 million and a subordinated tranche of RM30 million.

The bonds for the senior tranche, which has received an indicative AAA rating from Rating Agency of Malaysia and the subor-

dinated tranche which was not rated and held by AMMB carries a legal life of 5 years with a bullet repayment upon maturity. The underlying assets for the transaction are a pool of diversified corporate bonds issued by companies in Malaysia.

Pengurusan Danaharta Nasional Bhd

Pengurusan Danaharta Nasional Bhd ("Danaharta") sold RM310 million in asset-backed securities to generate cash and these were secured by RM570 million of performing loans held by the national asset management company.

Danaharta undertook the asset securitisation exercise instead of an outright sale of the loans because securitisation was a more efficient method of divestment as it overcomes the operational difficulties in selling or auctioning a large number of loan accounts. The issue of ABS would also enhance Danaharta's cash collection, which could be used to redeem Danaharta bonds upon maturity and for operational needs. The divestment of the performing loans held by Danaharta was in line with its targeted closure of operations by 2005.

An SPV, Securita ABS One Bhd ("Securita"), has been set up to undertake the securitisation exercise. Securita acquired RM570 million worth of performing loans from Danaharta for cash. The portfolio of performing loans include term loan, revolving credit, overdraft and bank guarantees. The acquisition was financed by the issue of two tranches of ABS on 20 December 2001 – RM310 million worth of fixed rate senior notes, due in 2005, and RM283.9 million worth subordinated notes.

Of the RM570 million worth of performing loans to be taken by Securita, 35% will come from Danaharta, 51% from Danaharta Urus Sdn Bhd, and 14% from Danaharta Managers Sdn Bhd.

Securita sold the senior notes, which have a coupon rate of 3.87% that is payable semi-annually, to the investing community for RM310 million cash. The senior notes were distributed via private placement through the book building process to Malaysian investors comprised institutional investors, banks and financial institutions, money managers, pension and insurance funds. They have been rated AAA by Rating Agency of Malaysia Bhd and approved by the Securities Commission. Meanwhile, Danaharta took up the subordinated notes, which would not be traded in the securities market.

Repayments on the notes will be made only after the full settlement of the senior notes. This means that Danaharta will bear the losses from any default on the loan repayment. Owing to the higher risk involved, the coupon rate for the subordinate notes is 20%, and is also payable semi-annually. The yield for the transaction was priced at 4%, which was 75 basis points above the four-year benchmark Malaysian Government Securities of 7.42% September 2005. One basis point means one-one hundredth (1/100 or .01) of one percent. Yield differences among bonds are stated in basis points.

Deutsche Bank (Malaysia) Bhd and Alliance Merchant Bank are the joint lead managers for the notes issue.

There is a reserve account as credit protection to cover any shortfall in payment for the senior notes. The account will hold on-going funds equal to the next one year's interest payment.

The ABS was the first issue of CLO securities in Malaysia.

Commerce International Merchant Bankers Bhd

Commerce International Merchant Bankers Bhd ("CIMB") has also launched an ABS transaction recently. CIMB is the lead manager for this collateralised bond obligation ("CBO") issue. CBO One Bhd ("CBO One"), a bankruptcy-remote SPV incorporated in Malaysia, was set up to undertake the transaction.

CBO One will issue RM360 million nominal value 7-year senior Class A bonds and RM25 million nominal value 7-year mezzanine Class B bonds. These bonds are supported by a RM126.93 million tranche of subordinated debt, which will be held by CIMB.

The Class A and Class B bonds have been rated AAA and AA3 respectively by Rating Agency Malaysia Bhd and both carry a 4.85% semi-annual coupon rate. The unrated subordinated debt carries a 5% coupon rate with an additional rate of 15% applicable in the final year.

As portfolio manager and portfolio trader, CIMB will manage and trade the collateral pool of private debt securities backing the CBO bonds and the subordinated debt. The collateral pool underlying the transaction consists initially of 30 private debt securities issued by 27 companies amounting to RM485 million in nominal value and RM17.65 million in cash reserves.

CIMB was the primary subscriber of this issue on a bought deal basis and would sell down these bonds in the secondary market.

CHAPTER 17
Synthetic Securitisation

FOR CORPORATES, ASSET securitisation provides off balance sheet funding, longer-term funding on a stand-alone basis, and these are clear benefits. Another aspect of asset securitisation that is not fully appreciated relates to synthetic transactions.

Synthetic structures are not triggered by off-balance sheet considerations. They are more a risk management tool, and with the growing need to shift credit risks, banks are increasingly concerned about managing their credit risk.

Banks do not always have to securitise on a cash basis and sell the assets. If banks want to get rid of specific risks, they can do this by doing a synthetic transaction. This has additional benefits in that the banks do not have to transfer assets, they do not need a sale and purchase agreement and all the legal work associated with perfecting a true sale.

The banks can also transfer the risk through a credit default swap and by doing this the bank can also circumvent the sovereign ceiling issue. Credit default swap is a contract where one party pays a fee and the other party has the contingent obliga-

tion to make a payment if a referenced entity defaults. The structure incorporates flexibility with respect to the definition of default and the calculation of the default payment.

Synthetic securitisation could be helpful for small banks or larger banks that want to transfer specific risks faster and more cheaply.

From the Originators' perspective, the incentives to use such products, apart from the greater flexibility, are that they are cheaper and quicker to arrange and they side-step legal and confidentiality difficulties in transferring assets. However, certain basis risks can reduce the completeness of risk transference. These risks arise from asset mismatches (when the underlying portfolio of assets differs somewhat from the assets referenced in the credit derivative), as well as currency and maturity mismatches, and materiality thresholds (below which a credit event is not called or no protection payment is paid out).

From the investors' perspective, notes can be structured to achieve a desired portfolio profile and seniority/rating. At the same time, due to confidentiality constraints for the sponsoring bank, the notes may be referenced to blind pool structures whose underlying components are not disclosed to investors. In these cases investors may know only the diversity score and average quality of the pool.

Synthetic securitisation is a comparatively cost-effective mechanism for repackaging credit risk portfolios in response to incentives in regulatory capital requirements. However, it should be noted that, under an internal ratings based approach, the

the incentive to engage in synthetic securitisations may very well be mitigated since, in theory, the regulatory capital requirements would be closer to the economic capital actually required against the risk of the reference portfolio.

Given the convergence of the two capital measures, the transaction costs also tend to reduce the incentive banks have to engage in a synthetic securitisation in order to minimise their capital requirements.

However, small, less sophisticated banks that are not eligible for the internal ratings based approach may legitimately wish to engage in synthetic securitisations for purposes other than arbitraging the capital requirements, such as transferring large exposures. Thus, a treatment for synthetic securitisations may be needed in the standardised approach, subject to robust operational requirements.

CHAPTER 18
Examples Of Synthetic Securitisation

Credit-linked notes

IN A COMMON synthetic securitisation structure, an SPV is set up to acquire the credit risk on a reference portfolio by buying credit-linked notes ("CLN") issued by the bank. The SPV will issue a series of notes in several tranches to investors in order to fund the purchase of the CLNs.

The notes issued to investors are collateralised by the CLNs. Every CLN issued by the bank represents one obligor and the bank's credit risk exposure to that obligor. By subscribing to the notes issued by the SPV, the noteholders are exposed to the full amount of credit risk associated with the individual reference obligors.

This process in effect has shifted the entire credit risk of the reference portfolio from the bank to the capital market, as the amount of notes issued to investors is equal to the notional amount of the reference portfolio. The bank will redeem the individual note issued to investors in accordance with the repayment terms specified in the note agreement if there is a default by any obligor.

The term of each CLN should be structured such that the credit exposure to which it is linked matures prior to the maturity of the CLN. This is to ensure that the CLN will run for the full term of the exposure to which it is linked.

Investors who bought the notes issued by the SPV are exposed to the risk of default of the underlying reference assets, as well as to the risk that the bank will not repay the full principal at the maturity of the notes.

Credit default swaps

This structure involves a bank purchasing default protection from an SPV for a specifically identified portfolio of credit exposures, for example loan commitments. The credit risk of the bank on the identified reference portfolio (will continue to remain in the bank's balance sheet) is transferred to the SPV through the use of credit default swaps.

In exchange for credit protection and for compensating the SPV for taking up the credit risk, the bank will pay the SPV an annual fee. The default swaps on each of the obligors in the reference portfolio are normally structured to pay the average default losses on all senior unsecured obligations of defaulted borrowers.

In order to support the guarantee, the SPV will issue CLNs to investors and use the cash proceeds to purchase government securities. Then the SPV will pledge the government securities to the bank in order to cover any default losses.

In this structure, the CLNs are usually issued in multiple tranches consisting of different seniority and in an aggregate amount that is significantly less than the notional amount of the reference portfolio. The amount of CLNs issued is set at a level sufficient to cover some expected losses, but well below the notional amount of the reference portfolio being hedged.

The SPV will normally have a small cash reserve accumulated over a period of years. This cash reserve is funded from the excess of the SPV's income (consisting of yield on the government securities plus the credit default swap fee received from the bank) over the interest paid to investors on the notes.

The investors in the SPV's senior and junior notes, which tend to be rated AAA and BB, respectively will assume a second-loss position. Any credit losses in the reference portfolio that exceed the first and second loss positions will be absorbed by the bank who will normally retain a high quality senior risk position.

In most structures, no default payments are made until the maturity of the overall transaction. This is regardless of when a reference obligor defaults. This feature has the effect of ignoring the time value of money but it is operationally important to the bank. When the reference obligor defaults under the terms of the credit derivative and the reference asset falls significantly in value, the bank will make appropriate adjustments to reflect the estimated loss relating to the time value of money in accordance with generally accepted accounting principles.

In some synthetic transactions, the bank may retain the credit risk associated with a first-loss position and, with the use of

credit default swaps, pass the second and senior loss positions to a third-party bank.

The third-party bank, acting as an intermediary, enters into offsetting credit default swaps with an SPV, thus transferring its credit risk associated with the second loss position to the SPV. The SPV then issues CLNs to the capital market for a portion of the reference portfolio and purchases government securities to cover some multiple of expected losses on the underlying exposures.

Total return swap

A total return swap is also designed to transfer the credit risk between counterparties. This instrument enables investors to enjoy all the cash flow benefits of a security without actually owning the security. Payments between the counterparties are not dependent upon the occurrence of a credit event but are based on changes in the market value of the underlying reference security.

In the case of a total return swap, the protection buyer swaps the returns on a reference asset (e.g. a bond) and increases in its value periodically with the protection seller in exchange for payment of a variable or fixed reference interest and compensation of losses in the value of the reference asset. Thus, the protection seller assumes from the protection buyer the overall market risk as well as the credit risk from the reference asset for the term of the transaction.

CHAPTER 19
Done Deals — Synthetic Securitisation

NOT MANY WOULD have anticipated Malaysia being a source of much securitisation activity and they have been proved right. However, one international deal was completed and this US$250 million deal was done by Nomura Securities in June 2001 for First Silicon, Malaysia's first wafer foundry located in the state of Sarawak, introduced an entirely new type of structure to the Asian market.

Whole business securitisation may not conform to most people's idea of what constitutes securitisation. There is, for example, no true sale of assets from a company to an off-balance sheet SPV. Essentially, whole business securitisation or operating company securitisation, as it is also known enables a business to finance itself from start to finish by securitising any cash flows that are generated in future.

Whole business securitisation is a hybrid between a plain corporate loan and a traditional ABS. Whole business or operating revenue securitisation views the operating company as an operator of the business, and the business as a series of cash flows, and backed by credit enhancements and structuring, it aims at

attaining better ratings for the instrument than a traditional corporate borrowing.

The major motivations of a whole business securitisation are better rating and therefore cheaper funding, and higher extent of funding than permitted by traditional loans. Off-balance sheet treatment is not applicable to these securitisations, therefore, motivations that spring from off-balance sheet treatment do not apply.

It is almost identical to a secured loan because in such deals borrowings are usually repaid by cash flows. The difference is that investors in a whole business securitisation have greater legal rights, such that they can effectively assume control of the Originator's business in the event of a default.

In common law jurisdictions such as Malaysia, the same technology could be applied to finance different start-up ventures that would find it difficult to leverage up because they do not have a track history.

When Nomura Securities, which has developed a niche with this product having previously done similar deals in Europe won the First Silicon mandate, the project was still in the construction phase, no wafers had been produced or sold, so the transaction was critical in funding the construction of and ensuring production from the First Silicon foundry.

The deal has a maturity of 7 years with a put and call option after the 5th year. It was rated Baa3/BBB by Moody's and Standard & Poor, largely because of the guarantee provided by the Sarawak Economic Development Corporation. Pricing was at 275 basis point over London Interbank Bank Offered Rate.

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