SOTTA SECURITISATION INTERNATIONAL LTD

INTERNET AND ELECTRONIC PUBLISHING

IS SOUTH AFRICA SHAPING UP TO SECURITIZATION?

Author: Eugene G van den Berg, Securitization Specialist, Sotta Securitisation International Ltd

The article sets out past and present developments by observing how these developments compare to the Standard & Poor's Emerging Markets Criteria.

Securitization was introduced to the majority economically established international jurisdictions through mortgage securitization. After its successful application on mortgages, securitization finds application on other securitizable asset-classes.

Evidence suggests that the tendency is reversed in developing nations. Securitization find application on non-mortgage assets and from there it spills over into the development of mortgage securitization initiatives.

The reasons for this unparalleled development between developed and developing economies are: 1) Mortgages are more complicated to securitize due to the mathematical permutations necessary to correctly compartmentalize cashflow-behaviour under different scenarios. 2) Foreign Investors do not invest on a high-scale in developing economies for a variety of reasons, such as foreign exchange control restrictions. 3) In the majority of cases, developing countries do not possess sophisticated capital market infrastructures, compared to developed countries, which for one, affects negatively on secondary market liquidity. 4) Equity markets do exist and have been in existence, which are preferred by local investors. 5) Emerging market investors prefer securitization with a shorter duration. 6) Emerging economies have a strong export component which paves the way for the development of future-flow cross boarder securitization initiatives given the large US Dollar dominance within emerging market exports.

Past future-flow cross boarder securitization transactions have contributed substantially to the overall development of securitization in emerging economies, both from a transaction and regulatory point of view[1].

[1] Standard & Poor's Emerging Market Criteria, 1999, pages 6-7

Developments in South Africa have been slow over the past 11 years. The first securitization concluded aimed at securitizing mortgages. In 1992, securitization was applied on corporate equipment rentals and leases. Stagnation is evident from 1992 until 1997/1998 and early 1999 when again mortgage securitization initiatives flared up. However, during 1998-2000 substantial development has taken place regarding the application of securitization on trade receivables, properties, future rebate flows, future cross-boarder flows and CLO's. Recent developments are geared toward the listing thereof on The Bond Exchange of South Africa [BESA]

It is however important to examine past developments and expectations regarding future prospects against key aspects that must be evident for the development of primary as well as secondary securitization and asset-backed security markets. The environmental and infrastructural drivers are[2]:

- Regulatory environment;
- Legal and tax framework;
- Asset volumes;
- Originator incentives;
- Originator preparedness;
- Investor base; and
- Capital market infrastructure.

Other infrastructural drivers include:

- Accounting framework; and
- The importance of Ratings.

Regulatory environment

The regulatory environment in South Africa is classified into direct and indirect legislation. The direct regulatory environment is controlled by The South African Reserve Bank, which promulgates Securitization regulations and Commercial Paper regulations [The definition of commercial paper includes "debenture". Asset-backed securities do not have a definition in legal terms. However, the characteristics of asset-backed securities belong to "debenture" and therefore are Commercial Paper regulations an important cornerstone of securitization in South Africa].

[2] Standard & Poor's Emerging Market Criteria, 1999 pages 8-11

Securitization regulations regulate, 1) the manner with which securitization assets and income flows are transferred from the originator to the Special Purpose Vehicle (SPV), and 2) operational aspects and efficiencies of the SPV.

Different opinions exist in the South African market regarding conformity to securitization regulation. On the one side the opinion exists, given the specific wording and use of the words "Bank or Deposit-taking Institution" within the said regulation, that only South African banks can originate a securitization. Other opinions hinge on non-conformity as appropriate if a company or business other than a bank originates a securitization.

The fact of the matter is that securitization is also designated within the regulation as an activity which is not limited to the business of a bank, provided that the prescribed conditions are met. This allows a company, other than a bank, to also utilize securitization. On the question of whether a securitization must conform to the conditions of securitization regulation, where the originator is a non-bank entity, the additional securitization spill-over risk that are being created through non-conformity weighs more than the instance where the transfer of securitization assets and flows do conform to securitization regulation.

Conformity to securitization regulation supports "clean-break" and bankcruptcy remoteness [the backbone and spinal cord of a securitization transaction] in securitization, which is supportive of a better rating being assigned to a securitization transaction and more importantly it is also supportive of investor transparency.

Existing securitization regulation in South Africa compares encouragingly to international Regulatory Accounting Practices evident in the United States of America.

Commercial Paper regulation regulates the conditions applicable on the issuing of asset-backed securities by the SPV. The regulation designates the issuing of commercial paper as an activity, which is not limited to the business of a bank provided that the prescribed conditions are met. Both banks and non-bank entities can issue commercial paper. However, commercial paper can only be issued for raising working capital and the proceeds of the commercial paper may not be utilized in the granting of credit directly or indirectly [except for customary credit]. This is an important feature that forms part of the definition of "the business of a bank" in terms of The Banks Act 94, 1990 [Banks Act]. Where commercial paper is issued and the proceeds are used in granting loans, such an activity contravenes the Banks Act. Only a registered bank can issue commercial paper [debt paper] and use the proceeds in granting loans.

The conditions, with regard to the use of proceeds, as stated above, do have an impact on securitization, to which a clear interpretation is not readily available according to the securitization scenarios reflected below:

<u>Where a bank securitizes loans and/or a finance company securitizes loans:</u>
The nature of business of the SPV facilitating such securitizations is supportive of working capital; hence, it can issue debt paper in order to acquire the lending assets being securitized. The possibility does exist, given the nature with which the assets are transferred from the originator to the SPV, in terms of securitization regulation, that the SPV is in effect granting credit on an indirect basis. Should this be the case, then the SPV do run the risk of contravening commercial paper regulation as well as the Banks Act.

When analyzing and interpreting the true meaning of "granting of credit", one should also look at it from a primary and secondary point of view. In primary terms, only a bank can issue debt paper and grant loans with the proceeds. From a secondary point of view, the SPV issues debt paper of which the proceeds are used to acquire existing loans [loans that have been extended by a bank and/or a finance company]. The secondary interpretation is supportive of the nature of business of the SPV in raising working capital and should therefore not lead to contravention of Commercial Paper regulation and the Banks Act.

<u>Where a non-bank securitizes assets [not lending related] or income flows:</u>
The nature of business of the SPV is more closely related to the interpretation of the meaning of working capital. The granting of credit directly or indirectly cannot relate to lending activities. The possibility of such securitizations contravening Commercial Paper regulation is less when measured against the meaning of "granting of credit".

Where the securitization structure includes an interposing SPV[3] and the issuing SPV grants a loan to the interposing SPV, the possibility, in both above mentioned scenarios, do exist that Commercial Paper regulation and the Banks Act are contravened. Until such time as a more clearer legal definition of the meaning of "granting of credit", within the scope of securitization, exists, securitization transactions using an interposing SPV, should be cleared with the South African Reserve Bank. This is however not necessarily the case with regard to the use of an interposing SPV

[3] Legal issues in Rating Structured Finance Transactions, Standard & Poor's, 1998

within future flow-cross boarder securitization, which is evident in one of the securitization transactions recently conducted.

The South African Reserve Bank has introduced amendments to the regulation of banks in South Africa. One such amendment includes the submission of a return (DI701) [on a six monthly basis and only applicable to South African registered banks], which sets out the various reporting requirements for banks involved in securitization. Not only must banks disclose assets being securitised but also further have to report on other levels of participation in a securitization[4]. The regulation further introduces reporting by a bank on investments it conducts in the securitization of its own assets. A new situation emerges from that, which depending on the structure of the asset-backed securities making provision for the inclusion of subordinated or mezzanine debt, create contradiction with securitization regulation to the extent that the investing bank, who is also the originator, provides financial assistance by investing in the subordinated or mezzanine portion of asset-backed securities.

On the other hand, this development is particularly important with regard to further stimulus being afforded to secondary market liquidity of asset-backed securities through indirect market-making enhancements. It can further be argued that these developments aim at paving the way forward, should new bank regulatory proposals by Bank of International Settlements be introduced to the South African banking system to the extent that regulatory capital relieve will be evident when banks can apply different risk weightings on rated financial assets.

The indirect legislative drivers consist of the control being exercised by The Financial Services Board, who regulates investments through various laws applicable on institutional investors, as well as the regulation of markets through the Financial Markets Control Act 55, 1989 [Markets Act]. It is anticipated, given recent developments, that the current definition of a "financial instrument" within the Markets Act is to be changed to include debt instruments that are issued for longer than one year, including securitized debt. These changes will further support investor transparency because securitizations will be required to be listed on BESA.

The introduction of the Collective Investment Schemes Control Bill, will certainly further promote the listing of securitization transactions on BESA in that, once enacted, will only permit investment funds established under the proposed Bill to invest in listed securities.

The regulatory framework for securitization in South Africa is technical and sometimes cumbersome to interpret and to understand. The situation in South Africa is further unique, in that different regulation and legislation, influences the other in order to ensure that the framework with which securitization is executed and the quality of the product thereto [asset-backed securities] is supportive of investor exactitude.

Legal and tax framework

The transfer of securitization assets or income flows; bankruptcy aspects regarding securitization assets and income flows transferred, especially where the originator becomes insolvent subsequent to the securitization taking effect; and perfection of rights to the securitization assets and income flows, is dependant on common law and case law in South Africa.

Apart from the type of asset being securitized, industry specific legislation will influence the manner with which rights are being perfected and bankruptcy remoteness being established.

The practice in some international jurisdictions saw specific new laws created to improve bankruptcy remoteness and perfection of rights. South African laws allow for the transfer of securitization assets and income flows without obtaining the permission from the underlying debtor that generates the cashflows in support of the securitization transaction. Some international jurisdictions, in order to have the transfer and supporting cashflows and collateral perfected, requires the underlying debtor to consent to the transfer of the securitization asset or income flows.

The taxation framework in South Africa need to be looked at from both an Income Tax, Value Added Tax, Transfer Duty, Stamp Duty and the Uncertificated Securities Tax Act point of view.

Income tax is governed by the Income Tax Act 58, 1962 [Tax Act]. No specific guidelines as yet, do exist regarding the tax treatment of securitization assets and income flows compared to other international jurisdictions where specific amendments were introduced to existing tax laws and tax regulation together with securitization regulation and/or amended securitization regulation that support the effective operation of securitization in line with securitization-specific regulation.

The nature of the securitization transaction, the type of cash- and income flows supporting it, together with aspects associated with the substance within the transaction, need to be related to the definition and interpretation of "Gross Income" within the existing Tax Act as well as taxation case laws and past taxation rulings relating to the interpretation of "Gross Income".

[4] Refer - Participation by South African Banks in Securitization, van den Berg Eugene G, Sotta Securitisation International Ltd, 2000

The SPV too, notwithstanding its organization form, is subject to the Tax Act with regard to the nature of income- and cashflows it receives in support of the securitization transaction. In addition thereto, depending on the transaction structural aspects, reinvestment income is taxable within the SPV. Limited expenses are tax deductible. The magnitude of deductibility is further a function of the overall taxation treatment of the transaction as well as the behavioural aspects of the assets and income flows regarding loss provisions and actual losses subsequent to the conduct of the transaction.

It will also be reckless, knowing that income tax securitization specific regulation is non-existent to facilitate a securitization through an entity that possesses huge assessed losses and being converted into an SPV, since it will have a disadvantageous impact on the rating of the transaction due to potential spillover risk.

Existing Income Tax legislation will have to be broadened and expanded in order to cater for securitization in an optimized fashion.

Given the previously mentioned, the income tax treatment pertaining to a securitization transaction in South Africa is based on a case by case basis with reference to taxation case law regarding the transfer of securitization assets and income flows within the framework of common law.

The transactional features of a securitization will further affect the application of the Value Added Tax Act 89, 1991 [VAT Act]. The application thereof stem from the nature of tax treatment regarding the income flows, which support the securitization transaction. In addition thereto, the income flows also need to be looked at from its true nature. For example, when securitizing bank loans, VAT on the income flows is not important, however securitizing income flows which only will come into existence in the future, such as a rental stream or a trade receivable, the VAT attached thereto need to be considered with regard to the correct treatment thereof subsequent to the conduct of the securitization. This stem from the time of actual accrual taking place, as well as the nature and magnitude of the substance within the securitization transaction. Existing VAT legislation is suitable for the conduct of securitization.

The safest manner in approaching income tax and Value Added Tax aspects is to treat both within the SPV. This will impact conservatively on the free cashflow within the SPV from which to service and repay the obligations attached asset-backed securities. Looked from another point of view, acceptable debt coverage ratios supportive of the rating being derived from a situation where Income Tax and VAT is accounted and modeled within the SPV produces conservative results. This would further depend on whether the securitization is conducted on a pass-through or pay-through structure.

The proposed introduction of a Capital Gains tax from April 1, 2001 will inevitably add further tax dimensions needed to be considered in a securitization transaction. Where once-off securitizations are conducted and a capital gain or loss is realized from the securitization, the gain or loss is currently not subject to capital gains tax. However, the introduction of capital gains tax could have an impact on such gains and losses in the future.

Where an originator's business include the regular parceling up of securitizable assets and or income flows, capital gains and or losses deriving there from, might fall within the interpretation and definition of "gross income".

The Stamp Duty Act 77, 1968 [Stamp Duty Act] creates the framework regarding the stamp duty payable on transfer of securitization assets and income flows other than fixed property. The transfer of fixed property is governed by the Transfer Duty Act 40, 1949 [Transfer Duty Act]. Transfer duty in property securitization is a direct function of the structural aspects pertaining to the securitization. It is important to further distinguish, in terms of The Stamp Duty Act, between mortgage securitization and other securitizable asset-classes. The Stamp Duty Act also set forth the relevant stamp duty payable, by the SPV, in respect of the issuing of asset-backed securities. In this regard, it is important to note the difference in stamp duty applicable on private placements and asset-backed securities that are listed on an exchange.

The Uncertificated Securities Tax Act 31, 1998 provides for substantial cost savings available to the SPV regarding the issuing of asset-backed securities in that no stamp duty is payable by an issuer where the asset-backed securities are listed and immobilized. It is however important to ensure which one of either the Stamp Duty Act or the Uncertificated Securities Tax Act will prevail.

Accounting

Another feature, which one could add to the list of applicable assessment criteria, is the nature and state of accounting disclosure requirements and developments. This is important in lieu of the fact that the relationship between accounting, common law and regulation is finely weaved.

Consolidation aspects pertaining to the SPV also need to be taken into account for structural consideration. The accounting regulation in South Africa that will have an impact on securitization is at present limited to normal GAAP principles. Accounting Standard 412, which deals with the circumstances under which an SPV is to be consolidated, was introduced during December 1999. These developments support the "clean-brake" concept within securitization and are based on international developments with regard to the UK standard, FRS 5, which deals with the substance in financial transactions; and IAS 27, which deals with the consolidation of subsidiaries. The practical affect, application and understanding of AC 412 also need to be extented to revised AC 110, which deals with investments in Associates, AC 132, which deals with consolidated financial statements and accounting for subsidiaries. Last two mentioned are applicable with regard to the structuring of ownership of the SPV, whilst AC 412 is geared towards transaction structural accounting aspects.

For the reader that is not well accustomed with securitization, the legal, taxation and accounting framework, in addition to securitization-specific regulations, create different degrees of technicalities which makes cross interpretation between different laws difficult to understand in order to create securitization structural efficiencies. Until new laws are created, that is supportive of existing securitization regulation, securitization remains a tool, which should not be attempted without adult supervision. For this same reason the success of any securitization depends on the extent to which different laws are being utilized in combination in support of investor requirements and demands.

Asset volumes

The securitizable potential evident in South Africa supports the required volume levels needed in developing an active securitization and liquid secondary asset-backed securities market [Transactions that are in the process of structuring are estimated at $1,470 bn [ZAR 10bn[5]]. It is argued that, large issuance supports liquidity. This is true only to some degree.

The creation of liquid markets is a gradual process. A variety of investment specific factors, even though the regulatory, legislative and taxation framework supports large issues of asset-backed securities; stimulate the demand for asset-backed securities by the investment market. The South African Investment market is predominantly equity driven. Liquidity is further an indirect function of legislation and regulation that governs the investment market and a direct function of the degree to which an SPV may avail of liquidity facilities. At present, securitization regulation prohibits the use of bridging finance facilities by an SPV. It limits the debt an SPV may have, at any point in time, to the asset-backed securities issued. The actual performance of asset-backed securities subsequent to the issuing thereof is driven by a degree of uncertainty. This uncertainty may affect the timely payment ability of obligations attached to asset-backed securities. This requires the modeling and rating of the transaction to be conducted with additional conservatism. This limitation further reduces the type of credit enhancement that is deployed in securitization transactions in South Africa.

The use of liquidity facilities, in other international jurisdictions, where securitization is actively practiced, is allowed in providing additional comfort to investors regarding the timely discharging of obligations attached to asset-backed securities.

It is recommended that the South African Reserve Bank consider the introduction of the use of liquidity facilities by an SPV in a controlled fashion. For example, such facilities could be limited to 10% of the nominal value of the asset-backed securities, or equal to the highest project coupon payment, and should only be utilized in accommodating timing differences between income flows supporting the securitization and coupon flows attached to asset-backed securities for predetermined periods of time in the future.

Arguably, mortgage securitization supports homogeneouality and greater underlying risk diversification. A closer analysis will reveal that product diversity, different loan origination standards and different product standardization practices exist amongst mortgage lenders. This together with the mortgage-title transfer costs, coupled with differing insurance arrangements [which forms part of the credit enhancement package] poses problematic in developing a solid base from where rating criteria, as seen internationally, can be developed and applied. This affects the quality of historic information in correctly compartmentalizing cashflows for the mathematical permutations involved in mortgage securitization.

Mortgage-title transfer costs, in South Africa, can however be reduced through the establishment of an interposing entity, at origination level, of which the sole purpose is to hold the mortgage-titles representing the underlying mortgage loans. When securitization takes place the interposing entity is then transferred across together with the mortgage loans to the SPV, which facilitates the securitization.

These problems are however in the process of being addressed with the introduction of better optimized standardised mortgage lending products, constituting origination that will eventually pave the way forward for more aggressive mortgage securitization developments.

[5] "Majority of non-equity savings are short term" Structured Finance Review, Survey, Business Report, June 26, 2000,

The mortgage lending market is dominated by the large commercial banks, which in addition having to conform to strict bank regulation also faces the risk that information unique to a specific lender will become known to their competition.
Securitizable asset-classes other than mortgages, although not catering for risk diversification in the same manner and degree [geographic], is more readily accessible and assessable due to the performance risks attached to the underlying cashflows which it supports can be analyzed and modeled with greater ease.

Based on recent developments, coupled with regulation governing the investment markets, the drivers for creating large asset volumes lies in an approach where initial transaction sizes are smaller compared to that generally required for securitization, since it will pave the way forward in creating gradual liquidity which is better supportive in allowing investors to gain familiarity with the technical and complicated aspects standing behind a securitization transaction. Past developments and more recent developments suggest that securitization growth will be generated from asset classes other than mortgages.

Originator incentives

The use and application of securitization by potential originators, and more importantly the magnitude of the effect it has on operational effectiveness, are not fully understood. Securitization competes with other corporate funding mechanisms and the issuing of equity. It is therefore important to understand the impact of the different funding tool-drivers attached to each funding tool in order to produce good judgment.

The use of securitization is not limited to one specific asset or income flow. The application thereof stretches beyond existing bank-funding products and equity funding arrangements. The challenge is the approach with which a securitization is considered and the ability to measure the impact thereof on the future of the business. This stem from the fact that securitization is cashflow driven and not earnings-improvement driven. A positive impact on earnings, subsequent to a securitization, is mere one of the positive effects of securitization.

Securitization creates funding diversification and in order to compare and measure it with other funding strategies the securitization inherent cashflow drivers, as well as securitization transaction "DNA", need to be understood. Given the off-balance sheet nature of securitization, combined with the diverse application thereof on a variety of different asset classes and income flows, it is not practical to create standardization within securitization. A certain degree of standardization is evident within the regulatory environment, which sets the parameters for the conduct of successful securitization. Each transaction possesses a unique "genetic code" which need to be carefully considered within the parameters.

The off-balance sheet nature of securitization contributes to unleashing of scares capital on a long-term basis, which should contribute to general interest rate stability, hence indirectly, through securitization, funding costs are being reduced[6].

The magnitude of securitization is not always brought in-line with the reasons for wanting to execute a securitization. Securitization is certainly a powerful tool to facilitate growth. Because it unchains future cashflow, the true value being derived from securitization lies in the future. It is important to measure the organizational behaviour inline with strategic direction but mapped against the productive utilization of the proceeds emanating from securitization, whilst generic financial evaluation is earnings driven, which is the result of past performance and not a good measurement of future expectation.

Corporate South Africa is largely earnings driven. On the other hand, securitization is a value creation tool, which need to be assessed from a pure cashflow point of view.

In many instances, it is argued that securitization reduces funding costs. This is more true for developed international securitization markets. In South Africa, securitization is a relatively new funding concept, which makes initial transactions expensive from a cost point of view. This has been well addressed over the last two years. Since the conduct of initial securitization transactions during the late 1980's and early 1990's [term driven securitization], cost reductions are being and will be introduced through the application and deployment of conduit and multi-seller conduit securitization developments. Recent developments regarding the listing of securitization transactions on BESA, will fuel further development along these routes which will lead to further cost savings that can be achieved.

A lack of solid understanding of the drivers behind a securitization transaction, as well as the ability to measure the impact thereof on future operations, coupled with initial costs involved in securitization, creates difficulty in clearly defining the true incentives for conducting securitization amongst South African companies.

Originator Preparedness

The extent to which originators are prepared for securitization flows from the incentives for the need of originating a securitization. In addition thereto,

[6] "Stability can be found in Lon-term financing" Structured Finance Review, Survey, Business Report, June 26, 2000

preparedness also needs to be analyzed from a bank and a non-bank originator point of view.

South African banks do possess asset-classes that support high securitizable asset volumes. However, given the extent to which banks fulfill regulatory capital requirements, the existing levels of profitability, which stems from historic rooted standardised credit pricing, South African banks do not express a willingness to embark on full scale securitization origination. This need to be further analyzed from an investor prospective, given the equity earnings driven nature of organizations in general coupled with the equity driven nature of the South African investment community. The concern do exist that, where a bank securitizes its assets on a true securitized basis, quality assets are being removed from the balance sheet, leaving equity investors potentially exposed to weaker organizational profitability and weaker earnings. This proof once again that both potential originators and investors do not optimally understand cashflow drivers behind securitization.

A different picture however emerges when the results of securitization, on the financial and business aspects of a bank is measured on an Economic Value Added basis as apposed to an earnings approach for measurement.

Non-bank originators have come more accustomed with securitization largely due to a basic understanding of the effects of securitization and how it can facilitate growth in an optimized fashion. This is evident from classifying past transactions and securitization developments underway between non-bank originated and bank originated. This confirms that corporates and commercial enterprises are realizing the effect of securitization compared to on-balance sheet bank funding, which supports a better preparedness amongst potential non-bank originators.

Other factors supporting greater origination from the corporate sector relate to greater system flexibility in producing specific historic information supportive of securitization, as well as flexibility regarding the need to adapt to changes and controls required in optimizing performance information supportive of maintaining required rating levels, once the securitization has been conducted.

By implication, it does not mean that South African banks cannot play a valuable role in developing securitization. This is evident from new profit opportunities that are created for banks through participation within different levels of securitization as well as the role that they could fulfill in optimizing investor transparency and liquidity requirements.

Investor base

The South African institutional investor capital base is diverse for investing in asset-backed securities. Although it can be viewed as a limiting factor, the investment market is well regulated. These regulations and legislation effectively governs the prescribed asset allocations and certain conditions to which institutional investors have to conform to. It is not least limiting for securitization, however a securitization need to be assembled with these legislative drivers at work and in mind for asset-backed security issuing aspects. The fact that investment markets are regulated supports the requirement of sufficient information that supports investor transparency.

The legislative framework, in South Africa, that governs the investor base consist of the Pension Funds Act 24, 1956, the Unit Trust Control Act 54, 1981, both the Long-term and Short term Insurance Acts, the Companies Act 61, 1973 [with regard to the powers of asset-management companies] and the Trust Property Control Act 57, 1988 [with regard to the powers of asset-management enterprises that are arranged in the form of a business trust].

Legislation through regulation prescribes predetermined percentages allowable for the allocation of investment funds. It further prescribes prevailing conditions for investment in either listed or unlisted shares and securities.

The Collective Investment Schemes Control Bill, once enacted, will have a positive impact on securitization, which is evident from the fact that asset-management enterprise and investment vehicles that are arranged and set up in terms of the proposed legislation will only be allowed to invest funds in securities that are listed on a recognized exchange. The securities in which the funds invest need to be rated securities that conform to minimum rating criteria and symbols being assigned by Standard & Poor's and Moody's Investor Services. The enactment of the proposed legislation will contribute to more securitization transactions being prepared for a listing on BESA.

Transactional specific and SPV characteristics reveal that these conditions within the Collective Investment Schemes Control Bill has already start filtering through within two of the recent securitization initiatives [this excludes recent securitizations that were issued and placed internationally].

The importance of regulatory investment fund allocations cannot be over emphasized enough. Knowing that securitization is still within its infancy stages of development in South Africa, coupled with secondary market liquidity concerns and the equity investment driven nature of institutional portfolio managers, these prescribed allocations is more supportive of growing a secondary securitization market with initial smaller transaction sizes compared to the transaction sizes evident internationally.

Empirical evidence, however, stand in conflict with the above observation in that investors have indicated a preference for larger-sized securitization transactions[7]. If this holds merit, then one should raise the question regarding difficulty being experienced with regard to the placing of some of the past securitization transactions.

Observation of other empirical evidence indicate that the South African Investment community holds the following preferences[8]:

- The majority are familiar with securitization developments internationally as well as the performance of securitization transactions once issued;
- Future flow type securitization transactions [trade receivables and/or income flows] are the preferred asset-classes with mortgage securitization being the least preferred asset-class;
- Market risk, credit risk and interest rate risks count as the major risk concerns;
- Prepayment, regulatory and taxation risks are not of major concern;
- Ratings are required as a definite prerequisite for investment consideration;
- Maturity preference for the 1-5 year category;
- Plain Vanilla bond characteristics;
- Floating rate driven securitization transactions are not seen as a limiting factor;
- Asset-backed securities need to be tradable which supports the listing thereof on BESA;
- Attractive initial yield especially where market-makers are limited; coupled with the overall less liquid corporate debt market; and
- Adequate credit enhancement

Credit enhancement techniques evident internationally and being provided by re-insurance companies, are still to be developed in South Africa. At present credit enhancement is structured in accordance with internal credit enhancement forms. Based on transactions concluded and initiatives being developed, credit enhancement is limited to over collateralisation, subordination and the use of reserve funds. The use of liquidity facilities will add substantial value to the overall credit enhancement process as well as the development of specific credit enhancement products being offered by re-insurance companies.

Of these two credit enhancement forms, the use of liquidity facilities is easier to execute and implement, which simultaneously further broadens bank participation in securitization by South African banks, and more importantly, it will promote secondary market liquidity. However, securitization regulation will first have to be amended in order to allow an SPV to also avail of liquidity facilities.

Demand for asset-backed securities are further driven by the following explicit drivers:

Asset Performance

In new securitization developments, the required data in tracking performance may be non-existent. This should not be an obstacle for initial transactions, since the pricing and modeling is dependant on detailed cashflow compartmentalization, which if done according to a high standard, establishes the platform in tracking performance subsequent to the conduct of a securitization.

Stated earlier in the article, the compartmentalization of cashflows pertaining to asset-classes other than mortgages is easier to conduct. This supports the higher preference of asset-backed securities forthcoming from future flow securitizations, which is further supported by past transactions originated by South African companies.

Servicers, credit enhancers and trustees

The genetic code attached to a securitization will largely drive the quality and performance of third parties to a securitization.

Past transactions and securitization developments satisfactorily demonstrates the ability of servicers and back-up servicers.

The young existence of securitization in South Africa, coupled with the underdeveloped status of third party credit enhancement products makes it difficult in measuring the quality of such credit enhancement providers. The majority of past transactions and securitization developments are structured according to the use and application of internal credit enhancement. Internal credit enhancement is derived from the securitization transaction as well as structural aspects in ring-fencing cashflows that support the asset-backed securities.

Only a few securitization transactions and developments to date included a sub-structure that caters for independent trustees. Some transactions and past developments include the structuring house also providing trustee services. One transaction to date,

[7] Securitization in South Africa, Duff & Phelps Credit Rating Co. Africa, survey 1999

[8] Securitization in South Africa, Duff & Phelps Credit Rating Co. Africa, survey 1999, pages 27-31

given the foreign structured content to the transaction, has utilized an interposing SPV in the form of trust with independent trustees. Internationally, trustee services are being provided by large investment banks [can also be referred to as independent investment banks and/or investment banks that are responsible for the structuring of the transaction] or companies of which their main and sole business is to only provide trustee and SPV managerial services.

Currency exposure

The South African foreign exchange market is adequately developed to cater for securitization transactions that include a foreign component. This is however an important consideration where the developments of a secondary securitization market is dependant on foreign investors. Exchange control also plays and important role regarding the attraction of foreign investors to the local securitization market

Where a future flow cross-boarder securitization is conducted, the currency risk is effectively being segregated from the other transactional and structural risk. One such securitization transaction achieved this where the supporting flows are being extracted into an interposing offshore SPV.

Prepayments

Prepayments are not only a function of accelerated normal income flows supporting a securitization. Prepayment risk, depending on the use and structure of external credit enhancement will also occur when predefined credit enhancement is triggered.

In mortgage securitization, prepayment risk is an important concern within international securitization markets, given the sophistication with which such markets operate. In South Africa, given the general level of prevailing interest rates, statistical data on past bankruptcy and insolvencies, general demand for credit, inflation data, consumer data and structural aspects within the South African economy, prepayment risk is lower than in international mortgage securitization markets.

What is however important within South African developments, is the ability to include, within the cashflow compartmentalization supporting the securitization, based on historical experience, the possible timing of default of pool constituents given certain macro economic conditions. The estimated timing of default should be analyzed into its next level, also being a function of experience, with regard to proceeds from liquidation and the estimated timing of receiving liquidation proceeds.

Because the South African securitization market is still developing, the optimized assessment, modeling and pricing of prepayment risk will evolve with the development of the market. To this extent South African institutional investors are not as concerned with prepayment risk as is the case for instance with liquidity risk.

Liquidity risk

Liquidity risk will be higher in jurisdictions where the development of securitization stands in its infancy. Liquidity risk is not only a function of transaction size but also dependant on political and macro economic policies which impacts on liquidity through foreign exchange and the general level of interest rates.

In South Africa, liquidity is also influenced by investment legislation that impacts on statutory asset-allocations as sited earlier on in the article.

Liquidity is a gradual process that is earned and developed through an initial focus on investor transparency and conformity to existing regulation and legislation. Once this is achieved, less difficulty will be experienced in optimizing secondary securitization market liquidity. This is evident from recent securitization developments, where the transactions and the developments are fully geared toward a listing on BESA.

The optimum approach in addressing issues that affect the investor base, coupled with legislation, credit enhancement aspects and the "genetic code" attached to each securitization lies in the ability to assemble, assess and pricing of a securitization from a solely cashflow point of view availing of financial engineering push-rather than financial reverse engineering pull strategies in conjunction with a solid understanding of BESA listing requirements as well as listing requirements evident within international jurisdictions. This further allows one to overcome plain vanilla bond characteristics, which given market conditions, at any point in time, is not always the most optimized debt structure. Plain vanilla bond profiles further increases payment risk attached to principal. In the South African market, where liquidity risk is of concern coupled with the infancy of securitization, pre-determined amortizing bond profiles are supportive in reducing payment risk. In so doing, liquidity risk is indirectly softened.

Capital Market Infrastructure

South Africa has a well-developed efficient and effective capital market. Optimized development has taken place since the formation and establishment of BESA during 1996. The market has supported electronic settlement for a number of years and these developments impacted positively in substantially reducing counter party settlement risk.

The listing requirements and settlement procedures for existing capital market instruments adequately supports the listing of asset-backed securities. Two of the recent securitization developments demonstrate the ability, although difficult in achieving, of securitization transactions to conform to strict listing and disclosure requirements. The majority of past transactions have been placed privately and a few were listed on the Johannesburg Stock Exchange [JSE] through the issuing of debentures. However, viewed against the listing requirements of the JSE, which by implication is geared towards the listing of equity, the JSE is not readily the chosen market for securitization listings. Asset-backed securities are cashflow driven. The nature of the instruments, within the capital market, too, although being expressed and traded on a yield-to maturity basis, is cashflow driven. In addition thereto, the listing requirements of BESA supports the regulatory environment for securitization as well as requirements and conditions evident within legislation and regulations governing the investor base.

A further contributing factor that will see more securitization transactions being prepared for a listing on BESA is the recent developments that have taken place within the South African Corporate Bond market. Four corporate bond issues to date [all during the first half of 2000] have been well received by market participants. International investment banks that have contributed to developments within international capital markets have further contributed to these successful corporate bond issues.

Transformation of the South African capital market is further evident from reduced new government issues compared to the last two decades[9]. This hold benefit for further securitization listings on BESA. Existing investors in the capital market necessarily will adapt to this transformation through shifting portfolio allocations into alternative capital market instruments.

In order for asset-backed securities to be correctly priced, similar benchmark instruments are required. In South Africa however, given the infancy of securitization, initial transactions have to be priced against all available risk free instruments. The scope of the maturity structure of such instruments covers a broad investment horizon with the majority risk free instruments falling due within the 7-10 year maturity. From this platform, it will be possible to develop unique asset-backed security pricing principles. This is supported by recent securitization developments and a true emergence of quality corporate bond issues by large corporates.

The infrastructural mechanism embodied within the South African capital market, supports adequate pricing of all risks associated with securitization. To this extent the South African capital market has the ability to facilitate both, once-off term related securitization transactions as well as conduit and multi-seller programme securitization structures. The most recent development, which is an extension of earlier initiatives, is the establishment of a multi-seller collateralized-loan-obligation debt programme.

Ratings-An absolute must

Remove the ratings aspect and securitization fails. Ratings add substantial value to securitization in that it measures payment ability[10] under different macro-economic scenarios and different default stress levels being derived from the transactional drivers and "DNA" characteristics. Payment ability is a function of cashflow, which is the supporting ingredient for properly analyzing the obligations attached to the asset-backed securities. Once payment ability is determined, given various scenarios and stress levels, it is related to default probabilities[11]. Default probabilities are assembled by rating agencies based on ongoing evaluation of performance data of securitizations and structured finance transactions rated in the past inline with general and specific rating criteria. The rating criterion is a guidance research product, which in turn is based on on-going and previously conducted extensive research from different asset classes, countries, economies, capital markets, legal aspects, and listing requirements.

A good understanding of applicable rating criteria allows for optimized transaction structuring and structural design, which allows for higher investor acceptance.

South African investors do not yet accept ratings as supportive of well-structured investment products forth coming from securitization.[12] This tendency can be related to the equity driven nature of investors in general where investment decision making is driven by market tendencies and strong evaluation of past earnings performance. Securitization and the effects thereof are forward-cashflow driven. Analysis methodology in evaluating past earnings performance is not readily equipped in analyzing the forward-looking behaviour of cashflows supporting securitization. Because securitization in South Africa is still in its roots, investors lack the analytical infrastructure in properly analyzing the cashflow "DNA" drivers within securitization transactions.

---

[9] Securitization in South Africa, Duff & Phelps Credit Rating Co. Africa, survey 1999, pages 43-48

[10] Kocks, Charl, CA Ratings, "What can a rating really do for you?" The South African Treasurer, Issue 3, December 1997

[11] Kocks, Charl, CA Ratings, "What can a rating really do for you?", The South African Treasurer, Issue 3, December 1997

[12] "Hesitancy in accepting assessments is behind slow uptake of securitisation" Structured Finance Review, Survey, Business Report, June 26, 2000

It is ironic to know that South Africa possess a well developed capital market infrastructure which compares favorably with international capital market sophistication.

At the same token sophisticated international markets places high reliance on ratings and rating processes.

South Africa do not lack quality in ratings, the problem being investors not having as yet grasp the intrinsic techniques in properly analyzing the segregation of assets and income flows from the company that owns them. The transfer of these assets and income flows by implication to a controlled environment [SPV and the conditions with which it operates] is done for the benefit of investors.[13]

The regulatory environment with which securitization is conducted in South Africa adds value to the rating process in properly ring-fencing the assets and income flows that are being separated from the company that originated them through securitization.

A better understanding of rating criteria, the rating procedural aspects and the transaction-specific rating drivers, will contribute to a higher level of acceptance which should dissolve hesitance in accepting ratings.

A matrix interpretation of the information sited in this article appears in the table on the following page. Each development criteria is assigned a score of 5. For each shortcoming evident, one point is deducted, stating the reason for the lower score.

Summary

South Africa does have an environment suitable for securitization. The low scores assigned to Asset Volumes, Originator Incentives, Originator Preparedness and Ratings are related to knowledge levels regarding the technicalities attached to securitization, which are at present lower than knowledge levels internationally. Knowledge levels will improve with further developments taking place.

Key to the further optimization of securitization and paving the way for accelerated development lies in:

- The use of liquidity facilities by an SPV. This will require broadening existing securitization regulation;
- Existing Taxation laws should be broadened to include taxation guidelines with regard to the treatment of taxation aspects attached to securitization;
- Banks and re-insurance companies have a strong role to play with regard to the development of external credit enhancement products; and
- Investors need to address and overcome their present hesitancy with regard to ratings and the quality that supports rating methodology

[13] "Hesitancy in accepting assessments is behind slow uptake of securitisation" Structured Finance Review, Survey, Business Report, June 26, 2000

Table 1: Evaluation Matrix

Criteria	Score assigned	Influencing factor contributing to a lower score
Regulatory environment	4	- Limitation on the sue of liquidity facilities by an SPV
Legal and Tax framework	4	- Non existence of specific income tax treatment guidelines for securitization transactions
Accounting	5	
Asset Volumes	2	- Limitation on the sue of liquidity facilities by an SPV - Investor base regulations in respect of asset allocations, bank lending dominance, mortgage title transfer costs - Inability of market participants in realizing the value attached to smaller initial transactions
Originator incentives	3	- Earnings driven nature of originators - Inability to understand the full effect of securitization
Originator preparedness	3	- Bank lending dominance - Inability of equity investors to understand the full effect of securitization
Investor base	4	- Un-matches relationship between perception of transaction sizes and evidence from the entire regulatory environment
- Asset performance	4	- Non standardization as evident in international jurisdictions
- Servicers, Credit enhancers and Trustees	4	- Under developed nature of external credit enhancement products
- Currency exposure	5	
- Prepayments	5	
- Liquidity risk	3	- Investor base regulation - Limitation on the use of liquidity facilities by an SPV
Capital Market infrastructure	5	
Ratings	2	- Hesitance of investors to accept ratings - Inability of investors to fully understand the cashflow drivers - Earnings driven nature of investors flowing from past performance
TOTAL SCORE	53	
CONFORMITY TO CRITERIA	76%	