REPORT ON ASSET SECURITISATION IN MALAYSIA
THE WAY FORWARD FOR THE MALAYSIAN MARKET

Prepared by the Asset Securitisation Consultative Committee (ASCC)
in collaboration with the Securities Commission

Suruhanjaya Sekuriti
Securities Commission

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PREFACE

The Securities Commission (SC) has established an Asset Securitisation Consultative Committee in March 2000 (ASCC) which comprises market participants such as lead managers, legal advisers, accountants, rating agencies and the national mortgage corporation. One of the objectives of the Committee, is to advise the SC on the steps needed to develop asset securitisation in the country. Since then, the ASCC and the SC have had discussions on the current legal, regulatory, tax and accounting impediments to asset securitisation as well as the necessary measures to address them. The result of these discussions is the finalisation of this report.

This report serves to map out strategic initiatives crucial to the establishment of an efficient and facilitative legal, regulatory, tax and accounting framework for securitisation. This could serve as an important foundation for the development of a critical mass of securitisation transactions in Malaysia. Accordingly, a host of recommendations are made by the ASCC in this Report which would be put forward to the Government and various regulatory bodies for their further consideration and adoption, wherever appropriate.

Following the concerted efforts by the Government to spearhead the development of a securitisation market here, the onus will now be on advisers, investors and corporate issuers to capitalise on the sound infrastructure being put in place by the Government. With ample liquidity in the financial system and the growing maturity of the Ringgit bond market, asset securitisation is set to provide further impetus to the already active domestic bond market by offering tremendous opportunities and benefits to market participants.

Given the nascent stage of development of asset securitisation in this country, the Report also serves to promote a greater understanding of securitisation concepts and mechanics in the market place. Finally, the Report has also made an attempt to address some of the constraints faced by the National Mortgage Corporation or Cagamas in securitising housing loans in the banking system.

The SC would like to express its deep appreciation to members of the Committee for their invaluable contribution to this Report.

SECURITIES COMMISSION
NOVEMBER 2002

Chapter I

Introduction

1. Asset securitisation can broadly be defined as the process whereby loans, receivables and other financial assets are pooled together, with their cash flows redirected to support payments on securities issued to purchase such assets. These securities, which are generally referred to as "asset-backed securities" or "ABS" are issued and sold to investors for the benefit of the owners of the assets, who utilise securitisation to source financing for their business activities.

2. The financial assets that support payments on ABS range from residential and commercial mortgage loans to a wide variety of non-mortgage assets such as trade receivables, credit card receivables, consumer loans, lease receivables and motor vehicle loans. Although these asset types are the basis of the more prevalent forms of ABS, the concept of securitisation may be applied to virtually any asset that has a reasonably ascertainable value, and generates a reasonably predictable future stream of revenue. This may include toll receivables, bond obligations, loan obligations and future rights to entertainment royalty payments.

3. Unlike conventional private debt securities (PDS) which continuously exposes investors to the credit risk of the issuer, asset securitisation is intended to largely confine investment risk to the performance risk of the financial assets that support payments on ABS. This is achieved by isolating the financial assets from the entity that originates the assets. Another basic feature of ABS that differentiates it from conventional PDS is the continuous repayment of principal (including prepayment) exhibited by many types of ABS such as those involving residential mortgage loans, consumer loans, among many others. In the case of PDS, the repayment of principal usually occurs at the maturity of the securities.

4. Asset securitisation is a significant component in most international financial markets. In the US, for instance, the size of the ABS market has reached an outstanding amount of USD854 billion[1] (or RM3.2 trillion) as at end-December 2000 with an average annual issuance of about USD200 billion. Similar growth patterns in the ABS market of Europe and Japan have been observed. This impressive growth is largely attributable to the inherent advantages of asset securitisation over conventional PDS. Compared to the issuance of PDS, asset securitisation would frequently result in a more cost efficient funding alternative for most corporations. It is also able to provide a wider array of instruments tailored to meet specific investor needs.

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[1] Based on an estimate from the Bond Market Association in the US. The amount excludes mortgage-backed securities which recorded an outstanding amount of USD2.5 trillion as at end-December 2000.

5. In recognition of this fact the NEAC and the NBMC have identified asset securitisation as a key strategy to further develop the domestic bond market.

6. Asset securitisation, until the introduction of Guidelines on the Offering of Asset-Backed Debt Securities by the Securities Commission on 11 April 2001, is virtually non-existent in the domestic bond market. This is due to a host of legal, regulatory, tax and accounting issues which need to be addressed to facilitate its introduction. As first steps, the Securities Commission (SC) established an Asset Securitisation Consultative Committee (ASCC) comprising lead managers, legal advisers, accountants, rating agencies and other market institutions as follows:

No	Members of ASCC [2]	Institutions
1	Mrs. Tan Wai Kuen	Cagamas Berhad (Retired)
2	Mr. N. Kokularupan	Cagamas Berhad
3	Mr. Christopher Lee	Wong & Partners
4	Ms. Sitpah Selvaratnam	Tommy Thomas & Co
5	Mr. Wong Fook Wah	Rating Agency Malaysia Berhad
6	En. Izzuddin Mohd Yusof	Malaysia Rating Corporation Berhad
7	Mr. Loh Shai Weng	Commerce International Merchant Bankers Berhad
8	Mr. Eugene Khoo	Arab-Malaysian Merchant Bank Berhad
9	Mr. Kuah Hun Liang	Deutsche Bank Berhad
10	En. Faiz Azmi	PricewaterhouseCoopers
11	Mr. Aditya Bhugtiar	Previously from PricewaterhouseCoopers
12	Mr. Chew Thiam Hock	KPMG Tax Services

7. The terms of reference of the consultative committee are to:

(i) Identify current impediments in legal, regulatory, tax and accounting aspects of asset securitisation;
(ii) Set out recommendations to address the above issues; and
(iii) Develop a comprehensive framework encompassing legal, regulatory, tax and accounting aspects which would facilitate the development of asset securitisation in this country.

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2 Mrs. Tan Wai Kuen has since retired from Perbadanan Cagaran Malaysia (Cagamas) and her position was filled in by Mr. N. Kokularupan. The resignation of Mr. Aditya Bhugtiar from PricewaterhouseCoopers in mid-2001 has also resulted in the appointment of Mr. Chew Thiam Hock from KPMG Tax Services to advise the Committee on tax matters.

Chapter II

Securitisation Mechanics – Process and Participants Involved

1. Although the list of assets that may be securitised is potentially endless and various structures can be used, the fundamentals of securitisation are present in nearly all types of transactions.

2. The intended goal and effect of virtually all securitisation transactions is to isolate the financial assets concerned that support payments for the related ABS. This isolation ensures that payments for the ABS are derived exclusively from the performance of a segregated pool of financial assets, rather than from the entity that originated the assets.

3. The process flow and key participants of a common securitisation transaction can be depicted as follows:

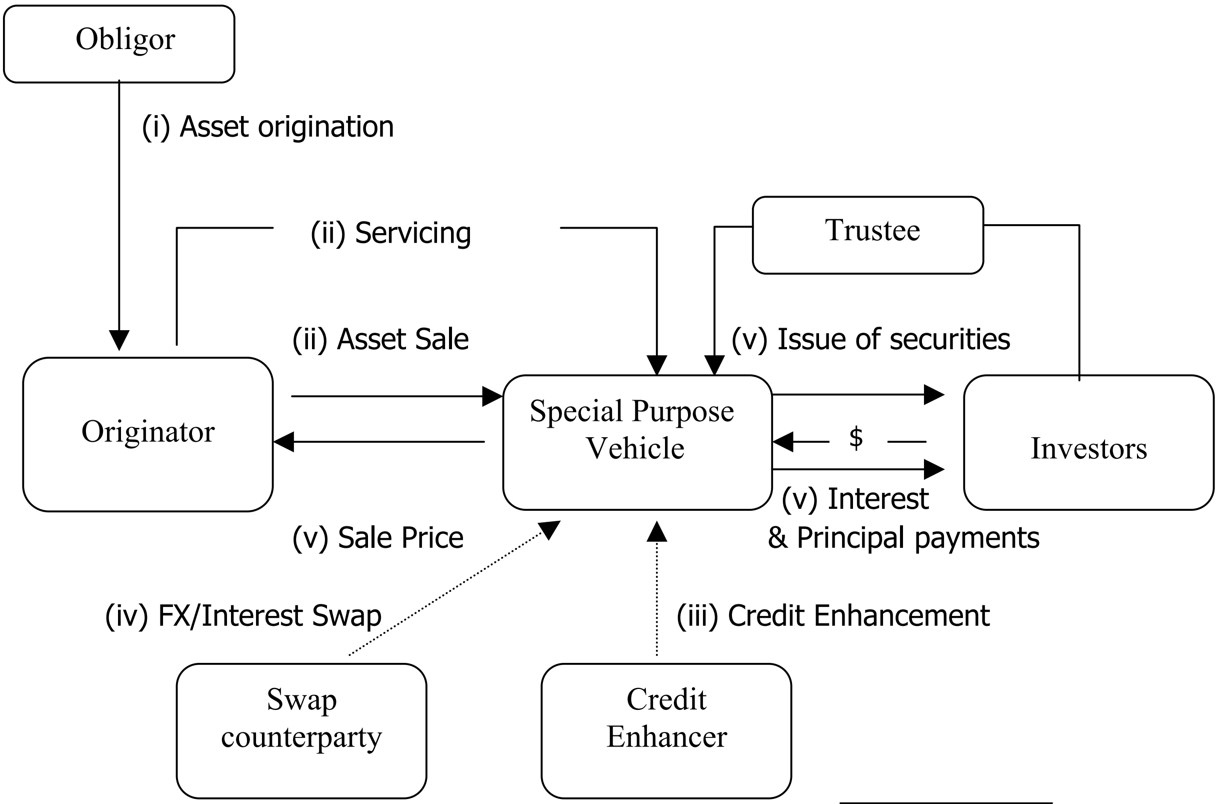


Diagram 1

Diagram 1: Description of the process flow

(i) Asset origination

- The assets that underlie securitisation transaction will first be originated when an entity ("originator") makes a loan or otherwise extends financing to a borrower (i.e. the "obligor"). For instance, a consumer loan granted by a financial institution would require the borrower to make periodic payments to the financial institutions, thereby creating a stream of cash flows necessary to support a securitisation transaction.

(ii) Asset sale and servicing

- In order for ABS to be issued, the originator transfers those assets to another entity which, for reasons discussed below, will usually be a "bankruptcy remote" special purpose vehicle (or "SPV").

- The transfer of assets normally occurs in the form of an equitable assignment although in some cases a legal assignment or novation. In novation, the existing agreement between originator and obligor is terminated and a new agreement between the SPV and the obligor is substituted. This effectively transfers all the originator's rights and obligations to the SPV. Novation ensures the "clean" transfer of assets to the SPV. On the other hand, under a legal or equitable assignment, the originator merely assigns its rights over the assets to the SPV. In the case of a legal assignment, notice of the assignment is given to the obligor in addition.

- After the assets are transferred, the originator or other entity will provide collection and management functions in connection with those assets. These activities are generally referred to as servicing activities and the entity performing these functions, is commonly referred to as the "servicer".

- The transfer of assets from the originator to the SPV generally needs to be conducted in a manner that results in a "true sale", and not, in substance, merely a secured financing.

- A true sale is necessary in order to remove the assets from the possible bankruptcy estate of the originator. Thus, if the originator were to become bankrupt or insolvent, a trustee or receiver of the bankruptcy or insolvency estate would not be able to reach the transferred assets to satisfy the claims of the originator's creditors if the sale is achieved. To the extent this legal isolation is accomplished, investors need to look only to the assets themselves, and not to the originator for repayment on the ABS.

(iii) Credit enhancement

- Depending upon the nature of the transaction and the assets involved, the asset pool is usually supported by one or more types of credit and/or liquidity support ("credit enhancement" and "liquidity enhancement," respectively) in order to improve the credit risk profile for the ABS being issued. A variety of internal and/or external credit supports are employed such as, subordination, third party or parental guarantees, letters of credit or excess servicing. A fuller explanation of these credit enhancements can be found in Appendix 1. These credit supports increase the likelihood that investors will receive the cash flows or payments to which they are entitled.

(iv) Interest rate and currency swaps

- It is often the case that the assets underlying a fixed -rate ABS issuance bear interest at a floating rate. It is also relatively common for the underlying assets to be denominated in one or more currencies that differ from the currency in which the ABS bond payments are made. In order to hedge against potential mismatches from interest rate and currency exchange rate movements, the sponsor of a securitisation transaction will typically arrange for the issuing entity to enter into interest rate swaps, currency swaps and other hedging and risk-management arrangements with another entity (a "swap counter-party").

(v) Issuance of securities and interest & principal payments

- The SPV, which is often organised in the form of a trust or limited company, will then issue debt securities (i.e. ABS) in the capital market (i.e. the "issuer"). As in the case of PDS, a credit rating is obtained prior to the issuance of the ABS. Proceeds from the sale of the securities issued by the SPV plus any surplus (which may arise during the term of the ABS) are paid back to the Originator. The cash flows from the assets are used to pay interest and redemption amounts to the Investors.

Chapter III

Principal objectives and benefits of securitisation

1. As a capital market financing mechanism, securitisation supports a number of objectives and may generate a wide range of benefits, whether viewed from the standpoint of an originator or an investor, or from a broader social and economic perspective.

Benefits to Originators

2. From an originator's perspective, securitisation provides a vehicle for transforming relatively illiquid individual financial assets into liquid and tradable capital market instruments. Through securitisation, an originator can replenish its sources of funds, which can then be used for additional origination activities.

3. Securitisation also provides an originator with what is frequently a more efficient, and lower cost source of financing in comparison with other bank and capital market financing alternatives. The principal reason for this greater efficiency and lower cost of financing is the ability of an issuer, through securitisation, to issue securities that carry a higher rating (and thus a lower interest rate) than the long-term credit rating of the originator. This affords originators cheaper financing than may be supported by their unsecured claims-paying ability.

4. At the same time, by offering an alternative to more traditional forms of debt and equity financing, securitisation allows originators to diversify their financing sources.

5. Another central objective and benefit of securitisation from an originator's standpoint is that it facilitates the removal of assets from the organization's balance sheet. This outcome can help an originator improve various financial ratios, utilize capital more efficiently and achieve compliance with risk-based capital standards. As many banks must either increase capital or dispose of financial assets to comply with these guidelines, and as increasing capital may be quite expensive, disposing of assets through a securitisation transaction has become an increasingly attractive means of assisting commercial banks in complying with the Basel framework.

6. Other benefits associated with securitisation relate to the more flexible and adaptable nature of this form of financing in comparison with more traditional alternatives. For example, the ability of an originator to subdivide and redirect cash flows from underlying financial assets often provides it with a better ability to manage its balance sheet, and to achieve a more precise and efficient matching of the duration of its assets and liabilities.

7. Similarly, many originators have found that securitisation permits a greater degree of specialisation and corresponding efficiency by allowing a financial institution to segregate and unbundle its loan origination, funding and servicing functions in a manner that best responds to that institution's competitive advantages and desired strategic focus.

Benefits to Investors

8. ABS provides a wide variety of product choices at attractive spreads that attract a diversified investor profile. Pension funds and insurance companies would constitute a large investor segment for certain types of ABS due to the relatively high credit ratings and predictable cash flows of an ABS. On the other hand, money managers would be attracted to invest in other categories of ABS issues that offer higher total return.

9. Further, 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.

Social And Economic Benefits

10. In markets where securitisation has been employed on a broader scale, a number of public, social and economic benefits have been realised. For example, the existence of liquid and efficient secondary securitisation markets has had the effect of increasing the availability, and reducing the costs, of financing in the primary lending markets. The financing needs being serviced often relate to areas that are favoured by social or governmental policy, such as increasing the supply of funds for home ownership.

11. It has also been observed that robust securitisation markets facilitate and encourage the efficient allocation of capital by subjecting the credit-granting activities of individual financial institutions to the pricing and valuation discipline of the capital markets. In this fashion, securitisation helps to promote the allocation of scarce societal capital to its most efficient uses.

12. Asset securitisation could also contribute significantly towards the reduction of risks within the banking system. From a regulatory and financial markets supervisory perspective, securitisation offers a useful mechanism by which financial institutions may shift concentrated credit, interest rate and market risks associated with their respective portfolio of activities to the more broadly dispersed capital markets. This reduces risk to individual institutions, and systemic risk within financial systems.

Overall benefits

13. For all of these reasons, the widespread use and encouragement of securitisation as a matter of governmental policy can help achieve desirable social and economic goals such as:

- stimulating the growth of affordable housing;
- increasing the availability and lowering the cost of consumer credit;
- promoting efficient market structures and institutions;
- facilitating the efficient use and rational allocation of capital; and
- facilitating the achievement of governmental fiscal, monetary and regulatory policy goals.

Chapter IV

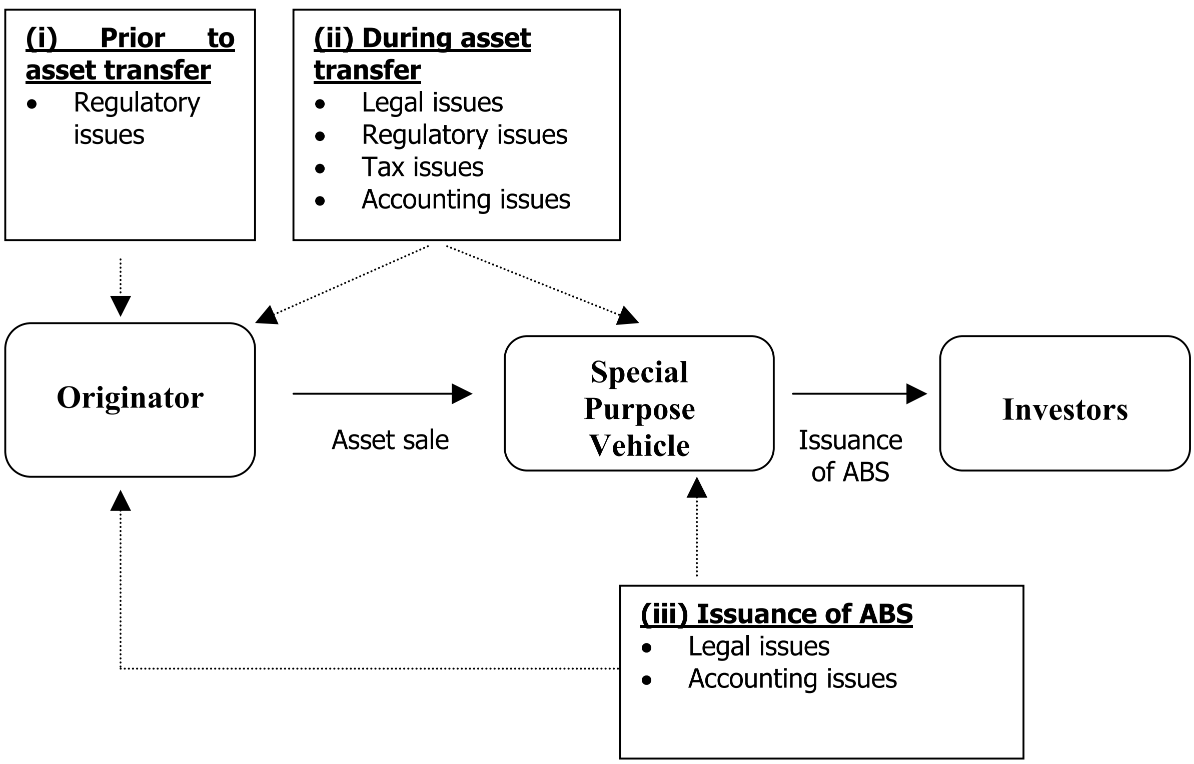
Impediments to Securitisation Transactions and Recommendations

1. As mentioned earlier, the non-existence of an ABS market, until recently, is attributable to a wide array of legal, regulatory, tax and accounting issues which impede securitisation transactions. The absence of an efficient, facilitative and transparent legal, regulatory, tax and accounting framework with regard to asset securitisation causes the structuring of such transactions to be high risk and inefficient. The impediments faced in securitisation can be categorised based on the three key stages of a securitisation transaction:

Stage 1 : Prior to the transfer of assets by originator to SPV;

Stage 2 : During the process of asset transfer from the originator to SPV; and

Stage 3 : When issuing asset-backed securities.



STAGE 1 : PRIOR TO THE TRANSFER OF ASSETS FROM ORIGINATOR TO SPV

Regulatory issues – Prohibition to sell, dispose or transfer assets without prior written approval

1. Interest in securitisation may wane rapidly if the approval process is lengthy as it affects the ability of an originator to raise funds quickly via asset securitisation. This is a real possibility given the current regulatory framework requires approval from the following regulatory bodies:

   (i) Bank Negara Malaysia (BNM), if the originator is a financial institution;
   (ii) the Foreign Investment Committee ("FIC") for transfer of assets; and
   (iii) the Securities Commission.

2. Licensed institutions are restricted under the Banking and Financial Institutions Act, 1989 ("BAFIA") in their ability to originate an asset transfer for an ABS transaction. Section 49(1)(b) of BAFIA provides amongst others, that,

   > "… no person shall enter into an agreement or arrangement for the sale, disposal or transfer, howsoever, of the whole or any part of the business of a licensed institution unless the proposed agreement or arrangement is in writing and all parties thereto have first made an application in writing to the Minister of Finance and the Minister's approval thereto has been obtained."

   And, "Business" for this purpose means:

   > "… any activity carried on for the purpose of gain or profit and includes all property derived from, or used in or for the purpose of, carrying on such activity and all rights and liabilities arising from such activity."

3. Given the wide definition of "business" and "property", the sale of assets by a licensed institution comes within the restriction in section 49(1)(b) BAFIA i.e. the licensed institution would be required to seek prior approval from the Minister of Finance every time it seeks to sell/transfer assets to the SPV notwithstanding that it is not the original intention of this provision to capture the securitisation transactions under its ambit.

4. Recently Bank Negara has sought and obtained an exemption from the Minister's approval in relation to the securitisation of assets by licensed institutions. However, such an exemption is subject to such terms and conditions as the Central Bank may impose. It is hoped that BNM will articulate clear and transparent criteria by which licensed institutions will be able to undertake such transactions and that the overall regulatory process for such institutions will be an efficacious one.

Regulatory issues – Multiple approval process for asset transfer

5. Licensed institutions which originate and participate in ABS transactions would also need to seek prior approval from BNM in order to satisfy its criteria in determining a true sale of assets as well as the necessary requirements for capital adequacy arising from the transaction. Where a sale of assets in a securitisation transaction involves real property assets, the prior approval from the FIC is inevitably required.

6. In line with the disclosure-based approach adopted by the SC to promote the domestic bond market, **a transparent set of prudential and capital adequacy requirements governing the activities of licensed institutions in ABS transactions published by BNM would go towards an efficient issuance process. The criteria include activities such as the sale of assets as well as the provision of financial services (e.g. credit enhancement, liquidity facilities, underwriting facilities and servicing activities) by licensed institutions.**

7. In considering these requirements, market feedback is that stringent criteria should be not introduced at this stage of development on the financial institutions. In this regard, the imposition of capital adequacy requirements, as recommended in the New Basel Capital Accord and the consultative document for asset securitisation issued by the Banks for International Settlements (BIS), on securitisation transactions prior to the adoption by the BIS may not be appropriate. **Further, the requirements, which would be introduced by BNM[3], should not put the financial institutions in a worse off position in terms of capital charge after engaging into a securitisation transaction.**

8. Where real assets, such as commercial property and shares, are securitised, it is likely that the ownership of such assets would be transferred from the originator to the SPV to ensure that the necessary beneficial interests are similarly transferred to the SPV. Such an act would require the approval from FIC under its Guidelines. It should be noted that the FIC has recently taken steps in order to be more facilitative of securitisation transactions and thus it has clarified that the transfer of financial assets for the purpose of securitisation transactions would not require its approval.

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[3] BNM has informed the SC in the first quarter of 2002 that a set of guidelines comprising capital adequacy requirements, best practices and minimum standards to govern securitisation activities of licensed institutions is in the process of finalisation and is expected to be announced soon.

STAGE 2 : DURING ASSET TRANSFER

1. The transfer of assets from the originator to the SPV forms the cornerstone of any asset securitisation transaction.

Legal issues

2. The legal issues, which affect the transfer of assets broadly covers insolvency, assignment and registration issues.

Insolvency

3. There are numerous provisions in the Bankruptcy Act 1967 ("BA67") with the potential to render void any transfer of assets or assignment of receivables pursuant to securitisation transactions. These provisions are contained in section 53 and section 53A BA67. The provisions of these sections are made applicable to companies by section 293 of the Companies Act 1965 ("CA65").

   Under section 53(1) BA67, every conveyance or transfer of property or charge thereon made, every payment made, every obligation incurred and every judicial proceeding taken or suffered by any person unable to pay his debts, as they become due, from his own money in favour of any creditor or any person in trust for any creditor shall be deemed to have given such creditor a preference over other creditors if the person making, taking, paying or suffering the same is adjudged bankrupt on a bankruptcy petition presented within six months after the date of making, taking, paying or suffering the same and every such act shall be deemed fraudulent and void as against the Official Assignee.

4. The implications of section 53(1) BA67 for securitisation transactions need to be considered in the event of the insolvency of:

   a. the obligor;

   b. the originator; or

   c. the SPV.

   Adverse effects arise principally because the section deems any disposal or payment of property or money to be a preference if, within the period of six months after such disposal or payment, a bankruptcy petition is presented against the person making the disposal or payment and the person is adjudged bankrupt on such petition (the "Preference Period")[4]. **Section 53(1) BA67 is**

[4] In the case of a company the date which corresponds with the date of presentation of the bankruptcy petition would be the date of presentation of a winding-up petition or the date upon which the resolution to wind-up the company is passed, whichever is the earlier.

fundamentally different from the English equivalent (from which it is derived) in deeming a preference whereas the English provision requires that there is in fact a preference.

5. In the case of an obligor, the creditor to whom it would make payments to would be the originator. If the originator sells the asset in respect of which the payments are made to the SPV for the purposes of a securitisation the SPV becomes the creditor. In the event of the insolvency of the obligor, any payment by the obligor to the SPV, during the Preference Period would be deemed fraudulent and void as against the Official Assignee; which means that the Official Assignee could recover such payments from the SPV.

6. The possibility referred to above is not likely, however, to be considered a material risk for securitisation since the possibility of default by some obligors in a pool of assets would be taken into consideration and a decision made as to whether the risk of default is at an acceptable level. However, it should be noted that the risk exists because of section 53(1) deeming the payment to be a preference when it is not in fact a preference.

7. Section 53(1) BA67 poses greater risks if the originator were to be insolvent There are two possible situations to be considered The first , is when assets are being sold to the SPV by the originator. It is unlikely that the SPV is at that time a creditor of the originator and therefore Section 53(1) BA67 would not be applicable.

8. This may not be the case for Cagamas which purchases assets on an on-going basis from financial institutions and is a creditor of those financial institutions. Any sale of assets within the Preference Period can be set-aside by the liquidator of an insolvent financial situation which had sold those assets to Cagamas notwithstanding the payment of valuable consideration by Cagamas. To mitigate this risk Cagamas can review the solvency of the financial institution to satisfy itself that the financial institution at the time of the sale to Cagamas and subsequent thereto is and would remain a going concern. This may not, however, be a practical step[5] to mitigate risks.

9. The second situation is where the originator goes insolvent after the seuritisation structure has been set-up and the assets have been sold to the SPV. In most cases the orginator would act as the servicer or administrator providing collection and management services in connection with the assets. The SPV is then a creditor of the originator. The term "creditor" has a broad meaning and in general, as laid down in case law, includes any person who has the right to prove in a winding up. The SPV is a creditor of the originator by virtue of the fact that any amounts due to it from the originator (even if the originator held it as trustee for the SPV) if not paid by the originator would entitle the SPV to prove in the winding up of the originator for such amount. Thus if an originator collects an amount on an asset during the Preference Period and pays it to the SPV, the originator is making a payment to a creditor which the liquidator of the originator could recover from the SPV. Again, the result arises from the payment being deemed a preference under section 53(1)

5 This issue has been further elaborated in Chapter 6 of this Report.

BA67 notwithstanding that it is not in fact a preference. It is not a preference because the payment is not made with the intention of preferring the SPV.

10. Although the risk in the second situation above is significant, it may possibly be mitigated for bondholders of the SPV by requiring any amounts paid by the originator to be paid directly into an account maintained by the trustee of the bondholders on behalf of the bondholders. Otherwise, notice might need to be given by the originator to the debtor/obligor for payment of debts or, in other words, by way of legal assignment into that account. These measures seek to take advantage of section 53(2) BA67 which provides that section 53(1) shall not affect the rights of any person making title in good faith and for valuable consideration through or under a creditor of the bankrupt. Essentially, bondholders making title to the money through the SPV would assert that their title is made in good faith and for valuable consideration and cannot be voided by the liquidator of the insolvent originator. The strength of the case for the bondholders remains untested as there appears to be no case law on the point.

11. The insolvency of the SPV raises similar problems under section 53(1) BA67 in relation to any payments to bondholders within the Preference Period. The risk, however, is mitigated by ensuring the bankruptcy remoteness of the SPV.

12. Section 53(1) BA67 does, accordingly, raise concerns for securitisation but there appears to be practical ways to mitigate the risk. Nonetheless, i**t is proposed that the amendment of section 53(1) BA67 be considered**.

13. Section 53A BA67 takes the risks associated with insolvency further. It renders void against the Official Assignee any assignment of **book debts that have not been paid** at the date of commencement of winding up.

14. In the case of a future flow securitisation there will be a transfer of assets by way of the assignment of receivables falling due in the future. In most cases, it would therefore not be acceptable that the liquidation of the originator result in the avoidance of future amounts falling due in respect of assets which had been sold.

15. Subsection (3) of section 53A saves any assignment of book debts due **at the date** of the assignment but this is not sufficient as the book debts under a future flow securitisation generally fall due **after the date** of assignment. In this sense it differs from the equivalent English provision which saves also "debts growing due."

16. One way of mitigating the risk is to require the originator of future flow assets to be rated and attain at least an investment grade rating. The risk of section 53A applying flows from the possibility of insolvency of the originator. By requiring the originator to have an investment grade rating the risk is mitigated. However, **similar to section 53 BA67, the Committee would propose that section 53A BA67 be amended to nullify its effect on future flow securitisations.**

17. **Alternatively, it is recommended that the transfer of book debts be effected by way of, or registered as, a charge under Section 108 CA65 or consideration be given for an establishment of a system of registration** which would rely on subsection (2) of section 53A which reads as follows :

"(2) This section shall not apply to an assignment of book debts registered pursuant to any written law if the assignment is valid under that law."

18. From an insolvency perspective, there are other issues which must be addressed by various interested parties in structuring the transfer of assets to the SPV and taken into consideration by the regulatory body in formulating the guidelines governing the asset securitisation transaction. These issues are listed as follows:

Undervalue

a. Under section 53C BA67 and section 295 CA65, the SPV may be liable for damages if the originator's interests are transferred to the SPV at an undervalue within 2 years before the commencement of the winding-up of the originator. Proper justifiable valuation of the originator's interests should therefore preclude the application of these provisions.

Set-Off

b. As provided in section 44 BA67 and section 291(2) CA65, any monies owing by the originator to the obligor may be set-off against monies owing from the obligor to the originator in the insolvency of the originator, if both debts arose prior to the commencement of the winding-up of the originator. This right of set-off is available to the SPV, if the right to the monies owing was assigned to it by the originator where the right of set-off is exercised, only the net balance owing from the obligor alone will be recoverable by the SPV in the insolvency of the originator. This risk to the SPV can be mitigated by requiring that the originator warrants that it has not done or omitted to do any act which enables the obligor to exercise such rights of set-off.

Co-mingling of Assets

c. In the event payments received by the originator from the debtor/obligor are mixed with other monies of the originator, complex rules of tracing and identification of the ownership of monies remaining in the common account of the originator will arise. A separate account should therefore be maintained by the originator for receipt of debts collected from the debtor/obligor.

Priority in Distribution

d. The SPV may find that interests transferred from the originator are subject to various other claims that compete for priority in payment from the same pool of assets:

- **Secured Creditors** whose interests arise after the transaction with the SPV is concluded, in certain instances, enjoy priority.

- **Preferential Creditors** as provided by section 292(4) CA65, to be paid out of assets under the SPV's floating charge in priority to the SPV.

- **Retention of Title** - Debtor/obligor's suppliers will have a better right to the assets it proved. An inquiry into the business of the Debtor/obligors may enable an assessment of this exposure. Introduction of registration requirements for such claims may be too drastic.

- **Trust Property** - Assets of the Debtor/obligor held on trust for third parties will not be caught under a charge taken by the Originator, and therefore not effectively transferred to the SPV.

- **Reputed Ownership** - pursuant to Section 48 BA67 creditors of the Debtor/obligor have a right to the assets held by the Debtor/obligor under hire-purchase. Where consent to the Debtor/obligor's continued possession of such assets is withdrawn by the Originator prior to the commencement of the winding-up, or the Liquidator of the Debtor/obligor is given prompt notice of the true ownership of the asset and of the Originators claim thereto, the effects of this doctrine are largely nullified.

- **Purchase Money Security** - Though the Originator may have a valid legal charge well perfected and first in time over after acquired assets of the Debtor/obligor, the financier for the purchase of the after-acquire asset could have a better right to the asset.

Assignment and registration

19. Notice is required under subsection 4(3) of the Civil Law Act 1976 to legally effect the assignment, and cannot be by way of a charge only. Without notice, only an equitable assignment is effected. A failure to give notice to debtors/obligors would result in the rights of the SPV against the obligor being subject to the rights of any legal assignee who had no notice of the SPV's interest as well as to any prior equitable rights.

20. However, it may be impracticable to give notice due to the number of obligors involved and in some cases, undesirable due to the obligors' sensitivity towards assignment of their debts. While it was acknowledged by the Committee that there were risks in transferring assets to the SPV by way of equity assignments, such risks were acceptable within normal business limits.

21. The Bills of Sale Act 1950 requires the registration of a security interest over personal chattels. Thus, in securitisation transactions, where there is an assignment of the right to receive the receivables as well as an assignment or transfer of the interest in the goods (e.g, in the context of a hire purchase transaction both the rights to receive the monthly instalments and the property in the goods are assigned), then there is a distinct possibility that the instrument concerned would be required to be registered pursuant to the Bills of Sale Act.

22. In addition, bills of sale are required to be registered within 7 days of their execution and such registration has to be renewed once at least every 12 calender months. This is a cumbersome procedure for the purposes of securitisation. **It is therefore proposed that this Act be repealed or otherwise be amended to provide that it does not apply in respect of securitisation transactions.**

Regulatory issues – True sale criteria and Re-characterisation

23. A major concern, particularly in the winding-up of the originator is the possible re-characterisation by Courts of the transfer of interests from the originator to the SPV. Where certain characteristics of the transaction suggests that the transaction is more in the nature of financing rather than a sale, the SPV may risk the transfer/sale being re-characterised as one of security or financing. If this occurs, assets thought to be available to the SPV alone will instead be distributed by the liquidators equally amongst all unsecured creditors of the originator, including the SPV.

24. Courts usually will study the substance of the transaction, as in cases involving retention of title clauses. It has in the past been held that the objective of the transaction is irrelevant, only the method employed is scrutinised in determining if the transaction is registerable as a charge. The method of dealing with the title/ownership in the assets is crucial. True sales of property, despite rights to repurchase the property, have been held as valid sales. **To mitigate this risk of re-characterisation, it is paramount that the criteria for true sale shall be clearly established by the regulatory bodies in relation to securitisation transactions[6].**

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6 The issue has been addressed in the ABS Guidelines issued by the SC on 11 April 2001.

Regulatory issues – Banking secrecy provisions

25. An originator that is also a financial institution may additionally face restrictions under BAFIA when disclosing information on its borrowers/customers for the purposes of issuing ABS.

26. Section 97 BAFIA prohibits the disclosure of any information or document whatsoever by licensed financial institutions relating to the affairs or accounts of a customer. However, in a securitisation transaction the SPV and its directors as well as accountants, lawyers and trustee for the bondholders will need to obtain information on the affairs or accounts of customers of the originator/seller of the asset for due diligence purposes.

27. **Therefore, exemptions would be needed from BNM pursuant to section 99(1)(i) BAFIA in order for licensed financial institutions to provide the necessary disclosure of customer information. In granting such exemptions, any imposition of time restrictions during the tenure of the transaction could result in administrative difficulties in conducting a proper and detailed due diligence process.** Such an exemption could nonetheless, impose some confidentiality obligations on the persons to whom the information is so disclosed. Further, this blanket approval may be subject to conditions requiring the exempted parties to report to BNM on the information accessed by them so as to mitigate any potential abuse from such exemption.

28. For certain types of securitisation transactions involving a small pool of obligors such as collateralised loan obligations, representatives from the credit rating agencies argue that it may be justifiable if the secrecy exemption is also extended to credit rating agencies[7]. When conducting the initial credit assessment and the continuous surveillance on such pool of underlying receivables, rating agencies would need to have access to detailed qualitative information on the borrowers. This would enable the rating agencies to assess the credit quality of the borrowers in a more comprehensive and precise manner, rather than imposing higher credit enhancement levels and/or more vigorous reporting requirements to make up for uncertainties as to the credit risk profile arising from the unavailability of information.

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[7] In the absence of the exemption from BNM under section 99(1)(i) of BAFIA, the rating agency would need to require the originating bank to seek permission in writing from the customer to make such disclosure as stated under section 99(1)(a) of BAFIA. Unless such written permission has been reflected in the loan documentation, this alternative would not be viable given the sensitivity of the customers involved.

Regulatory issues – establishment of the SPV as a bankruptcy remote entity

29. It is crucial that the SPV established is bankruptcy remote in the interests of ABS holders and to ensure the continued feasibility of the securitisation transaction. The bankruptcy remoteness of an SPV is made possible by limiting the activities of the SPV to that pertaining to the securitisation arrangement. In addition, restrictions should be imposed on matters relating to objects and powers, independence of directors who can be equity holders, merger or reorganization, payment of dividends, establishment of subsidiaries etc. concerns as to any possible related party transactions would, therefore, not arise. Further, rating agencies require an independent legal opinion on the bankruptcy remote status of the SPV. The recommended characteristics of an SPV should thus be clearly spelt out in its MOA to ensure bankruptcy remoteness[8].

Tax issues – on the originator

30. There is currently no specific tax legislation that deals with asset securitisation. As such, each transaction will be examined in relation to its own facts and circumstances by reference to existing tax legislation and practices. Under such circumstances, tax uncertainties are bound to arise which does not augur well for the development of the securitisation market.

31. Further, in the absence of tax incentives for asset securitisation, the importance of tax neutrality cannot be over-emphasised. Without tax neutrality, securitisation may lead to additional tax burdens for originators. If that happens, the desire of originators to enter such transactions will be greatly curtailed. The main tax considerations pertinent to the originator for transfer of assets under securitisation transactions include:

    (a) determining of the disposal price and gain or loss on the sale of receivables to SPV; and
    (b) the treatment of lump sum receipts from sale of future receivables.

32. There is presently, uncertainty as to how the disposal price should be determined and what should be the consequential gain or loss on the sale of assets by the originator. It is therefore proposed that the Inland Revenue Board (IRB) should accept the transfer value as the disposal value in order to avoid pricing disputes which may otherwise result in differing disposal values for tax purposes. **A more comprehensive report on tax issues pertaining to various securitisation structures and proposed recommendations to resolve these issues can be referred to in Appendix 4.**

8 This has been partially addressed in the ABS Guidelines issued by the SC on 11 April 2001.

Accounting Issues – Criteria for True Sale

33. Another possible benefit to an Originator in an asset securitisation transaction, as previously outlined is the possible off-balance sheet treatment for such asset transfers.

34. However, there is a lack of clarity on the accounting treatment of ABS transactions as the Malaysian Accounting Standards Board ('MASB') has not issued any standards or guidelines of its own in relation to asset securitisation transactions to-date. In addition, the MASB has yet to adopt the relevant International Accounting Standard (IAS) for asset securitisation i.e. IAS 39 – Financial Instruments: Recognition and Measurement which was issued in March 1999 and has taken effect internationally from 1 January 2001.

35. The basic principle of IAS 39 is to assess who has 'control' based on a test of 'substance over form'. IAS 39 also acknowledges that an asset can be made up of several components. These components can therefore be recognised or derecognised depending on whether 'control' is present or not. Thus one transaction can result in several components of assets being treated differently from an accounting perspective.

36. Legal isolation is not a requirement for de-recognition. Thus, the control of an asset can be transferred although the transferor retains certain components of the asset such as servicing rights, credit risk, rights to certain cash flows etc. The component retained should be recognised and measured separately.

37. This contrasts with the 'all or nothing' approach adopted by the United Kingdom and in previous IASs, which requires the asset to be de-recognised when substantially all risks and rewards of the asset are transferred. Based on IAS 39, the sale will constitute a "true sale" if the originator has surrendered its control over the asset and the transferee has obtained the benefits of the transferred assets.

38. The above requirements are also broadly consistent with the Statement of the Financial Accounting Standards Board No. 125 on Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities ("FASB Statement No.125"). Under FASB Statement No.125, the transferor is deemed to have surrendered over transferred assets if and only if all of the following conditions are met (where the transferee is a qualifying special-purpose entity):

    (a) The transferred assets have been isolated from the transferor–put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership; and

    (b) The holders of beneficial interests in the SPV have the right to pledge or exchange those interests and no condition both constrains them from taking advantage of that right and provides more than a trivial benefit to the transferor. The transferor does not retain effective control over transferred assets through the ability to unilaterally cause the transferee to return specific assets, other than through a cleanup call.

39. **Although IAS 39, particularly its provisions on the de-recognition of financial assets, is not yet technically applicable in Malaysia, it should be adopted as best practice in the absence of any other guidance from the MASB. Nevertheless, for clarity purposes, a standard or a guidance note on securitisation should be issued by the MASB[9].**

STAGE 3 : WHEN ISSUING ASSET-BACKED SECURITIES

Tax issues – Tax Status of SPV

1. Where an SPV exists in the form of a limited company, the tax status of the SPV remains unclear in terms of whether it would be considered an investment dealing/ trading company or investment holding company.

2. In cases of one-off securitisation transactions, the SPV, whose only activities consist of the purchase of a single block of receivables and issuance of long-term bonds to finance the purchase, is likely to be considered an "investment holding company" under section 60F of the Income Tax Act 1967 (ITA67). If so, it would be subject to restrictions on the deductibility of expenditure pertaining to the nature of such companies. In contrast, maximum tax deductions would be enjoyed by an SPV if it is treated as an investment dealing/trading company. It is also uncertain whether an SPV would continue to be entitled to capital allowances upon acquiring the asset from the originator. **Clarification from the IRD on the tax status of SPV is therefore necessary to provide tax certainty to securitisation transactions[10].**

3. Given the bankruptcy remote status of the SPV, the tax burden of an SPV arising from securitisation transactions should be kept to a minimum. This objective would not be accomplished if the SPV is considered to be an investment holding company as this attracts a significant tax burden for the SPV.

4. In order to clarify the tax treatment applicable to the SPV, the following options should be considered:

   (a) Exempt the SPV from corporate income tax;

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9 Pursuant to the recommendation from the SC, the working group 44, formed by the MASB to review the adoption of IAS39, would issue a technical release note for securitisation transaction pending the adoption of IAS39. The working group is co-chaired by Mr. Ranjit Ajit Singh, a Director of SC. A member of the ASCC is also represented in the working group.

10 The SC has taken initiatives to begin discussion with the tax policy division of the Ministry of Finance and the Inland Revenue Board to address the taxation issues surrounding the securitisation transactions.

(b) Accord SPV a trading status or treat it as a company involved in the purchase of discounted securities; and

(c) Tax the SPV on a cash basis.

(Please refer to the Appendix 4 for further details on the above)

Tax issues – Services tax

5. Similarly, **the Royal Customs and Excise Department should confirm whether any service tax would be imposed on any fees received by the Originator from the SPV for administering the assets**. There may be service tax obligations on the originator if the services it provided to the SPV fall into the list of taxable service under the Service Tax Regulations 1975.

Tax issues – Deductibility of Bad Debts

6. The taxable income earned by the originator before the securitisation should equate to the income received (servicer fees, sub debt interest and surplus) from the SPV, all other things being equal. In either case, the tax payable by the originator should be similar. It is important that the SPV achieves tax neutrality, meaning that it is able to claim as deductions all expenses, outgoings and losses so that its revenue after such deductions is minimal.

7. Thus, if bad debts are treated on capital account and are therefore not deductible, then the following situations can arise:

(a) The SPV will pay tax on the income it is not able to shelter with the bad debt deduction; or

(b) if the SPV is still able to achieve revenue neutrality by paying all surplus spread back to the originator, the originator will be assessed on the surplus spread received and lose the benefit of the bad debt deduction which the originator would have been entitled to had it not securitised.

8. Where the bad debts in the SPV are considered capital in nature, it will be difficult for the SPV to generate a capital gain against which it can be offset. However, if bad debts are treated as capital, at the end of the transaction after the SPV has repaid all senior funding, the SPV will have insufficient principal repayments (because some loans have defaulted) to pay back the subordinated debt ("sub debt") provided by the originator. At this stage, the originator will record a loss on the sub debt it has provided to the SPV due to non-payment. Presumably, at this stage, the originator is able to claim a tax deduction. The effect of this situation is that the originator has been penalised in a tax sense by delaying deductions for bad debts to when the sub debt is repaid, whereas if the originator had not securitised it would have been able to claim deductions when the bad debt had been incurred. More detailed recommendations can be found in Appendix 4 on this issue.

Accounting Issues – Consolidation of SPV

9. The Companies Act 1965 and MASB require holding companies to prepare a consolidated financial statement that includes all its subsidiaries. Under MASB 11 which was adopted from IAS 27, a subsidiary is defined as an enterprise that is controlled by another enterprise (known as the parent).

10. \`Control' refers to the power to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities. \`Control' is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than one half of the voting power of an enterprise unless, in exceptional circumstances, it can be clearly demonstrated that such ownership does not constitute control. Control also exists even when the parent owns one half or less of the voting power of an enterprise when there is :

    (a) power over more than one half of the voting rights by virtue of an agreement with other investors;

    (b) power to govern the financial and operating policies of the enterprise under a statute or an agreement;

    (c) power to appoint or remove the majority of the members of the board of directors or equivalent governing body; or

    (d) power to cast the majority of votes at meetings of the board of directors or equivalent governing body.

    Given this, the SPV will undoubtedly be consolidated with the originator if the latter retains control over the SPV subsequent to the transfer of assets. The originator must therefore bear this in mind if it intends to remove the assets from its balance sheet through securitisation. In addition there is ambiguous on the applicability of Interpretation SIC[11] 12 on Consolidation of Special Purpose Entities to Malaysian accounting standards. SIC[12] contains a more pervasive control criteria than that in IAS27 that may result in the securitised asset being derecognised from the balance sheet of the originator under IAS39 but reappearing in the group accounts of the originator (together with the ABS issued by the SPV) following the consolidation of the SPV.

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[11] An acronym for Standing Interpretations Committee of which its interpretation, if adopted by MASB, will be taken into account by the accounting profession in the preparation of financial statement.

Chapter V

Other Developmental Issues For Further Consideration

I. Introduction of a National Multiple-Seller Conduit

1. Given the wide array of legal, regulatory, tax, accounting and operational issues surrounding securitisation structures involving an SPV, there have been suggestions to consider a national multiple-seller conduit as it might be too inconvenient or administratively costly to create an SPV for each issue. A national multiple-seller conduit would have the ability to securitise an array of receivable types.

2. There is little knowledge of national multiple-seller conduits as SPVs that are currently in existence are largely designed to focus on the securitisation of specific types of receivables and are catered for a single securitisation transaction. However, the Belgian government has taken efforts to promote the creation of national multiple-seller conduits by making some reforms to their existing collective investment legislation and has received encouraging responses from the market.

3. Appendix 2 provides an illustration of reforms by the Belgian government in the creation of dedicated Belgian securitisation vehicles.

4. It has been previously suggested that the creation of a single national multiple-seller conduit, whether operated by the Government or some other authority, to cater for securitisation of a variety of receiveables has some merit. Such a mechanism might ensure the issuance of high quality ABS and also overcome current impediments with greater ease and in an efficient manner.

5. However, the centralisation of all issues with a single national multiple-seller conduit might concentrate risk and in a crisis situation, could have more adverse effects than single-transaction SPVs. Such structures might also stifle market innovation and add rigidity to the process.

6. Given these factors, a facilitative environment for the establishment of various multiple-seller conduit should be explored further as an alternative. However there must be clear market demand before further detailed consideration.

II. Introducing Securitisation Legislation

7. Another approach to streamline the development of asset securitisation would be to address the outstanding issues currently faced in securitisation arrangements by way of a Securitisation Bill.

8. However, it is felt that such legislation would require considerable time to develop and implement. Hence, it was felt more effective to address the various current impediments to securitisation directly rather than encompass all such issues by way of a single piece of legislation.

9. This issue, however, should be reviewed if the current approach to address the various current impediments does not achieve positive results.

III. Widening the investor base for ABS

10. Currently the Director General of Insurance (DGI) has classified the holding of corporate bonds by insurance companies as either secured or unsecured credit facilities. Bonds classified as `secured credit facilities' must be either guaranteed by banks or secured by real property or by shares. All other bonds, including ABS, which are not so secured would be deemed as unsecured credit facilities[12]. It is estimated that the holding of unsecured bonds has reached close to the 20% limit of unsecured credit facilities imposed on insurance companies. Given this, the number of insurance companies which are able to invest in ABS may become lesser over time.

11. As most ABS bonds would be secured by a pool of tangible assets and financial assets, the DGI should consider granting the secured credit facilities status to ABS which fall into certain categories of assets such as motor vehicles and lease obligations. This would inevitably make it very attractive for insurance companies to hold ABS bonds and contribute positively to the development of the ABS market. Alternatively, the prudential limits on credit facilities should be further liberalised to provide greater investment flexibility to the insurance companies which could be complemented by a more refined and robust risk-based regulatory framework on the insurance industry.

12. On the other hand, there is uncertainty as to whether the unit trust funds are currently allowed to invest in ABS. In this regard, a clarification should be issued to the industry as soon as possible to remove the doubts among the fund managers.

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12 Insurance companies are only allowed to invest up to 40% of their assets in both secured (in the forms of property, shares and bank guarantee) and unsecured credit facilities, of which a maximum of 20% could be allocated to unsecured credit facilities (unsecured corporate bonds).

Chapter VI

The Role of Cagamas Berhad
- Current Concerns and Possible Solutions

I. Background

1. Cagamas (Perbadanan Cagaran Malaysia) or the National Mortgage Corporation is currently the sole issuer of mortgage backed securities.

2. Cagamas was established in 1987. Its single largest shareholder is Bank Negara Malaysia with a 20% shareholding. The other shareholders include commercial banks, finance companies and merchant banks. The Chairman of Cagamas is the Governor of BNM and the remaining members of Board consist of prominent members of the banking system nominated by the Association of Banks in Malaysia, Association of Finance Companies of Malaysia and Association of Merchant Banks in Malaysia.

3. The establishment of Cagamas was fuelled by national objectives relating to the banking system. It was intended to be used as a policy tool for the Government to overcome the recession (at that time) by:

   a. alleviating the liquidity problems primary lenders by narrowing the difference between the maturity structure of their sources of funds and housing loans;

   b. reducing the risk of unfavourable changes in the difference between the cost of funds of the primary lenders and the rate of return on their housing loans; and

   c. assisting in the deepening of the financial sector by creating new investment options, especially in fixed-income securities.

4. Cagamas was also established to perform the function of an intermediary between the primary lenders and the investors of long term funds, and to play the role of a credible issuer of mortgage securities. This encouraged the primary lenders to lengthen the repayment period of their housing loans, thus making loans more accessible and affordable to potential house buyers.

5. In other words, by selling their housing loans (whether with or without recourse basis) at the secondary market level, the primary lenders would be able to obtain funds to grant more housing loans. The secondary mortgage market was thus set up to encourage the primary lenders to provide more end-financing to house buyers and to help achieve the key social objective of increasing home ownership.

6. The involvement of BNM was aimed at ensuring compliance with national policy objectives and to provide Cagamas with the high credit standing needed to minimise the cost of its borrowing and, ultimately, the cost of housing loans which it helps to refinance.

7. Besides lowering the cost of funds to financial institutions, Cagamas has also contributed significantly as a catalyst to the development of the Ringgit bond market by issuing large sized, high quality bonds. There is therefore a need to ensure that Cagamas continues to play a significant role in any new regulatory landscape for the PDS market.

II. Key Success Factors

8. To date, the operations of Cagamas have proven highly successful. It has managed to retain the credit rating of AAA for the papers it issues. Some of Cagamas' key success factors are as follows:

- The stature of the organisational set-up has helped to ensure the ready acceptance of Cagamas bonds in the market, thus enabling the company to raise funds at relatively low yields. In turn, this has enabled Cagamas to purchase housing loans at a competitive price.
- BNM recognises Cagamas bonds as liquid assets for the purpose of compliance with the statutory liquidity requirements by FIs under its supervision.
- The proceeds from the sale of housing loans obtained by FIs from Cagamas are permitted by BNM to be free from statutory reserve requirements. This lowers the cost of funds to FIs.
- Cagamas is exempted from stamp duty under the Stamp Act, 1949 for its housing loan transactions and its dealings in debt securities, thus lowering transaction costs.

III. Cagamas' Transactions: Purchase With Recourse Vs Without Recourse

9. As mentioned before, Cagamas began operations by purchasing housing loans on a recourse basis. Unsecured debt securities were issued to raise the requisite financing. The Purchase with Recourse (PWR) Scheme was later extended to industrial property loans and hire purchase and leasing debts in 1997 and 1998 respectively.

10. In March 1999, Cagamas introduced the Purchase Without Recourse (PWOR) scheme for housing loans but financial institutions have not sold any mortgages under this scheme to-date for the following reasons:-

a. The structure of a Cagamas issue can be referred to in Appendix 3

b. Excess liquidity in the financial system and the lower cost of funds in the inter-bank market;

c. As at end-August 2002, the overall banking system's risk-weighted capital ratio (RWCR) of 13.3% was substantially higher than the minimum requirement of 8% set by Bank Negara Malaysia. As such there is no urgency for financial institutions to sell their housing loans under the PWOR scheme. Moreover, the sale of loans under PWOR will have minimum impact on the capital adequacy ratio of financial institutions. Calculations show that the capital adequacy ratio of a large financial institution would improve only slightly by 0.12% or 12 basis points as a result of a sale of about RM300 million of housing loans under the PWOR scheme;

d. Due to the more stringent eligibility criteria for the PWOR scheme, financial institutions would be required to undertake considerable modifications to their existing computer systems. Furthermore, post-sale tracking of loans sold to Cagamas also requires modifications to their systems;

e. Since all the housing loans are pegged against base lending rates (BLR), the financial institutions are not subject to interest rate risks and therefore do not need to hedge their loans portfolio;

f. The financial institutions are currently earning a comfortable spread above the BLR. They are of the view that if these housing loans were to be sold to Cagamas, they have to forego the large spread and earn a smaller margin as service fee; and

g. The financial institutions are concerned that their non-performing loans ratio will deteriorate if good quality loans as specified under Cagamas' stringent eligibility criteria are taken off from their balance sheets.

The Importance of Purchase with Recourse

11. To enable Cagamas to maintain its triple-A rating so as to obtain low cost funds for meeting its social role, its ability to purchase assets on a recourse basis is still necessary to avoid the need for Cagamas to accept the credit risk of the originator. The other reasons to continue with the PWR scheme are as follows:

a. To pass on low cost funds to financial institutions so that they can originate housing loans at low rates and play a role in encouraging house ownership;

b. To allow financial institutions to obtain short-term fixed rate funding;

c. To enable sellers to sell their non-performing loans due to the less stringent eligibility criteria compared to Purchase without Recourse;

d. To continue issuing fixed rate bonds to promote trading notwithstanding that loans are Adjustable Rate Mortgages (ARMs);

e. To promote the giving of housing loans at a fixed rate by purchasing ARMs on a fixed rate basis;

f. To maintain market's familiarity with the present structure, which results in fast turnaround time;

g. To enable finance companies to obtain fixed rate funding for hedging their hire-purchase debts; and

h. To continue charging all sellers the same Cagamas rate regardless of their credit rating.

12. The success of Cagamas has been recognised by other countries as well as the World Bank. In its study in February 1999 entitled "Secondary Mortgage Facilities: A Case Study of Malaysia's Cagamas Berhad", the World Bank concludes that "Cagamas provides a successful example of a secondary mortgage facility in a developing country. Its model offers important lessons for other developing countries". An extract of the report is shown in Appendix 3.

IV. Cagamas' Current Concerns

The Risk of Recharacterisation

13. In purchasing housing loans on a recourse basis, Cagamas is faced with the risk of recharacterisation. This risk increased with effect from 1 September 2001, when Bank Negara Malaysia decided that all purchase with recourse (PWR) transactions would be treated as a financing transaction from an accounting point of view. This decision precedes the adoption of International Accounting Standard 39, Financial Instruments: Recognition and Measurement, by the Malaysian Accounting Standards Board (MASB). Under the proposed standard, the accounting treatment for the PWR Scheme would have reflected the transaction as a financing transaction.

14. Currently, the issue of recharacterisation is remote as the character of the transaction is generally challenged only when the seller becomes insolvent and given the context of the recent mergers this event appears to be an unlikely one for any of the financial institutions. However, in the event of such a challenge, Cagamas has been advised by its solicitors that the Malaysian courts could take either of the following views:-

a. Malaysian courts would regard the intention of the parties to the agreement as paramount and would not re-characterise the transaction on the basis of the change in the accounting treatment provided that:

- the transaction is not a sham; and
- the transaction is clearly documented in a sale and purchase agreement.

b. There are, however, other features in the PWR schemes, (listed below) which may cause the courts to recharacterise the transactions, such as

- the recourse element to the financial institutions;
- the non-transfer of legal ownership;
- the retention of all relevant documents by the financial institutions;
- the guaranteed returns to Cagamas i.e. the Cagamas Rate (which is subject to review) or the floating Cagamas Rate (which is also subject to review), as the case may be; and
- the right of first refusal granted to the financial institutions to repurchase the loans.

15. Given the uncertain outcome in the event the issue of re-charaterisation is raised in respect of PWR transactions, it would be safe to say that such a risk exists. There are both legal as well as accounting implications if such transactions are recharacterised:

a. From an accounting perspective, such transactions would then be regarded as "on-balance sheet" and therefore treated as amounts due to Cagamas. The financial institution's direct liability would increase and this would affect its leverage ratio.

b. From a legal perspective, there would therefore be a higher risk of Cagamas becoming an unsecured creditor in the event of a seller's insolvency. The possibility of such an outcome would adversely affect Cagamas' ratings and increase the bond yields. This will translate into higher Cagamas rates and undermine the Company's goal of providing a hedging tool and low cost funds to the financial institutions.

Suggested Solutions to the Risk of Recharacterisation

16. As re-characterisation would render Cagamas an unsecured creditor of the financial institutions instead of the beneficial owner of the receivables, a mechanism must be established which will recognise the beneficial ownership of Cagamas in all PWR type transactions. In doing so the following should be considered:

a. To create a statutory register of beneficial interests; and/or

b. To grant Cagamas a vesting or registration certificate issued by an appropriate authority which secures its interest over the assets underlying the purchase with recourse scheme (similar to the instrument provided for under the Pengurusan Danaharta Nasional Berhad Act 1998).

17. The PWR transactions should be protected from the risk of re-characterisation for the following reasons:

a. **Purchase of housing loans has enabled Cagamas to provide liquidity to the financial institutions at a lower cost and encourage home ownership**

Cagamas has a socio-economic role to play in promoting home ownership amongst the low and middle-income groups. By selling their housing loans to Cagamas with recourse, the financial institutions are able to obtain the necessary liquidity at a competitive cost to enable them to further originate housing loans and enhance their lending operations. The competitively priced funds obtained from Cagamas also enables them to price their own loan products competitively and this provides them with an edge in their business operations. By selling their housing loans to Cagamas, primary lenders are also able to hedge their interest rate risks, particularly if they have granted fixed rate loans.

The sale of housing loans on a recourse basis provides the market with the necessary liquidity to encourage the growth of the housing industry and helps the Government to achieve its policy of encouraging home ownership. Housing loans granted by the financial institutions to finance the purchase of houses costing RM100,000 or less are subject to an interest rate ceiling of 9.0% per annum as imposed by Bank Negara Malaysia. Cagamas' funds, which are competitively priced, enable the financial institutions to meet the policy objective of BNM to make housing loans more affordable to the lower-income group without any interest subsidy being incurred by the authorities.

b. **Purchase of hire purchase and leasing debts was introduced during the Asian economic crisis to serve as a hedging mechanism for the finance companies**

The scheme to purchase hire purchase and leasing debts was launched in December 1998 to provide the finance companies with a much needed source of medium-term financing during the economic crisis in 1997 and to serve as a hedging mechanism for such debts which are granted on a fixed rate basis. This scheme would eventually enable the finance companies to lower the rates charged to their customers as they are now able to source funding for a matching period of financing and at lower rates from Cagamas.

The scheme alleviates the funding mismatch problem and provides the finance companies an avenue to minimise their large exposure to interest rate risks. As at end 2001, hire purchase financing totalling RM44.4 billion accounted for 46.1% of the finance companies' total loan portfolio. According to BNM's Annual Report, a 1% increase in interest rate can erode the capital base and the balance sheet size of the finance companies by 20.1% and 1.6% respectively. This risk if not properly managed could lead to systemic risk for the banking industry as a whole.

c. **Purchase of industrial property loans has enabled Cagamas to support the development of small and medium scale enterprises**
This scheme to purchase industrial property loans provides the financial institutions with additional access to Cagamas funds and is aimed at supporting further development of the manufacturing sector, especially small and medium scale enterprises. The financial institutions will find it more attractive to grant loans for such purposes as they could be sold to Cagamas at any time in case of liquidity need. This would, in turn, enhance the industrialisation process in Malaysia. The scheme also provides financial institutions an additional avenue to lock-in their funding position in order to hedge their longer term fixed rate loans against interest rate risks.

18. The alternative to a PWR scheme would be to implement collateralised lending. However, this may not be attractive for the following reasons:

a. Impediments faced by financial institutions:

- Lack of familiarity;
- Time consuming and costly to modify existing IT systems;
- Direct liabilities of financial institutions will increase, thus affecting its leverage ratio[13] ;
- Financial institutions have to account for the pledged collateral;
- Difficulty in identifying and monitoring the collateral as non-eligible collateral would have to be replaced[14]

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13 The loan provided by Cagamas will be secured by eligible collateral and the transaction will be treated as financing. Since the transactions are on balance sheet and treated as amounts due to Cagamas, the financial institution's assets and liabilities would increase. As such, there will be a reduction in the financial institution's return on assets and an increase in its leverage ratio.

14 If the collateral value falls below the borrower's outstanding balance, the borrower is required to replace or substitute the non-eligible collateral with eligible collateral. Thus, the financial institution is required to periodically assess the underlying value of mortgage and non-mortgage collateral [e.g. government or private debt securities] to ensure compliance under the scheme.

These factors may prevent financial institutions from obtaining low cost funds from Cagamas. Additionally, it is unclear if the existing incentives afforded to Cagamas by BNM would still be applicable for these transactions[15]. If not, it would ultimately lead to higher mortgage rates, which would be detrimental to the homeownership policy.

b. Legal impediments

- Stamp duty may be payable for such financing transactions

- In order for Cagamas to become a secured lender it would have to comply with the following legislation:

  - Moneylenders Act 1951,

  - Sections 108 and 133A of the Companies Act 1965,

  - Section 52 of the Banking & Financial Institutions Act 1989; and

  - Bills of Sale Act 1950.

  It will be costly, time consuming and onerous for Cagamas to commence collateralised lending obligations without obtaining exemptions from the various legislation.

- Cagamas would nonetheless still be exposed to insolvency related risks in relation to the following legislation:

  - Section 176 of the Companies Act 1965 – Financial institutions may seek protection to avoid or delay payment to Cagamas;

  - Section 48 of the Bankruptcy Act 1967 – hire purchase equipment which has been pledged as collateral may be deemed the property of the bankrupt hirer divisible among creditors;

  - Section 53 of the of Bankruptcy Act 1967 – transactions and payments may be deemed as fraudulent preference and be void against the Official Receiver;

  - Section 53A of Bankruptcy Act 1967. – unpaid assigned debts as at a date of an available act of bankruptcy shall be void against the Official Receiver.

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[15] e.g. treatment of proceeds when computing the liquidity and statutory reserve requirement, liquifiable asset status for Cagamas debt securities, deductibility from eligible liabilities base of Principal Dealers for holdings of specified SSTS securities, and risk weighing of 10% for Cagamas debt securities.

V. ALTERNATE CONSIDERATIONS

19. Cagamas continues to play an important role in assisting the Government to achieve the objective of increasing home ownership among Malaysians, over and above assisting in the development of the bond market.

20. As such and for its further development, an analogy can be drawn from the Fannie Mae structure in the US which is governed by the Federal National Mortgage Association (FNMA) Charter Act.

21. A similar charter or statute, should therefore be considered in the case of Cagamas to protect its interests and to allow Cagamas to focus on extending low cost liquidity to financial institutions for further lending to potential homeowners in order to meet national objectives. (National mortgage corporations are generally accorded certain privileges to enable them to fulfil their national objectives of passing low cost funds to house buyers. In drafting such a charter, the authorities may wish to consider granting Cagamas appropriate privileges to enable Cagamas to play its role effectively.

22. These issues in relation to Cagamas and its operations should also be considered in any securitisation legislation in the future.

Chapter VII

Summary

1. As can be seen from the previous chapters, some legal, regulatory, tax and accounting risks and issues can in fact, be mitigated by careful structuring and diligence on the part of market participants. This is so as to attain a level of risk acceptable by the market. In some circumstances, such mitigation is not possible and will require structural and regulatory changes to facilitate securitisation transactions. This would include the following:

Regulatory issues

2. To establish an expedited approval scheme under section 49 BAFIA. This could speed up the issuance process and allow for BNM to articulate clear and transparent criteria on prudential and other requirements by which financial institutions will be able to undertake such transfers, if necessary.

3. BNM to grant a categorical exemption from the banking secrecy provision under section 99(1)(i) BAFIA to enable the disclosure of information pertaining to obligors to necessary parties in a securitisation transaction. In granting such an exemption, BNM should not impose a time restriction during the tenure of the transaction, particularly on those revolving securitisation structure which involves continuous transfer of assets. The secrecy exemption should also be extended to credit rating agencies for certain types of securitisation transactions involving a small pool of obligors such as collateralised loan obligations.

4. BNM to lay down a transparent set of prudential and capital adequacy requirements governing the activities of licensed institutions in ABS transactions in line with the disclosure-based approach adopted by the SC to promote the domestic bond market. In considering these requirements, it is imperative for BNM to ensure that the financial institutions are not worse off in terms of capital charge after engaging in a securitisation transaction.

Legal issues

5. To propose amendments to section 53 BA67 to limit the broad application of its deeming provision in relation to preferences for securitisation transactions.

6. To propose amendments to section 53A BA67 to include book debts that grow due after the date of assignment to ensure that the SPV shall continue to have rights over future cash flows derived from the assets transferred by the originator.

7. To consider repealing or disapplying the Bills of Sales Act for securitisation transactions given its cumbersome procedural requirements for registration.

8. To review and remove the legal impediments in the Companies Act 1965 on the issuance of debentures by a private company in order to further increase the accessibility of issuers to a wider range of investors.

Tax issues

9. To propose to the Inland Revenue Board (IRB) that it should accept the transfer value as the actual disposal value in order to avoid pricing disputes which may otherwise result in differing disposal values for tax purposes.

10. To consider taxing the lump sum receipt from the sale of future receivables on an amortised basis to enable the originator to match the tax shelter from capital allowances and be line with the accounting allowances.

11. To clarify with the Royal Customs and Excise Department as to whether any service tax would be imposed on any fees received by the Originator from the SPV for administering the assets.

12. To ensure that securitisation transactions are tax neutral so as to ensure that the originator's tax position is no worse than it would be if the originator were to issue PDS directly. This would mean, inter alia, that the SPV should be able to deduct all expenses incurred (outgoings, losses, bad debts etc.) from all income earned so that its revenue after all deduction is minimal.

    (please refer to the Appendix 4 for further details)

Accounting issues

13. To propose that MASB issues guidance notes that provide clarity on the accounting treatment for securitisation transactions, particularly on the issue of consolidation of the special purpose vehicle with the originator for accounting purposes.

14. To establish a mechanism which will recognise the beneficial ownership of Cagamas (i.e. the purchaser of the receivables), particularly in PWR type transactions. This could be achieved either by creating a statutory register of beneficial interests or granting Cagamas a vesting or registration certificate issued by an appropriate authority (which is similar to the instrument provided for under the Pengurusan Danaharta Nasional Berhad Act 1998).

Other issues

15. The Director General of Insurance (DGI) should consider granting the secured credit facilities status to ABS which are backed by certain types of assets such as motor vehicles and lease obligations. Alternatively, the prudential limits on credit facilities should be further liberalised to provide greater investment flexibility to the insurance companies while a more refined and robust risk-based regulatory framework is introduced to supervise the companies more efficiently.

Appendix 1

CREDIT ENHANCEMENT METHODS

A. Internal Credit Enhancement Methods

1. Subordination

A popular type of internal credit support is the senior/subordinated structure, which is technically a form of "over-collateralisation." It is characterised by a senior class of securities and one or more subordinated classes that function as the protective layers for the senior tranche. If a loan in the pool defaults, any loss thus incurred is absorbed by the subordinated securities. The tranche is unaffected unless losses exceed the amount of the subordinated tranches. The senior securities are the portion of the ABS issue that is typically rated triple-A, while the lower-quality (but presumably higher-yielding) subordinated classes receive a lower rating or are unrated.

2. Overcollateralization

In this case, the face amount of the financial asset pool is larger than the security it backs.

3. Yield Spread (Excess Servicing)

Excess servicing, comprises the difference between the coupon on the underlying assets and the ABS coupon. In some ABS structures, excess servicing may be applied to outstanding classes as principal. **Excess Spread** is the net amount of interest payments from the underlying assets after bondholders and expenses have been paid. The monthly excess spread is used to cover current-period losses, and may be paid into a reserve fund to increase credit enhancement.

4. Reserve Fund

A **Reserve Fund** is a separate fund created by the issuer to reimburse the trustee for losses up to the amount of the reserve. It is often used in combination with other types of enhancement.

B. External Credit Enhancement Methods

1. Surety Bonds

A surety bond is an insurance policy provided by a rated insurance company to reimburse ABS holders for any losses incurred. Often the insurer provides its guarantees only to securities already of at least investment-grade quality (that is, BBB/Baa or equivalent). Usually this requires one or more levels of credit enhancement that will cover losses before the insurance policy. An insured ABS is rated equal to the claims-paying rating of the insurance company, typically triple-A, because the insurance company guarantees the timely payment of principal and interest on the security.

2. Third-Party or Parental Guarantees

A third party — e.g., a rated insurance company, or the parent company of the seller/servicer — promises to reimburse a trust for losses up to a stated maximum amount. It can also agree to advance principal and interest as necessary and buy back defaulted loans.

3. Letters of Credit (LOCs)

LOCs are issued by financial institutions, typically banks, that are paid a fee to stand by with cash to reimburse the trust for any losses actually incurred, up to the required credit enhancement amount. These first three forms of external credit enhancement expose the investor to "third-party risk," where the ABS rating will be dependent on the creditworthiness of the institution providing the enhancement. If the institution is downgraded, then the ABS may also be downgraded.

4. Cash Collateral Account (CCA)

In this case, the issuer borrows the required credit-enhancement amount, usually from a commercial bank, and then invests that amount in the highest-rated short-term (one-month) commercial paper. Since this is an actual deposit of cash — unlike an LOC, which represents a pledge of cash — a downgrade of the CCA provider would not result in a downgrade of the transaction.

Appendix 2

The Belgian Model

In August 1992, a dedicated legal framework for setting up a Belgian based SPVs for securitisation of receivables was enacted. The main goal of this new legislation was to make dedicated SPVs available as part of an attractive and reliable regulatory framework and to make them cost efficient, in particular from a tax point of view. This legal framework was established with the amendment to the existing legislation on collective investment institutions and the creation of a new category called Institutions for Investments in Receivables. These take the form of either a company or a fund for investment in receivables. The new legislation allows for securities issued in a securitisation transaction to be offered publicly or through private placements. Institutions under this new legislation are only allowed to engage in activities relating to acquisition and financing of receivables.

Institution(s) set up under this legislation may not own any assets or enter into transactions other than for the purpose of the specific securitisation transaction the said institution(s) was set up for. However, these institutions are allowed to hold cash and certain investments and enter into various credit and liquidity enhancement arrangements, including swaps. Thus, every institution is by its very nature an SPV which is designed to be bankruptcy remote. Further, these institutions cannot engage in the origination of loan receivables or participate in lending to third parties and may only issue pass-through securities and debt obligations.

1. Securitisable Assets

The SPV can in principle acquire all types of receivables, including future receivables. As from 1994 merely entering into a written assignment agreement perfects the assignment of any receivables made under Belgian law. However, the assignment of a receivable secured by a mortgage over land can only be effective against third parties if the assignment is duly recorded in the land register, which normally entails a stamp duty of 1% on the secured amount and other additional costs. Assignments involving transfer of receivables to the SPV would on the other hand be fully effective without further formalities and stamp duties can be avoided.

2. Taxation

The Belgian legislation over SPVs were established such that it would not create any additional tax burden compared to a situation where the assets would remain on the balance sheet of the originator:

2.1 SPVs which are companies rather than funds are not subject to a stamp duty of 0.5% on capital contribution. However, these SPVs are subject to corporation taxes. The incorporation of an SPV which by nature are companies benefits from an exemption from withholding tax in respect of all types of movable income, except for Belgian-source dividends. In other words, since

SPVs may only invest in receivables, this exemption may only be relevant to interest income.

2.2 SPVs in the form of funds set up for investment in receivables also benefits from an exemption of withholding tax for incoming interest flows. This form of SPVs are not subject to corporation tax but instead, investors holding the parts issued by the SPV will be taxed on their proportionate share of profits of the SPV.

3. Compartments

Companies forming SPVs can create different compartments or sub-divisions which are legally considered to each be a separate group of assets corresponding to a separate group of liabilities. The liabilities of a compartment are exclusively backed by its assets and are not available for the creditors of another compartment. In other words, these compartments could be described as a statutory mechanism of ring fencing. The legislation in place allows these SPV-type companies to be set up as a multi-issuing conduit vehicle.

4. Risk Weighting

For the purposes of the own fund position of credit institutions, asset backed securities issued by an SPV (company or fund) may be given same risk-weighting as the underlying assets, however, subject to certain requirements. These requirements include among others the need for investors to be put in a position which is equivalent to the position of the original creditor of the receivables. This could only be achieved if the receivables are pledged to the investors.

5. Trustee

Securitisation transactions generally provide for the intervention of a trustee who will look after the interest of noteholders.

6. Private or Public SPV

Under the current legislation, the characteristics of the SPV would depend on whether or not the issue and/or sale of securities will be made to a selected number of persons or to the public at large. The new rules however do not allow securities issued by private SPVs to be listed on a stock exchange in Belgium.

6.1 Public SPV

The establishment of such a vehicle, the proposed securitisation structure and the main documentation would need the Commission's approval. The establishment of a public SPV would be further subject to Regulatory Requirements:

- Management Company: Each SPV must be managed by a management company, authorised by the Commission. In principle, the management company may not be affiliated with the originator or any companies controlled by it. The management company is required to have a predetermined minimum share capital and own funds to cover six months of operating expenses.

- Custodian: Each SPV must appoint a custodian who is authorised by the Commission. The custodian would be charged with the custody of the assets of the SPV. In public securitisation transactions in Belgium so far, the originating banks has been allowed to act as custodian.

- The Supervision Company: Each SPV must appoint an independent supervision company authorised by the Commission to monitor the issue, sale and repayment of securities issued by the SPV; to monitor the normal evolution of cash flows and the risk profile of portfolio of receivables in accordance with the financial plan; and to notify the Commission and the management company on any material change in the financial position of the vehicle.

- The Rating Agency: Rating on securitisation transaction is obligatory as securities are issued to the public unless specifically exempted by the Commission.

- The Auditor: The SPV must appoint an auditor who is acceptable to the Commission.

- The collection agent or servicer: The SPV may appoint a "collection agent" approved by the Commission to collect the receivables for its own account.

- Publication requirements: The public SPV must publish an offering-prospectus (that had attained Commission's approval) for each public issue of securities in Belgium. The SPV must also prepare and publish annual, semi-annual and quarterly reports concerning the status and development of the transaction.

6.2 Private SPVs

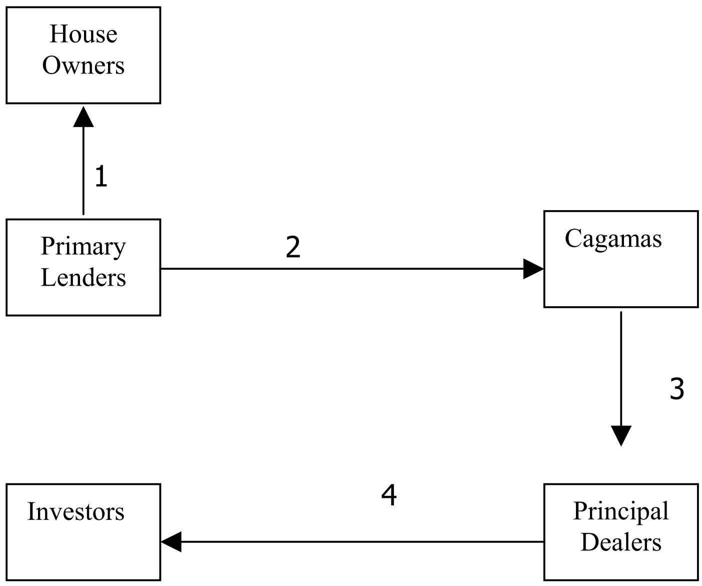
The regulatory requirements on private SPVs are minimal as the securities are not issued to retail investors but only to sophisticated investors. Thus, there is no need to protect the general investor public. Generally, there is neither a requirement for supervision by the Commission nor the need to appoint a custodian, a supervision company or a rating agency. However, each SPV must appoint an auditor and a management company.

6.3 Off-shore SPVs

There is no current legislation which restricts the use of only domestic SPVs to securitise Belgian assets. In practice, offshore vehicles are commonly used to securitise Belgian trade receivables, typically as part of a conduit structure sponsored by an international investment bank. Offshore vehicles which want to offer asset backed securities in Belgium require the approval from the Commission for any public offering in Belgium.

Appendix 3

The Structure Of A Cagamas Issue



(1) The primary lenders grant loans/financing to the house buyers.

(2) These primary lenders subsequently sell their loans/financing debts to Cagamas.

(3) Cagamas would then raise funds from the market to finance the above purchases by issuing debt securities in the form of the longer term Cagamas bonds and short-term Cagamas notes.

(4) These debt securities are placed in the capital market through the Principal Dealers who down sell to investors or hold the papers for themselves.

The investors in the Cagamas debt securities include the financial institutions, insurance companies, provident and pension funds, non-resident companies and other institutions which are interested in investing in short, medium and long-term papers offering a fixed or adjustable rate income.

This process enables the investors to earn an income from Cagamas debt securities which is basically derived from the mortgage interest paid by the house buyers on their housing loans.

Appendix 4

PART IV
TAX RECOMMENDATIONS AND CONCLUSIONS FOR SECURITISATION

Conclusions

The tax treatment applicable to the Originator would vary depending on whether the assets to be transferred from the Originator are held by them initially, as fixed assets or trading assets (eg. lease receivables or HP receivables).

This would in turn ascertain if the transfer of assets to the SPV would be treated on capital account or on trading account which would result in specific consequences under the existing tax framework as to the:

- treatment of 'losses' (possible deductibility);
- treatment of income arising from the sale of future receivables; and
- the market value on disposals and the treatment of capital allowances (including balancing charges & clawback issues).

Other tax issues which would be applicable to all Originators would include issues pertaining to the tax treatment for fees paid to the Originator by the SPV for support services rendered.

The tax treatment for the SPV would also vary depending on whether the SPV is considered to be an investment holding company or an investment trading company which would have tax implications for the SPV on the following aspects of securitisation processes:

- The tax treatment for the payment of rights to future receivables (possible deductibility);
- The value placed on acquisitions and the treatment of capital allowances (include balancing charges & clawback issues);
- The deductibility of fees incurred by the SPV (for support services, swap provision, liquidity provision etc..); and
- The tax treatment for bad debts and excess spreads earned by the SPV.

Recommended Tax Principles to be Applied to Securitisation Transactions

In order to create a conducive tax framework for asset securitisation, the following broad principles should therefore be considered for the securitisation transactions:

- The overall tax cost of the transaction should be no greater than it would have been if no transaction had taken place. Thus, tax neutrality should be a primary objective to achieve in clarifying the framework.

- The SPV must not be subject to a tax regime which gives rise to a possibility that it will be unable to meet a tax liability, and thereby render it insolvent. This situation may arise due to lack of transparency in tax treatment and potential differences in interpretation of tax legislation between the Inland Revenue Board (IRB) and tax advisors. Under the normal circumstances, the SPV would have budgeted its cash flows to retain sufficient reserve to meet its obligations which could otherwise be severely impacted by any unexpected tax charges.

Recommended Tax Treatment for the Originator

In the case of the originator, the current tax treatment for various aspects of securitisation structures in various categories does render the tax liabilities of an originator far more onerous than if the originator were to proceed to raise debt financing directly. This would make securitisation transaction less attractive and impede the development of the securitisation market.

In order to ensure that the broad principle of tax neutrality is achieved, we make the following recommendations:

Category of securitisation transaction	Transfer of receivables to the SPV	Transfer of underlying assets to the SPV	Provision of services to the SPV
Sale of receivables already recognised as assets in accounts (A)	• It would be crucial to allow the discount incurred by the originator on the sale of asset to be claimed as a debt factoring cost, which should be allowable as a deductible expenditure.	• Not applicable	• Service tax should not be chargeable on the support services provided by the originator/servicer.

Category of securitisation transaction	Transfer of receivables to the SPV	Transfer of underlying assets to the SPV	Provision of services to the SPV
Sale of future receivables without transfer of the underlying assets (B)	• The lump sum receipt should be taxed on an amortised basis to match the tax shelter from the capital allowances and be in line with the accounting recognition.	• Not applicable	• Same as above.
Sale of future receivables with transfer of the underlying assets (C)	• Not applicable	• It would be desirable if the tax authorities could provide clarity on the following issues. If necessary, certain concessions or less stringent interpretations on the current tax laws should be introduced for the following: - Determination of market value, taking into account the discount over book value of the assets. Current practice of 80 % of TWDV for leasing transaction should be similarly applied here; - 2 year clawback rule not to be applied to originator or SPV; - deferred sale consideration should be taxed on cash basis;	• Same as above.

Category of securitisation transaction	Transfer of receivables to the SPV	Transfer of underlying assets to the SPV	Provision of services to the SPV
		• It should also be noted that there are additional tax revenues from the originator and other service providers arising from the fee and interest income received from the SPV in relation to services, subordinated debt, swap arrangement (if the originator is a financial institution) and liquidity facilities extended by the originator. • Such payments to be deductible on SPV.	•
Sale of future business receivable (D)	• The lump sum receipt should be taxed on an amortised basis to be in line with accounting recognition.	• N/A	• Same as above

Recommended Tax Treatment for the SPV

Should such SPVs be considered IHCs for all securitisation transactions, tax neutrality will not be achieved and this would render such securitisation transactions less commercially viable. In these circumstances we therefore recommend as follows:

<table>
<tr><th>Proposals</th><th>Comments</th></tr>
<tr><td>Granting tax exempt status to the SPV</td><td>

This has the clear effect of achieving tax neutrality for securitisation transactions and mitigating any possible mismatch, for tax purposes, between the receipts and the outgoings of the SPV which could affect the bankruptcy remoteness of the entity.
Under the arrangement, the SPV will be deemed as a pass through vehicle which is not subject to income tax as in the case of local unit trust funds for certain classes of income. Ideally, the above arrangement is not expected to cause a loss of revenue to the Government.
The tax for the transaction, on the other hand, will be collected among others from the following sources:

tax on any profit paid back to the originator: income received by the originator on any residuals held by it is in fact taxed in its hands;
any gain on the acquisition cost of the residuals by the originator are taxed accordingly;
the interest income derived by investors from the securities is taxable in accordance with normal principles; and
servicing fees and swap payments paid by the SPV are taxable in the hands of the originator and the swap provider (usually financial institutions) respectively.

However, granting tax exemption to the SPV could potentially give rise to tax leakage resulting in some tax loss for the Government. It may provide an avenue to the originator to reduce tax liability by entering into a securitisation transaction. There is also concern that the surplus of the SPV upon its liquidation would be tax-exempt in the hand of the beneficiaries.

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Proposals	Comments
Granting tax exempt status to the SPV (contd.)	• Instead of full exemption status, it is possible that a concessionary tax rate, as in the case of tax regime for banks operating in Labuan International Offshore Financial Centre (RM20,000 annually or 3% of accounting profits, whichever is lower), be imposed on the taxable income of an SPV approved by the SC. - The concessionary tax rate would have positive effects of streamlining the tax computation for SPV and discouraging excessive tax avoidance by the originator.
Granting SPV a trading company status or treating it as a company involved in the purchase of discounted securities	• Given the above constraints, perhaps, a more efficient measure in the short and medium-term, would be to accord a trading status to SPV which meets certain operating criteria as set out by the tax authorities. • Tax neutrality for securitisation transaction could be achieved if the SPV is treated as trading or investment dealing company as well as a company involved in purchase of discounted securities. • This is illustrated in Appendix 2, 3 and 4 where the tax liability for the SPV is almost a non-issue given the deductibility of expenses incurred and availability of capital allowances, wherever applicable. As indicated in these appendices, the tax neutral position for the SPV could be similarly achieved without any tax loss to the Government. **Special concession for financial institutions** • In addition to the above, it would also be important if the existing concession given to financial institutions on the specific provision for loans is also extended to SPV where the transaction is originated by a financial institution. If this is given, it could further ensure the tax neutrality of securitisation transaction and to facilitate securitisation activities among financial institutions. • Another aspect would be to allow the SPV to stop accruing interest for tax purposes after a specified period of non-performance of the loans acquired, and would be able to deduct for tax purposes a loan loss reserve.

Proposals	Comments
Granting SPV a trading company status or treating it as a company involved in the purchase of discounted securities (contd.)	**Areas in which clarification is required** • Where swap receipts are taxable, deductions should also be granted to swap payments. • Interest income received from excess cash deposits or GIC should be treated as business income, rather than investment income.
Where SPV is taxed on a cash basis	• This may solve the problem of taxing the SPV on income it has not received. • It is a solution which applies in the UK to companies treated as passive investment companies, as opposed to companies carrying on a trading activity, known as trading companies, other than in respect of loan receivables, which must be taxed on an accruals basis whatever the status of the owner. • In Hong Kong and Spain, accounts prepared on a cash basis are acceptable by the tax authorities. • However, the cash basis of tax treatment does not address the concern that the entity could not carry forward the loss incurred in a particular year of assessment where expenses are incurred while no income is received on a cash basis.