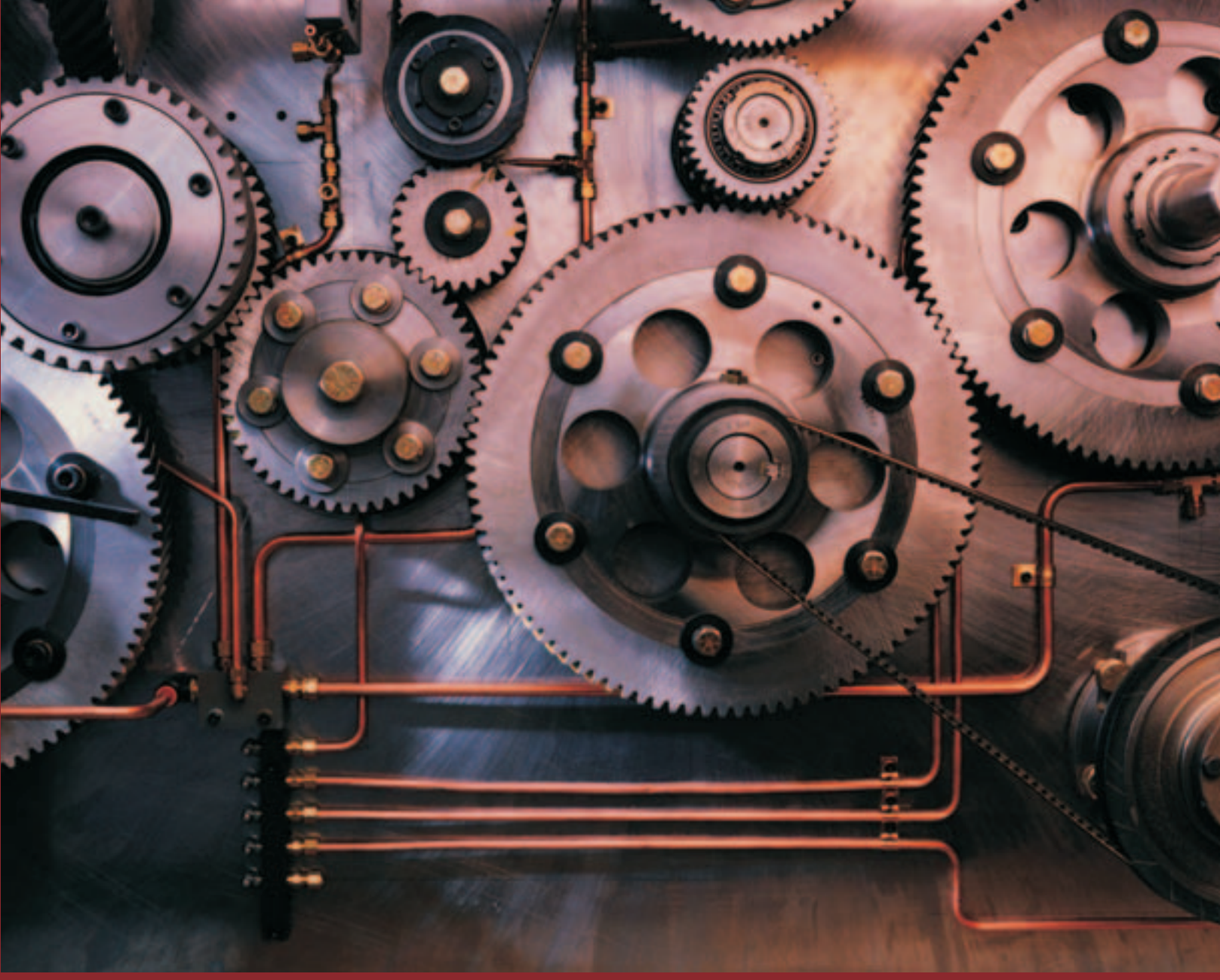


Structuring Securitisation Transactions in Belgium*

*connectedthinking

PRICEWATERHOUSECOOPERS

Table of Contents

1. General Securitisation 2
1.1 Introduction 2
1.2 Market overview and trends 3
1.3 What is securitisation? 4
1.4 Benefits of securitisation 4
1.5 Types of transactions 6
1.6 Securitisation players 6
1.7 Types of credit enhancement 7
1.8 Taxation in securitisation 8
1.9 Phases of the securitisation process 9
1.9.1 Feasibility Study Phase 9
1.9.2 Operations/Infrastructure Review Phase 10
1.9.3 Collateral Analysis Phase 10
1.9.4 Preparation for Rating Agencies Review 11
1.9.5 Structuring Phase 11
1.9.6 Pre-Closing Phase 11
1.9.7 Post-Closing Phase 11

2. The Belgian Securitisation Regulatory and tax Framework 12
2.1 Overview 12
2.2 Definition of securitisation 13
2.3 Flexibility 13
2.3.1 Forms of securitisation vehicles 13
2.3.2 Regulation of securitisation vehicles 14
2.3.3 Legal rules governing transfers 14
2.3.4 Classes of assets 15
2.3.5 Forms of securitisation transactions 15
2.3.6 Compartmental segregation 16
2.3.7 Accounting 16
2.4 Enhanced investor protection 16
2.5 Qualified service providers 17
2.5.1 The management company 17
2.5.2 The custodian 17
2.5.3 The supervisory company 17
2.5.4 The collection agent 17
2.5.5 The rating agency 17
2.5.6 The servicer 17
2.6 Tax neutrality 18
2.6.1 Tax aspects specific to securitisation companies 18
2.6.2 Specific tax aspects of securitisation funds 19
2.6.3 Common features 19
2.6.4 Tax treatment of shareholders, unit-holders and bondholders 20
2.7 Conclusion 20

3. Other Issues 22
3.1 Basel II 22
3.2 IFRS – Consolidation accounting issue 26
3.3 Risks on securitisation vehicles 30

4. Glossary 32

5. Contacts 36

1 General Securitisation

1.1 Introduction

Today, securitisation is the funding and risk transfer method of choice for an increasing number of issuers and the largest growing contribution to the global capital markets.

Though securitisation transactions as they are known today were made popular in the US, non-US transactions are increasingly becoming a share of the overall securitisation market, amounting to some 20% of the total volume in 2003. Securitisation may be of interest to any large corporate that owns suitable financial assets, whether a pool of debts or discrete revenue streams.

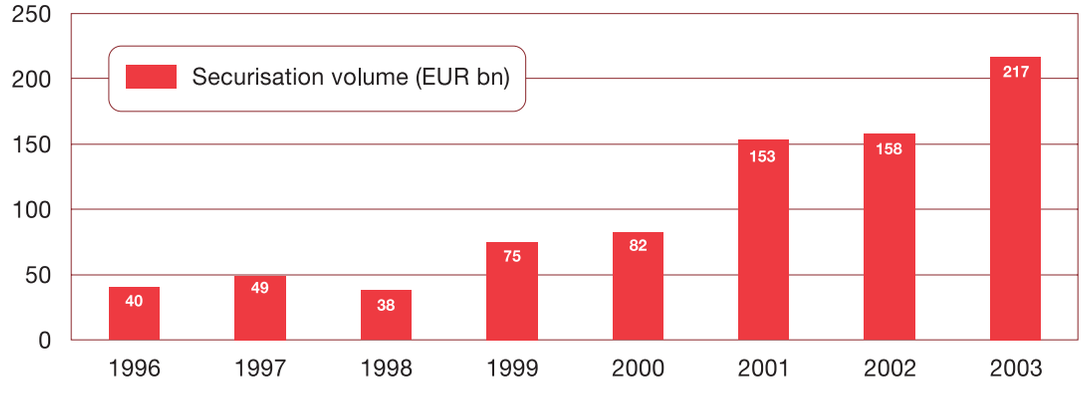
For the banking system, securitisation has allowed lower solvability ratios and risks linked to financial sectors and regions; for companies and households, better financing conditions.

In most countries, the securitisation market has historically started to develop through Mortgage-Backed Securities (MBS) and other types of financial receivables.
As a securitisation market grows and becomes more sophisticated, the types of assets that are securitised are broadened into non-financial types of asset and future cash flows.

Examples of Securitised Assets	
• Aircraft Leases	• Mortgages (Residential and Commercial)
• Auto Loans (Prime and Sub-prime)	• Railcar Leases
• Auto Leases	• Real Estate
• Boat Loans	• Recreational Vehicle Loans
• Credit Card Receivables	• Royalty Streams
• Equipment Leases	• Stranded Utility Costs
• Home Equity Loans	• Trade Receivables
• Manufactured Housing Contracts	• Train Wagons Leases
• Marine Shipping Containers and Chassis Leases	• Truck Loans

1.2 Market overview and trends

The European securitisation market grew by 37.7% in 2003 reaching a new high of EUR 217.2 billion, from EUR 157.7 billion in 2002. Economic recovery and lower levels of credit defaults have raised investor confidence in the market.



Source: Dealogic Bondware

As to the type of investors in securitisation bonds at present there is concentration in investment and insurance companies as a certain level of expertise is required. However, as the market develops, other types of investors tend to be attracted by the relative higher returns and collateral guarantees.

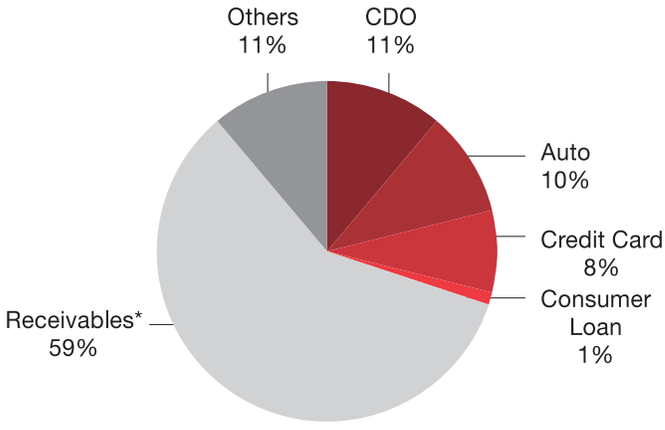
Investment Companies	43%
Insurance Companies	22%
Asset Management	16%
Federal/State/Local Government	5%
Corporations	4%
Mutual Funds	3%
Pension Funds	2%
Other	5%

Source: Moody's Investors Service

1.3 What is securitisation?

A securitisation is a type of structured financing in which a pool of financial assets (such as car finance loans, home or commercial mortgages, corporate loans, royalties, leases, non-performing receivables, and contractually pledged operating revenues) is transferred to a "special purpose vehicle" (SPV) that then issues debt – backed solely by the assets (collateral) transferred and payments derived from those assets.
The most common collateral types in Europe include the following:

European ABS Issuance
by Collateral Type – Through Q1 2004



** Includes Train, Mortgage Bond, Property Rent and Lease Receivables*

Sources: Dealogic Bondware, Thomson Financial Securities Data

The transfer is structured to isolate the assets from the credit exposure of the securitisation sponsor and to, potentially, remove the assets from the sponsor's balance sheet. Proceeds of the transfer may be used to originate new assets, to repay outstanding debt, or for any other allowable purpose. The valuation of the portfolio of assets, and hence the credit quality and anticipated timing of repayment of the debt issued in the securitisation, is based largely on projected cash flows on the assets sold as impacted by assumptions regarding prepayments and losses due to delinquencies and defaults. Typically, the originator retains a subordinate position in the cash flows generated by the assets,so that it receives all cash flows generated by the assets after the debt issued by the special purpose vehicle is repaid.

1.4 Benefits of securitisation

Below is a listing of common benefits of securitisation. A securitisation may offer one or more of the benefits described below. However, securitisations are complex structured financings and it is critical that potential issuers understand the range of options and related implications so that they can make informed decisions.
While these benefits have varying degrees of importance for different issuers, the common hallmark of securitisations is that they provide a lower cost of capital.

1. **Provide efficient access to capital markets:**
   transactions can be structured with "AAA" ratings on most of the debt, so pricing is not tied to the credit rating of originator.

2. **Minimise issuer-specific limitation on ability to raise capital:**
   capital raised becomes a function of the terms, credit quality, prepayment assumptions, and servicing of the assets and prevailing market conditions. Entities that are unable to borrow on their own credit, or to do so only at great cost, as well as entities that cannot raise equity, may be able to complete securitisations.

3. **Convert illiquid assets to cash:**
   assets that cannot readily be sold may be combined to create a relatively diversified collateral pool against which debt can be issued.

4. **Diversify and target funding sources, investor base, and transaction structures:**
   businesses can expand beyond existing bank lending and corporate debt markets to tap a new market and set of investors. This also has the potential to lower the cost of other types of debt by reducing the volume issued, thereby allowing placement with marginal purchasers willing to pay a higher price. Especially for complex organisations, segmenting revenue streams or assets securing particular debt offerings enables issuers to market debt to investors based on their appetite for particular types of credit risk, while allowing these investors to minimise their exposure to unrelated issuer risk. Similarly, complex principal and interest payment structural features, targeting the investment objectives of particular buyers, can be incorporated into the debt. This segmentation of credit risk and structural features should minimise the overall cost of capital to the seller.

5. **Raise capital to generate additional assets or apply to other more valuable uses:**
   for example, allows lines of credit to be recycled quickly to generate additional assets, as well as freeing long-term capital for related or broader uses.
   The capital raised can be used for any allowable purpose, such as retiring debt, repurchasing stock, purchasing additional assets, and completing capital projects.

6. **Match assets and liabilities to minimise risk:**
   a properly structured transaction could create near perfect matching of term and cash flows locking in an interest rate spread between that earned on the assets and that paid on the debt.

7. **Raise capital without prospectus-type disclosure:**
   allows sensitive information about business operations to be kept confidential, especially by issuing through a “conduit” or as a private placement.

8. **Complete mergers and acquisitions as well as divestitures more efficiently:**
   may assist in creating the most efficient combined structure and may serve as a source of capital in transactions. By segmenting and selling assets against which debt is issued, it may be possible to leave business lines that no longer meet corporate objectives more economically.

9. **Transfer risk to third parties:**
   financial risk from defaults on loans or contractual obligations by customers can be partially transferred to investors and credit enhancers.

1.5 Types of transactions

With regard to the transfer of rights of an asset, there are two forms of securitisation transactions:

"True Sale"

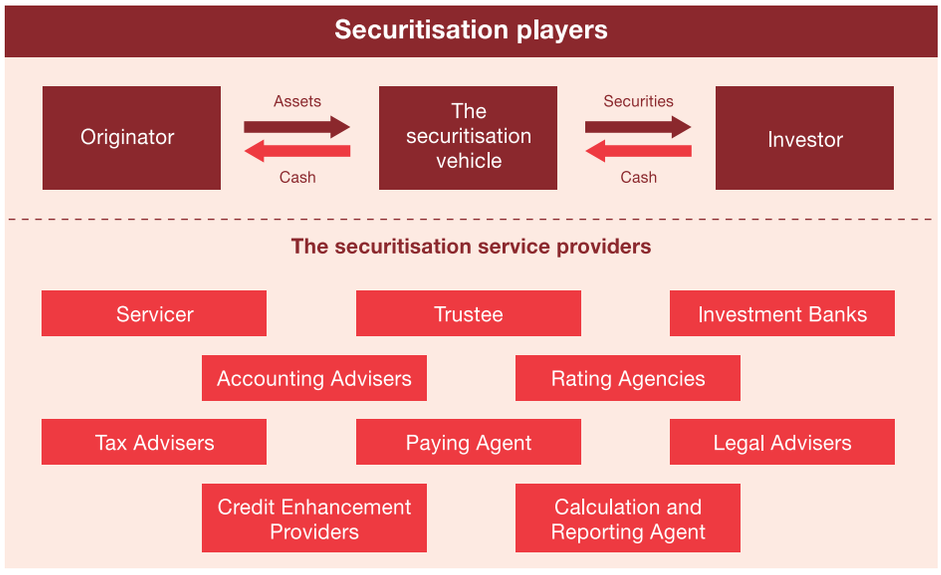
In a traditional true sale structure, the originator sells a pool of assets to a special purpose vehicle. The vehicle funds the purchase through the issue of tranches of securities, which are rated by an agency. The rating of the securities reflects the fact that the SPV is isolated from any credit risk of the originator, and the credit enhancement of the pool.

Synthetic

In a synthetic securitisation, instead of selling the asset pool to the SPV, the originator buys protection through a series of credit derivatives. Such transactions do not provide the originator with funding. These transactions are typically undertaken to transfer credit risk and to reduce regulatory capital requirements.

1.6 Securitisation players

This section describes the players of a securitisation transaction. In addition to direct involved parties, there are a number of other parties, generally defined as service providers, which are also involved in the securitisation process. Below you find an overview of the most relevant parties:



Originator: The entity assigning assets or risks in a securitisation transaction.

Investor: Buys the securities and overtakes the risks.

Servicer: The entity that collects principal and interest payments from obligors and administers the portfolio after transaction closing. It is very common in securitisation transactions that the originators act as servicers though this is not always the case. For example, in most of the NPL (non-performing loans) transactions, specialised servicers tend to carry out this role.

Trustee: Legal responsibility for activities of the securitisation vehicle and the receipt and disbursement of coupon payments to the investors.

Investment banks: Main functions include structuring, underwriting and marketing of the transaction.

Tax and accounting advisers: Advise regarding the accounting and tax implications for the involved parties of the proposed structure of the transaction.

Rating agencies: Based on expected performance of underlying asset portfolio, rating agencies set credit enhancement levels to achieve desired credit ratings of offered securities, assign rates to the bonds issued, evaluate the servicing capabilities and monitor the performance of the transactions.

Paying agent: Responsible for making the principal and interest payments to the security holders.

Legal advisers: In addition to developing the sale and purchase agreement for the portfolio and offering documents and any other relevant contracts, legal advisers provide the legal opinion on the "true sale" of the portfolio, if applicable.

Credit enhancement providers: Typically either third party monoline insurer or parent company of originator that guarantees principal and interest payments to security holders.

Calculation and reporting agent: Calculates the waterfall principal and interest payments due to note holders.

1.7 Types of credit enhancement

While there are other important considerations when structuring an efficient securitisation transaction (such as the separation of credit risk between SPV and originator, avoidance of co-mingling of accounts between the sponsor and the SPV, no double taxation of the vehicle or withholding requirements for cross-border transactions), credit enhancement protects investors so the pool of underlying assets is able to withstand fluctuations in the economy. If no credit enhancement was structured, then an investor would bear all the credit risk in the pool of assets. Accordingly, internal and external mechanisms are typically built into the structure — a process that drives the ultimate ratings of the issued securities.

In order to protect the investors' positions in the asset pool, a number of different credit enhancement techniques could be utilised, including external credit enhancement (insurance type policies purchased to protect investors in case of default) or internal credit enhancement (techniques structured within the transaction).

Common types of each include:

External credit enhancement

Third party/Parental guarantees
Policy that reimburses structure for losses up to a certain amount, usually provided by rated insurance company or parent company of seller.

Letters of credit
Loss coverage provided by financial institutions which are required to have cash readily available to cover losses.

Surety bonds
Policy provided by a rated insurance company to protect principal and interest payments for certain investors. Typically provided on investment grade securities with requirement that other forms of credit enhancement are employed as well.

Internal credit enhancement

Over-collateralisation
The value of the underlying pool assets exceeds the amount of securities issued.

Subordination
Prioritise cash flows so senior tranches are protected by subordinate tranches in case of losses.

Excess spread
Net amount of interest payments of underlying assets after transaction administration expenses and bondholders' interest payments have been made. The excess could be used to cover losses and top-up reserve fund.

Reserve fund
Funded either by cash at closing or excess spread and reimburses structure for losses up to the amount of the reserve.

Credit enhancement can be illustrated by the following example.

As is the case in other issued securities, a rating of "AAA" implies near certainty of timely payment of interest and principal on the issued debt. Though it is highly unlikely that an entire pool of residential mortgage loans will command such a rating, it is possible that a large portion of the portfolio will do so. The remaining portion of the portfolio is divided into different tranches through "A" and "BBB" to unrated first loss piece (which is typically held by the originator). Any losses on the portfolio are allocated to the unrated position and then usually to the lower rated securities up to the senior "AAA" position.

1.8 Taxation in securitisation

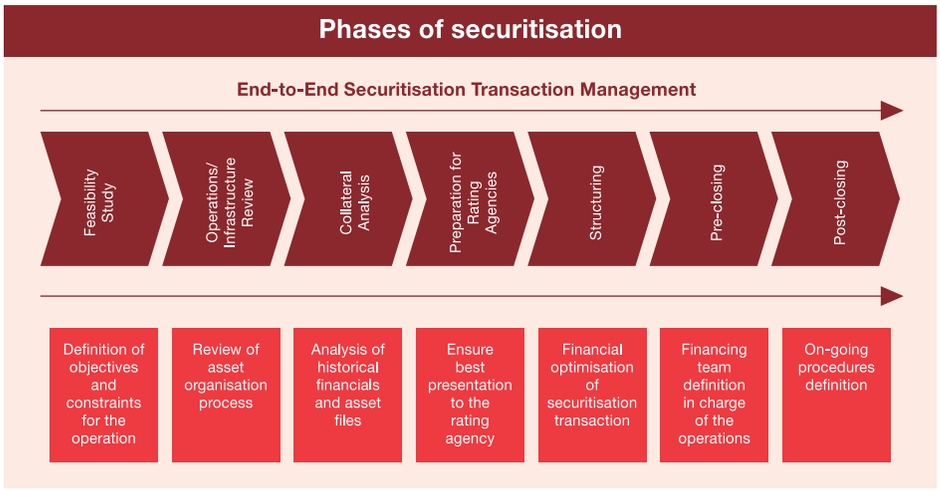
As it is the case for most of the products offered on the capital markets, their success largely depends on the tax environment they are subject to. Therefore, tax neutrality is a key success factor for a securitisation transaction in order to optimise investors' return and the originator's funding costs. Any tax levied on the securitisation vehicle or in relation to the securitisation itself would clearly increase the overall cost of the transaction, thus reducing its effectiveness. As a result, a securitisation transaction must be structured on a tax neutral basis in order to maximise its benefits.
This means that all structural features of a securitisation transaction have to be clearly analysed from a tax perspective in order to ensure that none of those features lead to any additional tax, or any acceleration of tax liabilities that would have been incurred had the securitisation not taken place. In practice, in many cases a securitisation transaction may lead to some level of tax costs. In these circumstances it is important that such costs are well known in advance and that there are no future uncertainties, so a decision can be taken by the originator and/or investors on whether these costs are acceptable, taking into account the overall commercial benefits of the transaction.

Achieving a high degree of certainty in relation to the tax position of the issuer is also a pre-requisite in any securitisation transaction. In order to substantiate the rating assigned to the bonds, rating agencies will require a high degree of assurance that the issuer will not be subjected to any unexpected tax charges.

On a general level, in most cases it is possible to structure securitisation transactions in order to achieve the required tax treatment. However, it is vital that relevant tax advice is provided at a very early stage in order to ensure that any potential tax pitfalls are identified and properly addressed so that the necessary changes to the structure are carried out prior to transactions that are subject to the evaluation of every external party (e.g. rating agencies, legal and regulatory authorities, investors, etc). Furthermore, in case that any advance tax clearances from tax authorities are required, these can be obtained at an early stage in the process.

1.9 Phases of the securitisation process

The different aspects of a securitisation transaction are outlined below. Though not exhaustive, the list should give a good idea of the processes involved in a typical transaction.



1.9.1 Feasibility study phase

A company considering a securitisation issue or program must be able to delineate its objectives and the constraints under which it operates. To ensure that the transaction gets off of the ground, corporate finance analysts must review the asset origination, servicing, and reporting processes as well as information about past performance of the assets to be securitised. For many new issuers, this phase is the most critical because it brings relevant factors and options to light that may significantly influence the direction taken. As a result, the company's objectives are more completely realised. Typical areas to review include among others:

— **Operations overview**: systems, policies, responsibilities of each party.

— **Portfolio performance**: compare to standard securitisation industry practices.

— **Financial overview**: funding alternatives, profitability measurement, current funding sources.

— **Legal overview**: asset segregation, existing covenants and agreements.

— **Tax implications**: impact on tax liability, tax advantaged structures.

— **Credit overview**: rating of individual obligors and portfolio overall, level of concentration, risk disclosure and risk management policies, and originator and servicer credit quality.

— **Regulatory overview**: National, EU or US requirements and impact of securitisation.

— **Strategic**: What business model achieves the highest overall profitability? What are the risk-reward trade-offs? What is the best way to raise capital in this business model?

— **Identification and evaluation of alternatives to achieve objectives and to mitigate weaknesses for key areas such as**: operations, systems, cash flow, financial reporting, legal, tax, regulatory, and credit.

If a structured financing is to be executed, it is in the issuer's interest to complete a self-assessment before presenting information to outside parties. The next two sections discuss operations and financial review; these phases are completed as part of the evaluation and planning processes before undertaking a transaction.

1.9.2 Operations/infrastructure review phase

Invariably, practical problems arise in a company's ability to provide historical data and information concerning the asset pool or with their ongoing ability to meet servicing and reporting requirements. It is imperative for outside parties to evaluate receivables and servicing systems as well as assess underwriting standards and collection policies. Items to consider include:

Asset origination

— What is the credit review process? Do policies exist and are they consistently applied? Can credit review be made more efficient through system improvements, staffing enhancements, credit scoring, etc.?

— Is application processing timely and efficient from originator and obligor perspectives? Can it be streamlined or expedited?

— Is documentation standardised (to the extent possible)?

— Are there any legal issues, such as enforceability?

Servicing and reporting

— Is the system sufficiently robust and does it have the flexibility to address servicing and reporting requirements of a securitisation?

— Can necessary data be made available in a timely manner?

— Are appropriate operating and management reports generated to make decisions regarding allocation of servicing resources, front-end pricing, performance triggers and trends, etc.

1.9.3 Collateral analysis phase

In conjunction with the aforementioned review of reporting systems and servicer collection policies and procedures, an evaluation of the collateral portfolio must be undertaken. In order to effectively assess the credit quality of a given portfolio, the major rating agencies typically review historical financials and sufficiency of asset files. This will include:

Portfolio data analysis

— Review of 10 years historical asset performance information;

— Analyse a static pool of assets which are isolated over a static three or five year period. Principal/interest, prepayment, and delinquency/default performance characteristics evaluated per origination time period.

Asset file review

— Review completeness of physical asset files;

— Identify all possible source documents and reports.

Ensure saleability of assets

— Identify data inconsistencies and deficiencies;

— Analyse the company's charge-off policy.

1.9.4 Preparation for rating agencies review

After in-depth analysis of collateral, systems and operations, it is important that the best presentation of the securitisation transaction is given to the rating agencies that, in turn, will determine the overall enhancement levels by assigning ratings to the offered notes.

1.9.5 Structuring phase

The fifth part of the evaluation and planning process for a securitisation transaction includes assessing the financial impact of the securitisation transaction. This phase focuses on funding approaches (e.g. securitisation versus whole loan sales or other alternatives), funding sources (e.g. interpretation and harmonisation of funding alternatives), credit considerations (e.g. desired credit rating, least expensive all-in credit structure), and legal issues (e.g. covenants, events of default, other legal terms impacting the business).

1.9.6 Pre-closing phase

After laying the groundwork for a transaction, originators/transferors must request and evaluate proposals and select financing team members whose strengths and ideas are best suited to the company's needs. The financing team will coordinate the negotiation of business and pricing terms as well as coordinate presentations to credit analysts to ensure the most favourable possible reception. The myriad of activities often undertaken as part of a first securitisation include:

— **Assemble financing team**: financial adviser, legal adviser, underwriter, third party credit enhancer/liquidity support, trustee, rating agencies.

— **Prepare legal and disclosure documents**: ensure key business terms reflected, set the agenda for future transactions, maximise flexibility.

— **Finalise deal structure**: issuer objectives and constraints, asset selection, credit enhancement, market conditions, test sensitivity to changing circumstances and stress test.

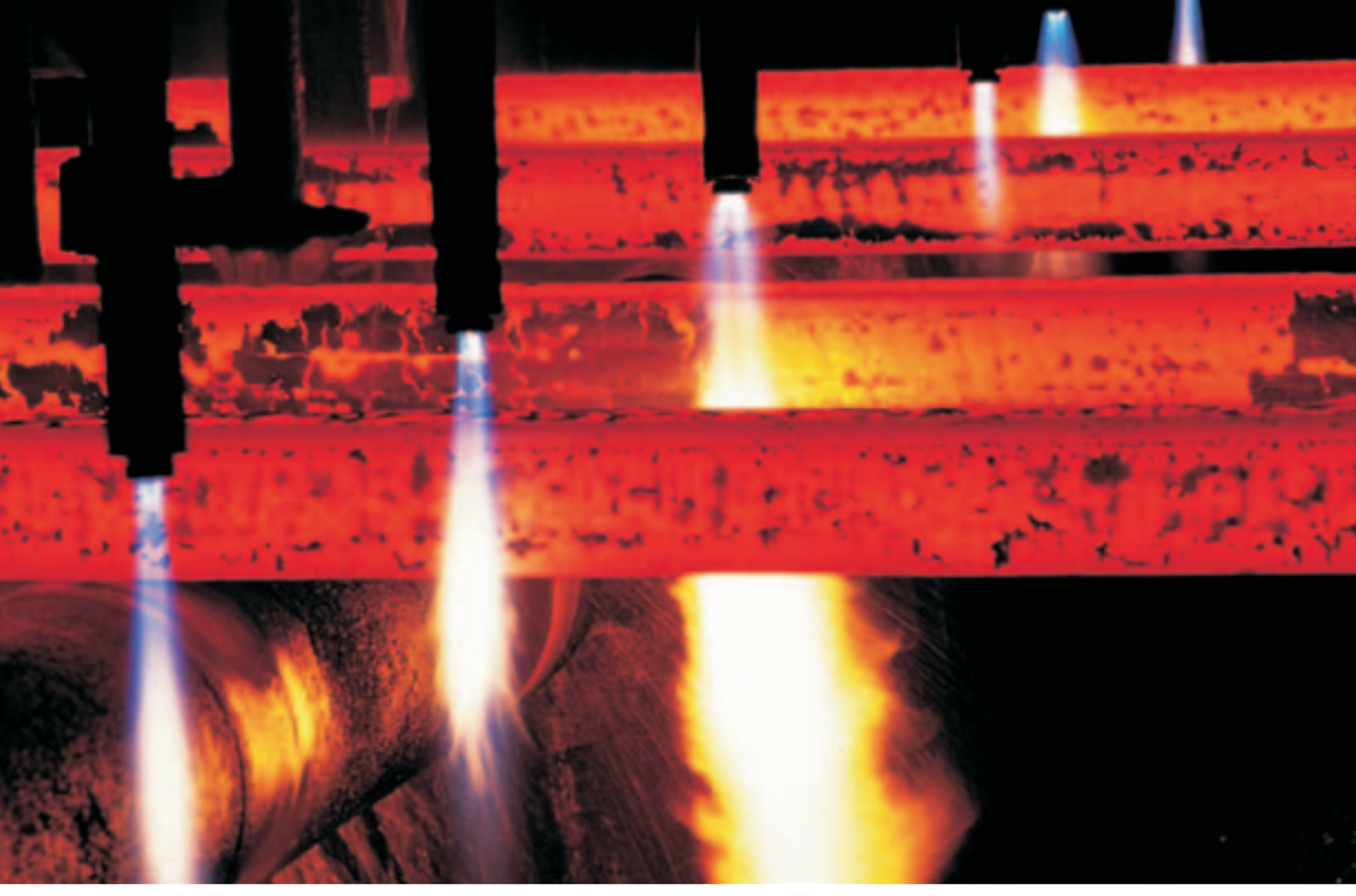
— **Present structure to credit and business analysts**: rating agencies, credit enhancers, underwriters, investors, internal constituencies.

— **Validate data**: portfolio due diligence, verification of disclosure information.

— **Price transaction**: review comparable transactions, general market conditions, etc., negotiate spread with underwriter?

1.9.7 Post-closing phase

After the transaction is completed, issuers have certain ongoing responsibilities for and interest in the financing and underlying assets, including: servicer statement preparation, investor reporting, internal management and operations reporting, procedures review/surveillance and related reporting of findings, tax calculations, financial reporting, portfolio and transaction performance tracking.



2 The Belgian Securitisation Regulatory and Tax Framework – Key features

2.1 Overview

The Act of 5 August 1992 amending the Financial Transactions and Markets Act of 4 December 1990 introduced into Belgian law a legal, regulatory and tax framework for securitisation of receivables that forms part of the body of rules governing collective investment schemes.

Further regulation came with the Royal Decree of 29 November 1993 governing "all necessary aspects of securitisation" (which was extensively amended in 1995). Also with a view to facilitating securitisation transactions, the legal rules set forth in the Belgian Civil Code regarding transfers of debts were amended in 1994.

Major changes to the Belgian rules came with the Act of 12 December 1996, implemented by Royal Decree of 8 July 1997. This Act essentially allows the creation of two alternative special purpose vehicles ("SPV") similar to pass-through and corporate-bond structures: these are the SIC ("Société d'investissement en Créances")/VBS ("Vennootschap voor Belegging in Schuldvorderingen") and the FPC ("Fonds de placement en Créances")/FBS ("Fonds voor Belegging in Schuldvorderingen").

Other changes to Belgian regulations are included in the recent Act dated 20 July 2004 implementing the UCITS III Directive.

As is explained below, there is a strong incentive to opt for a dedicated Belgian vehicle, which offers a specific regulatory and tax framework. The primary objective of the new rules has been to provide all originators, investors and creditors with a high degree of flexibility and legal stability.

2.2 Definition of securitisation

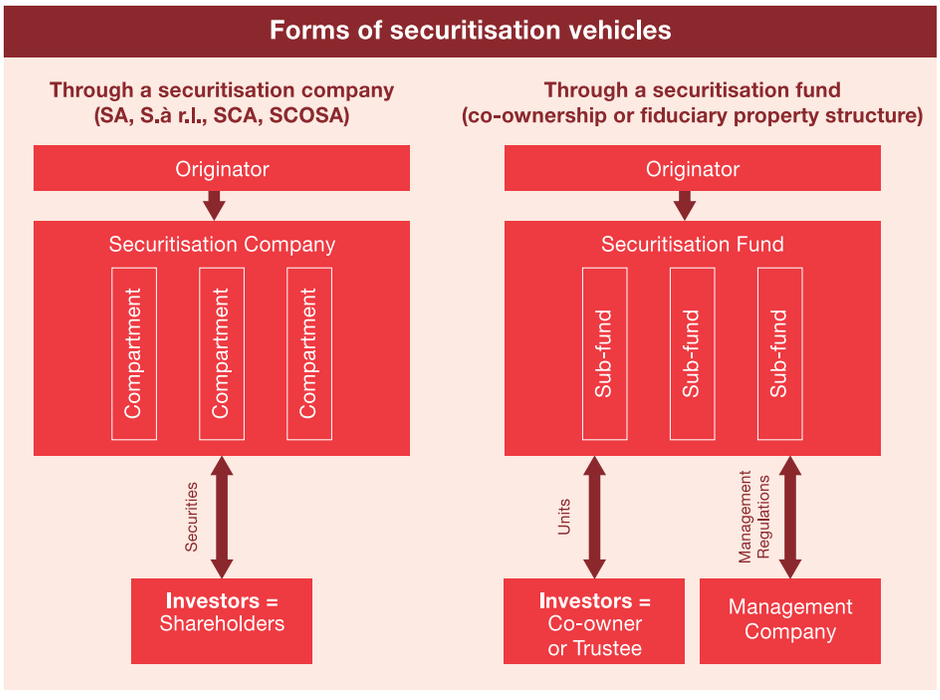
Under Belgian law, there is no general definition of "securitisation". However, for several years now, Belgian law has been undergoing developments that allow for the securitisation of receivables. The concept is based on international market practices: it involves a financial transaction in which an enterprise pools financial assets, mostly receivables, which are subsequently transferred to an SPV, which finances the acquisition by issuing securities.

2.3 Flexibility

The specific regulatory framework for the securitisation of receivables has been made progressively more flexible and better suited to international market practice.
The impediments of civil law regarding the formalities for transferring receivables have been removed and tax provisions have been enacted to allay any adverse tax consequences of securitisation transactions at SPV level.

2.3.1 Forms of securitisation vehicles

Belgian law allows securitisation vehicles in the form of a corporate entity or of a (contractual) securitisation fund to be run by a management company and governed by management regulations. The FPC/FBS form of investment fund is a portfolio owned by its pro indiviso owners and whose unit-holders bear a liability limited to the net asset of the investment fund and their part within the fund. An SIC/VBS investment company is a corporation that has a fixed capital as well as a variable capital according to subscriptions or redemptions (open-ended fund).



The first type of vehicle is essentially a mutual fund (or pool of assets), managed by a management company on behalf of the investors, who hold registered or bearer certificates representing their rights in the fund. The fund does not have legal personality and does not require a minimum share capital.

The second type of vehicle is a company, which can take the form of a public limited liability company (SA ("société anonyme")/NV ("naamloze vennootschap")) or, less often, a partnership limited by shares (SCA ("société en commandite par actions")/ CVA ("commanditaire vennootschap op aandelen")). Hence, an investment company has legal personality and requires a minimum share capital of EUR 61,500.
An SIC/VBS may issue various classes of units, backed by different categories of assets, which are separate and distinct property as far as creditors and investors are concerned.

A further distinction is made between "public" and "institutional" securitisation vehicles. Public vehicles may raise funds by either public placement or a public offering of their securities or by a private issue, whereas institutional vehicles must offer their securities exclusively to specified institutional or professional investors, acting for their own account.

2.3.2 Regulation of securitisation vehicles

The Belgian Banking, Finance and Insurance Commission ("BFIC"), the supervisory body for credit, financial and insurance institutions and the public raising of funds, has extensive powers to regulate securitisation transactions. Not only does the BFIC has to approve the intervention of the different operators in the securitisation process, but the SPV and its compartments are subject, like all other collective investment undertakings, to the BFIC's prudential supervision. This means that the BFIC must approve the articles of incorporation or management regulations of the securitisation vehicle or management company. The regulatory provisions require that the originator of a securitisation transaction should not be under any legal or moral obligation to support the transaction in order to qualify for off-balance-sheet treatment.

Public SPVs must be licensed by and registered with the BFIC prior to commencing any transaction. Their offering prospectuses also have to be approved by the BFIC. By contrast, a private SPV does not need to register with the BFIC and is not subject to its oversight. It must, however, register with the Ministry of Finance. Registration does not imply any recognition of legal, regulatory or tax compliance by the SPV.

By virtue of the recent Act implementing UCITS III Directive, the SIC/VBS has to adopt appropriate internal control processes. These must guarantee, on the one hand that each transactions can be identified as for its origin, the parties involved, its nature, as well as for the time and place where the transaction occurred, and on the other hand that the assets of the SIC/VBS are invested in line with the articles of incorporation of the company and the regulatory provisions.

2.3.3 Legal rules governing transfers

The Belgian Civil Code regulates the transfer of receivables. The simple consent of both the assignor and the assignee makes a transfer effective as against all third parties, including the creditors of both parties but excluding the debtor. In order to make the assignment effective against the debtor, he must either receive notice of it or acknowledge it. However, in the absence of notice or acknowledgement, payments made by the debtor to the assignor will still be of legal effect. "Silent" transactions have the advantage of not being detrimental to third parties and of preserving the assignor's relationship with the debtor.

It should be noted that, if a foreign SPV structure is used, the transfer of receivables backed by a mortgage or lien on immovable property is only effective against third

parties once it has been recorded in the mortgage register, which requires a notary deed (the recording of which is subject to registration duty). No specific requirements apply if a Belgian SPV structure is used.

Furthermore, the transfer to a regulated securitisation vehicle of receivables due under consumer credit agreements is not subject to the stringent requirements of consumer credit law.

2.3.4 Classes of assets

A wide range of assets can be securitised, such as mortgage-backed loans, credit-card receivables, railway vehicles, diamonds, champagne, student loans, or intellectual property. However, the Belgian regulatory framework only applies to securitisation transactions of receivables. Where the dedicated vehicle is not an option, it might be envisaged to securitize assets using a regular, unregulated Belgian company.

The terms governing the receivables to be transferred will be found in the agreements under which the receivables arise and in the specific securitisation legislation.

— The receivables must be freely transferable and must not be of a personal character (intuitu personae).

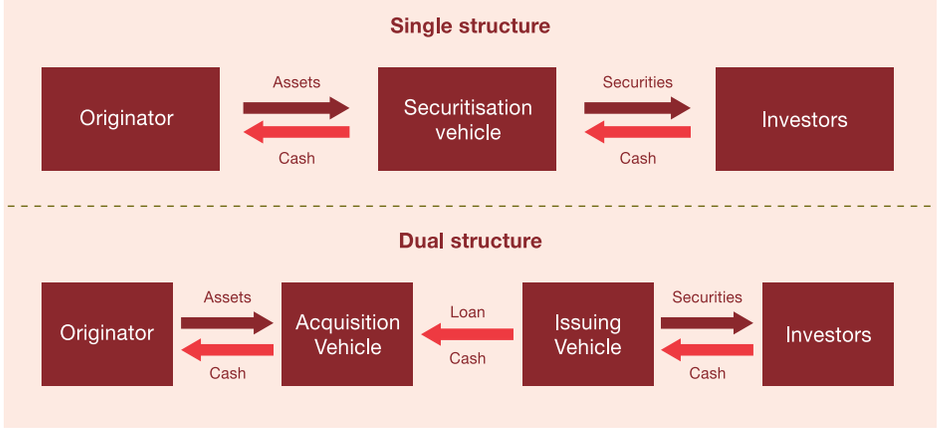
— The receivables should be "homogeneous". This means that a single receivable can normally not be securitised, although the BFIC can permit otherwise. It also means that groups of receivables should have similar characteristics, mainly from a financial point of view, even though the regulations do not specify so.

— The repayment conditions (due dates and amounts) must be fixed contractually. It is not, therefore, sufficient for these conditions to be determinable; they should be fixed as of the date the securitisation transaction comes into effect.

2.3.5 Forms of securitisation transactions

Securitisation transactions can be executed in the two forms described above in Part I. Within the scope of a "true sale" transaction, the originator sells a pool of assets to a securitisation vehicle whereas, under a "synthetic" transaction, the originator buys credit-risk protection through a series of credit derivatives. A synthetic transaction does not, as such, fall within the range of activities or investments that SIC/VBS or FPC/FBS is permitted to engage in.

Forms of securitisation transactions



As shown in the following diagram, it could be conceivable to shape the securitisation transaction as a single structure or as a dual structure. In a single structure, the securitisation vehicle purchases the assets or risks and issues the securities, whereas in a dual structure, two or more vehicles are constituted. In the former structure, the vehicle acts as an "acquisition" vehicle, purchasing the assets or risks and being funded by loans provided by an "issuing" vehicle, issuing securities to the market. In a dual structure, the acquisition vehicles can also be established in the country of the originator or in the country where the transferred assets are located.

2.3.6 Compartmental segregation

Compartmental segregation within a securitisation vehicle is also a feature of the flexibility of the Belgian regulatory framework. The possibility of segregation has to be mentioned in the articles of incorporation of an SIC/VBS investment company.

Compartmental segregation means that the assets and liabilities of the SPV can be split into different compartments, each of which is treated as a separate entity, making discrete transactions possible. The rights of the investors and creditors are limited to the risk allied to the assets of a given compartment. Each of the compartments can be liquidated separately without any negative impact on the vehicle's remaining compartments, i.e. without triggering liquidation of the other compartments. The liquidation of the last compartment triggers the liquidation of the SIC/VBS investment company.

In addition, if this is provided for in the articles of incorporation, management regulations or issuance agreement, the securitisation vehicle or one of its compartments can issue several tranches of securities corresponding to different forms of collateral and providing for different values, yields and redemption terms.

2.3.7 Accounting

Each SPV must, like all other collective investment undertakings, appoint one or more auditors, who must be registered with the BFIC.

The accounting rules applicable to securitisation vehicles vary according to their form. Securitisation companies must comply with the accounting regulations for commercial companies laid down by the Corporate Accounting Act of 17 July 1975 and its implementing decrees. Their management reports must contain all material information relating to their financial situation that could affect the rights of the investors. By contrast, securitisation funds are subject to the accounting regulations applicable to investment funds laid down by the Royal Decree of 29 November 1993. The accounting valuation principles and methods are subject to approval by the BFIC.

If a private SPV is segregated into compartments, separate accounting should be held for each compartment.

Regarding the consolidation of SPVs, no specific rules apply within the Belgian accounting framework. As a result, the general consolidation rules should be followed, which basically focus on the "control" aspect.

Derecognition under current Belgian accounting rules follows the legal characteristics of the securitisation transaction. If the transaction qualifies as a true sale, derecognition will, in general, be appropriate.

2.4 Enhanced investor protection

One of the most important aspects of the law is to ensure enhanced investor protection. The bankruptcy remoteness principle separates the securitised assets from any risk of insolvency of the securitisation vehicle, the originator, the service

provider or the collateral. The law allows for the validity and enforceability of the following contractual provisions, which will protect the securitisation vehicle from the individual interests of the parties involved:

— **Subordination provision**: investors and creditors may subordinate their rights to payment to the prior payment of other securities or debts by the securitisation vehicle.

— **Non-recourse provision**: investors and creditors may waive their rights to demand enforcement. This means, for example, that, if the payment of interest is in default, the investor may agree to wait and not take recourse to legal action because he is aware of the situation or it is temporary.

— **Non-petition provision**: investors and creditors may waive their rights to initiate bankruptcy proceedings (and upon entry into force of the Act dated 20 July 2004, a judicial composition) against the securitisation vehicle. This clause protects the vehicle against the action of individual investors who might have an interest in putting the vehicle into insolvency.

2.5 Qualified service providers

2.5.1 The management company

The appointment of a management company is no longer compulsory for institutional SIC/VBS investment companies provided that the SIC/VBS has an appropriate management structure, but it is mandatory for FPC/FBS investment funds.
If a management company needs to be appointed, it should be licensed by the BFIC and comply with certain other statutory requirements.

2.5.2 The custodian

In order to guarantee that transferable securities and other financial instruments held by a securitisation vehicle are kept under optimum security conditions for investors, the SPV must deposit such assets with a custodian, which must be approved by the BFIC.

2.5.3 The supervisory company

In the event of a public offering, a supervisory company is appointed to monitor the securitisation process and ensure that the sale and issue comply with the applicable laws and transaction documents. In addition, the supervisory company has to check whether there are any events that could alter the risk profile of the portfolio or the expected results of the portfolio and whether the return on the receivables is in line with the financial plan. Any risk of default must be reported immediately to the management company and to the BFIC. Furthermore, appropriate steps must be taken by the supervisory company to safeguard investors' rights.

2.5.4 The collection agent

The collection and recovery of receivables from debtors may be carried out by a collection agent. The originator or a third party may act as collection agent and servicer on behalf of an SPV. From a commercial perspective, keeping the processes surrounding the receivables with the originator preserves the assignor's relationship with the debtor.

2.5.5 The rating agency

To be acceptable to the BFIC, the management company has to appoint a rating agency. The rating agency has to report on the quality of the receivables that

constitute the SPV's portfolio and on the solvency risk of each type of security issued by the SPV.

2.5.6 The servicer

By virtue of the Act dated 20 July 2004, the servicer will have to be recognised by the BFIC in certain circumstances.

2.6 Tax neutrality

Tax neutrality is one of the key success factors for a securitisation transaction. Belgium has been successful in achieving tax neutrality in its laws.

2.6.1. Tax aspects specific to securitisation companies

Securitisation vehicles organised as corporate entities are, as a rule, fully liable to corporate income tax at the standard rate of 33.99%. However, although an SIC/VBS is subject to corporate income tax, its tax base is quite narrow, being limited to the sum of:

— any non-arm's-length benefits received; and

— expenses and costs that are not deductible as business expenses (i.e. disallowed expenses), other than impairment and capital losses on shares (not applicable to an SIC/VBS, since it cannot invest in equities).

Any contribution to the capital of a SIC/VBS is exempt from the non-recurring 0.5% capital duty and is only subject to a nominal fixed fee of EUR 25. The exemption applies upon the SIC/VBS registering with the BFIC (for public vehicles) or the Ministry of Finance (for institutional vehicles).

The SIC/VBS benefits from a conditional exemption from withholding tax with respect to all types of interest income.

Furthermore, the SIC/VBS can also benefit from unconditional statutory or administrative exemptions from withholding tax, such as the withholding tax exemption on interest earned on mortgage loans.

In respect of the redemption of shares and liquidation surpluses, any redemption premium or liquidation surplus paid out by an SIC/VBS is exempt from withholding tax.

Since an SIC/VBS is a fully taxable resident company, it benefits from the Belgian double taxation treaty network and from the EU Parent-Subsidiary Directive.
At present, the following countries have signed double taxation treaties with Belgium:

Double tax treaties with Belgium			
Albania	Finland	Macedonia	Slovakia
Algeria	France	Malaysia	Slovenia
Argentina	Georgia	Malta	South Africa
Armenia	Germany	Mauritius	South Korea
Australia	Greece	Mexico	Spain
Austria	Hong Kong	Moldavia	Sri Lanka
Azerbaijan	Hungary	Mongolia	Sweden
Bangladesh	Iceland	Morocco	Switzerland
Belarus	India	Netherlands	Tajikistan
Bosnia-Herz.	Indonesia	New Zealand	Thailand
Brazil	Ireland	Nigeria	Tunisia
Bulgaria	Israel	Norway	Turkmenistan
Canada	Italy	Pakistan	Turkey
China	Ivory Coast	Philippines	Ukraine
Croatia	Japan	Poland	United Arab Emirates
Cyprus	Kazakhstan	Portugal	United Kingdom
Czech Republic	Kyrgyzstan	Romania	United States
Denmark	Kuwait	Russia	Uzbekistan
Egypt	Latvia	Senegal	Venezuela
Ecuador	Lithuania	Serbia & Montenegro	Vietnam
Estonia	Luxembourg	Singapore	

2.6.2 Specific tax aspects of securitisation funds

Since an FPC/FBS does not have separate legal personality, it is not a taxpayer as such and therefore is not subject to corporate income tax or the tax on legal entities. Instead, the income received by an FPC/FBS is deemed to be attributed directly to its unit-holders, who are taxed on their shares of the profits.

No capital duty is due upon the creation of an FPC/FBS, since it is an entity owned *pro indiviso* and has no separate capital. However, a nominal fee of EUR 25 is charged if the articles of incorporation are recorded.

An FPC/FBS benefits from an unconditional exemption from withholding tax on interest income.

2.6.3 Common features

Any transfer of securities that are (or can be) publicly traded at a stock exchange is subject to Belgian stock exchange tax (from 0.07% to 0.5%) if the transfer is effected in Belgium through a professional intermediary. Like any other collective investment vehicle, the SPV is eligible for an exemption for securities transactions carried out for its own account.

Furthermore, the SPV is exempt from the annual tax on collective-investment, credit and insurance institutions, calculated at the rate of 0.06% of the net asset value.

However, the SPV is not exempt from the tax on the physical delivery of bearer securities that are (or could be) publicly traded at a stock exchange, if this is done through a professional intermediary. The tax is set at 0.6% of the purchase price.

The SPV qualifies as a VAT-payer, but its activities are expressly exempt from VAT. Services required to manage the vehicle and its assets are exempt from VAT, with the exception of the enforced collection of receivables.

2.6.4 Tax treatment of shareholders, unit-holders and bondholders

Any dividends distributed by an SIC/VBS are subject to a reduced withholding tax of 15% provided the issuer has not irrevocably waived the benefit of the reduction. Certain categories of shareholders are eligible for a total exemption, such as "non-resident investors".

Investment income passing through an FPC/FBS is subject to withholding tax, which varies depending on the type of income. For example, if the investment income comprises exclusively interest, the withholding tax generally amounts to 15% where applicable.

Interest payments to bondholders are in principle subject to a 15% withholding tax. However, the withholding tax may be reduced to nil if, e.g., the bonds are held in the X/N clearing system or where interest is paid to an associate company in accordance with the EU Interest and Royalties Directive.

2.7. Conclusion

Belgium's parliament has wisely introduced not only a specific regulatory framework for securitisation transactions in receivables but also an appropriate set of tax rules in order to avoid any tax leakage.

The key features that make this specific legal, regulatory and tax scheme attractive in practice are:

— flexibility in entity-establishment from a cost and structuring point of view

— legal certainty

— tax neutrality

— qualified service providers

3 Other Issues

3.1 Basel II

Introduction

Basel II is the name widely used for the new capital adequacy framework to be implemented worldwide by bank supervisory authorities.

The Basel II framework is structured in three "Pillars". The first "Pillar", Minimum Capital Requirements, deals with the methodology for calculating the capital adequacy. Given that the approach on Basel II is based on the economic substance of transactions rather than its legal form, the chapters encompassing Pillar 1 contain a number of quantitative aspects backed by qualitative analysis. Pillar 2, Supervisory Review Process, is exclusively qualitative and provides a significant level of discretion to supervisory authorities when evaluating the application of the Basel II framework. Pillar 3, Market Discipline, aims to enhance the degree of transparency of a bank's public reporting. It requires the disclosure of both quantitative and qualitative aspects of the methods a bank uses to manage its capital requirements.

Basel II and securitisation

The capital treatment of securitisation transactions has been one of the most difficult areas to be determined in the new framework. A number of publications solely related to the theme were issued by the Basel Committee, where the final publication contains chapters exclusively dedicated to securitisation.

In summary, there are two key issues that made securitisations a difficult area for the Basel Committee:

1. **The inherent level of complexity existing in securitisation transactions and the fact that there is little standardisation.**
   As previously described in Part I, there are a number of drivers for a securitisation transaction, which are not limited to funding and risk transfer. Normally, there is no one exclusive driver but a combination of those. Once Basel II determines the "economic substance" approach is to be applied, the evaluation of capital needs to take into account those drivers and the establishment of detailed and fully prescriptive rules becomes an almost impossible task.

2. **The fact that supervisory authorities, and law-makers, have adopted different approaches to securitisation transactions.**
   Largely, we can divide a country's approach into two groups:

   — Those who regard securitisation as an unregulated business, and consequently focusing regulatory issues on the originating entity, like United Kingdom, the Netherlands, and Ireland; and

   — Those who adopted the "fund approach", equating securitisation to an investment fund, and consequently focusing the regulatory issues on the fund and on its manager, like France, Spain, and Italy.

Given the fact that a country's financial market practices and laws have developed through one of the approaches described above, any radical change in the rules would most likely result in a significant market disruption, and therefore the increase of systemic risk. As a result, Basel II needed to be flexible enough to accommodate both approaches and, at the same time, it had to minimise the potential arbitrage risk arising from such flexibility. There are a number of questions as to whether Basel II is clear enough to avoid different interpretation of its rules by supervisory authorities.

Overview of the Basel II chapters related to securitisation

Pillar 1 – Chapter IV – Credit Risk Securitisation Framework

Chapter IV of Pillar 1 is the most important with regards to the capital treatment for securitisation transactions as it details all quantitative aspects as well as the key qualitative aspects (i.e. operational requirements) to be taken into account when calculating the capital requirements of securitisation transactions.

There are two cornerstones in relation to the regulatory approach described in the chapter. Those are:

— **The "economic substance approach"**
  As previously described, the overall Basel II approach is based on the economic substance rather than the legal form. Therefore, the analysis of securitisation transactions follows the same principles. Although such an approach may be very similar to that currently adopted by a number of regulators, generally speaking, the countries which followed the "fund route" as described in the previous section, will be most impacted, as their regulators tended to follow an approach substantially based on the "legal form" of transactions.

  It is important to re-emphasise, however, that although Basel II established the "economic substance" approach, it seems, at least implicitly, to only consider risk transfer and funding as drivers of a securitisation transaction and does not take into account other drivers of the transaction and their impact in the originator's activities. The framework, though, allows certain flexibility to supervisory authorities to take such elements into account.

— **A broad focus on "securitisation exposures"**
During the initial stages of development of Basel II, a focus was placed on the role played by a bank. However, now there is a significant shift on the focus towards the risk arising from different exposures.

The practical evaluation of securitisation exposures is broader than credit risk exposures, and it includes the evaluation of structural elements (such as early amortisation and clean up calls for instance) as well as commercial aspects such as implicit support. This is in line with the "economic substance approach".

The framework also divides securitisation transactions in two groups: the "traditional securitisation" and the "synthetic securitisation".

Another important definition is that of "originating banks" which also includes the definition of "sponsoring bank" in ABCP (Asset-Backed Commercial Paper) transactions. Normally, in such transactions a bank does not tend to originate the assets but rather provides a guarantee (normally at secondary credit enhancement level) for the whole ABCP program.

Operational requirements

There are detailed operational requirements that an originating bank has to comply in order to be able to calculate its capital requirements. The operational requirements are divided into requirements for traditional securitisations, synthetic securitisations, those related to clean-up calls, those for the use of credit assessments and those for inferred ratings. In essence the first three requirements aim to ensure that exposures are transferred and that there are no mechanisms that allow these exposures to be returned to the originating bank, whereas the last two aim to ensure that a rating can be relied upon.

From a "principle" point of view the operational requirements are clear. However, it does not clearly define a number of the terms used, which can be highly subjective.

Treatment of capital exposures

The treatment of capital exposures for a bank is defined based on the exposure rather than the role played by the banks. There is one aspect in which a distinction between originator and investor is made. This is related to exposures rated between BB+ and BB- for the standardised approach (as detailed below) that investors can apply a risk weight of 350% rather than a capital deduction.

In summary, a bank can calculate the capital requirements arising from securitisation exposures based on two approaches: (a) the standardised approach; and (b) the Internal Ratings Based (IRB) approach. It is compulsory to use the same approach selected by the bank for the treatment of the underlying portfolio of assets. In other words, if for instance, for a Mortgage-Backed Securities transaction, the bank has selected the standardised approach for its mortgage portfolio held in the bank's books, this approach is to be used for any Mortgage-Backed Securities transaction carried out by the bank. In certain instances, it may be that a securitisation transaction may contain more than one type of underlying portfolio. In this case, Basel II is clear that the approach to be used is that of the dominant portfolio.

— **The standardised approach**
The standardised approach consists in calculating a risk weight asset amount of the exposure based on an existing table in the framework. In summary exposure rated BBB- and above, attract certain risk weights based on the table, and exposures below that are a full capital deduction.

When the exposure is an asset, it is easily quantifiable as it is basically the value recorded in the books. However, a more complex analysis needs to be carried out for other types of exposures, like second loss positions, liquidity facilities, cash advance facilities, or early amortisation provisions, which are converted into "assets" through the application of credit conversion factors (CCFs).

— **The IRB approach**
The IRB approach is subdivided into two potential calculations: (a) the Ratings-Based Approach and (b) the Supervisory Formula and the Internal Assessment Approach. The maximum capital requirement of securitisation exposures under the IRB approach is limited to the capital requirement that would have been calculated if the underlying exposures had not been securitised.

There is a hierarchy of those approaches and the Ratings-Based Approach (RBA) must be applied for all rated exposures that are either rated or a those in which a rating can be inferred. For all other exposures, the Supervisory Formula (SF) or Internal Assessment Approach (IAA) is to be applied.

The RBA approach is relatively similar to the standardised approach with the exception that the tables included in the framework are more sophisticated and the risk weight will depend not only on the ratings but also on the granularity of the underlying pool and the seniority of the position. In summary, this means that securitisation exposures backed by retail pools will attract less capital than those backed by big ticket transactions.

The Supervisory Formula is a complex methodology for non-rated exposures, which is clearly defined in the framework. There are certain simplifications, which can be made depending on the underlying portfolio of assets. It is based on five inputs which are needed to be supplied by the originator: (1) the IRB capital charged had the underlying exposures not been securitised; (2) the tranche's credit enhancement level, (3) the thickness of the tranche; (4) the pool's effective number of exposures; and (5) the pool's exposure weighted average loss given default.

Given the complexity of the Supervisory Formula, it is expected that less sophisticated banks will adopt full capital deduction for its non-rated exposure rather than applying the formula and obtain all the data necessary for its calculation. Also, it is unlikely that an originating bank will share with an investing bank certain of the above input data. Therefore, an investing bank will most likely also deduct its exposure from the capital base.

The Internal Assessment Approach is limited to exposures arising from ABCP programs and it is subjected to a number of operational requirements.

Pillar 2 – Chapter V – Supervisory review process for securitisation

The chapter V of Pillar 2 can be substantially considered a complement to the operational requirements already defined in Pillar 1. In summary, the chapter provides the necessary support for supervisory authorities to modify, or refine, the calculation of capital requirements in order to take into account the specifics of each securitisation transaction, and any factors which have not been directly dealt by the existing framework.

General remarks

Basel II provides a solid step towards convergence of capital requirements, and the principles of the framework are well established. However, from a securitisation perspective, given the level of complexity of transactions, sole agreement on the

principles is not sufficient in the medium to long term. From a number of potential issues that may arise from Basel II, the interpretation of risk transfer is the most important. As the framework fails to define in clear terms how supervisory authorities should approach and evaluate risk transfer, it is highly possible that significant level of regulatory capital arbitrage will exist among different countries, which ultimately may cause complex issues with regards to fair competition in interdependent financial markets such as the European Market.

3.2 IFRS – Consolidation accounting issue

Introduction

The final derecognition rules in IAS 39 were published just before Christmas 2003 and a considerable amount of effort since then has gone into trying to understand and interpret them. The rules are complex, confusing and in some parts seem contradictory. However, the bottom line appears to be that most securitisation structures will be fully "on balance sheet". Indeed the standard itself says:

"The Board recognises that many securitisations may fail to qualify for derecognition…"

Even if some derecognition can be achieved, it is likely that this will require the application of the continued involvement rules, which are themselves confusing.

The interaction of IAS 39 and SIC 12 may also result in the surprising consolidation of some structures.

Accounting framework

The chart below sets out the four possible accounting options for a securitisation issue under IAS 39:

It should be noted that the standard only applies to financial assets and does allow in certain circumstances (para 16) for the derecognition of a portion of an asset or group of similar assets, although it seems this paragraph is mainly designed to allow for sub-participations.

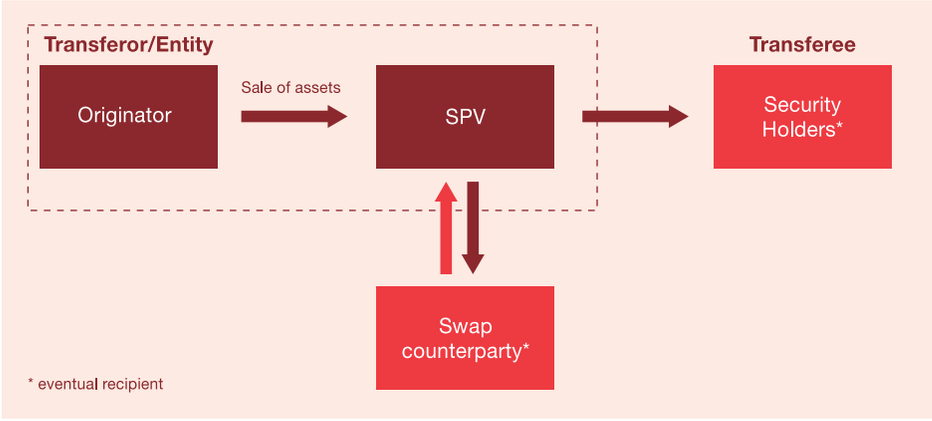
Interaction with SIC 12

A helpful feature of the new standard is that the derecognition tests are designed to apply after you have applied SIC 12, thus avoiding the nonsense of the previous standard when you derecognised under IAS 39 and then re-recognised after applying SIC 12.

However, SIC 12 remains problematic in its interpretation and will eventually be subsumed within a new IAS 27 on consolidations.

In applying and understanding the IAS 39 derecognition rules it is important that you understand how you have applied SIC 12.

When considering the consolidated accounts of an originator who has securitised assets you will normally consolidate the SPV under SIC 12 and get the following position:



As can be seen in the figure above it is important when applying IAS 39 that you recognise that the entity trying to derecognise is the combined originator and SPV, and that transactions between them are eliminated. Using IAS 39 your transferee is the security holders. It is also helpful to define your swap counterparties as eventual recipients.

"Getting off the starting blocks" (para 17 & 18)

You can consider derecognition, continued involvement or the components approach in a securitisation either if you have transferred the contractual rights to receive cash flows or you have assumed contracted obligations to pay the cash flows to one or more eventual recipients and you meet the "pass through" tests.

In practice it is the latter that will apply to most securitisations as the combined entity will have assumed an obligation to the security holders. A transfer of cash flows to, say, a servicer does not, in our opinion, qualify nor does declaring a trust over the assets, which in most cases will be within the SIC 12 group.

Hurdle One – The "pass through tests" (para 19)

If you get off the starting blocks then your first hurdle to derecognition is the high hurdle of the pass through tests. This hurdle has three parts and is designed to demonstrate that the entity no longer has an asset and is acting more as an agent, in a typical securitisation for the security holders. The overall concept is of "cash in; cash out".

The first tests require the entity to have no obligation to pay eventual recipients unless cash is received from the original assets, although short term advances are allowed. This may mean that security holders cannot be paid out of guarantees, reserve funds (unless funded from asset cash flows) or any other cash flows from the entity such as swaps. It also means that the entity must not be obligated to fund any clean up call.

The second test prohibits the entity from selling or pledging the assets other than to secure payment to the eventual recipients. Thus assets can be sold to third parties, such as on a clean up call, so long as the funds are utilised to pay off the security holders.

The third test requires cash flows to be passed onto the eventual recipients without material delay and in the meantime cash may only be invested in cash instruments with the resulting interest going to the eventual recipients.

It should be noted that "without material delay" is not defined. In our opinion this is a short period and while delaying passing through cash until the next quarterly interest payment date might be acceptable, any delay over six months will probably be unacceptable. The judgement to what constitutes material delay will to some extent reflect the type of assets securitised. It should be remembered that the delay is measured from when the cash is received by the entity and not when due to eventual recipients. Care will be needed to ensure you can demonstrate that any invested interest is passed on to eventual recipients.

An important issue to consider is the fact that reinvestment of cash flows is precluded. If you have a revolving structure which amortises after a number of years, a probable analysis is that you don't get off the starting blocks and can not consider derecognition until the amortisation period kicks in.

Hurdle Two – "Risk and Rewards"

If you have got off the blocks and through the pass through hurdle you can begin to decide into which segment of the chart "Risk and Rewards" (page 17) you fit into. To avoid full on balance sheet treatment you must show you have not retained substantially all the risk and rewards of the assets. If you can demonstrate that you have passed on substantially all the risks and rewards (very unlikely in a securitisation), you can get complete off balance sheet treatment.

Again it should be noted "substantially all" is not defined by the standard. However, from discussions with the IASB it is clear that this is a high hurdle and you should be thinking in terms of percentages of risk transfer in the eighties and nineties rather than the sixties or seventies.

It should also be noted that, unlike the US Standard, IAS 39 considers risk and rewards together. The standard in this case explains how you evaluate the transfer of risk and rewards and says:

"This… is evaluated by comparing the entities exposure before and after the transfer with the variability in the amounts and timing of the net cash flows of the transferred assets".

The standard does not, however, tell you how in detail such a comparison should be undertaken. We believe you could undertake the following steps:

Steps

1. Determine a range of economic scenarios involving differing permutations of credit losses, prepayment and interest rates;

2. Probability weight each scenario;

3. Determine the cash flows for the entity under each scenario pre and post securitisaton;

4. Net present value the cash flows – the standard requires you to use "an appropriate current market interest rate" as the discount rate;

5. Probability weight each NPV cash flow – the sum of which should give you, pre securitisation, the fair value of the assets and post securitisation the fair value of your residual;

6. Compare for each scenario, its variability from the sum of the probability weighted NPV cash flows;

7. Compare the variability profile pre and post securitisation in some way.

Clearly one of the key factors is what you put into the cash flows pre and post securitsation. In our opinion the pre securitisation cash flows should not include funding or swap costs although in some cases insurance premiums may be taken into account.

The standard, and we concur, does remind us that in many a case such a detailed calculation will not be required and says:

"Often it will be obvious whether an entity has transferred or retained substantially all risks and rewards of ownership and there will be no need to perform any computation".

Hurdle Three – The middle ground (para 23)

If, after carrying out your risk and reward analysis, you determine you have neither retained nor transferred substantially all the risks and rewards, you are in the middle ground and will achieve some derecognition. To determine how much derecognition, you have to decide if you control the assets.

If you do not control the assets, you can account on the basis of partial derecognition. If you continue to control the assets then you account on the basis of your continuing involvement.

Control is defined as to the transferee's ability to sell the assets. It should be remembered in this context that given that the SPV has been consolidated under SIC 12 to meet this requirement you would have to show that the security holders as the transferees have the ability to sell the assets, which in a typical securitisation is unlikely.

Victory – Partial derecognition

If you do manage to pass all the hurdles and get derecognition then the standard requires you to do three things:

— Recognise either a servicing asset or liability depending on whether you expect the servicing fee to exceed or be less than your servicing cost (para 24).

— Recognise any new financial assets or liabilities e.g.: a right to some residual income (para 25). In practice the value of such an asset may be volatile.

— Calculate a gain or loss on sale (para 26).

Partial victory – Continued involvement

In this approach, the maximum amount of the continued involvement, capped at the amount of the transferred asset, is recognised in the accounts. Continued involvement includes both obligations to support the asset cash flows and the right to receive benefits from the cash flows.

Example AG52 in the standard, which in our opinion needs to be treated with caution, demonstrates the rather bizarre and some would say double counting nature of the continued involvement approach. For example where a seller retains a subordinated tranche of 10% of a securitised asset pool of USD 1,000, the continuing involvement

approach will typical result in the seller showing assets in the order of USD 200 and a liability of USD 100 subordinated loan.

Conclusion:

Under IAS 39 Revised many existing securitisations will fail to get off the starting blocks and not qualify for the derecognition analysis. Of the remaining, many will be fully on balance sheet as the entity will have retained substantially all the risks and rewards of the assets. However, the new standard does offer originators the prospect of achieving derecognition for future deals that are structured appropriately, although this may well come at an economic cost.

3.3 Risks on securitisation vehicles

Following the collapse of Enron, the role that special purpose vehicles (SPV's) played in allegedly concealing the true financial position of Enron has been the subject of much speculation. Structured finance departments create SPV's as part of transactions that they structure on behalf of clients or for their own financial institution. Once the transaction is implemented, the existence of these SPV's is often forgotten.

Audit Committees and senior executives are beginning to ask themselves whether they really understand the risks that arise from transactions involving SPV's and whether their institution is properly controlling those risks.

The circumstances surrounding Enron may be unique, but it prompts questions of wider applicability to the senior management of investment banks and other companies actively involved in the use or promotion of SPV's.

Accounting for SPV's is a complex area. Rules concerning derecognition of assets and consolidation of SPV's differ between local and international accounting rules. Many institutions have yet to evaluate the implications of the potential local adoption of IAS, and SIC 12 in particular, on the way they account for SPV's. It is important therefore that institutions maintain a comprehensive list of all the SPV related transactions that they have entered into, and review the appropriateness of their treatment of each.

The risks associated with SPV's however go well beyond those associated with an incorrect accounting treatment. Counterparty exposures to SPV's created on behalf of corporate clients present obvious risks as they are generally thinly capitalised and cannot be controlled nor supported by the client. Moral hazard connected with a bank's own SPV structures may also mean that in reality the bank's exposures are much larger than those indicated by its credit risk reporting systems.

The Basel II capital regulations may also have a significant impact for sponsors of securitisation SPV's to which they provide liquidity support. Typically such structures cannot easily be terminated and some banks and securities firms may find significant additional capital requirements are imposed on them.

Considerable reputational risks, if not legal liability, exist for banks structuring transactions for clients, the probity and motivation of which subsequently come into question. A number of banks have previously faced regulatory fines and other penalties for structuring inappropriate transactions.

Banks should also not forget that anti-money laundering know-your-customer rules apply to SPV's as to other companies.

In practice companies often struggle simply to produce a comprehensive list of SPV's that they have created or sponsored. Individuals involved in structuring a transaction some years ago may have left, and unless a periodic credit review is required, there may be no documentation readily available to allow an independent risk assessment.

Senior Management needs to ask themselves a series of questions:

— Are they comfortable that they understand the extent and nature of transactions undertaken that involve SPV's?

— Are transactions with SPV's, whether as arranger, end user or counterparty, undertaken in a manner consistent with the policies and risk appetite approved by the Board?

— Are the responsibilities of risk management, financial control and compliance departments clearly defined in relation to transactions using SPV's.

— Is there a robust process before a transaction is approved and executed, which requires an evaluation of the risks and the ability of the institution to control those risks, and sign-off by individual departments to that effect?

— Do reporting systems adequately capture information concerning SPV's?

— Are accounting policies concerning structures involving SPV's still appropriate?

— Is there an ongoing risk assessment process which ensures that SPV related transactions are subject to periodic review?

4 Glossary

Arbitrage transactions: Transactions of securitisation where assets are acquired from various originators, or from the market, and are securitised with the intention of making an arbitrage profit resulting from the difference between the average return of the assets and the average coupon on the liabilities.

Asset-Backed Commercial Paper (ABCP): Transactions, where normally short-term receivables (e.g. trade receivables) are pooled into a special purpose vehicle (SPV). The SPV in turn issues Commercial Papers (normally remaining time to maturity 90 days to 180 days), which are called Asset-Backed Commercial Papers. The SPV may be established for a single seller of short-term receivables or for a pool of sellers (multi-seller ABCP conduit).

Asset-Backed Securities (ABS): Securities in general issued by a SPV, which are backed by assets rather than by a payment obligation. Securitised instruments are Asset-Backed Securities.

Back-up servicer: Normally, the originator of a securitisation transaction continues to service the original transaction. In pre-agreed circumstances the SPV can, however, obtain the authority to bring in a back-up servicer to replace the originator as servicer.

Beneficial interest: In contrast to legal interest, beneficial interest means the right to stand to benefit, short of legal title. In a securitisation transaction, the receivables/ cash flows or security interest thereon are legally held by the SPV or trust, for the benefit of the investors; that means the investors are beneficiaries and their interest is the beneficial interest.

Cash collateral: In a securitisation transaction, the originator may deposit some cash in the SPV in order to enhance creditworthiness for the investors. The cash deposit is normally not used by the SPV to acquire receivables from the originator.

Clean up buyback or call: An option providing the right to the originator to buy back the outstanding securitised assets, when the principal outstanding has been substantially amortised. The option is usually exercised when the outstanding principal is less then 10% of the original principal.

Collateral: Is the underlying security, mortgage, asset or risk for the purposes of securitisation or borrowing and lending activities. Regarding securitisation transactions, it means the underlying cash flows.

Collateral manager: The collateral manager manages the collateral that is purchased and sold by the SPV regularly (especially used in arbitrage transactions)

Collateralised Bond Obligations (CBO): Obligations, usually structured obligations, issued which are collateralised by a portfolio of bonds, transferred by an originator or purchased from the market with the intention to securitise them.

Collateralised Debt Obligations (CDO): A common name for collateralised bond obligations and collateralised loan obligations.

Collateralised Fund Obligations (CFO): Obligations, usually structured obligations, issued which are collateralised by a portfolio of hedge fund or equity fund investments, transferred by an originator or purchased from the market with the intention to securitise them.

Collateralised Loan Obligations (CLO): Obligations, usually structured obligations, issued which are collateralised by a portfolio of loans, transferred by an originator or purchased from the market with the intention to securitise them.

Collateralised Mortgage Obligations (CMO): A securitisation transaction where cash inflows of the SPV are divided into different tranches. The tranches, having different payback periods and priority profiles, repay the bonds issued by the SPV in line with the pre-determined payback periods and priority profiles of the bonds. On issue, the bonds are usually structured and served in accordance with objectives and risk profiles of the investors.

Co-mingling: When the originator in a securitisation acts at the same time as the servicer, the cash flows collected by the originator may sometimes co-mingle, or may intentionally be mixed up with that of the originator himself. Thus a clear identification of the cash flows collected on behalf of the SPV is not possible anymore. This is called co-mingling.

Commercial Mortgage-Backed Securities (CMBS): A part of Mortgage-Backed Securities. The expression is used to avoid confusion with the term Residential Mortgage-Backed Securities (RMBS). Commercial mortgages represent mortgage loans for commercial properties, such as multi-family dwelling, shops, restaurants, showrooms, etc.

Conduit: A securitisation vehicle that is normally used by third parties as a ready-to-use medium for securitisation, usually for assets of multiple originators. Conduits are mostly used in case of Asset-Backed Commercial Paper, CMBS etc. There are two types, the single seller conduit and the multi-seller conduit.

Credit default swap (CDS): In case predefined credit events that indicate credit default by a reference obligor occur, this credit derivative deal as executed, which means that either a specific obligation of the obligor will be swapped between the counterparties against cash or one party will pay a compensation to the other.

Credit enhancement: General term for measures taken by the originator in a securitisation structure to enhance the security, credit or the rating of the securitised instrument. Among these measures are cash collateral, profit retention, third party guarantee. Credit enhancement devices can be differentiated in structural credit enhancement, originator credit enhancement and third party credit enhancement.

Credit derivative: A derivative contract whereby one party tries to transfer the credit risk, or variation in returns on an asset, to another. Common types are credit default swaps, credit linked notes and synthetic assets.

Credit linked note (CLN): A note or debt security which allows the issuer to set-off the claims under an embedded credit derivative contract from the interest, principal, or both, payable to the investor in such note.

Deferred purchase price: A type of credit enhancement where a portion of the purchase price of the assets is reserved by the SPV to serve as a cash collateral.

De-recognition: The action of removing an asset or liability from the balance sheet. In securitisation transactions, the term refers to the de-recognition of assets securitised by the originator when they are sold for securitisation. Before a de-recognition is permitted, certain conditions, stated in the accounting standards, have to be fulfilled.

Eligibility criteria: The choice of receivables that the originator assigns to the SPV. The eligibility criteria are usually stated in the receivables sale agreement with a provision that a breach of the criteria would amount to breach of warranties by the originator, obliging the originator to buy-back the receivables.

Excess spread: Is the excess of the proceeds inherent in the asset portfolio of the SPV, over the interests payable to the investors and the expenses of the transaction.

Expected maturity: The time period within which the securities are expected to have been fully paid back. However, the expected maturity is not the legal final maturity as the rating of the transaction is not based on repayment by the expected maturity. See also hard bullet, soft bullet.

Extension Risk: The possibility that prepayments will be slower than an anticipated rate, causing later-than-expected return of principal. This usually occurs during times of rising interest rates. Opposite of prepayment risk.

First loss risk: In case when the risks in the asset portfolio of the SPV are segregated into several tranches, the first loss risk to a certain extent is borne by a particular class before it can affect the other classes. The first loss class must fully cover the loss before it affects the other classes. The first loss class can be compared to the equity of an entity and provides credit enhancement to the other classes.

Future flows securitisation: Securitisation of receivables which only arise in future periods.

Guaranteed investment contract: Contract in which a particular rate of return on investments is guaranteed.

Issuer: Within the framework of securitisations, the issuer is the SPV which issues the securities to the investors.

Junior bonds: Bonds that rank after senior bonds.

Legal final maturity: Recourse with a limitation in amount or other criteria. See also recourse.

Limited recourse: The right of recourse limited to a particular amount or a particular extent. For example, in a securitisation transaction, the right of recourse being limited to the over-collateralisation or cash collateral placed by the originator is a case of a limited recourse.

Liquidity facility: A short-term liquidity or overdraft facility provided by a bank or by the originator to the SPV to meet the short-term funding gaps and pay off its securities. Liquidity facilities can sometimes be substantial and be the only basis of redemption of securities – for example, in case of ABCP conduits.

Mezzanine bonds: Bonds that rank after senior bonds, but before junior bonds.

Mortgage-Backed Securities (MBS): Securities backed by cash flows resulting from mortgage loans. MBS can be divided into Residential Mortgage-Backed Securities and Commercial Mortgage-Backed Securities.

Non-petition provision: Legal provision meaning that investors and creditors may waive their rights to initiate a bankruptcy proceeding against the securitisation vehicle. This clause protects the vehicle against the actions of individual investors who would, for example, find an interest in a bankruptcy proceeding against the vehicle.

Obligor: The debtor from whom the originator has right to receivables.

Originator: The entity assigning assets in a securitisation transaction.

Originator advances: A liquidity facility provided by an originator to a securitisation transaction where the originator pays a certain month(s)'s expected collections by way of an advance and later appropriates the actual collections to reimburse himself.

Originator credit enhancement: Credit enhancement granted by the originator, like cash collateral, over-collateralisation, etc.

Orphan company: A company without identifiable shareholders, e.g. a SPV owned by a charitable trust. Such a company is often used to avoid consolidation of the SPV with any other entity.

Over-collateralisation: A type of credit enhancement in a securitisation transaction where the originator transfers an additional collateral to the SPV to serve as security in the event of delinquencies, etc.

Pass through: A special payment method, where the payments made by the SPV to the investors take place in the same periods and are subject to the same fluctuations as the receivables. This means that the cash flows collected every month are passed through to investors, after deducting fees and expenses.

Pay through: A special payment method, where the payments made by the SPV to the investors take place at a pre-fixed pattern and maturity, not reflecting the payback behaviour of the receivables. During the intervening periods the SPV reinvests the receivables, mainly in passive and pre-defined kinds of investments.

Pfandbriefe: A German traditional secondary market mortgage product where the investor is granted rights against the issuer as also against the underlying mortgage.

Prepayment Risk: The possibility that prepayments will be faster than an anticipated rate. This can lead to a loss of interest. The SPV can either pass through the prepaid amounts to investors thus resulting into earlier payment of principal than expected, and reduced income over time, or if the SPV reinvest the prepayments, the rate of return of the reinvestment is lower than the rate of return of the underlying receivables.

Recourse: The ability of an investor to claim payment against an investment to the originator of the investment. In a securitisation transaction it could mean, the right of the investor to claim payment from the originator.

Regulatory arbitrage: The possibility for banks to reduce their regulatory capital requirements of a portfolio of

assets without any substantial reduction in the real risks inherent in the assets. For instance, this is the case of a securitisation transaction where the economic risks of the assets securitised have been substantively retained.

Retained interest: Any risks/rewards retained by the originator in a securitisation transaction – for example, service fees, any retailed interest strip, etc.

Securitisation: A securitisation is a type of structured finance in which a pool of financial assets is transferred to a special purpose vehicle which then issues securities solely backed by those assets transferred and the payments derived by those assets.

Senior: Bonds that rank before junior bonds. These bonds or tranches of securities issued by a SPV have high or the highest claim against the SPV.

Sequential payment structure: A payment structure where the cash flows collected by the SPV are paid in sequence to the various classes. This means the cash flows are first used for the full payment to the investors of the senior-most class, and then used for the full payments of the second class and so on.

Servicer: The entity that collects principal and interest payments from obligors and administers portfolio after transaction closing. It is very common in securitisation transactions that the originators act as servicers though this is not always the case See also back-up servicer.

SIC 12: An accounting interpretation by the International Accounting Standards Board whereby SPVs which are supported or credit-enhanced by the originator are to be treated as quasi-subsidiaries of the originator and hence consolidated with the originator.

Special purpose vehicle: The legal entity established especially in securitisation transactions with the purpose of acquiring and holding certain assets for the benefit of investors of the securities issued by the SPV. Hence, the investors have acquired nothing but the specific assets. The vehicle holds no other assets and has no other obligations.

Structural credit enhancement: A type of credit enhancement. It means the creation of senior and junior securities, thereby enhancing the credit rating of the senior securities.

Subordination: The technique to subordinate the rights of investors and creditors to payment to the prior payment of other securities or debts by the securitisation vehicle

Synthetic Transaction: In a synthetic securitisation transaction, instead of selling an asset pool to the SPV, the originator buys protection through a series of credit derivatives. Such transactions do not provide the originator with funding. These transactions are typically undertaken to transfer credit risk and to reduce regulatory capital requirements.

Tax transparent entity: The entity that is not subject to tax itself. The shareholders/ partners of the entity will be taxed directly.

Third party credit enhancement: A credit enhancement provided in a securitisation transaction by third party guarantees, i.e. insurance contracts or bank letter of credit.

Tranche: Piece, fragment or slice of a deal or structured financing. The risks distributed on different tranches concerning losses, sequential payment of the cash flows, etc are different. That's the reason why the coupon on different tranches is also different.

True sale: In a true sale structure, the originator sells a pool of assets to a special purpose vehicle, which funds the purchase through the issue of tranches of securities. If the sale is structured in a way that it will be considered as a sale for legal or tax purposes, it is defined as a true sale.

5 Contacts

Should you have any questions, please do not hesitate to contact one of the following experts:

Assurance

Roland Jeanquart, Partner	roland.jeanquart@pwc.be	+32 2 710 4024
Jurgen De Raedemaeker, Senior Manager	jurgen.de.raedemaeker@pwc.be	+32 2 710 9597

Tax Services

Olivier Hermand, Director	olivier.hermand@pwc.be	+32 2 710 4416

Advisory Services

Sebastian di Paola, Partner	sebastian.di.paola@pwc.be	+32 2 710 7212

For any further information about our firm or our services please contact the PricewaterhouseCoopers Marketing & Communications department.

PricewaterhouseCoopers
Woluwedal 18
B-1932 Sint-Stevens-Woluwe

Telephone: +32 2 710 72 11 Facsimile: +32 2 710 72 99

www.pwc.be

PricewaterhouseCoopers (www.pwc.com) provides industry-focused assurance, tax and advisory services for public and private clients. More than 120,000 people in 139 countries connect their thinking, experience and solutions to build public trust and enhance value for clients and their stakeholders.

("PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.)

© 2005 PricewaterhouseCoopers. All rights reserved. PricewaterhouseCoopers refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

*connectedthinking is a trademark of PricewaterhouseCoopers LLP.