

Impact Assessment and the Regulatory Design of Securitisation in Croatia

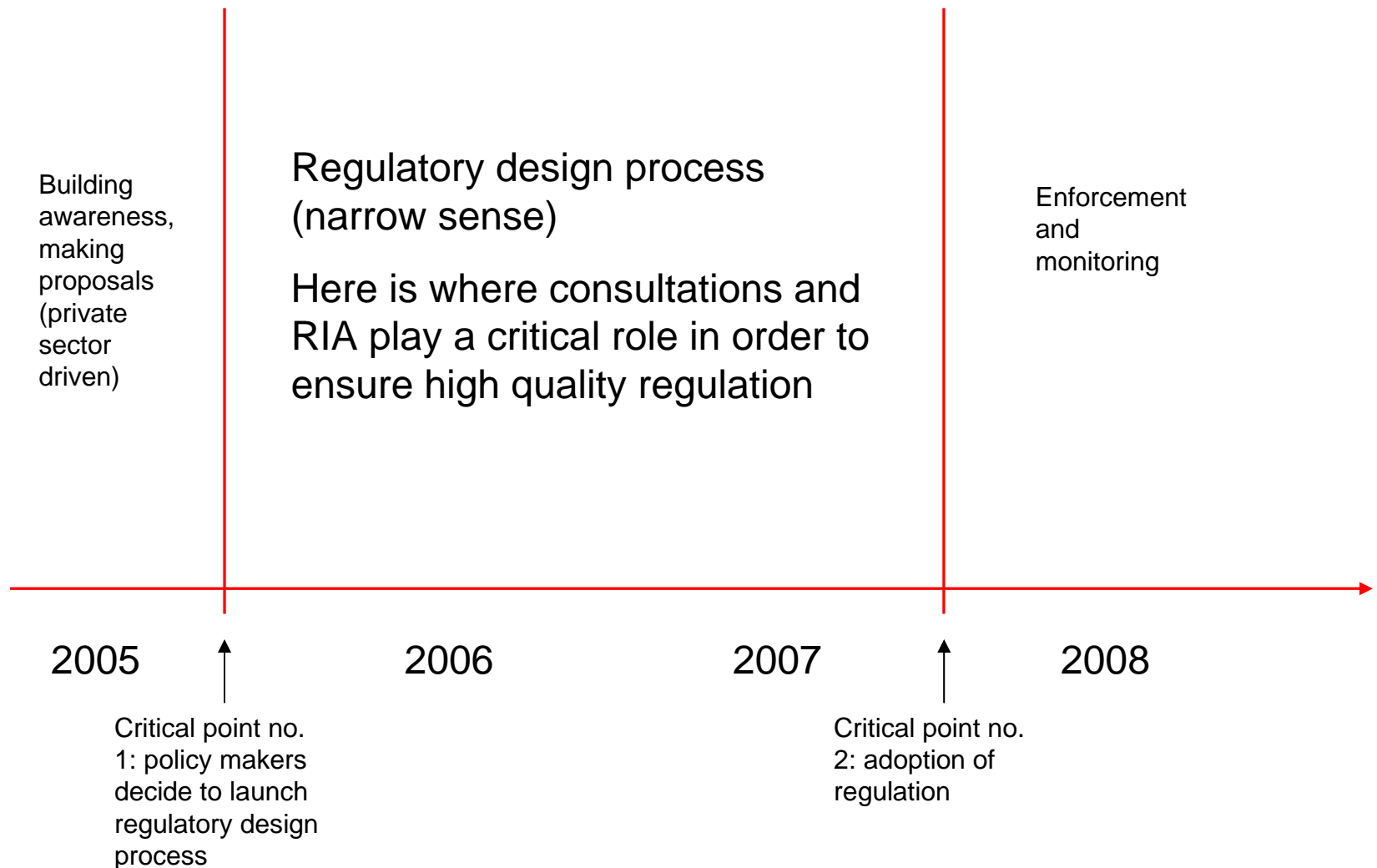
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Contents

- Introduction: time perspective, models of regulatory design and project organization
- What is Securitisation?
- Why regulation (introduction to RIA)?
- Role of RIA
- Pitfalls and benefits

Time Perspective: Longer Than We're Used To



Models of regulatory design

Traditional

Top-down
Administration driven
- Bureaucratic spirit
- Reform spirit
Fast
Cheap

Adjusted Traditional

Top-down
Administration driven
- Some consultation & dialogue
- Reform spirit
Slower
More expensive

Dialogue driven

Both directions
Driven by any stakeholder
- Based on consultations and dialogue
Slow
Expensive

Capture

Top-down
Interest group driven
- Lobbying, lack of transparency
- Corruption
Fast
Cheap



Project Development Steps in Croatia

20+ Key Events up to end 2006!

All of this happened without prior knowledge about RIA within administration and without any formal RIA framework

2nd Steering Committee Meeting
 ILA Opinion on Zero Draft Law
 Zero Draft Law
 Draft RIA Issued
 ILA Final Guidelines
 Market Feedback

MoF Press Conference
 ILA Draft Guidelines
 ILA Consultative Document

1st Steering Committee Meeting

Independent Legal Advisor (ILA) Opinion
 LSG Principles Issued

Legal Solution Group (LSG)
 Created (D,I&HR)

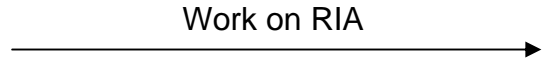
Convergence, EBRD,
 KfW meetings in Zagreb

Project Governance Structure Set-Up

Consultations with local regulators

MoF CBA Issue Exploration
 Convergence- Working Group
 EBRD invitation

First MoF-Convergence discussion
 CBA Book Launch Endorsed by Authorities



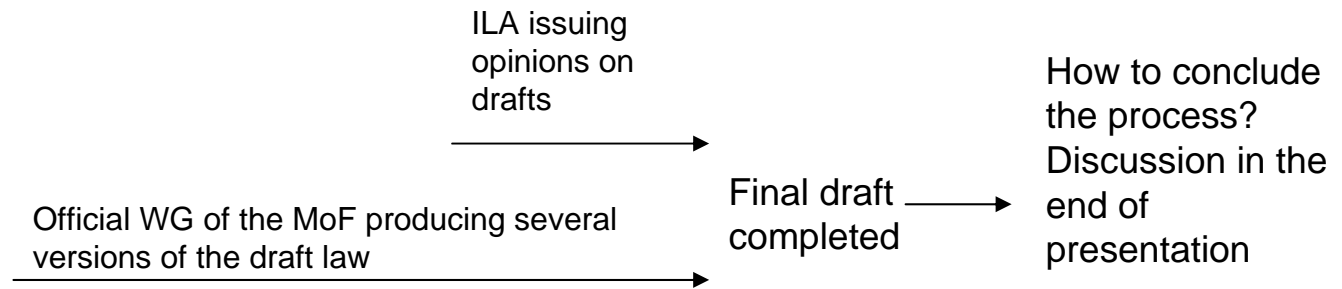
CBA – Croatian Banking Association
 MoF – Ministry of Finance
 LSG – Legal Solutions Group
 ILA – Independent Legal Advisor

Oct 05 Dec Jan 06 Apr May Jun Jul Aug Sep Oct Nov Dec 06

Project Development Steps

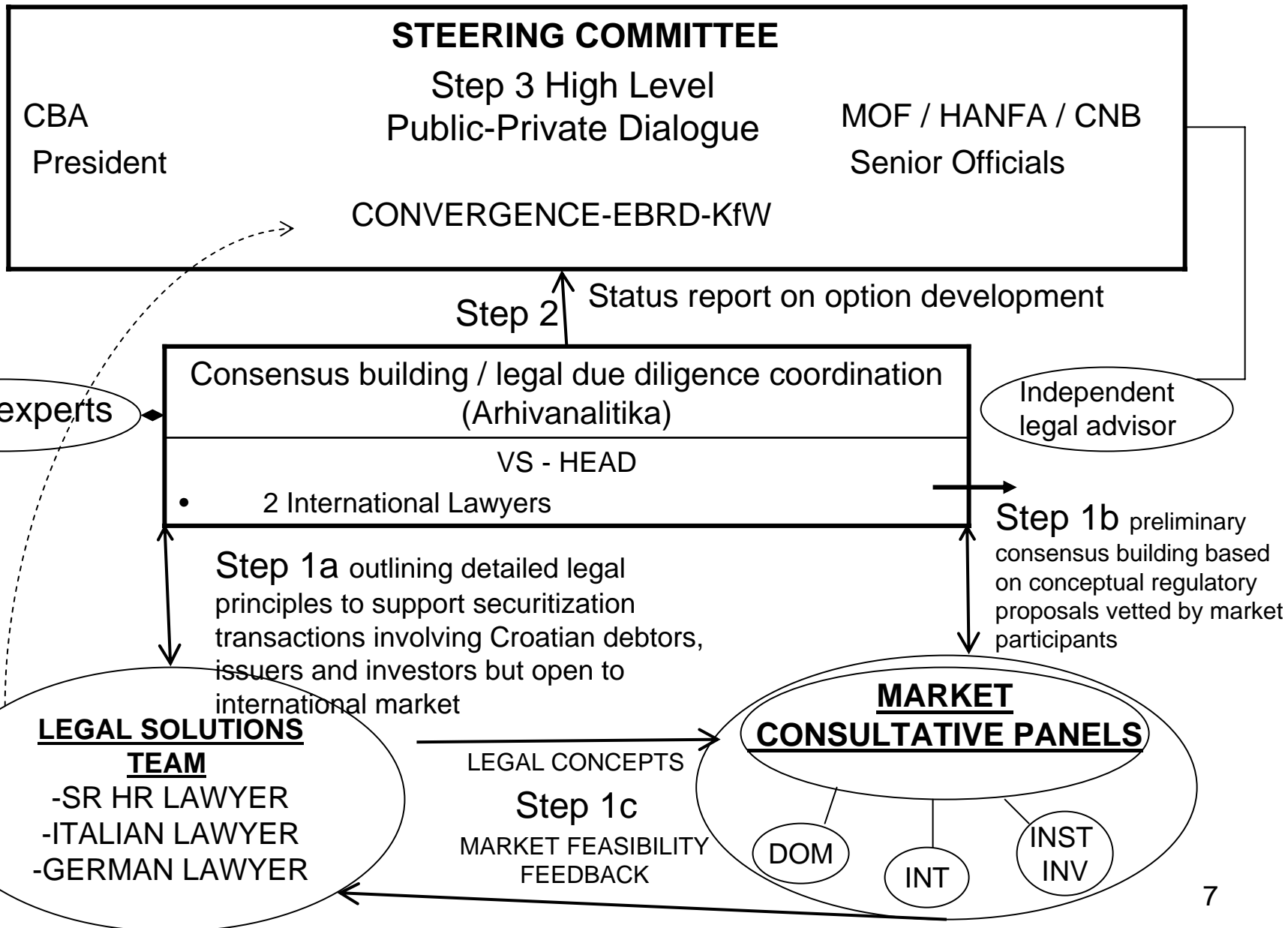
Key Events During 2007

Prior setup of the MoF working group (legal writing team) comprising representatives of the central bank, MoF, regulator and consultants



Jan 07 Apr May Jun Jul Aug Sep Oct Nov Dec 07

Croatian Securitization Project Development Structure



Key Conceptual Issues

(issues that absorbed most resources)

- Broad understanding of benefits and pitfalls (attach appropriate weight to PR activity)
- Ensuring quality (“best practice”)
- Ensuring “horizontal” consistency of regulation (key to enforcement)

Use of PR Within This Model

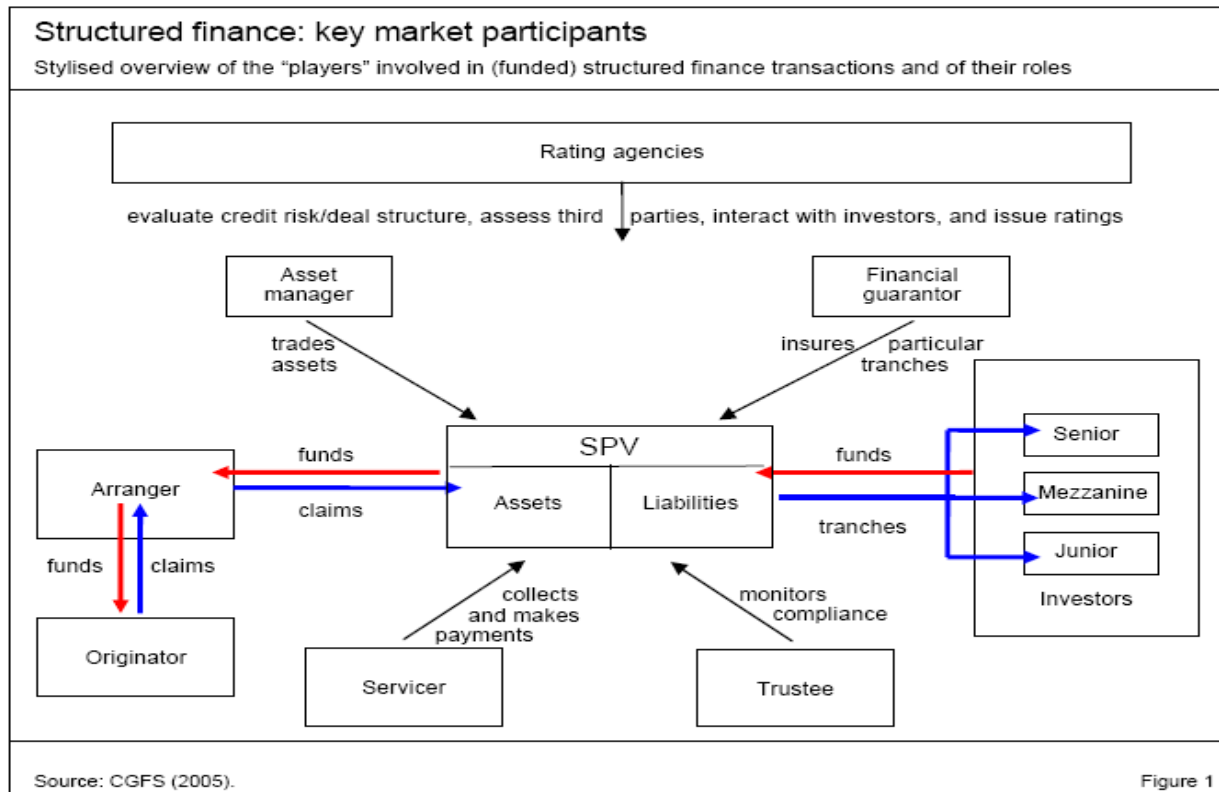
- Stakeholders' legitimate concern (not PR problem – has to be dealt with transparently through regulatory design process)
- PR has to make all stakeholders immune to the lack of information and knowledge
 - “Securitisation is a way to diminish monetary policy effectiveness”
 - “Securitisation will diminish the legal rights of final debtors”

What is securitisation

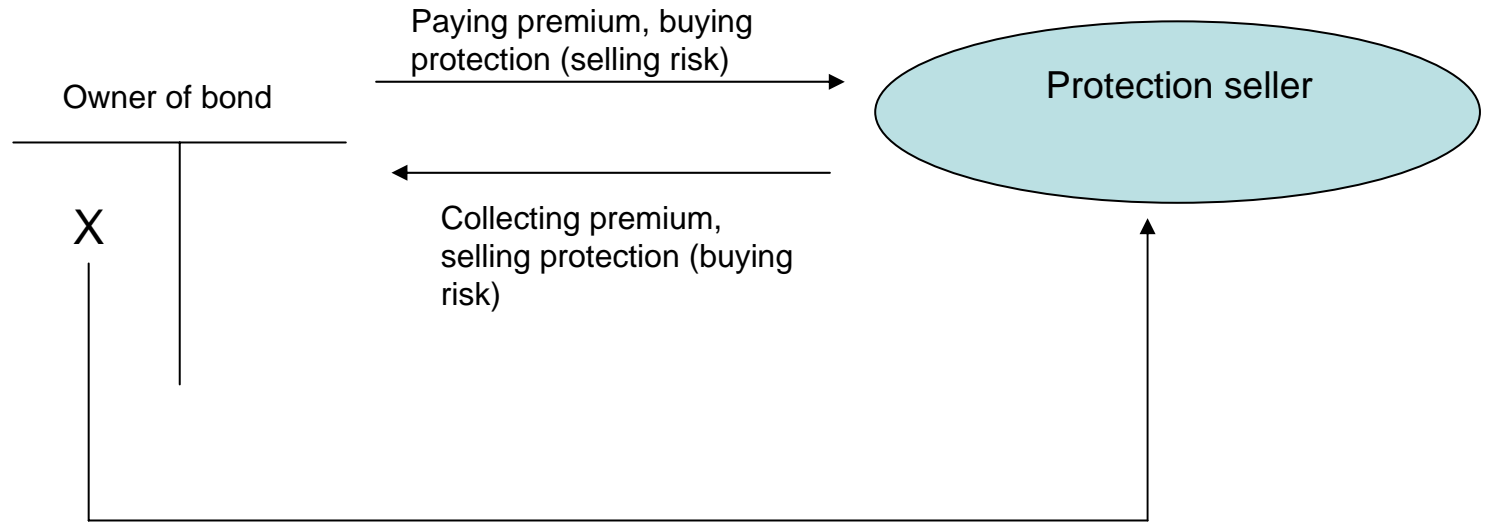
Securitisation belongs to a family of structured financial products. It consists of financing or re-financing of assets by re-packaging them into tradable, liquid form through issue of debt securities.

Traditional vs synthetic securitisation

Traditional securitisation scheme



Synthetic securitisation scheme



Bond transferred to protection seller at par value in the case of "credit event"

- Nonpayment of interest/principal
- Change of currency denomination
- Restructuring (changing coupon, term, "haircut"), etc

This is the logic of credit default swap

Why Regulation?

- Introduction to RIA
- Around 20 key issues identified by the CBA exploration team (this is the list of issues that will have to be assessed in terms of policy options)
- E.g. data secrecy, eligible assets, transfer of collateral, legal form of SPV, tax treatment, risk capital regulations etc.
- Listing key issues at an early stage of project development provides framework for thought and dialogue and helps find out whether regulatory effort is needed at all.

Developing Definitions and Options for Key Issues

Definition of key regulatory issues

As early as possible. Impossible without consultations process starting at early stage.

Developing regulatory options

Goes on throughout the process. Keeping it open-end as long as possible.

Option chosen with explanation

Strategic issues should be closed before final drafting process. Operational issues should be closed at the end of the legal drafting process.

Example (1 of 17 key issues)

What legal form can SPV take?

(issue at strategic level)

Option I

Company according to Company Law without additional provisions in the Securitization Law

Option II

Company according to Company Law with additional provisions in the Securitization Law

Option III

Securitization Fund with special provision in the Securitization Law

Options chosen:
II and III (let the market decide)

RIA in brief

- An aid, not a substitute for decision making
- Reflecting main benefits and costs/pitfalls from the perspectives of all stakeholders
- Using maximum possible quantifications
- Reflecting possible regulatory options
- Open-ended document to be supplemented by analytical work of all parties involved

Stakeholders' Perspectives Households

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- Borrowing at more favourable terms
- Lower volatility of supply of new loans and leasing (long-run)
- In general, more stable access to finance at better terms

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- Lower incentives to monitor final borrowers (SPV's incentives problem)
- Changing legal position of final borrowers needs to be prevented

Stakeholders' Perspectives

Corporate Sector incl. SMEs

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- New funding instrument
- More stable access to finance at better terms
- New potential channel for public (IFI's) intervention to support SMEs lending

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- Lower incentives to monitor final borrowers (SPV's incentives problem)
- Changing legal position of final borrowers needs to be prevented

Stakeholders' Perspectives

Banks and Other Intermediaries

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- Improvement in management of liquidity, capital and A/L structure in general
- Diversification of credit risk
- Reduced volatility of earnings

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- Banks buying equity (high risk) tranches expose themselves to macro risks
- Changing legal position of final borrowers needs to be prevented

Stakeholders' Perspectives

Domestic Investors

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- New opportunity to generate returns on investment
- New opportunity to diversify risks
- Especially related to pension funds

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Stakeholders' Perspectives

Foreign Investors

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- New opportunity to generate returns on investment
- New opportunity to diversify risks

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Stakeholders' Perspectives

HANFA / MoF

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- More precise pricing of debt (increased market efficiency)
- New funding instrument for public sector projects
- Further integration with EU single financial market
- Retaining degree of control over transactions after full liberalization of capital flows

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- Required resources

Stakeholders' Perspectives Croatian National Bank

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MICRO

- Improvement in liquidity management
- Increased stability of banks
- Improved early warning signals

MACRO

- Stronger links between domestic savings with domestic credit growth and investment

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- Unsustainable growth of foreign debt

Results of Survey of Potential Originators

Type	Assets estimated by respondents as presently suitable for securitization EUR mln	Expected transactions EUR mln								
		Year 1			Year 2			Year 3		
		No. of trans.	o/w cross border	Total amount	No. of trans.	o/w cross border	Total amount	No. of trans.	o/w cross border	Total amount
Mortgage loans	4 719	4	0	700	6	2	1 300	7	2	1 350
Car loans	927	0	0	0	1	1	50	1	1	50
Leasing portfolio	395	0	0	0	3	0	50	3	0	60
Other	733	0	0	0	0	0	0	1	1	100
TOTAL	6 774	4	0	700	10	3	1 400	12	4	1 560
memo: synthetic				80			70			50
Avg amount of true sales transact.				175			127			120
Avg amount of MBS				175			217			193

Domestic Demand Estimate

	Year 1	Year 2	Year 3	Year 4
Rate of AUM - pension	30%	26%	23%	20%
Rate of AUM – investment	35%	30%	26%	22%
Allocation in % of AUM as stated by respondents	2,5%-5%	4%-5%	5%-6%	assumed the same as Year 3
Total demand estimate (EUR mn)	202	412	571	714
banks	100	120	140	160
funds	102	282	431	554
Funds' allocation as % of AUM	2.5%	5.4%	6.5%	6.9%
Annual increase in funds' allocation as % of annual increase in AUM	10.0%	16.4%	10.6%	8.8%
Aggregate demand estimate (EUR mn) after 20% correction for non-responded demand	242	484	675	857

Scenario A Based on Expert Assessment of Likely Developments and Scenario B based on Survey

EUR million		2007	2008	2009	2010
SCENARIO A					
1	Supply: total cumulative o/w banks	0 0	900 800	2 000 1 890	3 000 2 890
2	Domestic demand estimate (cumulative)	242	494	675	857
3	Supply – demand (cumulative stock): potential foreign demand	0	406	1 325	2 143
4	Implied increase (-decrease) in gross foreign debt if banks use 100% of securitization receipts to repay foreign debt*		-494	-675	-857
SCENARIO B					
1	Supply: total cumulative o/w banks	700 700	2 100 2 000	3 660 3 550	- -
2	(minus) supply cross border**	(0)	(434)	(820)	-
3=1-2	Supply: domestic cumulative	700	1 666	2 840	-
4	Domestic demand estimate (cumulative)	242	494	675	857
5=3-4	Supply – demand (cumulative stock): potential foreign demand	458	1 202	2 165	-
6	Expected cost of funds savings in bps	23	23	23	23
7	Supply if marginal reserve is applied	300	350	610	-
8=7-5	Supply – demand (cumulative stock) with marginal reserve requirement applied	-58	-144	-65	-
9	Implied increase (-decrease) in gross foreign debt if banks use 50% of securitization receipts to repay foreign debt and if cross-border securitization takes place (worst case scenario)	108	581	1 210	

Summary Quantitative Impact Assessment

MICROECONOMIC PERSPECTIVE		Cumulative amount in EUR million (3 years perspective except for consumers)		Methodology of microeconomic calculation	Amount of savings in EUR million (PV over 3 years except for consumers)	
		Scenario B	Scenario A		Scenario B	Scenario A
Banks	Securitized loans	3 550.0	2 890	Lower cost of funding (net)	-35.5	7.5
	Lower capital requirement	355	289	Lower cost of capital	44.2	27.9
Consumers / banks' clients*	Borrowing at better terms (bps decrease as of end period)		-23	Consumer surplus*	170.2	170.2
	Increase in banks' lending to the private sector		600-700 p.a.			
Leasing	Additional finance at lower cost	110.0	110.0	Multiple of additional supply and cheaper funds	0.2	0.2
Domestic investors	Positive shift of risk/return frontier given total allocation to MBS and ABS securities	675.0	857.0	Additional yield/lower risk over alternative investment	17.9	24.6
TOTAL MICROECONOMIC BENEFITS					197.0	230.4
o/w short term					26.8	60.2
o/w long term					170.2	170.2
Total as % of 2006 GDP					0.6%	0.7%
MACROECONOMIC PERSPECTIVE						
Decrease in banks' foreign borrowing		1 775.0	2 890	Repayment of old foreign debt due to cost of regulation		
Non-resident investors' purchases of bonds in 3 ys		2 985.0	2 143			
Impact on growth of gross foreign debt in 3 ys		1 210.0	-747.0	Cumm. growth	4.3%	-2.7%
Impact on growth of net foreign debt in 3 ys		605.0	-374.0	Cumm. growth	3.7%	-2.3%

In Addition ...

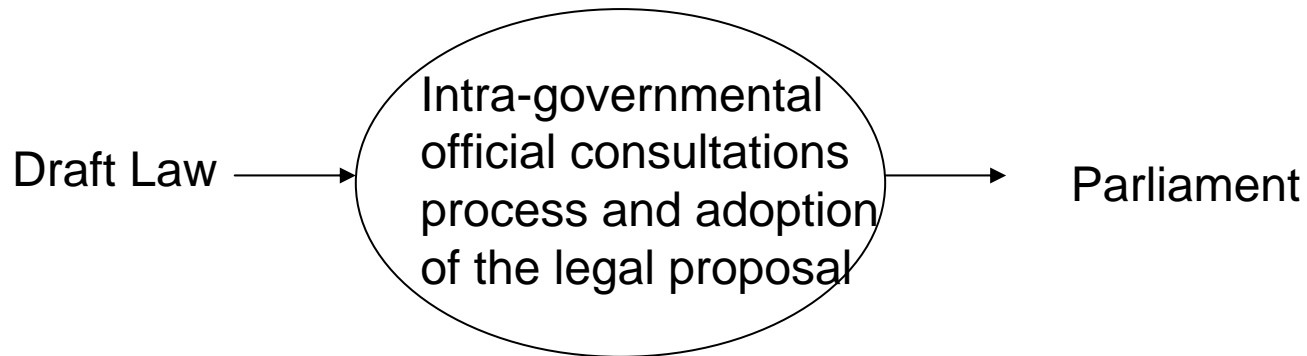
... RIA shows second – round impacts on use of released reserves and impact on net international debt, also showing that banks' incentives is to use maximum receipts from securitization for repayment of foreign debt ...

... RIA also shows how coordinated implementation of Securitization Law, Securitization Framework of Basle II and high Marginal Reserve which is not applied to securitization receipts may lead to firm control and even decline of foreign debt ...

... but ...

... THE POINT IS TO SHARE RIA'S MODELS AND RESULTS SO THAT RIA BECOMES A BALANCED REFLECTION OF VIEWS AND BELIEFS OF ALL THE PARTIES INVOLVED.

How to Conclude the Process



The final steps (adoption process) has to be accompanied by RIA summary document



Assessment (pitfalls and benefits) of the process

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- Spreading knowledge about the topic
- Building consensus about key issues
- Getting access to “best practice”
- Thinking about details (“horizontal coordination of regulation”, enforcement and monitoring)

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- Cost in terms of resources
- Cost in terms of time needed
- Overly cumbersome for top policy makers to appreciate the benefits and quality
- Very hard to manage due to complex governance structure and a large number of players involved