FEASIBILITY STUDY OF A PARTIAL CREDIT FACILITY (PCGF) FOR MORTGAGE-BACKED SECURITIES IN ROMANIA

FEASIBILITY STUDY

Submitted to:

MINISTRY OF TRANSPORT, CONSTRUCTION AND TOURISM (MoTCT)

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August 12, 2006

Abbreviations & Acronyms

BSE	Bucharest Stock Exchange
BUBOR	Bucharest Interbank Offered Rate
CDS	Credit default swap
CEC	National Savings Bank
CMHC	Canadian Mortgage Housing Corporation
CNVM	National Securities Commission
EBRD	European Bank for Reconstruction and Development
EU	European Union
EUROBOR	Euro Interbank Offered Rate
FHA	Federal Housing Authority (US)
FMR	Financial Market Reform project
FMO	Dutch Overseas Investment Corporation
FOGAFIN	Fondo de Garantías de Instituciones Financieras
GOR	Government of Romania
GSE	Government Sponsored Enterprise
HUD	Department of Housing and Urban Development (US)
IADB	Inter-American Development Bank
IFC	International Finance Corporation
IFI	International Financial Institution
JSC	Joint Stock Company
LIBOR	London Interbank Offered Rate
MBS	Mortgage-Backed Securities
MIGA	Multi-lateral Investment Guaranty Agency
MOF	Ministry of Public Finance
MTCT	Ministry of Transport, Construction and Tourism
NBR	National Bank of Romania
OC	Over-collateralisation
OFHEO	Office of Federal Housing Enterprise Oversight
OPIC	Overseas Private Investment Corporation (US)
PCGF	Partial Credit Facility
RMBS	Residential Mortgage-Backed Securities
RON	New Romanian Leu
SPV	Special Purpose Vehicle
UI	The Urban Institute
USAID	United States Agency for International Development
USTDA	United States Trade Development Agency
VA	Veterans Administration (VA)
WBG	The World Bank Group

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ACKNOWLEDGEMENTS

The Urban Institute Team (Pamela Hedstrom, Michael Lea and Nicoleta Mihalache) would like to acknowledge the people who gave a lot of support to this report by offering their time, insights and comments. We wish first to recognise the assistance offered by Mariana Ionita and Alexandra Radu from the Ministry of Transport, Construction and Tourism in Bucharest, as well as the assistance offered by Nicoleta Bala and Cornelia Munteanu from the Ministry of Public Finance. They provided useful comments and supportive suggestions throughout our work.

The Team held either telephone or in person meetings with some 33 individuals during our work to obtain information and insights about Romania's mortgage sector and financial markets. We consulted with key government institutions – the Ministry of Transport, Construction and Tourism, the Ministry of Public Finance; potential issuers including commercial banks, mortgage credit companies and bauspar savings banks; institutional investors including investment funds, international financial institutions (IFIs); credit enhancement experts including rating agencies, IFIs and mortgage insurers; and service providers to the Romanian capital including brokerage firms, law firms, insurance companies and consultants.

In addition to meeting with team members, 30 mortgage market participants attended the July 5, 2006 Workshop – *Mortgage-Backed Securities Market Development: Issues & Opportunities.* We would like to thank the Romanian Bankers Association for graciously hosting this event at their facilities. The names of persons with whom we met and who attended the Workshop are listed in Annex II. These individuals were cooperative, open, and informative, and we are grateful to them for their time and good ideas.

We were fortunate to have strong support for the fieldwork. In particular, Ioan Bejan, from Elite Financial Services, Ltd., did an excellent job of updating us on Romanian mortgage market statistics and information as well as organising the workshop. Dana Timotin and Raluca Ghicuta did a fine job of interpreting and translating. At Urban Institute headquarters, Katherine Carson helped with administration of the project.

While these individuals provided invaluable assistance to the Team, the authors are solely responsible for the report. The statements herein are the authors' alone and not necessarily the views of The World Bank Group or the Urban Institute.

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EXECUTIVE SUMMARY: FEASIBILITY STUDY OF A PARTIAL CREDIT FACILITY (PCGF) FOR MORTGAGE-BACKED SECURITIES IN ROMANIA

The purpose of this study is to provide interested stakeholders with basic information on the reasoning and structure of the project and to determine the potential for securitisation in Romania.

The report stresses the importance and the benefits of securitisation worldwide and its current potential in Romania. Mortgage securitisation has become widely accepted as a financing and risk diversification technique. Securitisation can increase accessibility to diversified, longer term funding sources for lenders, encourage increased competition, and improve borrowing conditions for homeowners.

During the course of this Feasibility Study, the Team focused on the specifics of the Romanian market for a potential securitisation. There is a wide variation in the factors affecting the viability of mortgage securitisation in Romania. The mortgage market is growing rapidly and performing well. However, there is an excess of liquidity in the banking system with a resultant low demand for funding at this point. There is still a lack of standard origination practices. Only a few lenders have implemented standardised underwriting procedures and documents, and the aggregation of loans from multiple lenders is problematic. However, general opinion stressed that refinancing of mortgage loans could become problematic within one to two years and a secondary market will be needed to provide financing alternatives.

Although all of the market participants with whom we spoke see great potential for mortgage-backed securities and regard them as important products for the further development of the Romanian capital market, they identified several near term obstacles to such issuance. These include an overvalued investment climate, increased competition for mortgage loans, legal and regulatory shortcomings, institutional capital market limitations and an untrained audience.

The Team found a large discrepancy in the awareness and understanding of the risks and rewards of mortgage-backed securities, which demonstrates the need for further product training and market development. Mortgage loans and mortgage securities are relatively complicated and market participants need to fully understand the associated risks. Stakeholder perceptions of mortgage-backed securities varied widely depending on their function in the markets and their familiarity with the product. Those unfamiliar with securitisation were more cautious about purchasing, issuing or underwriting these new financial instruments.

The new Romanian legal framework provides the framework for a potential securitisation transaction. Three new laws (Mortgage Banks Law, Mortgage Bond Law, and Securitisation Law) and amendments to the Mortgage Loan Law were published in March 2006. The stakeholders contacted were supportive of the new mortgage legislative package and noted its importance in the continued development of the Romanian mortgage market.

The mortgage legal and regulatory framework continues to evolve. While the framework is in place, the NBR and the CNVM issue implementing regulations. There are still several structural deficiencies including the taxation and accounting requirements for securitisation such as tax neutrality, bankruptcy remoteness, true sale treatment of assets, withholding taxes, balance sheet treatment/consolidation, and regulatory capital treatment.

The credit risk due to loan default is one of the major risks associated with mortgage loans. In this respect, credit enhancement is required to insure that investors receive timely payment of principal and interest from securities. The report reviews a variety of structures for credit enhancement, both external and internal.

In Romania, the strong balance sheets and high demand for mortgage product on the part of banks suggests that there is no need for a government backed guarantee program. European experience has demonstrated that securitisation can take place through a combination of internal and private external enhancement when issuer need arises. The lack of a sustainable market also suggests that a PCGF is not needed at this time. The most likely sources of credit enhancement in any future securitisation transaction are likely to be multi-lateral or monoline partial transaction guarantees (or senior/subordinated structures).

In Romania, the secondary market development needs investor demand. At this point, the number of investors is still limited, although it is expanding. Domestic demand will continue to increase as new institutional investors emerge with the introduction of private pension funds next year. The domestic market participants still lack the expertise and the understanding of a securitisation structure.

International investors are more sophisticated and are interested in purchasing bonds, especially if there is an investment grade granted by one of the major agencies. The improvement in economic fundamentals and upcoming EU accession has brought increased foreign investment and new players into the domestic markets. The appreciation of the RON has resulted in local currency denominated assets being aggressively demanded by both domestic and international investors.

Based on capital and mortgage market information, the study examines representative domestic and international MBS structures backed by Romanian mortgage loan collateral. The attainment of an investment grade country rating has increased the overall attractiveness of Romanian securities to local and foreign investors. RON denominated assets would be highly desirable to each, but Euro would be attractive as well.

In a domestic structure, such a transaction would have a limited number of tranches and would require internal and possibly external enhancement. The internal enhancement may include some combination of excess spread, over-collateralisation and a senior/subordinated structure. Although not a direct form of external credit enhancement, the purchase of the junior securities by an international financial institution would signal confidence in the deal structure and underlying collateral. The reputation of the issuer would be important to the success of the transaction.

Under the international structure, a first transaction from a new issuer would probably require a higher amount of credit support due to the lack of historical performance data. A credit rating would be necessary and although a significant expense it will facilitate the issuance of MBS on more favourable terms and conditions. A well-structured deal will allow the senior tranche to "pierce the sovereign ceiling" and be rated higher than Romania's Baa country rating.

The Team modelled the financial viability of a potential domestic RON issue. The principal finding of the exercise is that the all-in costs of a securitisation transaction significantly exceed the mortgage loan margin, making mortgage-backed securities transactions not economically feasible at this time. A major factor is the high securities issuance and listing fees that may very well drive issuance to cheaper and more flexible offshore domiciles. A Romanian mortgage-backed securities structure will also have expenses for the SPV administrator, the SPV portfolio manager as well as ongoing legal, accounting and other operating expenses.

Over time, evolution in the primary mortgage market, capital market and regulatory environment may change this "negative arbitrage" allowing a securitisation transaction to be completed on an economically viable basis.

In recent years, the Romanian mortgage market has continued to adapt and expand despite the shortcomings previously noted. Although it has reached many significant milestones, additional goals must be achieved prior to mortgage-backed securities issuance reaching sustainable levels. To create the institutional conditions needed to introduce securitisation as a new product for the Romanian mortgage market, the ongoing support and commitment of market participants will be required. Fortunately market participants recognise that this will change and continue to support further market development in anticipation of a more favourable environment.

FEASIBILITY STUDY OF A PARTIAL CREDIT FACILITY (PCGF)
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1. INTRODUCTION & SCOPE OF PROJECT

In 2003, the Financial Market Reform project (FMR), a USAID project administered by Deloitte Emerging Markets, established an industry-wide Mortgage Task Force (Task Force) to drive the development of the Romanian mortgage market. The Task Force activities were focused on increasing market awareness, participating in the legislative and regulatory process and designing a suitable securitisation process. In their activity, the Task Force worked closely with the Inter-Ministerial Group created by the Government of Romania (Working Group).

This Feasibility Study for a Partial Credit Facility (PCGF) for Mortgage-Backed Securities is a by-product of the task force efforts to improve the conditions for housing finance in Romania. The primary purpose of the UI team (the "Team") carrying out the study is to assist the Ministry of the Transport, Construction and Tourism to examine the potential for mortgage securitisation. Securitisation may increase accessibility to diversified, longer term funding sources for lenders, which encourages increased competition, broader loan product offerings and improved borrowing conditions for homeowners. The objective of the study is to raise awareness of mortgage-backed securities (MBS) and gather important market feedback required to design viable financial instruments and a partial credit guarantee facility (PCGF) concept that would work in the Romanian environment.

During this project, the Team analysed current mortgage market conditions, reviewed the Romanian legal and regulatory securitisation framework, identified mortgage risk factors and mitigation methods, explored various forms of credit enhancement, and identified potential mortgage-backed securities structures for the domestic and international markets. The study broadly focuses on the readiness of the Romanian market for mortgage securitisation. Topics addressed included key securitisation concepts, issuer needs and objectives for securitisation, potential securitisation products and forms of credit enhancement, investor parameters, requirements and constraints, and legal and regulatory requirements for new products. The partial guarantee facility is one form of credit enhancement that can improve the attractiveness of Romanian MBS and is reviewed in the context of the needs and readiness of the market.

1.1. Government Housing Finance Policy Initiatives

This study addresses one of two topics identified by the government as possible ways to foster the development of a MBS market. One topic is the creation of a mortgage default insurance scheme. A mortgage insurance provider (public, private or a public-private partnership) bearing some of the risk associated with making loans with high loan-to-value ratios can broaden access to loan products and improve the credit quality of loans backing mortgage securities.

The second topic is the provision of a partial guarantee on mortgage securities. Such a measure could benefit the long-run development of the mortgage market by expanding the investor base in the securities. In turn the development of a mortgage security market can permit lenders to offer loans with fixed rates and other features that can benefit all housing borrowers.

A related policy initiative is the one that supports the full development of institutional investors such as pension funds and insurance companies. These investors are the natural complement to the introduction of more sophisticated mortgage securities. In fact, their existence is mandatory in the development of the secondary market. The full evolution of these aspects of the housing finance market will take a few years, but it will further support the ability of the private market to maximise the housing options of Romanian people without heavy burdens on the state budget.

1.2. Prerequisites for a Secondary Mortgage Market

A successful housing finance system is premised on a well-developed legal, regulatory and primary market infrastructure. The development of a satisfactory legal framework for mortgage securities is often complex and time consuming, requiring amendments to the existing laws, creation of new laws and secondary regulations for concepts and instruments previously nonexistent. In particular the law must allow the creation of a bankruptcy remote vehicle to protect investors against the bankruptcy of an originator or servicer. In addition, accounting and tax regulations may need to be revised to facilitate securitisation.

The primary mortgage market must accumulate a critical mass of mortgage loans that are underwritten and originated according to best practices. Collateral suitable for "pooling" or packaging for sale in the secondary market must be based on standardised terms and characteristics.

There must be both the demand for and supply of securities for a secondary market to develop. Investors will need to understand and manage the complex risk of mortgage securities, which requires a combination of disclosure and education. Different types of investors must have the regulatory authority to purchase the securities. Potential issuers must have a need for alternative sources of long-term funding to better manage their interest rate risk and balance sheets; they must also be committed to bringing frequent transactions to the market to create liquidity.

Credit enhancement is a necessary, but not sufficient component to the securitisation process. Partial guarantee facilities are but one form of credit enhancement. Issuers will decide on the most efficient form of credit enhancement to achieve a target rating to attract sufficient investor interest.

2. OVERVIEW OF ROMANIAN FINANCIAL MARKETS

2.1. Capital Markets

The Romanian banking sector and financial markets have progressed substantially since 1989. The economy is exhibiting relative macroeconomic stability, high growth, low unemployment and increasing foreign investment. Economic growth has averaged over 5% since 2000, rising to 8.3% in 2004, despite a declining population, and it is expected to continue to increase in the range of 5-6%. Last but not least, Romania was granted the status of a "functional market economy" in October 2004 by the European Union (EU).

The state-owned banks except for the National Savings Bank (CEC) have been privatised and there is significant participation from major European banking institutions bringing a depth of resources and expertise to the markets. The Bucharest Stock Exchange (BSE) has experienced strong but highly unstable performance over the past 10 years. Municipalities and local corporations have floated bond issues as well as equities. Legislation for second and third pillar pension funds has been enacted and the funds are expected to be offered to the Romanian workforce starting in 2007.

Romania is scheduled to enter the European Union in 2007. The country's improving economic fundamentals has obtained investment grade ratings from Standard & Poor's and Fitch and it is graded one notch below by Moody's. The harmonisation of the legal and regulatory frameworks with the EU will continue to improve the country's attractiveness for both domestic and foreign investment.

2.2. Competition in Mortgage Loan Offerings

The Romanian mortgage market has experienced explosive growth over the past three years. At the end of 2002, only six lenders offered mortgages with an estimated total residential loan volume of 200 million USD or less than 0.5% of GDP. Currently, there are over 25 lenders participating in the market, including universal banks, mortgage credit companies, bauspar institutions and builders.

As of January 2006, total outstanding loan volume has increased to 1.5 billion euros. The market is still in a relatively early stage of development as this represents approximately 2% of GDP. Although there are no published data, robust demand for housing due to overcrowding, strong need for current housing stock renovation and rehabilitation and overall positive outlook for the economy indicate substantial potential for the primary mortgage market.

There are two types of housing loans, both of which would be called a mortgage loan in most countries. In Romania, as provided by the Mortgage Loan Law, a mortgage loan must be a credit used for a housing purpose. It cannot be a consumer or a business loan secured by a residential mortgage. In addition to this aspect, under the Mortgage Loan Law, a mortgage loan with a variable rate must be indexed to one of the main public market rates for low-risk short-term debts, namely EURIBOR, LIBOR or BUBOR.

In response to these restrictions, many lenders offer so-called "housing loans", which are credits that do not need to be for a housing purpose and can have a rate that varies on any basis the lender wishes. This is significant for many banks, because their cost of funding does not correlate with any of these rates. This is clear in the case of foreign exchange denominated (forex) loans, where there will be many factors affecting a bank's cost of funds relative to EURIBOR or LIBOR. Thus, banks prefer to index loans to their own cost of funds.

2.3. Recent Evolution of Mortgage Markets

In February 2004, the NBR's restrictive monetary policies resulted in the regulation of the loan-to-value (LTV) and payment-to-income (PTI) ratios for mortgage loans to 75% and 35%, respectively. The goal of these regulations was to decrease the current account deficit and the precarious growth in forex denominated consumer credit. However, the banks demonstrated the ability to create new products to address the needs of borrowers.

The NBR has also adopted unfavourable reserve and capital requirements for foreign currency loans. The statutory reserve ratio for forex liabilities is 40%, or 2.5 times that of the 16% required for RON liabilities. The NBR also has adopted a basic capital adequacy ratio of 12%, instead of the 8% rate applied in most European countries under Basel I. As part of the effort to encourage lending in RON, the NBR raised the basic capital required for forex denominated assets to 30%. Thus, forex mortgage loans bear a 15% required capital rate relative to RON-denominated rate of 6% (as mortgage loans have a 50% risk weight). Additionally, the banks are restricted to an absolute lending ceiling for forex loans to 300% of their social capital. Even with these significantly higher capital requirements, the banks are still offering forex products to their customers. They have either obtained forex capital infusions or sold forex denominated loans offshore to related entities.

Prior to the adoption of these higher reserve requirements, over 85 percent of mortgage loans were denominated in foreign currency due to the significantly higher loan limits for hard currency loans. More recently, lenders' product mix has adjusted to an approximately equal balance of domestic and forex loans. The steady decline in spreads between foreign and local interest rates, in some cases to zero, has made RON loans more attractive to Romanian borrowers.

There is an excess of liquidity in the banking system, and commercial bank mortgage lenders are aggressively marketing for retail loan customers. The banks have a large supply of short-term deposits primarily in domestic currency. The European Bank for Reconstruction and Development (EBRD) and other international financial institutions have been active in making long-term forex denominated loans at very attractive terms. The majority of banks have foreign ownership and access to reasonably priced funding from the parent institution.

Mortgage loans are a relatively high margin business for the banks. At this point, the banks we spoke with are net buyers of mortgage loans and are more interested in acquiring portfolios of loans from other banks than securitising their own assets. However, they realise that this situation may change at some point and that they will need alternative sources of long term funding and risk management that a secondary mortgage market provides. Some commentators believe that a problem of refinancing mortgage loans could arise within one to two years, and a secondary market will be needed to provide financing alternatives.

3. MORTGAGE RISK FACTORS AND MITIGATION

Long-term housing loans may create significant credit, interest rate, liquidity and currency risks for mortgage lenders and investors. Risk is defined as "the adverse impact on profitability of several distinct sources of uncertainty". Many of the risks inherent in mortgage loans can be mitigated through primary market lending requirements and secondary market transaction structures. Or they may be passed through to investors better able to manage these risks.

Credit risk arises from the customers' inability to comply with their debt service obligation. Probability of delinquency and default can be partially predicted by the loan-to-value and payment-to-income ratios. In many emerging economies the perception and reality of mortgage credit risk is high - notably due to ineffective legal protections, regulatory inconsistencies, market distortions and limited historical performance data. More stringent underwriting and origination standards can mitigate this risk.

Credit risk in mortgage loans can have a major impact on the structure of a securitisation transaction. The lender can manage credit risk to some extent through geographic loan distribution, low LTVs, and well-defined pool selection criteria. However, investors in mortgage securities usually require one or more forms of originator and/or third party credit enhancement to protect against such potential loan losses. The various forms of internal and external types of credit enhancement and their use in securitisation will be discussed in detail in the following sections of this report.

Interest rate risk is an important problem facing lenders worldwide. It develops when there is a mismatch between the interest rate characteristics of longer maturity of mortgage loan assets and the shorter term of funding sources. This asset/liability imbalance can be a major source of banking instability particularly in a rising rate environment when banks' face higher liability costs with limited ability to adjust asset revenues. Transitional economies, such as Romania, lack capital market or derivative instruments that can be used for hedging. Interest rate risk may be minimised through granting adjustable rate mortgages (ARMs), which may shorten but do not eliminate the interest rate gap. Indexing these loans to public market rates is more transparent to the borrower and has less basis risk for the lender than internal funding rates. ARMs have a greater credit risk, however, due to the possibility of payment shock at rate adjustment.

Liquidity risk is the inability to rapidly convert assets into cash without suffering losses. It occurs whenever liability holders of an intermediary, such as depositors or insurance policyholders, demand immediate cash for their financial claims. Mortgages are long-term assets that are not readily tradable, as investors require extensive analysis for loan quality verification and risk assessment. However, liquidity risk can be mitigated through secondary market institutions such as loan warehouses, liquidity window facilities or the ability to post mortgage assets as collateral in the interbank market.

Foreign exchange or currency risk is another significant issue in transition economies. It arises when the asset and the liability are denominated in different currencies. Banks tend to transfer currency risk to borrowers who choose foreign exchange denominated loans due to their lower nominal interest rates. However, these consumers usually earn incomes pegged to the local currency. In the event of local currency depreciation due to shocks in the domestic economy, delinquency and default experience may spike, as it becomes more difficult for borrowers to pay their hard currency mortgages. In emerging markets, currency risk is a significant concern in securitisations. Foreign exchange hedging instruments may not be liquid if available at all. An absence of hedging instruments may limit the issuance of local currency denominated transactions.

Prepayment risk occurs when the estimated cash flow of assets changes as a result of the borrower's partial or complete loan repayment before maturity. When the principal is paid faster than originally scheduled future spread income is reduced and the lender may not recoup the costs of originating the loan. Depending on market practices and regulations, many banks charge prepayment penalties that allow them to recover part or all of their expenses and lost revenues. Prepayment risk may also be "passed through" to the investor although different tranches within each deal may have various degrees of prepayment protection.

Agency risk arises due to the separation of the functions of origination, servicing and investment. This risk can be managed through a combination of quality control of loans purchased or guaranteed and rigorous reporting standards for originators and servicers.

Many cash flow risks that remain after mortgage loan origination can be redistributed in the transaction structure to create securities acceptable to traditional investors. Mortgage market performance will improve as the risks enumerated above are distributed among the parties that are able to bear them more efficiently. The process of shifting these risks requires the creation of a secondary mortgage market that links the capital and housing finance markets.

4. SECURITISATION & SPECIAL PURPOSE VEHICLES

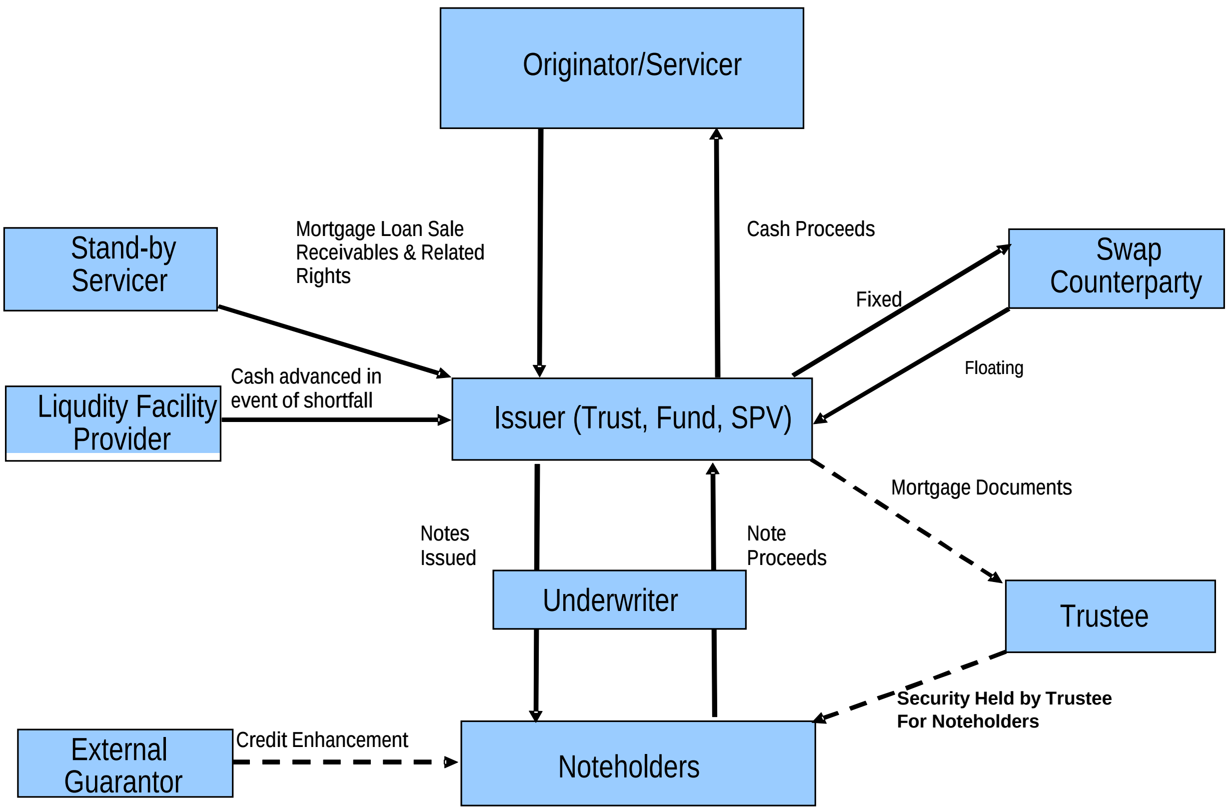
Securitisation is the process that converts assets or cash flows into capital market instruments. It brings important benefits to borrowers, financial institutions, investors, regulators and others. Mortgage securitisation has become widely accepted as a financing and risk diversification technique in Europe and is the dominant source of home financing in the United States. In most developed countries, the mortgage market is among the largest components of the capital markets. In the United States mortgage debt is the largest component of the domestic debt market, larger than corporate or treasury issues.

Securitisation is accomplished through the transfer of assets via a "true sale" to a legal entity formed solely for the purpose of acquiring and financing specific assets – the **Special Purpose Vehicle (SPV)**. An SPV may be a trust, partnership, or joint stock company. It may be domiciled either in the issuer's country or may be located offshore. The SPV is bankruptcy remote; its assets are isolated from the insolvency of seller/originator, giving the investor legal and structural preference. The SPV also needs to be fiscally transparent and tax neutral so that the transaction is feasible. The SPV structure (e.g., trust, fund, company) will depend on the legal jurisdiction in which it is created.

4.1. Generic Securitisation Transaction

A securitisation transaction starts, as shown in the diagram below, when the originator sells the mortgage collateral to the SPV. In turn the SPV issues securities, which may be debt or equity interests depending on the transaction structure. These may be publicly or privately placed. The originator may choose to retain some components of the securitisation transaction such as servicing or subordinated tranches. When the originator sells collateral to an SPV, it is usually obtains "off balance sheet" treatment for those assets and regulatory capital relief.

Figure 1: Generic Securitisation Transaction



There are a number of parties to the typical securitisation transaction. The Originator is the entity that either generates the mortgages in the ordinary course of its business, or purchases or assembles portfolios of mortgages (in that sense, not a true "originator"). During the term of the securitisation, payments on the mortgages are collected by a servicing entity (Servicer), usually the Originator, deposited and invested in various accounts under the control of a Trustee, and disbursed by the Trustee to the security holders in accordance to the terms and conditions on the securities. The Trustee is usually a bank or other entity authorised to act in such capacity. The Trustee holds the mortgages (collateral documents), receives payments on the mortgages and makes payments to the security note holders.[1] The Underwriters or Placement Agents are the brokers, investment banks or banks that sell or place the Securities in a public offering or private placement. The Underwriters/Placement Agents usually play the principal role in structuring the transaction, frequently seeking out originators for transactions and working with investors on placing the securities. Investors or Noteholders are the ultimate purchasers of the securities. Usually banks, insurance companies, retirement funds and other "qualified investors." In some cases, the securities are purchased directly from the Issuer, but more commonly the securities are issued to the originator or intermediate SPV as payment for the mortgages and then sold to the Investors, or in the case of an underwriting, to the Underwriters.

Additional parties include a Stand-by Servicer, a bank or another lender, that can take over servicing in the event of a default by the primary servicer. A Liquidity Provider, usually a bank, will agree to temporarily advance payments in the event of a servicing disruption. A Swap Counterparty is a bank or financial institution that will exchange payments from the mortgages for payments in a different form – either an interest rate swap (exchanging fixed for variable rate interest or vice versa) or currency swap (exchanging payments in one currency for another one).

4.2. Rating Agencies

Once the type of issuing vehicle has been established, the issuer will face the decision of how to structure the resulting class of securities. A driving force behind this decision will be the level of credit enhancement necessary to achieve a given credit rating (AAA, AA, A, BBB, etc.) for each of the various classes of the security. The basis for the required credit enhancement is the estimated losses for each of the classes under a range of assumptions. This is the point at which the credit rating agencies (e.g., S&P, Moody's, Fitch) enter into the process.

The rating agencies will forecast loss coverage amount as a product of probability of default and loss per default. Default probability represents the percentage of the loans that will default over the life of the transaction. Their forecast depends on the availability of some data history to correlate loan underwriting, servicing performance and loss. Loss per default (severity) represents the losses experienced by the transaction and consists of any loan amounts not recovered as a result of foreclosure or other sale of the loan. Severity includes all costs of liquidation as well as any accrued interest not paid by the borrower. It critically depends on the legal environment determining the amount of time for the process. The rating agencies will establish different levels of loss probability and loss severity for the various rating levels.

[1] Alternatively the mortgages may be held by a custodian, usually a bank, as agent for the Trustee or Trustees.

5. CREDIT ENHANCEMENT MECHANISMS FOR SECURITISATION

The credit risk due to loan default is one of the major risks associated with mortgage loans. New issuers, particularly in emerging economies, have limited historical performance data making it difficult to predict the probability of default with much confidence. Untested legal procedures (e.g., foreclosure) or lack of default experience make it difficult to forecast loss severity. Originator or third party credit enhancement is used to protect against such potential events.

5.1. Types of Credit Enhancement

All forms of securitisation involve credit enhancement. To attract a wider group of qualified investors, the securitisation structures must include highly rated tranches or classes. The amount and type of credit enhancement will be dependent on the desired credit rating (AAA, AA, A, BBB, etc.) for each of the various classes of the security. The basis for the required credit enhancement is the estimated losses for each of the classes under a range of assumptions. The rating agencies will forecast the loss coverage amount as a product of probability of default and loss per default.

Credit enhancement is required to insure that investors receive timely payment of principal and interest from the securities. This form of cash flow insurance differs from loan loss insurance, typically provided by mortgage insurers, which compensates the insured (typically the lender but possibly the investor) for ultimate loss due to a default. Cash flow insurance is required to make the securities more equivalent to bonds (e.g., government, mortgage or corporate) in their cash flow certainty.

Credit enhancement can come from external or internal sources. External credit enhancement is provided by highly rated third parties. Table 1 shows the various types of guarantees offered on securitisation transactions, the entities that offer them and some of their advantages and disadvantages.

5.2. External Credit Enhancement

<u>Issuer Guarantees:</u> In the US and Hong Kong, government owned or backed conduits provide timely payment guarantees on the securities they issue. A conduit is an institution that purchases loans from lenders and issues guaranteed pass-through securities. The most notable examples are Fannie Mae and Freddie Mac in the US and the Hong Kong Mortgage Corporation. These institutions are highly rated primary due to their government backing. The advantages of issuer guarantees are simple (no third parties or structuring) and relatively cheap (the average guarantee fee charged by Fannie and Freddie is around 20 basis points, lower for larger lenders with negotiating power and higher for smaller lenders and certain types of loans (e.g., ARMs, lower quality loans). Fannie Mae and Freddie Mac collectively have guaranteed more than 2.5 trillion USD in securities (OFHEO).

Non-government issuers do not typically guarantee their own securities for several reasons. First, they typically do not have a high enough stand alone rating. Second, providing a guarantee will probably negate true sale treatment for the security sale and thus capital relief. The guarantee would result in the loans being included in the balance sheet of the issuer and the securities being classified as debt for accounting and regulatory capital purposes. Fannie Mae and Freddie Mac are subject to special capital adequacy and accounting treatments. Accountants have ruled that their large, widely diversified and low risk portfolios reduce the risk of their guarantees allowing off-balance sheet accounting treatment. They are subject to risk-based capital guidelines based on a stress test of their portfolio performance in an adverse credit and interest rate scenario. Another disadvantage of issuer guarantees is the contingent liability they represent to the government. In a proper accounting system, the government's support should be quantified and budgeted – in the US there is simply a footnote reference to the liability. The government backing is implicit which is less efficient than a full faith and credit guarantee (i.e., the bonds trade at yields lower than AAA issuers but higher than government for comparable durations). While the private ownership of the GSEs brings efficiency to their operations, critics point out that the part of the government backing is captured by management and shareholders.[2]

The government-sponsored entity (GSE) structure has come under fire recently in the US, in part due to accounting scandals at Fannie Mae and Freddie Mac. These institutions are government-chartered corporations, privately owned but viewed by investors are backed by the government. They are subject to dual regulation – one regulator for safety and soundness, Office of Federal Housing Enterprise Oversight (OFHEO), and another for programmatic oversight, the Department of Housing and Urban Development (HUD), which monitors compliance with legislatively mandated affordable housing programs. Many critics believe the regulatory oversight has been weak until recently, reflecting the large size and political influence of the institutions.[3] There are legislative proposals (Summer 2006) to curtail the size of the GSE portfolios and create a new and more independent regulator but these efforts are unsure of passage. The scandals surrounding Fannie Mae and Freddie Mac and the issues surrounding the GSE structure has reduced international interest in this model. A proposal to create a European GSE in 2004 was soundly rejected by regulators and market participants.

[2] Congressional Budget Office, Federal Subsidies and the Housing GSEs, May 23, 2001

[3] See for example L. White, On Truly Privatizing Fannie Mae and Freddie Mac: Why It's Important, and How to Do It" Wharton Conference on Fixing the Housing Finance System, April 2005 and Ely, Bert, "How to Privatize Fannie Mae and Freddie Mac," in Federal Reserve Bank of Chicago, How Do Banks Compete? Strategy, Regulation, and Technology, 40th Annual Conference on Bank Structure and Competition, May 2004,

Table 1: External Credit Enhancement

Type	Description	Offered By	Advantages	Disadvantages
Issuer Guarantee	Issuer guarantees of timely payment of P&I	Fannie Mae, Freddie Mac, Hong Kong Mortgage Corp.	Simple, easy to understand, can be relatively cheap (~20 bp in US); stimulates competition by allowing access to a wide range of lenders; offered by gov't. or quasi-gov't institutions with high ratings	Creates contingent liability for gov't., may be mis-priced (+/-); Would not be off-balance sheet for corp. issuer; Should be properly capitalised and budgeted
Agency Guarantees	Third party guarantee of timely payment of P&I from government agency	GNMA, CMHC, Colombia, KfW	Simple, easy to understand, can be relatively cheap (6 bp in US, 20 bp in Canada); stimulates competition by allowing access to a wide range of lenders	Explicit liability of the gov't.; subject to agency risk (due to actions of lenders); may be mis-priced; should be properly capitalised and budgeted
Monoline Financial Guarantees	Provides guarantee of timely payment of P&I. Typically covers 100% of loss up to stipulated aggregate loss limit	Bond insurers (AMBAC, MBIA), Private mortgage insurers (PMI, Genworth, UGI)	Insurers typically rated AA or AAA – improves credit quality of securities. Provider may assist in structuring	Cost: 15-45 bp for AAA wrap; Bond insurers provide guarantees only in investment grade countries
Political Risk Insurance	Provides insurance against non-commercial risks such as currency transfer restrictions, certain types of expropriation	Multi-laterals (MIGA, IFC.), Bi-lateral (OPIC)	Applicable for emerging markets with unstable economies and/or legal systems. Allows issuance of securities for international investors	Cost: 8 bp/yr. for 1.5 yrs. In Baltic American transaction
Multi-lateral and Bi-lateral Agency Guarantee	Provides guarantee of timely payment of P&I. up to a specified percentage of the pool or tranche balance.	World Bank (back-stopped by gov't.), IFC, EBRD	AAA + guarantees, will assist in structuring and marketing	Some require gov't. counter-guarantee; cost – e.g., 25 bp for IFC partial guarantee, additional delays and cost for agency approvals
Liquidity Facility	Covers temporary shortfalls in cash flow due to disruption in servicing. Typically limited to a max % of the outstanding balance	Banks	Steps in before timely payment guarantor if shortfall not due to loss	Cost (10-20 bp commitment fee); Could be covered by reserve fund

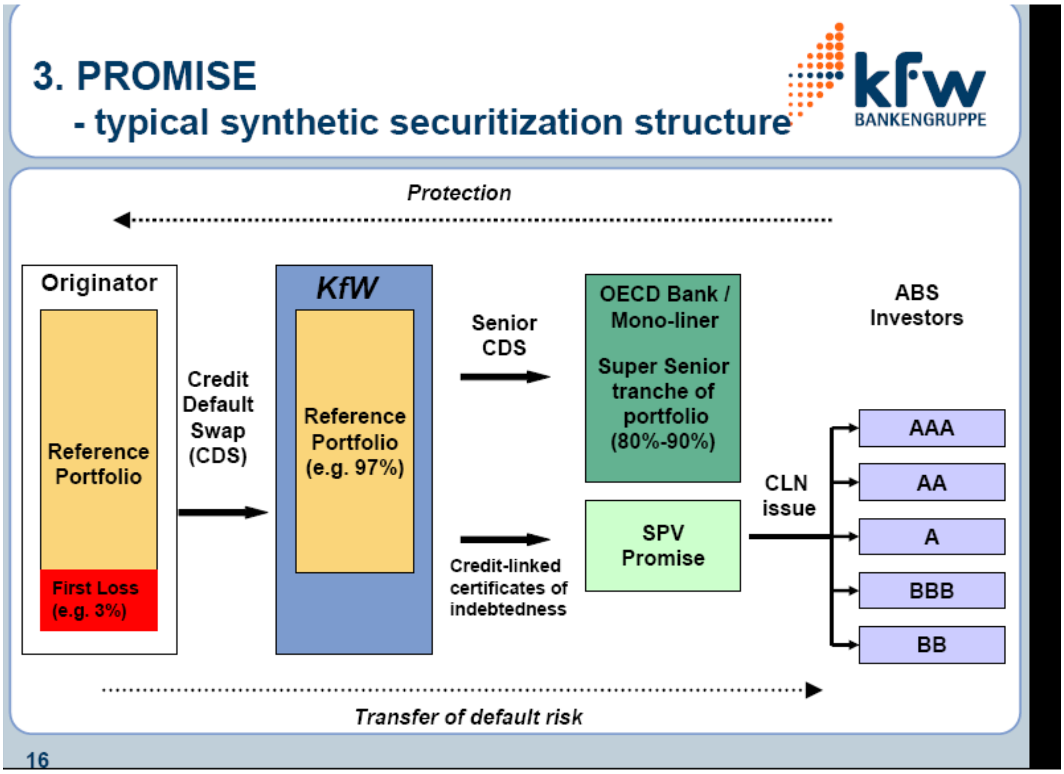
Agency Guarantees: Agency guarantees are provided by third party government agencies to credit enhance securities issued by lenders. The best known example of agency guarantees is the Ginnie Mae (Government National Mortgage Association) program. Ginnie Mae provides 100% cash flow insurance on pools of government loss insured (Federal Housing Administration – FHA and Veterans Administration - VA) mortgages. The first pass-through securities, issued in 1970, were issued with Ginnie Mae guarantees. The Canadian Mortgage and Housing Corporation (CHMC) has a similar program providing guarantees on securities issued by providers of government insured loans. These guarantees are full faith and credit of their governments. As such they have a zero capital adequacy risk weight.

Both the Ginnie Mae and CMHC programs have been viewed as highly successful. There are more than 600 billion USD in Ginnie Mae securities and 96 billion USD in CMHC securities outstanding. These programs facilitate issuance by any qualified lender (in the US many FHA/VA lenders are small mortgage banks with limited capital and ability to access the capital markets) thus promoting competition. They are simple and easy to understand for investors (although the cash flow characteristics of the securities may not be). The guarantee fees are relatively inexpensive – 6 basis points for GNMA and 20 basis points for CMHC. However, these programs only work with government insured mortgages – they provide cash flow insurance on top of government provided loss insurance. As such they mainly cover risk of payment disruption due to servicer problems (e.g., bankruptcy and need to transfer servicing).

Agency guarantees expose the guarantor to agency risk – that is the risk of fraud or mis-representation on the part of the originator (re. quality of underwriting) and/or of the servicer (e.g., improper reporting of delinquency and prepayment). This risk can be substantial if the guarantees are provided to thinly capitalised or lightly regulated issuers. Management of the risk can also be costly requiring extensive quality control and servicing audits. While they have worked well in Canada and the US, their use is problematic in other countries where the ability to monitor the risk and legal sanctions against fraud is weaker.

The German Development Bank, KfW, provides credit enhancement on pools of mortgage loans. KfW's securitisation programs are typically synthetic involving no loan transfer to a special purpose company, without true sale or funding. Banks as the loan originators pay premiums to KfW and conclude credit default swap (CDS) contracts to transfer credit risk of the loans (typically they retain a small first loss position). These procedures alone do not represent any loan transfer or provide liquidity to loans. KfW can combine these programs with its "global loan" lending program to provide a loan of the same amount as the portfolio swapped, making the synthetic securitisation as liquid as the cash securitisation. The transaction boosts the credit quality of the portfolio to sovereign level (a full faith and credit guarantee), reducing the capital risk weight for investors. The credit enhanced loans are included in jumbo Pfandbrief (German covered bond) issues. Obtaining the guarantee allows the mortgage bank to avoid the 60% limit on LTVs in the collateral portfolio backing the bond. Thus the major advantages are in liquidity and regulatory arbitrage. KfW hedges its risk by issuing credit linked notes and participating in a credit default swap although it has the alternative of managing and pricing the risk internally. KfW has provided enhancement on more than €25 billion, mainly in Germany but also in Austria, France, Portugal and the UK. The generic structure shown below in Figure 2 (the PROMISE program is for SME loans and is the same structure for mortgage loans under the PROVIDE program).

Figure 2: KfW Synthetic Securitisation Structure



In Colombia, the government deposit insurance agency, FOGAFIN - Fondo de Garantías de Instituciones Financieras, provides 100% cash flow guarantees on social interest housing loans included in residential mortgage-backed securities (RMBS). FOGAFIN (also the deposit insurance agency) charges a premium based on estimated loss from default. In Mexico, the Sociedad Hipotecaria Federal (SHF) provides a partial guarantee on securities issued by Sofols (mortgage companies). The SHF is the national mortgage bank that issues bonds and provides loans to Sofols, provides partial mortgage default insurance on individual loans and enhances bank lines of credit to developers. It is a well-capitalised national development bank with a full faith and credit guarantee of the Mexican government. Its security guarantees are partial with the issuer taking a first loss position. It will also make a market in the bonds it guarantees.

In general these programs require the government to set up an entity responsible for allocating and monitoring the risk of the guarantees. This requires capital, expertise (both managerial and regulatory) and patience. The guarantees should be explicit and properly accounted on the government budget.

<u>Multi-lateral and Bi-lateral Guarantees:</u> Multi-lateral development agencies including the World Bank Group (WBG), the Inter-American Development Bank (IADB) and the European Bank for Reconstruction and Development (EBRD) provide various forms of guarantees to enhance the credit on securitisation transactions. Table 2 below shows the types of guarantees offered by the World Bank Group. The World Bank can offer partial credit and risk guarantees for pools of loans or individual projects. In most cases, The World Bank will require a government counter-guarantee. MIGA (Multi-lateral Investment Guarantee Agency) provides political risk insurance against specified acts as shown in the table below. The insurance is provided to private sector investors and does not require a government counter-guarantee. The International Finance

Corporation (IFC) provides the widest range of credit enhancement products for securitisation transactions. They provide cash flow guarantees up to a specified amount of a tranche on issues of majority private sector owned companies. They will also purchase the mezzanine or subordinated tranches of internally enhanced transactions (below). The IFC also offers liquidity facilities and structured credit lines. Through 2005 the IFC has conducted 58 housing finance transactions in 22 countries for more than 5.2 billion USD. The cost depends on the transaction. The IFC can assist in structuring and placement. The transactions are generally non-standard, can be time consuming due to the need to get IFC Board approval, and costly. However, they bring the name of a global AAA entity to the transaction, which can have significant value for investors, particularly for first time or early stage transactions in under-developed markets.

Table 2. The World Bank Group Credit Guarantees

	IFC	MIGA	IBRD/IDA
Products	**Partial Credit Guarantees** **Hedges for clients (interest rate, currency and commodity swaps)**	**Non-commercial political risk insurance**	**PRG – IBRD & IDA** **PCG & PBG – IBRD Only**
Clients	**Private sector investors, lenders for private sector projects**	**Private sector investors, lenders for private projects**	**Private lenders for public projects**
Loans	Yes	Yes	Yes
Equity (Quasi-Equity)	Yes	Yes	No
Coverage (Risk)	Full and timely payment of principal and/or interest up to a specified amount - IFC covers all risks that may result in non-payment of a client's obligations.	•Currency convertibility and transferability •Expropriation •War and Civil Disturbance (incl. terrorism and sabotage) •**Breach of Contract**	Government contractual Obligations *including:* • Currency convertibility • Expropriation • Political Violence • Breach of Contract • Regulatory • Subsidy payment (e.g. OBA)
Guaranteed Percentage	Determined on a case by case basis (credit risk driven).	Debt: up to 95% Equity: up to 90%	Up to 100% of a tranche

	IFC	MIGA	IBRD/IDA
Eligibility	Must be a member country	Must be a member country	Must be a member country
Tenors	Market based but IFC's involvement can lengthen tenors	Up to 15 years (20 years in some cases)	Market based
Limits	Based on client's needs	Project: up to \$110mm (net) Country: up to \$420mm (net)	Based on project and country needs and CAS allocation.
Priority Areas of Focus	All IFC member countries. Dev of domestic capital markets.	• Africa • IDA eligible countries • South-South investments & SMEs	• Infrastructure • IDA eligible countries
Government Counter Guarantee	No	No (through the MIGA Convention)	Yes – for IDA in the event borrower is not the sovereign, a sovereign guarantee may not be required.
Public Sector Projects	No	No	Yes
Areas of Collaboration	Joint project preparation, environmental analysis, Board processing, etc.		

Source: Cledan Mandri-Perrott, World Bank, Workshop, PPP in Highways, Latvia May 9th 2006

Bi-lateral guarantors include OPIC (Overseas Private Investment Corporation, US), TDA (US Trade Development Agency), FMO (Dutch Overseas Investment Corporation). They insure similar structures to multi-lateral guarantors. OPIC also provides political risk insurance. The principal advantages that the bi-lateral and multi-lateral guarantees bring are the reputation and expertise of the guarantor and the ability to limit the involvement to one or a few transactions, thus demonstrating feasibility without requiring the government to create a permanent institution or program. The disadvantages may be cost (relative to domestic government guarantees – however, both should be actuarially priced), timeliness and sustainability.

A typical product offered by the guarantors is a partial guarantee – covering between 10-90% of the credit risk. A partial guarantee can provide liquidity or absorb a certain level of losses on an underlying pool of assets and reduce the probability of default on note payments. The guarantor may be senior, subordinated or pari passu with investors. The guarantee can cover principal and interest or principal only.[4]

A partial credit guarantee represents a promise of full and timely debt service payment up to a predetermined amount. Typically, the sum that is paid out under the guarantee covers creditors irrespective of the cause of default. The guarantee amount may vary over the life of the transaction based on the borrower's expected cash flows and creditors' concerns regarding the stability of these cash flows.

Guarantees are tailored to meet the needs of both borrower and creditors. They are structured to reduce the probability of default of the debt instrument and increase the recovery if default occurs. Guarantees have several advantages:

- allowing the borrower in most cases to achieve a lower all-in cost of funds,
- allowing investors to maximize their return given their risk tolerance (e.g., taking a first loss position), and
- allowing the issuer to achieve a desired rating level to facilitate sale of securities.

Partial guarantees can be either in local currency (for domestic transactions) or foreign currency (for cross-border transactions). Local currency partial guarantees are most applicable for a company or project that has local currency revenues but lacks access to local currency financing of the desired tenor. A partial guarantee can help the client better match assets and liabilities by obtaining local currency financing, mitigating the foreign exchange risk that would arise from borrowing in foreign currency.

Cross-border partial guarantees are best for a company that cannot access international markets on its own because of the high-risk premium associated with the country in which it is domiciled. With a cross-border partial guarantee the company may gain access to international markets by mitigating the sovereign risk associated with the borrowing.

Partial guarantees benefit clients by bringing them improved market access, longer-term funding, a broader investor base, and embedded liquidity support. A borrower facing temporary liquidity problems may proactively draw upon the guarantee to prevent a default on creditors. An example of an IFC partial guarantee is shown below.

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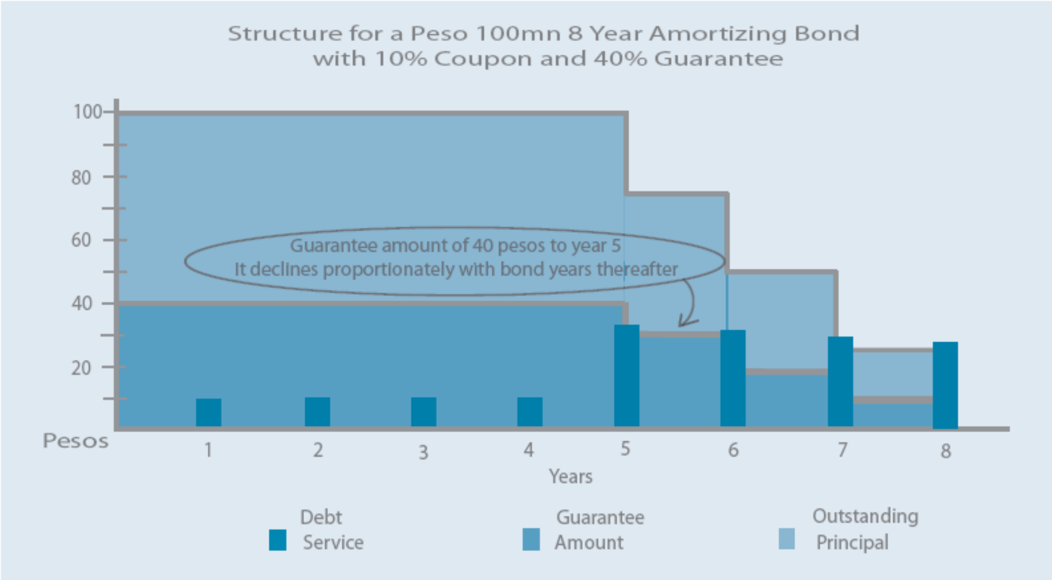
[4] Fitch Ratings, "Partial-Credit Guarantees Help Improve Recovery Rates in Emerging Markets", September 13, 2005

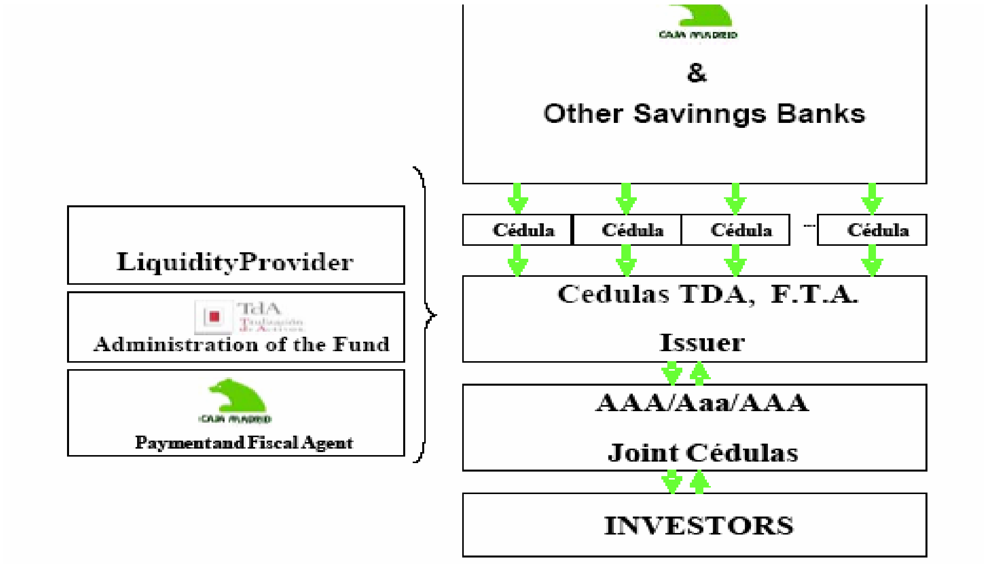
Figure 3: Partial Credit Guarantees



Source: IFC

Partial guarantees can also be offered on an on-going basis, for example through a facility. A PGCF is a transaction-based entity that is used to provide partial credit enhancement to securities issues. A PCGF is a flexible structure and can be developed to meet specific credit and market conditions. One advantage of a facility is its ability to aggregate portfolios from different issuers to support a larger and more liquid bond issue. A third party guarantee can then be applied to one large issue rather than numerous small issues, providing some transactional scale economies. An example of a multi-issuer structure is the Spanish Cedulas TDA run by the trade association for savings banks. Individual savings banks create mortgage bonds (cedulas – see diagram) that are acquired by Cedulas TDA, F.T.A., which is a special purpose fund that issues joint Cedulas. The fund does not specifically credit enhance the structure but does engage a liquidity facility (explained below) to provide support for temporary cash flow shortfalls. As the securities are covered bonds rather than MBS they do not represent a true sale but rather a financing. This structure can be used for credit enhancement – for example, the bonds could be guaranteed by a multi-lateral or mono-line guarantor or the facility could be backed by a World Bank Group liquidity facility.

Figure 4: Cedulas Covered Bond Structure



Source: Caja Madrid, 2005

Monoline Financial Guarantees: Private mortgage insurers and bond insurers provide guarantees (sometimes referred to as wraps) to improve the rating on certain tranches of securitisation transactions. Financial guaranty insurance offers unconditional and irrevocable guaranties of principal and interest on mortgage-backed securities. Pool insurance provides supplemental coverage to holders of mortgage debt by providing first- or second-loss protection on loans in aggregate. Pool policies call for the guarantor to pay all credit-related losses, subject to an aggregate amount of claims paid. Monoline guarantees are provided by private mortgage insurers (PMIs including Genworth, UGI, PMI, Radian) rated AA, and AAA bond insurers including AMBAC, MBIA and FGIC. PMIs will do wraps in emerging markets, bond insurers only in investment grade countries. From one PMI, we obtained an indicative pricing range of 15-45 basis points for an unspecified Romanian transaction. The advantages of a monoline guarantee are the ability to improve the rating (including piercing the sovereign ceiling) and help in structuring. The limitations of this product include that they can be difficult to attract, expensive and often subject to investment grade ratings before the guarantee.

Liquidity Facility: The timely payment of principal and interest depends on a qualified, financially sound servicer. Many securitisation transactions benefit from access to a liquidity facility provided by a financial institution in the form of commitment to lend, a commitment to purchase assets or a letter of credit. Liquidity facilities are used in structures to cover potential time lags between inflows of revenue from the securitisation's asset pool and its payment obligations under the ABS. A liquidity provider will temporarily make payments in the event of a disruption to servicing. Disruptions can occur through financial difficulties of a servicer, servicing transfers or a servicer systems failure. Typically, liquidity facilities are provided by domestic or international banks but may also be obtained from the IFC or World Bank. A reserve fund as described below is an alternative to a liquidity facility.

5.3. Internal Credit Enhancement

Excess Interest/Spread: The difference between the coupon or interest rate paid by the borrowers and the coupon or interest rate paid to the certificate holders is deposited into an account that accumulates over time to cover any losses that occur during a specified time period. Thus, if a loan defaults, the excess interest could be used to make payments to the certificate holders. Once a deal has reached its target level, any remaining excess spread is distributed to the residual holders. This form of credit enhancement provides incentive for good servicing.

Over-collateralisation (OC): This involves transferring to the issuing vehicle receivables in amounts greater than required to pay the securities if the proceeds of the receivables were received as anticipated. For example, if 100 million Euro of bonds were secured by 105 million Euro of collateral, the OC amount would be equal to 5 million Euro (105 million Euro minus 100 million Euro equals 5 million Euro). The amount of over-collateralisation (usually 5% to 10%) is determined by the rating agencies and the underwriters/placement agents, and this in turn will depend upon the quality of the receivables, other credit enhancement that may be available, the risk of the structure (such as the possible bankruptcy of the originator/servicer), the nature and condition of the industry in which the receivables are generated, general economic conditions and, in the case of foreign-based securitisations, the sovereign risk. If all goes well, it is repurchased at the end of the transaction as the receivables are returned as part of the residual interest. This form of credit enhancement is present in virtually all securitisations.

Senior/Subordinated Structure: In this form of credit enhancement, subordinated or secondary classes of securities, which are lower rated (and bear higher interest rates) are sold to other investors or held by the originator. In the event of payment problems, the higher rated (senior) securities receive payments prior to the lower rated (subordinated) securities. It is not uncommon for there to be a number of classes of securities that are each subordinated to the more highly rated, resulting in a complex "waterfall" of payments of principal and interest. In the common structure, senior and subordinated classes of notes would be paid, in order of priority, prior to any equity securities or to any residual interest to the issuer. This form of credit enhancement is routine.

Cash Collateral Account/Reserve Fund: In this form of credit enhancement, the originator deposits funds in account with a trustee to be used if proceeds from receivables are not sufficient to make required bond payments. The amount may be adjustable depending upon events.

Early Amortisation: If certain negative events occur, all payments from underlying assets are applied to the more senior securities until they are paid. This type of credit enhancement is very common.

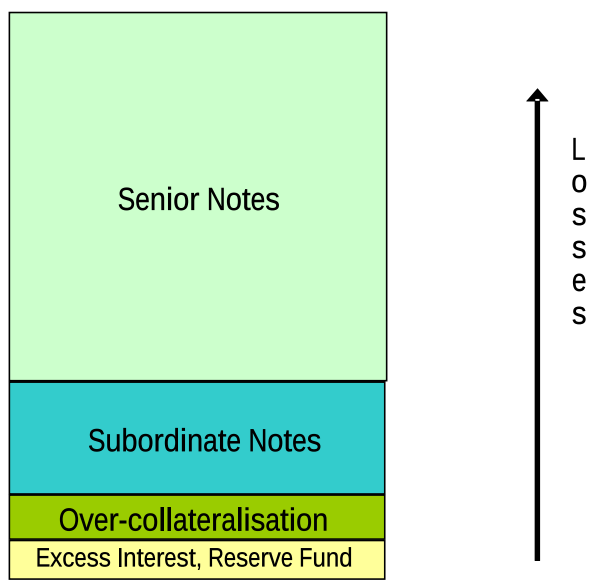
Table 3: Internal Credit Enhancement

Type	Description	Advantages	Disadvantages
Excess Interest/Spread	Difference between interest rate on mortgages and interest rate on securities, net of servicing fees and other expenses, is reserved and paid to cover loss	Provides incentive for aggressive servicing as issuer can "earn out" the excess; No need for additional funding	Reduces income earned by issuer, particularly in early years of issue
Over-collateralisation	Balance of loans is greater than balance of securities. Excess is used to absorb losses on collateral pool.	Simple	Opportunity cost of foregone interest on collateral (typically around 2%); Issuer needs funding source for collateral
Subordination	Rights of junior class subordinated to that of senior class of security holders. Junior class(es) are in first loss position and shield senior security holders from losses in collateral pool.	More complex, need to find investors to buy subordinated tranches. Sometimes held by issuer (no capital relief) for a period (seasoning) over which performance can be assessed	Higher yield requirements of junior security investors (B class yields 180-280 bp over index in Baltic, S. Africa); potential large size of junior class if lack of loss experience history and/or volatile environment (can range between 2-25%)
Reserve Fund/Cash Collateral Account	Funds (securities) deposited with trustee to be used if proceeds from pool are insufficient to make required bond payments	Simple, robust (cash or securities easy to value, very safe)	Opportunity cost on funds. Issuer needs funding source for collateral if pledged up front. May be built from excess spread.
Early Amortisation	If certain negative events occur, all payments from assets are applied to the more senior securities until they are paid.	Contractual; protects senior bond holders	Delays or eliminates payments to other security holders

A simplified waterfall structure is shown in Figure 5 below:

- Losses come first from reserve fund (funded up-front or through accumulation of excess interest)
- Second loss position through over-collateralisation (balance of assets in excess of securities)
- Third loss position from holders of subordinate (junior) notes

Figure 5: Credit Enhancement Waterfall



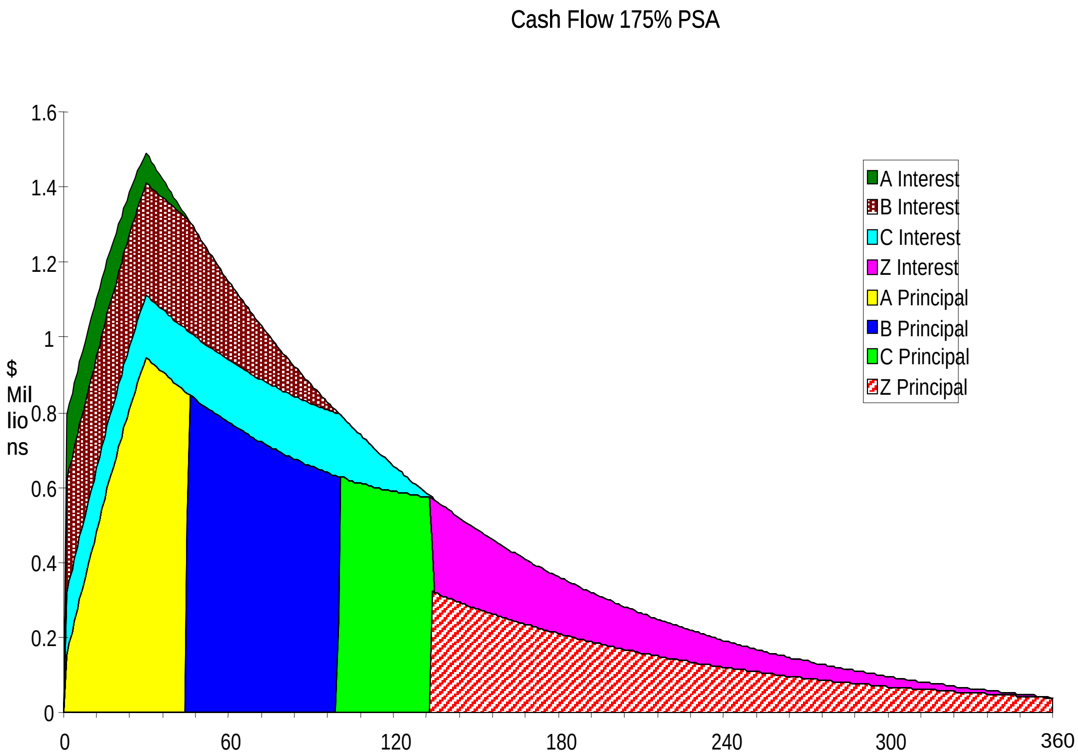
5.4. Cash Flow Structuring

Securitisation frequently includes cash flow as well as credit enhancing structuring. Mortgages have uneven cash flows due to amortisation and prepayment that may make them unattractive to investors. Cash flow structuring involves the creation of bond like securities from mortgage cash flows.

One example of cash flow structuring is the sequential CMO (Collateralized Mortgage Obligation). Sequential CMOs create bonds that tend to narrow the time over which principal payments are received, creating a more bullet-like structure. The structuring creates bonds with different expected durations, which can broaden the investor base (e.g., short duration bonds may be favoured by banks whereas longer duration bonds may be favoured by pension funds).

In the example figure below, classes A, B, C, and Z are sequential bonds. Class A receives all of the principal payments first. Once class A is completely paid off, then class B begins to receive principal payments. Once class B is paid off, then C begins principal payments, and so on until class Z is paid off. Note that each bond receives principal payments over a relatively narrow time period. Structuring re-allocates cash flows to create greater stability in bond payments. It does not, however, eliminate the risk of uncertain cash flows. The timing of the receipt of payments will depend on when and how they are made by borrowers.

Figure 6: Sequential CMO Cash Flows



Source: A. Davidson, A. Sanders, L. Wolff, A. Ching, Securitisation: Structuring and Investment Analysis, Key Finance, 2005

6. DEMAND FOR SECONDARY MARKET INSTRUMENTS

Institutional investors benefit from purchasing securitised assets. MBS are high credit quality, liquid instruments. They offer strong asset security, attractive spreads, stable performance, low default rates and may be structured to meet specific portfolio objectives. Many institutional investors have long-term liabilities and need long-term assets. Therefore, institutional investors may hold large percentages of MBS in their portfolios. Banks may also invest in high quality, liquid MBS as an alternative or addition to whole mortgage loans, particularly if the transaction structure creates bonds with shorter durations.

To be successful in the capital market, mortgage-backed securities, as any other fixed income instruments, have to meet the main condition of the secondary market, namely liquidity.

Liquidity is determined by:

- size of the issue,
- attractiveness of the underlying collateral,
- structure of the security that meets a broad array of investor needs,
- supportive legal and regulatory framework,
- investor sophistication,
- market transparency, and
- compliance with the regulations in force by all participants to the market.

When analysing the potential attractiveness of MBS in Romania we focus mainly on the first two conditions - the size of the issue and attractiveness of the collateral.

6.1. Domestic Investor Demand

For the market to continue to evolve there must be investor demand for mortgage-backed securities. In general, the Romanian capital market remains underdeveloped – there are a limited number of institutional investors and overall consumer financial sophistication is low. Domestic capital market participation varies from highly sophisticated to very naïve. However, this may be said of all capital markets to some extent, especially in their developing stage.

A major issue in Romania is the lack of high quality investments. The Treasury has not issued new bills in three quarters. There have been only a limited number of new initial public offerings, municipal bond issuances and only a few corporate bond issues. This is due to several reasons but primarily because of the relatively expensive and time-consuming process for securities issuance. The few fixed income securities that have come to market have been purchased at tight spreads and are being held to maturity.

Although the number of domestic institutional investors is limited, it is expanding. The Romanian public has a limited number of options for their savings so the mutual fund market is developing slowly. Insurance premiums collected are increasing rapidly. The legislation for pension funds has been passed and there is an expectation for pension funds in 2007. The regulations governing asset allocation for these investors are reasonable and will support their investment in mortgage-backed securities.

The local investors with whom we spoke are willing to purchase Romanian residential mortgage-backed securities. Most are familiar with the local real estate market and expect it will continue to grow. They have confidence in the banks' underwriting guidelines and although there is little historical delinquency or default experience, they believe that it will remain low. Local investors do not have significant concerns about the enforcement and foreclosure process although it remains untested at this time.

Although local investors are comfortable with mortgage loan collateral they are not familiar with the nuances of securitisation structuring. The participation of a major international financial institution such as the World Bank or EBRD, in the form of a guarantee or the purchase of one or more tranches would build local investor confidence. Over time, as the market matures and as mortgage-backed-securities performance becomes positive, the level of guarantee or participation can be reduced.

The domestic market participants are more concerned with the participation of the international financial institutions than with an investment grade rating from one of the major agencies (Standard & Poor's, Moody's, and Fitch). Romanian institutional investors are not limited to investment grade securities; since until recently there have been none. Only the few local capital market players that are interested in accessing the international capital markets have obtained or have thought of obtaining a credit rating.

6.2. International Investor Demand

Romania's improving economic fundamentals has resulted in the country obtaining an investment grade rating. Combined with accession to the European Union expected in 2007, this has increased the attractiveness of Romanian investments to international capital markets participants. The appreciation of RON and the relaxation of currency controls have resulted in strong demand for local currency investments – both domestically and internationally.

International investors view RON interest rates as attractive. Since the March 2006 law that allows foreigners to purchase bonds issued in domestic currency, several RON denominated bonds have been issued outside of Romania. In April 2006, the Government of Austria issued 100 million in RON (€28 million) of two-year bonds to European investors. Several other RON denominated securities have been privately placed so further details are not readily available. Currency hedging instruments have been developed externally to Romania and are available to those international investors that may wish to limit their exposure to the RON.

Generally, international institutional investors are limited by practice or by statute in the percentage of their portfolios that they may hold in unrated securities. Therefore, they are more interested in purchasing bonds that have obtained investment grade ratings from one of the major agencies. Few international residential MBS transactions in emerging markets have been completed to date. Those that have obtained credit enhancement in several forms including both internal and external.

7. POTENTIAL ROMANIAN SECURITISATION TRANSACTIONS

Based on capital and mortgage market information, we have developed representative deal structures for mortgage-backed securities for both domestic and international investors. Although the domicile, size of the issue and method of credit enhancement may be different for our two potential transactions, the form and substance are likely to be the same.

7.1. Mortgage Collateral

The collateral pools for a Romanian MBS will have characteristics comparable to other jurisdictions. Lenders in Romania have relatively strong underwriting and origination procedures due to the predominance of foreign ownership, long term funding from IFIs and technical assistance from various donor projects. Loans would be first lien mortgages on residential properties primarily located in Bucharest although loans from other areas in Romania would be included.

Overall loan credit quality is strong as mortgage underwriting is restricted by NBR regulations to conservative LTVs and PTIs of 75% and 35%, respectively. Lenders typically do borrower income and employment verification and check the applicant's credit in one of the credit bureaus operating locally. Mortgages are floating rate and denominated in both Euro and RON. Upon implementation of the revised Mortgage Law, loans will be required to be linked to a market-based index, which is reset in a transparent procedure. Currently, many lenders index their loans, on a discretionary reset schedule, to an internal cost of funds rate with little correlation to the fixed income markets making these loans difficult for investors to understand. Loan balances are low relative to affordability and prepayments tend to be high as borrowers pay partial prepayments or refinance as margins decline. Delinquency and default experience appear to be low but there is little performance history and foreclosure is essentially untested in the Romanian legal system.

The underlying properties are appraised by certified professionals and carry property insurance. Often the borrower has life insurance or some lenders purchase pool life insurance for their entire portfolio.

Currently, standard contracts and documents are not widely implemented. Lenders offer a wide variety of loan products that have evolved over time resulting in heterogeneous portfolios. These are some of the factors that have prevented lenders from amassing the volume of mortgages required to bring a single lender deal to market. Securitisations in Romania could involve pooling of loans from multiple originators, which would have a benefit of reducing collateral risks. However, the lack of standardisation may make multi-lender deals unfeasible in the near future.

7.2. Domestic Mortgage-Backed Securities Structure

Once the relevant regulations are implemented supporting the newly enacted asset-backed securities law, a domestic transaction can be offered. As detailed in the following section of this report, a Romanian SPV can be established as a joint stock company or civil partnership. It may issue debt or equity securities and may be privately placed or offered publicly and subsequently listed on the BSE. The new legal framework specifies the requirements for other parties that provide administration and oversight to a securitisation transaction such as the SPV administrator, SPV portfolio manager and agent.

As securitisation is a new concept in Romania and due to many structural factors in the domestic capital markets, the first transaction would have a limited number of tranches. The deal would need at least internal credit enhancement and perhaps external as dictated by the underwriters/placement agents and major investors. The internal enhancement may include some combination of excess spread, over-collateralisation and a senior/subordinated structure as shown previously in Figure 5. Although not a direct form of external credit enhancement, the purchase of the junior securities by an international financial institution would signal confidence in the deal structure and underlying collateral. Given the small size of the potential market and the current lack of issuer interest, a government guarantee or PCGF does not appear feasible at this time. Most likely a domestic deal will not require a credit rating from one of the major rating agencies unless a lead international investor such as one of the IFIs requires it. The rating process although somewhat costly and resource intensive does provide comfort to investors and will increase the issue's tradability. But local capital market participants have stressed that the reputation of the issuer(s) is important and a good name will be important to the success of the transaction.

At present, the improvement in Romania's fundamentals has resulted in a strong demand for local currency assets. Investors have indicated that they would also participate in Euro offerings although they may bear significant currency risk due to the mismatch between borrower income and loan denomination.

These securitisation deal parameters are outlined in Table 4 below.

Table 4: Domestic Romanian MBS Characteristics

Collateral:	First lien mortgages on Romanian residential properties
Issuer:	Onshore SPV
Principal Amount:	€50 million minimum with follow on issues to add liquidity
Currency:	RON assets highly desirable, Euro attractive
Seller/Originator:	One or more Romanian mortgage lenders, name is important
Arranger:	Domestic investment bank
Servicer:	Romanian mortgage lender
Credit Enhancement:	Internal may be sufficient
Guarantee:	May not be required
IFI Participation:	Preferred by nearly all market participants
Credit Rating:	May not be required
Liquidity Provider:	Romanian financial institution
Deal Structure:	Sequential multiple tranches
Maturity:	~15-30 years
Trustee/ Administrator:	Romanian financial institution
Issuance Concerns:	High filing & trading fees

**Note - based on interviews with market participants and market data as of July 2006*

7.3. International Mortgage-Backed Securities Structure

A Romanian MBS targeted at international investors will most likely be domiciled offshore in a tax neutral country such as the Netherlands, Luxembourg or one of the many island financial centres. Issuers often use offshore domiciles when the domestic legal, tax or regulatory accounting framework is incomplete or makes securitisation difficult. If the law permits transfers of title, it may be beneficial to structure the transaction offshore and launch the issue in the Euro-markets encouraging foreign investments.

Romania has obtained an investment grade country rating and is on target for accession into the EU in 2007. This has increased the overall attractiveness of Romanian investments but international capital markets participants (particularly for RON denominated assets) will still require a credit rating for any securitisation backed by Romanian mortgage loans. Although a credit rating is a significant expense it will facilitate the issuance of MBS on more favourable terms and conditions than would be obtainable outright in the Romanian capital markets.

A well-structured deal will allow the senior tranche to "pierce the sovereign ceiling". This means that the senior notes is rated higher than the country rating, e.g. Romania is rated Baa so the security would be rated A. Usually this is accomplished through multiple forms of credit enhancement, most particularly a senior/subordinated structure that places the junior security in a loss position in front of the senior notes.

A partial credit guaranty from a highly rate IFI or strong monoline insurer that will cover some portion of the credit risk in the event of default will also be important to the rating of the various tranches. The first deals for a new issuer may require a higher amount of credit support due to the lack of historical performance data. Over time if the MBS performance is positive, future issues may need less enhancement. This supports the case for guarantees being transaction-based that can adapt to specific credit and market conditions rather than through a government-sponsored entity with the higher cost structure associated with an operating insurance company.

Many of the market participants that we spoke with were familiar with recent MBS transactions in other emerging markets such as the Baltic-American Mortgage Trust Mortgage Pass-Through 2004-1. This 65 million USD transaction was the first residential mortgage securitisation out of Central and Eastern Europe. It was a three-tranche structure with credit enhancement consisting of excess interest, subordination, over-collateralisation and a reserve account. In addition, MIGA provided political risk insurance. Moody's rated the deal and the A and B tranches were investment grade, Aa2 and Baa1, respectively. The IFC participated in the transaction structuring and purchased part of both the senior and mezzanine tranches.

Vneshtorgbank brought Russian Mortgage-Backed Securities 2006-1 to market in July with a very similar structure. The IFC supplied credit support through a guarantee on an offshore liquidity facility that covers up to 18 months of interest payments in the event of currency convertibility or transferability restrictions. This credit enhancement allowed the senior Class A securities to receive a credit rating (A1/BBB+ from Moody's/Fitch) one notch higher than that of Vneshtorgbank and the agencies' respective country ceiling.

An international MBS collateralised by Romanian mortgage loans would be very similar in structure to these deals. Given the strength of the Romanian economy and its likely acceptance into the EU, political risk insurance will most likely not be necessary. The final terms of the transaction would be driven by the requirements of the credit rating agencies. Prospective deal parameters are outlined in Table 5 below.

Table 5: International Romanian MBS Characteristics

Collateral:	First lien mortgages on Romanian residential properties
Issuer:	Offshore SPV
Principal Amount:	75-100 million Euro to provide credit rating and liquidity
Currency:	RON assets highly desirable, Euro attractive
Seller/Originator:	One or more Romanian mortgage lenders, name is important
Arranger:	International investment bank
Servicer:	Romanian mortgage lender and / or third party servicer
Credit Enhancement:	Preferred by all – both internal and external methods
Guarantee:	May be required depending on other forms of credit enhancement
IFI Participation:	Depends on credit enhancement
Credit Rating:	Required
Liquidity Provider:	International financial institution
Deal Structure:	Sequential multiple tranches
Maturity:	~15-30 years
Trustee/ Administrator:	International financial institution / Foreign owned local bank
Issuance Concerns:	Expense for obtaining credit rating

**Note - based on interviews with market participants and market data as of July 2006*

7.4. Indicative RON MBS Pricing

We modelled the financial viability of a potential domestic RON issue. We assumed 25 year amortising mortgage collateral offered at BUBOR plus 140 basis points. There were very few mortgage products based on a transparent index as will be required by the revised Mortgage Law. Many lenders are currently offering floating rate loans with “teasers” or low initial rates that will reset after only a few months. These are offered at rates that are lower than the overnight rate on deposits at the NBR so it is evident that the banks will raise the mortgage coupon rate as soon as contractually permitted.

As shown in Figure 7 below, on the bond side of the transaction, we priced the tranches at a coupon of BUBOR + 75 basis points – this was very aggressive but reflects the tight spreads on Romanian fixed income investments. We estimated loan servicing costs of 35 basis points and credit enhancement at 25 basis points – on the lower end of the range we were quoted. The high issuance costs associate with a Romanian securities offering were amortised over the 25-year life of the mortgage collateral. At 11 basis points each, high issuance and listing fees are prohibitive to MBS issuance and may very well drive issuance to cheaper and more flexible offshore domiciles and other European stock exchanges. A Romanian MBS will also have expenses for the SPV administrator, the SPV portfolio manager as well as ongoing legal, accounting and other operating expenses.

Overall, the costs of a securitisation exceed the mortgage loan margin by a significant number of basis points in relative terms making MBS transactions not economically feasible at this time. However, evolution in the primary mortgage market, the capital markets and regulatory environment may change this “arbitrage” allowing a securitisation transaction to be completed on an economically viable basis, taking into account the savings in capital (if true sale).

Figure 7: Indicative RON MBS Pricing

Mortgage Loan Margin	1.40	Weighted Average Bond Spread	0.75
		Servicing	0.35
		Issuance Costs	0.11
		Credit Enhancement	0.25
Negative Spread!		BSE Listing Fee	0.11
		SPV Administrator	0.10
		Portfolio Manager	0.05
		Other Costs	0.10

**Note - based on interviews with market participants and market data as of July 2006*

8. SECURITISATION LEGAL FRAMEWORK

8.1. Legal and Regulatory Market Infrastructure

A successful housing finance system is premised on a well-developed legal, regulatory and primary market infrastructure and this seems to be one of the major concerns of the stakeholders in the Romanian market. Such infrastructure should already be in place to create a liquid secondary market.

The development of a satisfactory legal framework for mortgage securities is often complex and time consuming, requiring amendments to existing laws, and the creation of new laws and regulations for concepts and instruments previously nonexistent. In this respect, the new legal framework for the secondary market in Romania faced the same difficulties. Given the complexity of the legal and regulatory aspects regarding the secondary market, the time lapse between the creation of the legal infrastructure and the actual development of regular mortgage-backed securities issuance may be very long, somewhere between 4 to 10 years. Optimistic stakeholders consider the shortest period for such transactions as somewhere between 12 to 18 months.

At this moment, Romania has the new legal framework in place. Three new laws (Mortgage Banks Law, Mortgage Bond Law, and Securitisation Law) and amendments to the Mortgage Loan Law have been published in March 2006. The unanimous opinion of stakeholders contacted was supportive of the new mortgage legislative package and noted its importance in the continued development of the Romanian mortgage market.

One of the improvements brought by the new secondary market legislative package is a clear delineation of the competences held by the regulators: the National Bank of Romania for the primary market and the National Securities Commission for the secondary mortgage market. Credit institutions, National Savings Bank, specialised mortgage finance institutions and mortgage banks are the issuers in the secondary market. To date, the National Bank of Romania has taken an active role in regulating the housing finance sector, both from the point of view of prudential norms and for management of macroeconomic policies.

The specific norms to support the secondary legislation represent the second step in the development of the securitisation legal framework in Romania. The CNVM has prepared Regulation no. 11/2006 regarding the Securitisation of Receivables. Technical assistance has been provided to the CNVM by Deloitte Romania and Deloitte Italy through the Dutch Grant program administered by the World Bank. The CNVM drafting process has being carried out in cooperation with the NBR. The NBR Norm no. 10/2006 issued in July 2006 amends the NBR Norm no. 10/2004 regarding the authorisation of banks, electronic currency issuer institutions, real estate savings institutions and Romanian branches of foreign credit institutions and regulates the procedures to be followed by banks, mortgage banks, and savings institutions that become involved in securitisation transactions.

8.2. The Legal Framework for Securitisation in Romania

Through Law no. 31/2006, securitisation is for the first time defined and this new concept is introduced in the market as the financial operation by which a special purpose vehicle acquires, groups, and affects receivables to guarantee an issue of securities.

The issuers (the originators), the special purpose vehicle (SPV), the Service Provider (the SPV administrator), the SPV portfolio manager, the agent and the investors are the actors in the securitisation process. The originator transfers the assets to the securitisation entity and may continue to service the assets. Issuers of asset-backed securities typically are passive SPVs, created for the limited purpose of acquiring the underlying assets and issuing securities and any activities incidental thereto. Most of them have no employees, but they have an administrator, a portfolio manger and, as the case may be, an agent to perform tasks for securities holders.

In accordance with the Romanian Securitisation Law, the receivables that may be securitised are loan agreements, including mortgage loan agreements, leasing agreements, sale agreements when payment is on instalment or at term. Therefore, any receivables that can be assigned may be securitised.

The issuer selects the loans that constitute the collateral pool. For such receivables to be assigned, the law expressly stipulates that no other encumbrances should affect the receivables. The legal act that originated the receivables needs to comply with all the legal provisions in force at the date of its conclusion. The assignment should be paid for at transfer and such assignment has to be registered with the Electronic Archive for publicity reasons. In addition to the registration with the Electronic Archive, notification by mail is required to the assigned borrowers and notification by mail or publication at the assignor's headquarters for the assigned creditors.

Challenge of the assignment is also a major key feature of the new Securitisation Law. The law stipulates a 45-day statute of limitation for the receivables assignment to the SPV. After this period an assignment is not subject to the insolvency claw-back of the originator, and thus it assures the bankruptcy remoteness of the SPV from the originator. This is the so called "true sale", when the transfer of the securitised assets to the purchaser is final, i.e. is not subject to reversal, avoidance, claw-back or other challenge (whether by the originator's bankruptcy receiver or otherwise).

The SPV is a new concept brought in place by the new law. It can be established as a civil entity (fund), with no personality, and may be used for a single securitisation transaction, or as a joint-stock company, established for several securitisation operations. It should be authorised by the National Securities Commission and it must have a minimum share capital of 25,000 Euro equivalent in RON.

The management of an SPV has to be provided by a joint-stock company, authorised by the CNVM, with a minimum share capital of 125,000 Euro equivalent in RON. In addition, the joint-stock company's sole business activity must be the administration of such entities, including their creation, documentation, etc. To insure effective functioning of such management, at least two of the shareholders must be financial or credit institutions and the majority of the board of administration must have relevant experience in the financial banking sector.

There is a different entity in charge with the portfolio management of the SPV: it should be a credit or financial institution, whose main responsibility includes monitoring the performance of the portfolio, as well as making payments to securities investors.

The agent (it fulfils the function of a trustee) is also mentioned among the actors of a securitisation transaction. Although mandatory in the new Mortgage Bonds Law, the appointment of an agent is facultative in securitisation transactions. It represents the interests of securities holders and may be either an entity without legal personality or a legal person, i.e. audit firms, lawyers, notaries or financial investment services companies.

To protect investors, each securitisation transaction is guaranteed by the receivables pool that the issue is based upon, as described in the internal evidence register.

To complete the framework for securitisation transactions, the Regulation no. 11/2006 regarding the Securitisation of Receivables regulates the detailed procedures, authorisation conditions and documentation to be presented to CNVM for the approval of securitisation funds, securitisation companies, SPV management companies and SPV portfolio management companies. The CNVM is the entity that can modify, suspend, and revoke such authorisations. It sets rigorous conditions for the set up of securitisation funds and companies, imposes screening of management companies and severe sanctions in case of default.

The NBR Norm no. 10/2006 mainly regulates the procedures, authorisation conditions and documentation to be presented to NBR for the approval of banks, mortgage banks, electronic currency issuer institutions, real estate savings institutions and Romanian branches of foreign credit institutions. It also includes provisions regarding the capacity of banks to act as agents or portfolio management companies. For mortgage banks, the capacity to act as portfolio management companies is restricted to those who are the assignors of the receivables to be managed.

There are legal aspects that remain vague and need further explanations. The most criticised aspect resulting from the new Securitisation Law and its norms and regulations is the lack of tax and accounting provisions to regulate the operations created under the new law, particularly in reference to true sale definitions. Although not expected to be entirely included in the above-mentioned normative acts, such provisions should be included in the Fiscal Code; the lack of such information is viewed as a major obstacle for a first securitisation deal in Romania.

8.3. Tax Issues

Major tax issues are not addressed in the new Securitisation Law. An assessment of the current tax regime and international best practices in terms of specific tax provisions and regime applicable to a securitisation transaction must be considered in the near future by the Ministry of Public Finance. Such an assessment should also be in line with the EU best practices and legislation.

Recommendations also envisage amendments that are needed to the existing domestic legislation to properly cover the specific transactions undertaken during a securitisation deal; the existing Fiscal Code should be modified and a practical tax guide should be issued to educate relevant parties involved in a securitisation transaction (including local tax authorities, professionals and other end-users).

8.4. Accounting Issues

From an accounting perspective, the relevant authorities, including the Ministry of Finance, should harmonise the relevant domestic legislation that covers the entities involved in a securitisation transaction. The purpose would be to mitigate divergent interpretations of the applicable accounting regime.

Accounting standards are mandatory to provide a clear and consistent conceptual framework that ensures clarity of treatment. Such standards should require disclosure of sufficient specific information in the financial statements of an originator/transferor to facilitate the users' understanding of the economic impact of a securitisation transaction.

In addition, the Romanian authorities should cover the implementation phase together with the other professional institutions (i.e., CNVM, NBR), by issuing specific accounting guidelines for the securitisation deals envisaged to be undertaken.

9. CONCLUSIONS & RECOMMENDED NEXT STEPS

During the course of this Feasibility Study the Team found a wide variation in the factors affecting mortgage market development in Romania. Although all of the market participants that we spoke with see great potential for mortgage-backed securities and regard them as an important product for the further development of the Romanian capital market, they identified several near term obstacles to such issuance. These include an overvalued investment climate, increased competition for mortgage loans, legal and regulatory shortcomings, institutional capital markets limitations and an untutored audience. The combination of these various factors, as discussed in greater detail below, has taken much of the spread out of the securitisation arbitrage. Although current market conditions are less than promising for MBS issuance, market participants recognise that this will change and continue to support further mortgage development in anticipation of a more favourable environment.

Strong (Overheated) Investment Demand

There has been an ongoing shortage of high quality domestic fixed income investments in the Romanian capital market. The improvement in economic fundamentals and upcoming EU accession has brought increased foreign investment and new players into the domestic markets. The appreciation of the RON has resulted in local currency denominated assets being aggressively sought after by both domestic and international investors. Domestic demand will continue to increase as new institutional investors emerge with the advent of private pension funds next year. This dynamics have resulted in high valuations in many segments of the Romanian capital markets. The few fixed income securities that have come to market recently have been purchased at tight spreads and are being held to maturity.

Weak Collateral Supply

Banks and other lending institutions are adept at creating new mortgage products to address the needs of borrowers despite the unstable regulatory environment. Large lenders have a surplus of funds and are aggressively marketing for retail loan customers. They are net buyers of mortgage loans and have little need for securitisation at the moment. Smaller lenders have fewer funding alternatives but their portfolios lack the scale needed for an MBS transaction.

There is a lack of standard origination practices. Only a few lenders have implemented standardised underwriting procedures and documents making the aggregation of loans from multiple lenders problematic. Many lenders have not been offering mortgage products that will be in compliance with the revised Mortgage Loan Law no. 34/2006, which requires that loans must be based on a transparent market index. Subsequently, there is not a critical mass of mortgage loan collateral suitable for securitisation.

Incomplete Legal and Regulatory Framework

The mortgage legal and regulatory framework continues to evolve. The NBR and the CNVM continue to make progress in implementing the new mortgage laws and issue the relevant regulations. However, there are still several structural deficiencies including the taxation and accounting requirements for securitisation such as tax neutrality, bankruptcy remoteness, true sale treatment of assets, withholding taxes, balance sheet treatment/consolidation, and regulatory capital treatment. Undoubtedly, further clarifications will need to be made in the future.

Undeveloped Capital Markets

Overall domestic capital market development has been slow in Romania due to a variety of institutional and market factors. The securities issuance process is universally viewed as onerous and expensive. Although the CNVM has recently reduced issuance fees from 50 basis points to 15 for local issuers and 25 for private issuers, this is still very expensive for fixed income securities. The approval process is also slow and time-consuming, which is problematic for MBS issues that need to be priced quickly when market conditions are favourable.

Unless the CNVM streamlines the securitisation transaction approval process and reduces issuance costs, Romanian financial institutions will circumvent this situation by executing private placements or doing transactions offshore. In either scenario the securities will not trade on the Bucharest Stock Exchange and will avoid its high listing fees.

Inexperienced Stakeholders

We found a wide disparity in the awareness and understanding of the risks and rewards of MBS, which demonstrates the need for further product training and market development. Mortgage loans and mortgage securities are relatively complicated and market participants need to fully understand the associated risks. Stakeholder perceptions of MBS varied widely depending on their function in the markets and their familiarity with the product. Those that are unfamiliar with securitisation will be more cautious about purchasing, issuing or underwriting these new financial instruments.

Unclear Need For External Credit Enhancement

The strong balance sheets and high demand for mortgage product on the part of Romanian banks suggests that there is no need for a government backed guarantee program. European experience has demonstrated that securitisation can take place through a combination of internal and private external enhancement when issuer need arises. The lack of a sustainable market also suggests that a PCGF is not needed at this time as well. The most likely sources of credit enhancement in any future securitisation transaction are likely to be multi-lateral or monoline partial transaction guarantees (or subordinated tranche purchases).

Recommended Next Steps

In recent years, the Romanian mortgage market has continued to adapt and expand despite the shortcomings previously noted. Although it has reached many significant milestones, additional goals must be achieved prior to mortgage-backed securities issuance reaching sustainable levels. To create the institutional conditions needed to introduce securitisation as a new product for the Romanian mortgage market will require the ongoing support and commitment of market participants. We recommend that the following steps be undertaken:

Complete the Legal and Regulatory Framework

Fill in the missing pieces including the tax and accounting regulations that support SPVs.

Streamline the Securities Issuance Process

Waive or reduce issuance costs fees and exchange listing fees - there have been precedents of such actions by the CNVM and BSE to support the introduction of new financial instruments.

Further Education for All Stakeholders

The knowledge base of the various actors that will be involved in Romanian securitisation transactions needs to be expanded indicating a need for continued training.

Need for Unified "Industry Voice"

Creation of a Mortgage Association open to all types of market participants to encourage broad based support of continued mortgage market development.

Annex I – Romanian Securitisation Law no. 31/2006

Law
on securitisation of receivables

Chapter I. General provisions

Art. 1. The purpose of this law is to establish the principles and the general legal framework to utilise receivables to obtain financing through securitisation, as well as the regulation of rights and obligations of the parties to a securitisation transaction.

Art. 2. (1) Securitisation is a financial operation through which a special purpose vehicle acquires, groups, and affects receivables to guarantee an issue of securities.

(2) Under the present law, may be eligible for securitisation receivables deriving from:

a) loan agreements, including mortgage loan agreements, car loan agreements, and credit card agreements;
b) leasing agreements;
c) deferred payment sale-purchase agreements, including instalment sale-purchase agreements;
d) equity or debt financial instruments issued in compliance with the provisions of this law; and
e) any title incorporating receivables, other than the ones listed under a) - d), provided that the rights attached to such receivables are assignable.

Art. 3. For purposes of this law, the words and expressions herein shall have the following meanings:

1. agent – a natural person or entity without legal personality assigned and authorised under conditions of Chapter VII of this law to represent the interests of asset-backed securities' holders in a particular issue;
2. archive – the Electronic Archive for Secured Transactions;
3. competent authority – the National Securities Commission empowered to regulate and supervise and control the issuers and issues of asset-backed securities in compliance with the provisions of this law;
4. assignor - the holder of receivables who are transferred to a special purpose vehicle for the purpose of securitisation;
5. receivable – the right to receive a sum of money based on a title incorporating a receivable of the type provided under art. 2 paragraph (2) and with all the accessory rights attached;
6. assigned debtor – the obligor of the receivables assigned to a special purpose vehicle;
7. accessory rights – all rights *in rem* or personal rights attached to receivables, including security rights and receivables deriving from the insurance agreements concluded by the assigned debtor;
8. issuer – the special purpose vehicle authorised by the National Securities Commission to issue asset-backed securities under this law;
9. securitisation fund – a special purpose vehicle without legal personality, created under a civil partnership contract, in compliance with the terms and conditions of Chapter III, Section 2 of this law;

10. asset-backed securities – dematerialised asset-backed bonds and asset-backed units issued in a securitisation transaction;
11. investor – any person holding asset-backed securities on its own account;
12. qualified investor – entity that has the capacity to evaluate the risk and yield characteristics of asset-backed securities, as defined under art. 2 (1) item 15 of Law no. 297/2004 regarding capital markets, as amended;
13. asset-backed bond – debt financial instrument secured by an assets pool, issued by a securitisation company under Chapter VI of this law and negotiable in the capital market;
14. public offer for asset-backed securities – communication addressed to persons, made in any form and with any means, that has enough information about the terms of the offer, about the asset-backed securities to be offered, to allow the investor to make a decision regarding the sale, purchase or subscription of the mentioned asset-backed securities. This definition will apply as well for asset-backed securities offers made through financial intermediaries;
15. offer addressed to qualified investors – the full sale of an issue of asset-backed securities to qualified investors, with the observance of the provisions of Law no. 297/2004 regarding capital markets, as amended, and of the norms for the application of this present law;
16. affiliated person – natural person or legal entity that is, according to art. 2 (1) item 23 of Law No. 297/2004 regarding capital markets, assumed to act together with other natural persons or legal entity;
17. pool of receivables or asset pool – all the receivables acquired and allotted by a special purpose vehicle to secure the rights of the holders of asset-backed bonds or asset-backed units of one issue;
18. issue prospectus or prospectus – the announcement and the public offer prospectus for the sale of asset-backed bonds or asset-backed units, made under the terms of the present law, the Law no. 274/2004 and the norms issued in accordance thereof;
19. securitisation company – a special purpose vehicle created as a joint stock company, under the terms and conditions of Chapter III, Section 2 of this law;
20. asset-backed unit – equity title representing an undivided ownership interest in an asset pool issued by a securitisation fund under Chapter VI of this law and negotiable in the capital market;
21. nominal value – the outstanding principal of a receivable, or in the case of personal guarantees, the maximum amount for which such guarantees have been created;
22. receivable value – the outstanding amount to be reimbursed out of the nominal value of the receivable;
23. portfolio value – the aggregated amount of receivables in the portfolio;
24. reference value – the value established according to the norms provided in the prospectus; and
25. special purpose vehicle – an entity with or without legal personality having as sole business activity the issuance of asset-backed securities on the basis of a pool of receivables.

Chapter II. Assignment of receivables

Art. 4. (1) The owners may assign present or future receivables to a special purpose vehicle for securitisation, according to the provisions of this law.

(2) Receivables may be allotted for securitisation provided that the following conditions are observed:

a) compliance of the legal document generating the receivables with all legal provisions in force as of the date of its conclusion; and
b) no receivable in the pool, individually or wholly, has been pledged or otherwise encumbered to secure any obligations other than obligations that shall result from securitisation.

Art. 5. (1) The special purpose vehicle acquires individual or grouped receivables from one or more assignors to secure the issuance of asset-backed bonds or asset-backed units.

(2) The gratuitous assignment of receivable to a special purpose vehicle is void.

Art. 6. (1) The acquisition of receivables by a special purpose vehicle shall be made exclusively for the purpose of issuing asset-backed securities.

(2) The use of the receivables so acquired for a purpose other than that specified in paragraph (1) and the creation of charges over such receivables in favour of persons that are third parties in relation to the issue of asset-backed securities collateralised by such receivables, is void.

Art. 7. The writ of execution title recognised by law to a receivable initial holder shall benefit to its assignees, including the special purpose vehicle, investors, or any person having ownership or a security interest right over the receivable.

Art. 8. (1) For opposability, the assignment of receivables covering an issue of asset-backed securities shall be registered with the archive at least 15 days prior to the launching of the prospectus, shall be notified by the assignor to the assigned debtors by registered mail and to the assignor's creditors either by registered mail or by posting a notice at the assignor's headquarters, mentioning the assignee and the assignment price.

(2) The action to cancel the assignment of receivables that affects the interests of the assignor's creditors is barred by statute of limitation after the lapse of 45 days as of meeting the cumulative requirements regarding publicity by registration with the archive and notification of the assignor's creditors as provided under paragraph (1) and cannot be exercised by administrators, liquidator or creditors under a judicial reorganisation or bankruptcy procedure initiated under Law no. 64/1995 regarding the judicial reorganisation and bankruptcy procedure, republished, as subsequently amended and supplemented, or as under the Government Ordinance no. 10/2004 regarding the bankruptcy of credit institutions, as approved of and amended and supplemented by Law no. 278/2004.

Art. 9. If an assigned receivable is collateralised with security interests in real property, the assignment of the receivable shall be subjected to the publicity requirements provided for in the mortgage bonds law.

Art. 10. The assignment of receivables under this law shall not be deemed to be an operation subjected to value-added tax under art. 141, paragraph (2) letter c) item 5 of Law no. 571/2003 regarding Fiscal Code, as subsequently amended and supplemented.

Art. 11. In exchange for the assigned receivables, the assignor may receive asset-backed units or asset-backed bonds secured by such receivables.

Chapter III. Issuers

Section 1. Common rules

Art. 12. The special purpose vehicle (SPV) is an entity established as a securitisation fund through a civil partnership contract or as a securitisation company organised as a joint stock company.

Art. 13. The special purpose vehicle has no employees.

Art. 14. The special purpose vehicle shall not:

a) sell, transfer in any way whatsoever, pledge or otherwise dispose of the asset pool, either in whole or in part, other than as set forth in the prospectus;

b) make any offsets or deductions from the amounts received from the assigned debtors, except for any withholding taxes on such payments as may be required by law and of the expenses payable for the agent, management, audit services or of any other costs of similar nature, within the limits established in the prospectus;

c) incur any indebtedness other than as provided for in the prospectus;

d) relocate its headquarters without providing the agent or each asset-backed securities holder with 30 days' notice thereof;

e) without the consent of the general meeting of asset-backed securities holders, amend its constitutive act, the provisions of the management agreement, or the provisions of the portfolio management agreement or the assignment of receivables agreement; and

f) without the consent of the general meeting of asset-backed securities holders, transfer the rights/duties appertaining to the assignment of receivables agreement, the management agreement, or the portfolio management contract by way of novation.

Art. 15. The dissolution, merger, or the split of a special purpose vehicle shall be decided upon the vote of all asset-backed securities holders and shall be notified to the National Securities Commission, called therefore C.N.V.M.

Art. 16. (1) The special purpose vehicle must obtain prior authorisation from C.N.V.M. C.N.V.M shall decide to grant authorisation to a special purpose vehicle within 20 working days of the date the documents listed under the regulation for the application of this law have been submitted thereto.

(2) Any modification to the conditions upon which the authorisation for the functioning of a special purpose vehicle has been issued shall be notified to C.N.V.M. within 5 days of the date such modification was adopted by the competent corporate body. The scope of activity and legal form of a special purpose vehicle may not be changed.

(3) In the event that C.N.V.M. ascertains that such modifications are contrary to legal provisions in force, and the issuer does not cure such situation within the term granted to such end, the authorisation may be amended, suspended, or withdrawn, as the case may be, upon taking the necessary decisions for the protection of investors.

(4) C.N.V.M. shall maintain a special registry of the securitisation funds and securitisation companies. The special registry shall be public.

(5) The securitisation funds and securitisation companies shall specify in all their acts, documents, and correspondence the registration number with the special registry specified in paragraph (4) above.

Section 2. Creation, authorisation, and functioning of securitisation funds and securitisation company

Art. 17. (1) A securitisation fund shall be created through a civil partnership contract concluded between at least 5 founding members, Romanian or foreign natural persons, and/or legal entities. The initial minimum capital of the securitisation fund is the RON equivalent of 25,000 Euro.

(2) The securitisation fund is established for a single securitisation transaction, dissolution and liquidation procedure being commenced *de jure* upon realisation of all the receivables in the asset pool.

Art. 18. The civil partnership contract shall specify the conditions regarding the management and operation of the fund, transfer of titles, call and holding of the meetings, subsequent adherence to the fund, withdrawal, and exclusion of members, dissolution and liquidation of the fund.

Art. 19. Asset-backed units represent fractions of the undivided ownership right over the asset pool acquired by the fund.

Art. 20. The creation of a securitisation company shall be made according to the provisions of Law nr. 31/1990 regarding commercial companies, as republished, completed, and subsequently modified. The registration of the securitisation company with the trade registry office shall be made subject to prior authorisation by C.N.V.M., according to art. 16 of this law.

Chapter IV. Management of special purpose vehicles

Art. 21. (1) The management of securitisation funds and securitisation companies shall be carried out by legal entities established as joint stock companies. Registration with the trade registry office of a company having as object of activity management of special purpose vehicles shall be made upon prior authorisation by C.N.V.M.

(2) C.N.V.M. shall authorise a legal entity to act as management company of special purpose vehicles provided that it fulfils the following cumulative conditions:

a) its subscribed and paid up share capital amounts to the RON equivalent of 125,000 Euro;
b) it has as sole business activity the management of special purpose vehicles;
c) at least 2 significant shareholders are financial and/or credit institutions within the meaning of Banking Law no. 58/1998 regarding the banking activity, as republished; and
d) its board of directors consists of at least 3 persons, all of whom shall have a sound personal and professional reputation and the majority of whom fulfil the requirements established by C.N.V.M. regarding professional experience in the financial-banking field.

(3) The documents required and procedure for obtaining the prior authorisation of the companies managing special purpose vehicles shall be established by the norms of C.N.V.M.

(4) Any modification of the conditions upon which the authorisation has been issued shall be notified to C.N.V.M. within 5 days from it being adopted by the competent body.

(5) In the event that C.N.V.M. ascertains that such modifications are contrary to legal provisions in force and the management company does not cure such situation within the term granted to such end, the authorisation may be amended, suspended or withdrawn, as the case may be, upon taking the necessary decisions for the protection of investors.

(6) C.N.V.M. shall maintain a special registry for management companies. The registry shall be public.

(7) The companies listed in line (1) have a duty to record in all of their documents and correspondence the registration number from the special registry foreseen in line (6).

Art. 22. (1) The services to be provided by the management company include:

a) managing the incorporation process of the special purpose vehicle;
b) providing secretarial and other administrative services;
c) acquisition of receivables on the account of the special purpose vehicle, structuring asset pools, initiating the issuance of asset-backed securities;
d) ensuring that the publicity requirements with respect to security interests of investors in the asset pool are properly perfected in accordance with the prospectus;
e) maintaining a registry of asset-backed securities holders;
f) filing current and periodical reports with C.N.V.M. and the agent;
g) representing the special purpose vehicle before third parties;
h) the receivables' portfolio structure; and
i) any other activities authorised by C.N.V.M.

(2) The activities provided in lines (1) letters c) and f) are mandatory.

(3) The management company may hire in the name of the special purpose vehicle consulting firms or financial investment service companies but may not subcontract or delegate any of the responsibilities undertaken thorough the management contract with the special purpose vehicle to a third party without the prior consent of C.N.V.M.

Chapter V. Portfolio management services

Art. 23. (1) In order to be authorised as a portfolio management company, an entity must be a credit or a financial institution under the meaning of the Banking Law no. 58/1998.

(2) The documents required and procedure for obtaining the authorisation of portfolio management companies shall be established by the norms of the National Bank of Romania for the credit institutions and by the norms of C.N.V.M. for the financial institutions operating on the capital market, respectively.

(3) The assignor of an asset pool may continue to manage the assigned asset pool.

Art. 24. For the portfolio management, the issuer, through the administrator that represents its interest toward third parties, may contract one or several portfolio management companies, as provided for in the prospectus.

Art. 25. The portfolio management company is liable to the special purpose vehicle and the asset-backed securities holders issued in compliance with the provisions of this law for any loss incurred by such persons due to the failure of the portfolio management company to perform its obligations or to delayed or improper performance.

Art. 26. (1) Termination of the contract with the portfolio management company indicated in the prospectus and the hiring of another portfolio management company to provide servicing of the asset pool may be decided only with the vote of asset-backed securities holders representing 25% of the value of the issue secured with the respective cover pool and upon notification of the National Bank of Romania and of C.N.V.M.

(2) The management company of the special purpose vehicle shall be jointly liable with the portfolio management company in breach of the condition of paragraph (1) for any loss incurred by the asset-backed securities holders due to such company's failure to perform its obligations or to delayed or improper performance of such obligations.

Art. 27. In the event that the portfolio management company is the assignor or one of its affiliates, the contract is terminated *de jure* upon notification by the management company, by the agent, or by the investors with respect to the breach of the undertaken obligations.

Art. 28. (1) Portfolio management activities include:

a) satisfaction of the receivables in the asset pool, including notification of the assigned debtors, calculation of interest and delay penalties, commission fees and other dues, as well as collection of the amounts deriving from the receivables;
b) custody of the documents evidencing the receivables;
c) monitoring the performance of payment obligations of the assigned debtors and restructuring of the receivables; the restructuring activity is made based on a special mandate granted to this end by the issuer;
d) acceleration of the receivables in the asset pool and forced execution of the receivables, under the terms provided in the respective contract;
e) renewal of the registration or deregistration of the rights *in rem* created to secure receivables in the pool; and
f) payment of the amounts due to asset-backed securities holders from the funds generated by the securitised receivables in the pool securing that particular issue.

(2) For the carrying out of the servicing activities provided under paragraph (1), the portfolio management company acts in own name but on behalf of the securitisation company and, respectively, of the holders of asset-backed units.

Art. 29. The collected amounts from the asset pool shall be kept in accounts that are separated from those of the portfolio management company, distinct for each special purpose vehicle and portfolio.

Art. 30. (1) The portfolio management company shall keep for each issue of asset-backed securities an internal register containing at minimum the following information with respect to each receivable in the asset pool:

a) identification data of the legal act from which the receivable is derived, specifying the relevant category;
b) identification data of the assigned debtor;
c) identification data of the collateral created for the satisfaction of the receivables; and
d) the receivable value and the nominal value as well as the reference value of the personal guarantees, as the case may be, calculated on the date of the guarantee contract.

(2) The internal register shall be completed by the portfolio management company. The portfolio management company shall communicate to the management company of the special purpose vehicle, on a monthly basis, an initialised copy of the internal register as well as a written report regarding the structure of each portfolio within the asset pool, the amount of patrimonial liabilities of the special purpose vehicle towards asset-backed securities holders in that issue, the value of the receivables in the pool for that issue, and the nominal value as well as the reference value of the guarantees created for the satisfaction thereof according to paragraph (1) letter d).

(3) The agent is entitled to request, on a monthly basis, an initialised copy of the internal cover register signed on each page by the legal representative of the portfolio management company and to check the summary documentation on the basis of which the relevant values were specified under paragraph (1) letter d).

(4) Investors that have not designated an agent have a right to solicit, on a monthly basis, a copy of the internal evidence registry.

(5) In connection with the fulfilment of the duties specified hereunder, the portfolio management company shall be subjected to the provisions of art. 49-53 of Law no. 58/1998 or, as the case may be, Title VII “Market Abuse” of Law no. 297/2004 along with any additions or modifications.

(6) The management company shall submit monthly reports containing the information received from the portfolio management company according to paragraph (2) above to C.N.V.M. and to the agent.

Art. 31. In the event that the contract with the portfolio management company is terminated, the management company shall ensure temporary servicing of the asset pool by a company licensed to provide such services in accordance with the provisions of art. 23 until a decision is taken in compliance with art. 26, paragraph (1), to replace the portfolio management company. The portfolio management company whose mandate terminates shall be liable to the asset-backed securities holders and the issuer for all the losses incurred by them due to its omission to collaborate for the delivery-receipt of the asset-pool servicing operation.

Chapter VI. Issuance of asset-backed securities

Art. 32. (1) An issue of asset-backed securities may be carried out by public offer authorised by C.N.V.M. or by offer addressed to qualified investors, under the conditions provided in the norms for the application of this law and of Law no. 297/2004, as subsequently completed and/or amended.

(2) The public offer of asset-backed securities shall comply with the provisions of this law, law no. 297/2004, and any norms and/or regulations issued to ensure their implementation.

(3) Exchanges of asset-backed securities shall take place either on the regulated markets or any alternative exchange mechanism.

Art. 33. Issues of asset-backed securities may be single class or structured in classes, depending on the rights granted to the investors with respect to:

a) interest;
b) maturity;
c) order of payments;
d) voting; and
e) other entitlements established through the prospectus.

Art. 34. The minimal content of the prospectus shall include the following categories of information:

a) information regarding the issuer and the principal provisions of its constitutive documents or of the civil partnership contract;
b) information regarding the assignor and the principal provisions of the assignment of the receivables agreement;
c) information regarding the management company, including the principal provisions of the management contract;
d) information regarding the portfolio management company, including the principal provisions of the contract for the administration of the asset pool;
e) information regarding the agent, including information on the payment rights of the agent;
f) information regarding the financial auditor;
g) characteristics of the issue, namely the total value of the issue and number of the asset-backed securities to be issued, nominal value and issue price, aggregate purchase price of the receivables forming the asset pool, proceeds deriving from the receivables to be received by the special purpose vehicle, duration of the offer, maturity, interest (if any), interest computational method (if any) and payment schedule, securities reimbursement program, redemption option, payment modality for the subscribed securities and allocation method in case of over-subscription, costs of the transaction, costs of pool servicing and of any professional services rendered in connection with the issue as well as expenses incurred by the special purpose vehicle either as initial costs for establishment or as periodical payment obligations; in case of structured issues, the information regarding aspects under art. 33 shall be provided distinctly, per each class of asset-backed securities in the respective issue;
h) information regarding compliance with the conditions of art. 4 paragraph (2) of this law;
i) the characteristics of the asset pool, including the value of the asset pool, the nominal value and, as the case may be, the reference value of the guarantees created to secure satisfaction of the

receivables calculated on the date of the guarantee contract as well as information regarding maturity, interest, interest computational method and payment schedule, prepayment conditions of the receivables in the asset pool; and

j) conditions and type of financial instruments under which the issuer may reinvest any surplus after payment to asset-backed securities holders and the transaction costs out of the amounts collected from assigned debtors.

Art. 35. (1) The total value of the receivables in the asset pool securing an issue on the date of the closure of the subscription period shall be at least equal to the total amount of the issuer's liabilities towards the holders of asset-backed securities in the respective issue.

(2) Through the prospectus, the issuer may undertake the obligation to supplement the asset pool in the event the total value of the receivables included in the asset pool diminishes throughout the duration of the issue under the limit provided under paragraph (1), if a higher limit is not provided in the prospectus.

(3) The issuer may include in the asset pool own receivables such as cash collateral and other financial instruments cashable on demand or tradable on a capital market to enhance the value of the pool or compensate for a reduction in the value of any receivables in the pool.

Art. 36. The results of the public offer of asset-backed securities shall be communicated to C.N.V.M. and other market institutions, as the case may be, in compliance with the C.N.V.M. regulations.

Chapter VII. Rights of the asset-backed securities holders

Art. 37. The common interests of the holders of asset-backed securities in an issue may be represented by an agent. The provisions of mortgage bonds law, including with respect to appointment and revocation of the agent, its rights, obligations, and duties as well as its liability towards investors shall apply accordingly.

Art. 38. (1) An issue of asset-backed securities is covered with the asset pool described in the internal registry. Based on the security created in their favour, investors shall have the right to satisfy their receivables against the special purpose vehicle by means of enforcing the pool with priority before any other creditor, irrespective of the nature of another creditor's claims and regardless of whether such creditor would have a right *in rem* over the asset pool or a part of the entirety of the asset pool, if such right *in rem* has not been registered with the archive prior to the registration of the rights of the asset-backed securities holders.

(2) The provisions of art. 8 and art. 9 on publicity requirements shall apply accordingly on creation of the security interest over the asset pool in favour of investors.

(3) Creation of a security interest over the receivables in an asset pool in favour of asset-backed securities holders shall be notified by the portfolio management company to the assigned debtor no later than 7 days from the date of security creation.

Art. 39. (1) The holders of asset-backed units to the securitisation fund are *de jure* members of the issuing securitisation fund. Members of securitisation funds are assembled in fund members meetings.

(2) The securitisation fund members meeting has the competencies and may take decisions according to the provisions of the civil partnership contract. The decisions of the meetings are published in the Official Gazette of Romania, Part IV, as well as in a national newspaper.

Art. 40. (1) The legal provisions regarding general meetings of mortgage bondholders shall apply accordingly to the general meetings of single-class asset-backed bonds.

(2) Where there is more than one class in an issue, the voting rights of the holders of asset-backed bonds in each class shall be established through the prospectus.

Chapter VIII. Special provisions regarding the bankruptcy of securitisation companies

Art. 41. (1) The provisions of Section 6, "Reorganisation" of chapter III of Law no. 64/1995, as republished and subsequently modified and completed, are not applicable to securitisation companies.

(2) The provisions of the mortgage bond law shall apply accordingly.

Art. 42. By derogation from the provisions of Law no. 64/1995, in the event that the bankruptcy procedure is commenced against the issuer, the general meeting of asset-backed bondholders may decide with the vote of 75% of the value of all issues for one of the following modalities for the realisation of their claim rights: (i) sale of the pools directly, by public auction or by any other modality provided by law; (ii) adjudication of the pools for the account of their claims against the estate of the debtor, without the obligation to fulfil any formalities towards third parties, upon payment of the amounts representing the costs of the agent, and portfolio management company and liquidation costs.

Chapter IX. Special provisions regarding forced sale

Art. 43. (1) The forced sale of the asset pool securing an issue in its entirety shall only be initiated by the holders of asset-backed securities in the respective issue.

(2) The distribution of the proceeds derived from the forced sale shall be made in the following order:

a) claims representing expenses of any type made with the forced sale and conservation of the asset pool subject to the forced sale, including remuneration of the agent;
b) claims resulting from the holding of asset-backed securities in the issue secured with the asset pool subject to the forced sale; and
c) other categories of creditors in the order established by law.

Chapter X. Minor offences and sanctions

Art. 44 (1) The following acts qualify as minor offences:

a) breach of the conditions set in the authorisation applicable to any activities and operations for which this law requires authorisation;
b) failure by the special purpose vehicle to comply with the provisions art. 14 of this law; and
c) incorrect keeping by the servicing companies of the internal cover register.

(2) The perpetration of the minor offices mentioned under paragraph (1) shall be sanctioned by:

a) fines ranging from 10 to 50 thousand RON ; and
b) the following complementary sanctions: withdrawal of the authorisation and/or the temporary or permanent interdiction for natural or legal persons to hold certain offices or carry out certain activities and services stipulated under this law.

(3) The perpetration of the minor offences provided under art. 43, paragraph (1) letters a) and c) shall be ascertained and sanctioned by the authorised bodies and upon compliance with the procedural provisions of the Law no. 297/2004 regarding the capital market, respectively by the persons empowered to this end by the National Bank of Romania, conform the provisions of Law no. 58/1998, as republished.

(4) The perpetration of the minor offences provided in line (1), letter b) shall be ascertained and sanctioned upon compliance with the procedural provisions of the Law no. 297/2004 regarding the capital market.

(5) The provisions regarding minor offences and sanctions shall be supplemented by the provisions of the Government Ordinance no. 2/2001 regarding the legal regime applicable to minor offences as approved of and amended by Law no. 180/2002, as subsequently amended, to the extent to which such provisions do not conflict with this chapter.

(6) As an exception to the provisions of paragraph (5), the procedure for the investigation and inquiry into possible violations, as well as C.N.V.M.'s sanctioning regime, derogate from the provisions of Governmental Ordinance no. 2/2001, approved and completed through Law nr. 180/2002, regarding the applicable legal regimes for minor violations.

Chapter XI. Final provisions

Art. 45. The name of "securitisation fund" or "securitisation company" shall be exclusively used to refer to the types of special purpose vehicles regulated under this law.

Art. 46. Provisions of art. 167 under Law 31/1990 regarding commercial companies, as republished and as subsequently amended and supplemented, do not apply to asset-backed bonds issued under this law.

Art. 47. The National Bank of Romania and C.N.V.M. shall issue the norms and regulations provided hereunder within 3 months as of this law coming into force.

Art. 48. This law comes into force within 30 days as of the date of its publishing with the Official Gazette of Romania.

Annex II – List of Market Participants Contacted

Market Participants	Person	Category of Market Participants
Accendo	Viorel Udma, Managing Partner	Investment banking services
Alpha Bank	Sergiu Oprescu, Executive Vice President	Commercial bank
Bancpost	George Calligas, Treasurer Dorin Badea, Chief Dealer	Commercial bank
Bucharest Stock Exchange (BSE)	Septimiu Stoica, President	Stock exchange
Cameron McKenna	Cristian Lina, Partner John Fitzpatrick, Partner	Law firm
Certinvest	Eugen Voicu, President Horia Gusta, Legal Counsel	Asset management company
National Securities Commission (CNVM)	Mirela Ciuvat, Director	Regulatory institution
Deloitte Romania	Andrei Burz-Pinzaru, Manager	Consulting firm
Domenia Credit	Carmen Retegan	Mortgage credit company
Dragon Finance	Dragos Neacsu, Managing Partner	Former Secretary of State, Ministry of Finance
European Bank for Reconstruction & Development (EBRD)	Jonathan Woollett, Director of Non-Bank Financial Institutions	International Financial Institution
European Housing Finance	Pamela Lamoreaux, Chief Operating Officer	Private secondary mortgage market company (Turkey)
Financial Market Reform Project (USAID)	Horia Sas, Capital Markets Advisor Simona Negoita, Research Analyst	Donor consulting project
HVB Banca pentru Locuinte	Petre Tulin, President	Bausparkasse
IMPACT	Carmen Sandulescu, Economic Director	Residential builder & financier
Imobilia	Bogdan Cretu, President	Mortgage credit company
Intercapital	Razvan Pasol, President	Securities brokerage firm
International Finance Corporation (IFC)	Ana-Maria Mihaescu, Chief of Mission	International financial institution
International Finance Corporation (IFC)	Kenroy Dowers, Group Leader, Housing Finance	International financial institution
Ministry of Public Finance (MOF)	Stefan Nanu, Expert	Government of Romania
Ministry of Transport, Construction and Tourism	Mariana Ionita, General Director, Department of Housing Alexandra Radu, Expert Housing Policy and Subsidy Review Roundtable	Government of Romania
Moody's	Yaron Ernst, SVP Business Development, Structured Finance Group	Rating Agency
National Bank of Romania (NBR)	Veronica Raducanescu, Director Regulation and Licensing Department	Regulatory institution
PMI	Tony Porter, Managing Director	Private Mortgage Insurer
Raiffeisen Asset Management	Felicia Popovici, Vice President	Asset management company

Raiffeisen Bank	James Stewart, Vice President	Commercial bank
Raiffeisen Capital & Investment	Laurentiu Ciocirlan, Director Debt & Equity Origination	Investment banking services
The World Bank	Michel Noel, Europe Central Asia Private & Financial Sector Development Kyoichi Shimazaki - Project Finance & Guarantees	International Financial Institution

List of Persons Who Attended July 5, 2006 Workshop - *Mortgage-Backed Securities Market Development: Issues & Opportunities*

Name	Company
Ioan Bejan	Elite Financial Services, Ltd.
Oana Boteanu	BRD
Catalina Bucur	ProCredit Bank
Carmen Cristea	Finansbank
Sorin Coclitu	Romanian Loan Guarantee Fund
Valentin Cudric	EFG Eurobank Securities
Dana Enache	ProCredit Bank
Elena Georgescu	National Bank of Romania
Dana Ilie	National Bank of Romania
Eliza Ionica	Banca Carpatica
Pamela Hedstrom	The Urban Institute
Irina Lupa	National Bank of Romania
Romeo Jantea	BCR Insurance
Michael Lea	Cardiff Consulting
Corina Mararu	USAID
Oana Marinoiu	National Securities Commission
Alina Matache	OTP Bank
Nicoleta Mihalache	The Urban Institute
Cristian Nae	OTP Bank
Stefan Nanu	Ministry of Public Finance
Dragos Neacsu	Dragon Finance
Simona Negoita	Financial Market Reform project
Vlad Peligrad	Salans
Felicia Popovici	Raiffeisen Asset Management
Alexandra Radu	Ministry of Transport, Construction & Tourism
Sorina Sanda	BRD
Bogdan Teodorescu	OTP Bank
Sorin Teodoru	The World Bank
Cristina Virtopeanu	Nestor Nestor Diculescu Kingston & Petersen
Roxana Vitan	Romanian American Enterprise Fund